River Valley Asset Management

Softbank's Vision Fund's "WUS(s) Moment"
Day of Reckoning for Private Assets' Valuations
Newsletter for October 2019

Wuss (noun) – a weak or ineffectual person
Wuss out (verb) – fail to do or complete something as a result of fear or lack of confidence

Every investment era has a few companies that embody the spirit, achievements, beliefs, excesses, mistakes and sometimes the eventual end of those times. Some of these exist and thrive for long periods of time; on the other hand many do not survive past the era they embodied.

Softbank is surely one of the top companies that embody the spirit of this era. This era is primarily defined by a combination of hyper-innovation and hyper-cheap capital. The positive impact of this is manifold in terms of the emergence of innovative new businesses, huge improvements in the cost structure of various value chains, wide dispersion in the access to various services which were earlier only available to the upper strata of society and, most importantly, the democratisation of the access to cheap capital.

On the other hand the negatives are building up. While easy access to capital helps new and good companies emerge, it conversely also helps poor businesses to be built and survive. The misallocation of capital thus accelerates and the weaknesses in business structures are hidden for longer. While this has been building up over most asset classes, we feel this is happening in a much bigger way in the private assets space.

The Excesses in the Private Space

The excesses in the private space revolve around a few points.

1. **The process of valuation looks unreliable**: There are multiple points where this process looks compromised.
    a. *Too limited a number of players controls the price discovery process:* For watchers of public markets, this process looks from some angles similar to what is commonly known as price fixing. This is defined as a relatively small bunch of buyers and sellers creating both the bid and the ask on a group of assets,

relatively low transparency of financial information and a lower focus on near term numbers and stronger focus on the long term story. A large part of the so called smart money that influences this price discovery can be traced back to about 10-20 large pools most of which have also been generated by liquidating such assets. These 10-20 names include ones like Softbank, the tech giants of China (BAT) and the tech titans of the US (FANG).

b. *Valuation on last traded price is risky:* The second point is basing the valuation on the last traded price of similar assets. Because of the infrequency of such trades and the in-transparency of the details of the trade, this becomes a very difficult game. Often when you hear of a company being priced at a certain valuation in the private space, one does not have knowledge of the many side deals that could be happening between buyer and seller. There could be put options from the buyer back to the seller, there could be dilution from seller to buyer in case some metrics are not met, etc. This obviously means that all class of equity shares are not pari passu for a private company – a situation that is not true for most public companies.

c. *Infrequency of valuation:* This is true across all forms of the private space. This creates two problems. The price is stale and probably not vetted by an adequate number of participants in the markets. Have you ever heard of people shorting assets in the private space (like they do publicly traded securities)? It never happens. This means that the negative view in the price discovery mechanism has no voice. When only the positive guy can influence the pricing process and the negative guy can't, the price can only move up. The second problem with this infrequency of valuation is a false sense of lower volatility of this asset. Logically some of these assets in the private space are riskier, but they are sometimes perceived to be less risky as the price does not move on a regular basis. This sometimes leads to a lower return expectation from the private space. This is especially true for example in infrastructure assets in the private space compared to similar infrastructure stocks in the public space.

2. **High leverage in the system:** The second problem in the private asset space is that the leverage used to buy it is too high given the underlying illiquidity, high duration and high valuation risk. Here let's take the example of Softbank's Vision Fund. Of the USD100 bln that it raised, about USD 40 bln was in the form of preferred stock with a coupon of 7%. This, in fact, is debt. About USD 33 bln of the rest of the USD 60 bln is from Softbank itself. Now 65% of the current enterprise value of Softbank is debt (USD 167 bln of gross debt now). Hence in a way USD 22 bln of the USD 33 bln invested by Softbank in the Vision Fund is debt funded. Assuming the rest of the USD 27 bln is all equity funded with no underlying debt, we still have nearly two thirds of the Vision Fund units being bought with debt funding. Hence the return on investment for the pure equity investors will be very high – positive or negative – depending on which way the underlying asset value moves. This is wrong on so many fronts: leveraging to purchase illiquid, poorly valued, high mortality assets is intrinsically high risk. This would be fine if the impact were limited to only the investors in the Vision Fund losing money. However, given the Vision Fund's large size and its strong influence on pricing of assets across the private assets space, the impact from an unruly unwind of the Vision Fund could be catastrophic. It could be similar to the impact on the public listed space if there was an overnight run on ETFs across the world.

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3. **Access to capital determining winners**: Remember in the first para we had said that one of the positives of this current investment era has been a democratisation of the access to capital. This should have meant that if you had a good business you would get capital to grow it. But, with what is happening in the private space, it seems that access to capital becomes a *prerequisite* to a business being defined as a good business. We have turned the original logic on its head. And access to capital is often defined by the charisma and storytelling ability of the entrepreneurs, the plan and path to exit….a la WeWork.

Softbank and its "WUS" Investments

WUS in Softbank's case stands for three of the headline investments made by the Vision Fund – **W**eWork, **U**ber and **S**lack. The biggest problem with these three companies is that the valuation given to them by the private space does not match the valuation that the public markets are willing to give. WeWork (officially "The We Company") had its last private round funding at USD 47 bln in early 2019, but in the public space it could not do a listing at even USD 10 bln. The CEO had to be fired, the board changed and now it is aggressively selling out assets. The existing shareholders have gotten aggressively diluted as Softbank bailed out the company with a USD 5 bln infusion. Without this the company could have gone bankrupt before the end of 2019…..so much for the USD 47 bln valuation in the beginning of 2019.

Uber was luckier in the fact that it could list and raised USD 8.1 bln in May 2019 at USD 45/ share. Since then, in six months, while global markets are up the stock is down 40%; again putting to question the process of valuation of these assets. Slack similarly is also down 47% from its peak of late June.

SLACK Technology

Uber Technologies

The point being made here is **What is the real value of these companies?** If investors' perception of their value fluctuate by tens of billions of dollars within a few months how can you buy such assets on leverage and how do you believe any of the valuation numbers being put out by the holders of private assets across the world?

The only way to sustain the valuation of these assets is to pump in more money to support these businesses and valuations. That is why Softbank is raising a second Vision Fund. Rephrasing the quote of Chuck Prince (the ex-CEO of Citigroup) just before the 2008 crash – "As long as the music is on every one will keep dancing". The current situation is aptly described by that.

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