Kevin Cousins

Masayoshi Son and SoftBank: how great management can assist us as stewards of capital

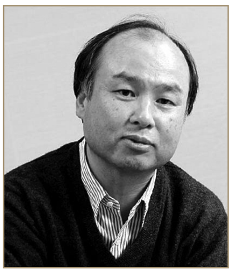
Kevin has 22 years of experience in investment management. After working at BoE Asset Management from 1993 to 2002, he co-founded Lauriston Capital, a specialist hedge fund manager. Kevin then worked as part of the hedge fund management team at Brait (now called Matrix Fund Managers) until joining PSG as an Investment Analyst in 2015.

Why our focus on management?

The PSG Asset Management team has an extensive local network and many decades of collective experience investing both on the JSE and internationally. When investing in global companies, the emphasis our process puts on a company's management is one way to broaden our network offshore. By finding global company management teams that can assist us as stewards of capital, we can effectively access their local networks, experience and context on behalf of our clients.

We look for management teams whose track record of action and their communication with shareholders consistently display independent and long-term thinking. Add to this evidence of well-managed operations and successful key capital allocation decisions over time, and we really get interested. Finally, if the team has a majority of their net worth invested in their own shares, and pays careful attention to governance and disclosure, the resulting alignment of interests makes them excellent candidates to be 'stewards of our clients' capital'.

One company with a management team we believe can be regarded as good stewards of our clients' capital is SoftBank. SoftBank is a Japanese-listed IT business with a market capitalisation of some \$55 billion and a net asset value by our estimates of over \$110 billion. Its largest investments are focused on E-commerce and telecommunications. It was founded by Masayoshi Son, and he remains the CEO and largest shareholder today.



Masayoshi Son

Masayoshi Son 'Masa': The story of a remarkable entrepreneur

Japan has a deserved reputation for rigidly conservative management teams (we have the perfect adjective in South Africa: 'verkrampte'). Low returns on capital are the norm, often exacerbated by massive surplus cash holdings. Little regard is displayed for the rights and concerns of minority shareholders. It seems an unlikely place to find 'stewards of our capital'.

Like so many iconic companies, the story of SoftBank is really the story of a remarkable entrepreneur, Masayoshi Son ('Masa'). Masa's father was Korean, but he was born in Japan. He was from humble origins (his father ran a pinball arcade) and had a tough childhood as a foreigner growing up in Japan. He was obsessed with business from the start, and the advice he received during a scholars' meeting with the head of McDonald's in Japan was to change his life: 'Learn English and study computers.'

Early days

At sixteen he set out for California to do just that. He funded his studies by importing and selling arcade games from Japan, and he designed and sold the patent for a translation device to Sharp for \$450 000 in 1978, providing the capital for his first business venture. Masa graduated from Berkeley in 1980, and went back to Japan with a clear idea that shaped his plans – personal computing was going to change the world.

Masa founded SoftBank in 1981, initially as distributor of packaged software in Japan (a 'software bank' as it were), but they quickly grew into many aspects of the computer business as the PC era swept the country. SoftBank listed on the Tokyo Stock Exchange in 1994.

Shopping for internet companies in the US

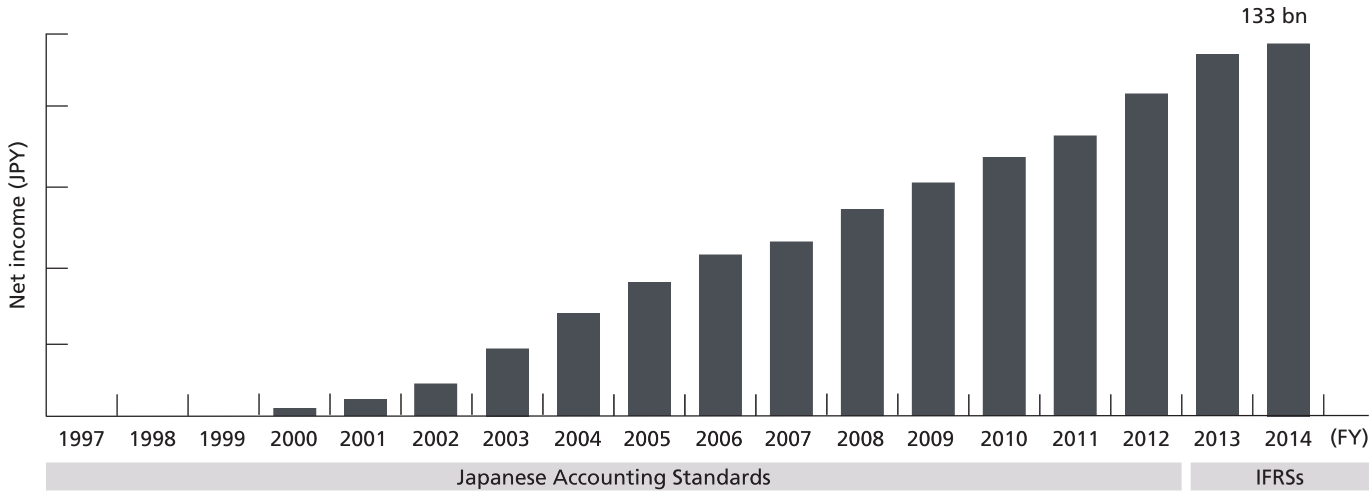
By the early 90s, SoftBank was a major competitor in Japan's IT industry, but all the talk was about a new thing called 'the internet', which was all happening in the US. SoftBank established an investment arm in the US, and Masa went shopping. His first purchases were the publisher of the top PC magazine, Ziff Davis, and COMDEX, the hosting company of the largest computer trade fair. He then tasked those management teams to take him to meet all the key internet start-ups, resulting in many subsequent investments.

Building from scratch: SoftBank and Yahoo build Japan's leading internet company

Most importantly, Masa met the founders of the leading internet player of the time, Yahoo Inc., Jerry Yang and David Filo. The fit between the two companies was obvious. SoftBank bought 40% of Yahoo for \$100 million, and together they also established a joint venture, Yahoo Japan, to replicate many of Yahoo's services in the Japanese market. Today Yahoo Japan is the dominant web portal and is the domestic leader in both search and consumer to consumer E-commerce. Yahoo Japan is still a subsidiary of SoftBank, and is separately listed on the Tokyo exchange.

Yahoo Japan has shown 18 years of consecutive growth in attributable income (as illustrated in Graph 1) – a remarkable performance over a period when Japan's economy was beset by persistent deflation and suffered four recessions. The business made ¥133 billion (\$1.1 billion) in the year to March 2015 (their 2014 financial year) and has a market capitalisation of \$21.7 billion.

Graph 1: Yahoo Japan net income (1997-2014)



Sources: Yahoo Japan 2015 Annual Report, Yahoo Japan 2015 Results Presentation

An aside: Masa reshuffles management at Yahoo Japan

Despite this fantastic track record, several years of flat E-commerce revenues during a period of market growth prompted Masa to reshuffle the Yahoo Japan senior executives in 2013, lowering the average age from 51 to 40. Bold changes in strategy have followed, and while they require considerable near-term investment, Yahoo Japan appears set for a new long-term growth runway.

Opportunistic: reaping rewards from the internet bubble

More than 15 years later it's easy to forget the sheer violence of the internet bubble, but what happened after Masa's investment binge in the US is still without parallel in markets. Yahoo Inc. listed in 1996. At the end of that year its market capitalisation was $468 million. Three years later, at the end of 1999, Yahoo Inc. was valued at an incredible $116 billion. Their net income that year was $47 million, putting it on a price-earnings ratio of 2468 times! Within another year the bubble was well and truly popped and gone, along with literally trillions of dollars of paper profits.

Unlike most of the bubble participants, Masa's bold US excursion netted him several enduring benefits. Apart from creating the Yahoo Japan joint venture, SoftBank realised massive gains on the sale of investments of $4.8 billion between 1999 and 2004 (including the sale of the Yahoo Inc. stake). This capital provided the base to build SoftBank's Japanese telecoms business over the next decade. Also, in January 2000, just before the bubble popped, Masa met a Chinese entrepreneur, Jack Ma. They hit it off, and SoftBank invested an initial $20 million, buying 35% of Alibaba Group. They have never sold a share, and today this stake is priced at an incredible $60 billion!

Taking a long-term view: investing in broadband

Importantly, the US experience gave Masa the conviction that the internet was going to change the computing world. In 2004 he invested his new capital into building a broadband fibre network in Japan (taking on NTT, the former monopoly telco), an extremely controversial decision, much derided by the media and market during its loss-making roll-out phase. But Masa had a clear view that providing access to the web would be a lucrative business. He then acquired Japan Telecom and finally Vodafone KK, all in pursuit of his goal to enable customers to be connected at all times.

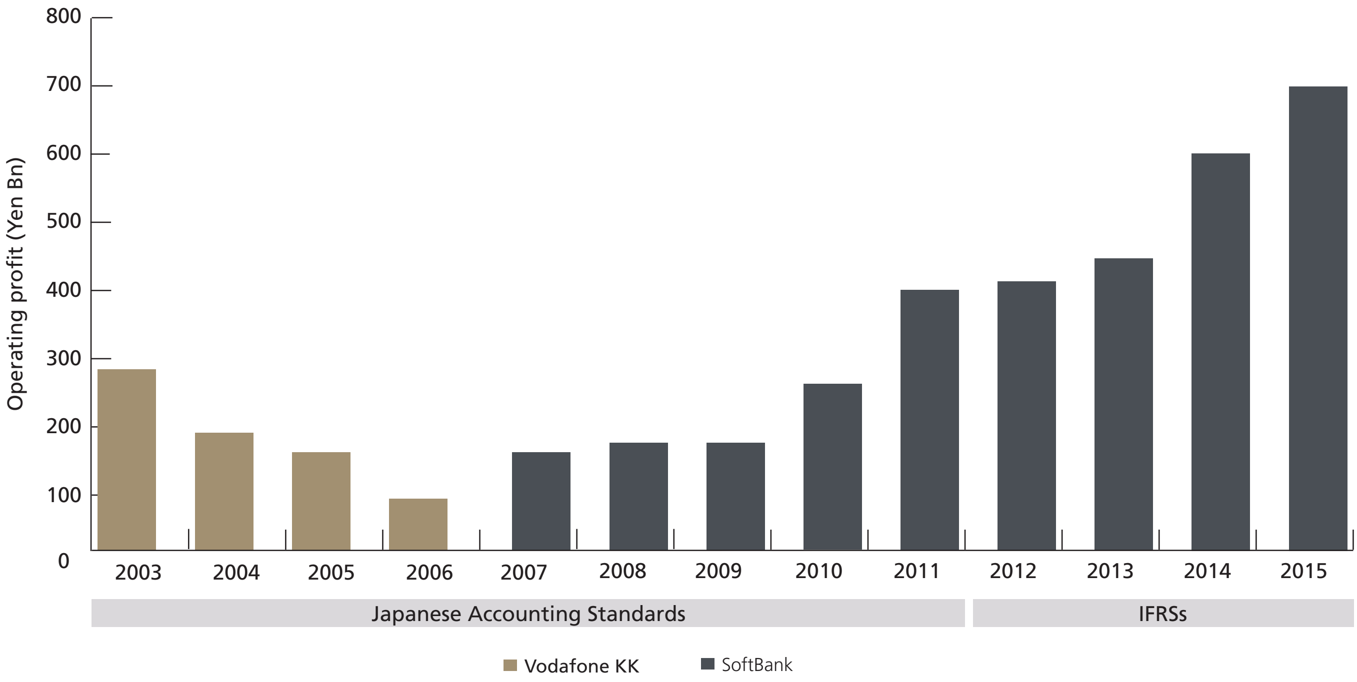
Buying and fixing: Vodafone KK and SoftBank Mobile

Vodafone KK (Vodafone's Japanese subsidiary) went from being viewed as a key market for them to an exit in the space of three years. Between 2003 and 2006 Vodafone KK's operating profit dropped from ¥275 billion to ¥76 billion, the network was ranked as the worst in the country and market share collapsed. Vodafone took a $9 billion loss on the sale of Vodafone KK to SoftBank.

Immense capacity to take calculated risk for long-term rewards

In 2006 Masa bought Vodafone KK for $15 billion, then a massive transaction for SoftBank, much of it funded by gearing. This demonstrates a remarkable capacity to take calculated risks. He cut costs, upgraded the network and signed an exclusive deal with Apple to launch the iPhone in Japan. By 2008 he was gaining market share and by 2011 operating profit was above ¥400 billion. The debt to fund the acquisition was repaid in four years. Today SoftBank mobile has the highest operating margins in the Japanese market, and generates more than $5 billion of free cash flow per annum. This incredible turnaround is well illustrated by Graph 2, which shows the historic operating profit of Vodafone KK and subsequent to the acquisition, SoftBank Mobile.

Graph 2: SoftBank Mobile Division operating profit (2003-2015)



Sources: SoftBank Group 2015 Annual Report, SoftBank Group 2015 Results Presentation

Recently SoftBank has bought another ailing mobile operator in a weak competitive position – Sprint in the US. Sprint makes up only 7% of SoftBank's total assets, but is currently loss-making and Masa is once again facing short-term criticism about a long-term investment.

SoftBank today: a great team investing in information technology at a deep discount

The standard value investor's response to technology companies is that they are too complex to understand and so one should not play there. Huge information asymmetries exist between management and industry insiders on the one hand and minority shareholders on the other. However, today technology-enabled competitors are disrupting market after market, and the sector is becoming harder and harder to ignore. What prompted our initial interest in SoftBank was the excellent management team with a long track record, who could act as our 'guides' to the IT sector. Masa's current holding in the company is worth nearly $12 billion, providing good alignment of interests between management and minority shareholders. Finally, that we could buy SoftBank shares at a deep discount to our calculated intrinsic value also provided a substantial margin of safety to the investment, a rare occurrence in the technology space.

We believe backing Masa and his team as 'stewards of our clients' capital' allow us to benefit from SoftBank's formidable global network, with their deep industry knowledge and experience enabling our investors as shareholders to successfully invest in the global technology sector.

In closing: Masa and succession, how Google lost Nikesh Arora to SoftBank

Nikesh was the Chief Business Officer of Google, regarded as one of their brightest stars for the future. Masa had regularly interacted with Nikesh after Yahoo Japan started using Google search algorithms. After many years of trying, Masa persuaded Nikesh to join SoftBank in 2014, and this year he was appointed as Chief Operating Officer. He is regarded as Masa's likely successor.

Nikesh left India for the US as a youngster 'with $400 in my pocket'. He describes how during a discussion about the prospects for SoftBank over the next decade, Masa challenged his current capacity to take reasoned risks relative to that leap as a young man. In response Nikesh initiated one of the largest executive share purchases in history. He has bought ¥60 billion ($500 million) of shares in SoftBank. Masa is only 58 and we are sure he has many, many years ahead of him leading SoftBank. However, in our experience the best managers devote a huge amount of time and effort to hiring and succession planning.

Sources:
The Verge, "Meet Masayoshi Son" October 2012
Your Story, "Nikesh Arora unplugged" November 2015
"Aiming High – A Biography of Masayoshi Son", Atsuo Inoue, 2004