

Softbank Group: Focus shifting to AI-related investment

Credit Memorandum JCRE436

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Daiwa Securities Co. Ltd.

Creditworthiness should be assessed based on LTV as an investment firm

- 1Q FY18 results clarified that SVF contributed to profit, in addition to the contributions from mainstay businesses
- Steadily shifting to a strategic holding company to achieve the “synergy group” strategy
- Low LTV reassures investors about SBG bonds
- Our rating forecasts after the shift to investment firm (i.e., after the listing of Softbank KK)

“Winners in AI will be winners in the future”

Overview of 1Q FY18 results

Softbank Group (SBG) has been accelerating AI-related investment via Softbank Vision Fund (SVF), based on the company’s view that “winners in AI will be winners in the future.” SBG has completely shifted its focus from mobile communications services to AI investment. The firm’s 1Q FY18 results clarified that investment via SVF has begun to contribute to earnings.

SVF contributed to profit, in addition to the contributions from mainstay businesses

In 1Q FY18, SBG booked net income of Y313.7bn (IFRS basis¹), a solid bottom line result. Operating profit was Y715.0bn. Excluding SVF, operating profit in mainstay businesses came to Y475.0bn². In addition, profit in the SVF segment surged to Y239.9bn on an increase in the fair value of investees such as Flipkart and WeWork, thereby making a sizeable contribution to overall profit. Excluding limited partners’ interests, SVF’s net contribution to SBG’s pretax income came to Y167.0bn³. At the pretax income level, higher fair values for Uber and Grab, investees via subsidiaries other than SVF, made a Y94.5bn contribution. In addition, Alibaba made a Y32.7bn contribution to equity-method income.

Analyzing consolidated balance sheet to be of less value; LTV valuation should be the key

In terms of credit valuation, analyzing SBG’s consolidated balance sheet is of less value because (1) the merger between Sprint and T-Mobile US has now been scheduled (i.e., the deconsolidation of Sprint) and (2) SVF limited partners’ investments have been booked as liabilities. As we mentioned previously⁴, due to a shift to a strategic holding company (investment company) to achieve its “synergy group” strategy, SBG’s credit valuation should be assessed primarily by the ratio of net interest-bearing debt to the value of shareholdings (LTV), a stock-based indicator. This is because (1) the consolidated balance sheet does not properly show the enterprise value of investees and (2) the source of the creditworthiness of SBG, which is becoming an investment firm, lies not in investees’ cash flow but rather in the size of their enterprise value. For reference, consolidated free cash flow was deeply negative at Y617.6bn in 1Q FY18 partly owing to aggressive investment through SVF and for the purpose of transfers to SVF. Interest-bearing debt increased by Y159.4bn from end-FY17 to Y16,014.9bn. Net interest-bearing debt also swelled by Y463.8bn, to Y13,114.2bn. Accordingly, the adjusted EBITDA to net interest-bearing debt ratio worsened slightly, from 4.8X at end-FY17 to 4.9X despite a rise in adjusted EBITDA. That being said, we think this type of analysis will be of less value going forward.

¹ From FY18, the firm adopted IFRS 9 “Financial Instruments” and IFRS 15 “Revenue from Contracts with Customers.”

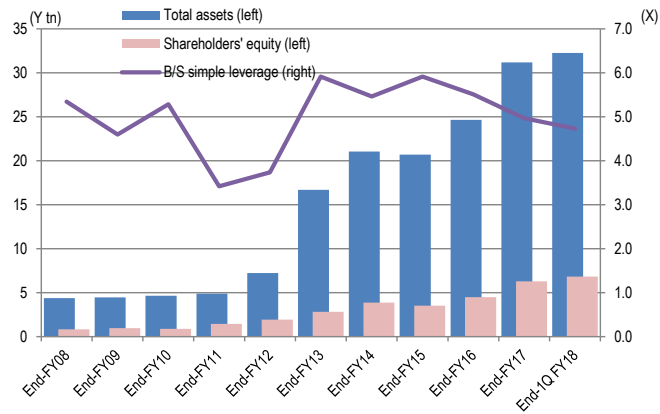
² Including one-off gains of Y161.3bn due to Arm’s Chinese business having changed from a subsidiary to an associate.

³ Excluding SVF’s financial costs.

⁴ Refer to our reports, e.g., our 14 May report *Softbank Group: Steady progress toward becoming an IT investment firm (JCRE428)*.

SBG’s consolidated balance sheet has posted a more than six-fold increase from around Y5tn to Y30tn over the past six years, alongside a surge in debt. This makes it difficult to evaluate SBG’s credit and puts the brakes on investment in the group’s credit. We would like to point out that simple leverage has not changed substantially, partly due to an increase in internal reserves, despite the drastic expansion in the balance sheet.

Chart: Change in Consolidated Balance Sheet at SBG



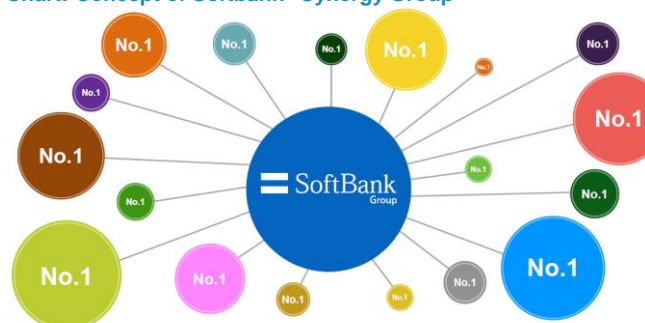
Source: Company materials; compiled by Daiwa Securities.
 Note: Firm adopted IFRS in FY13 and new IFRS standard in FY18.

Steadily shifting to an investment firm

SBG is steadily shifting to a strategic holding company to achieve its “synergy group” strategy

SBG has been steadily shifting to a strategic holding company to achieve its “synergy group” strategy⁵, as witnessed by (1) accelerated investment via SVF including Delta Fund (\$32.1bn in investment was implemented⁶ versus a committed cumulative investment of \$97.7bn), (2) the agreement on the merger between Sprint and T-Mobile, in which SBG gave up on taking a management leadership position, resulting in the deconsolidation of Sprint, and (3) preparations for an IPO for domestic telecommunications subsidiary Softbank KK. Regarding the guarantee provided by Softbank KK for SBG’s corporate bonds (excluding subordinated bonds and hybrid bonds), which could become a hurdle for Softbank KK’s IPO, SBG has completed its preparations for releasing the guarantee⁷.

Chart: Concept of Softbank “Synergy Group”



SB Synergy Group: Strategic Partnerships

Source: Extract from company materials.

⁵ Refer to our 14 February 2018 report [Softbank Group is becoming an IT investment firm \(JCRE419\)](#).

⁶ On top of this, SBG has invested in firms such as Uber, which are expected to be transferred to SVF.

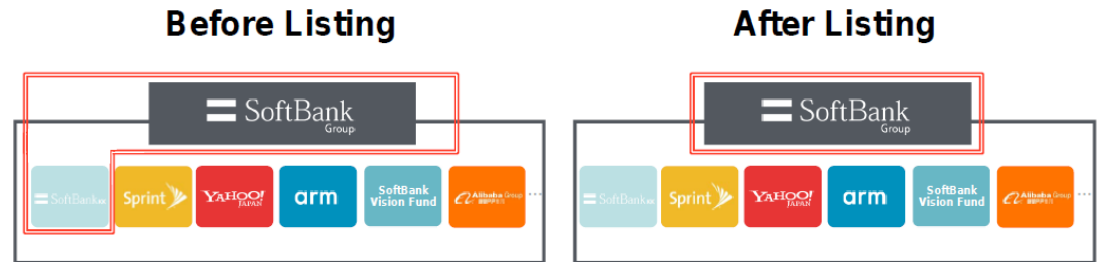
⁷ SBG obtained the necessary consents from its senior loan lenders to release the guarantee. The change in covenants for foreign bonds is also a strategic move to release the guarantee.

It will become easy to assess SBG's creditworthiness

SBG's credit valuation should be assessed primarily using LTV

We often hear that it has become difficult to assess SBG's creditworthiness. However, the group's creditworthiness can be readily assessed as an investment firm. To put it rather boldly, we think that the credit of SBG, which is shifting to an investment firm, should be evaluated like a REIT. In other words, the most important indicator for credit valuation of SBG is the ratio of net interest-bearing debt to the value of shareholdings (LTV), a stock-based indicator. If we are able to monitor whether the LTV is being controlled at an appropriate level (SBG's in-house control target is 35% or lower⁸), we would not have to be overly concerned about daily headlines relating to the group. In an environment where UK-based ARM has been delisted and Softbank KK has not yet been listed, it is not easy to calculate the value of shareholdings. Under some assumptions⁹, we estimate that LTV is currently at around 30%. If so, we can conclude that SBG is creditworthy to a certain extent.

Chart: Change in Management Style of Softbank Group



Source: Extract from company materials.

Note: Currently, (before listing), Softbank Group and Softbank are managed as a single entity. After listing, Softbank Group to be strategic holding company:

Chart: Viewpoints for SBG's Credit Valuation After Announcement of "Synergy Group" Strategy

Value of shareholdings	Net interest-bearing debt
Softbank KK Yahoo Japan Sprint Arm Alibaba etc.	SBG's net interest-bearing debt (recourse debt)

Source: Compile by Daiwa Securities.

We still recommend a buy-and-hold stance for absolute yields

New type of corporate bond issuer

As witnessed by the acquisition of US-based Sprint and UK-based ARM, the establishment of SVF (which is worth as much as Y10tn), the restructuring in the US telecommunications industry (reaching agreement on the merger between Sprint and T-Mobile US), and preparations for Softbank KK's IPO, there is no doubt that SBG is a company that aspires to grow and add to its corporate value. We maintain our view that SBG, which is becoming an investment firm, should be regarded as a new type of corporate bond issuer, unlike conventional Japanese corporate bond issuers whose creditworthiness is assumed to be stable until debt redemption. When investing in SBG bonds, investors should assume significant/unexpected changes in credit valuation. We will very likely see SBG-related headlines going forward, such as announcements of large-scale investment projects via

⁸ Management intends to maintain LTV at 70% even if the value of shares held were to halve.

⁹ Regarding the enterprise value of Softbank KK and recourse debt at SBG. In addition, we have reached a similar figure when adding the estimated enterprise value of SBG to its per-share shareholder value based on sum-of-the-parts analysis, which is disclosed on the firm's homepage.

SVF. In addition, we expect the firm to continue to raise funds by aggressively utilizing the credit market. We thus should assume there is a risk that spreads may widen on SBG bonds, depending on conditions. We recommend a buy-and-hold stance to obtain absolute yields.

Rating trends

Interested in how the current ratings will change in line with the firm's shift to an investment firm

We do not think that investment decisions on SBG bonds should have to rely on ratings (JCR: A-/stable, Moody's: Ba1/stable, S&P: BB+/negative). Meanwhile, we have a certain amount of interest in how the current ratings will change in line with the firm's shift to an investment company.

Status quo expected for JCR's rating (A-/stable)

First, the status quo is expected for JCR's rating (A-/stable), which is used as the basis of investment decisions by many Japanese investors. In JCR's February 2018 release following the announcement that SBG had begun preparations for Softbank KK's listing, the agency stated that the impact on its rating would be limited if (1) Softbank KK remains an important consolidated subsidiary positioned as a core company for the group's communications business, and if (2) SBG maintains a framework to secure sufficient cash flow from Softbank KK to operate the holding company, even after Softbank KK's listing. As SBG announced that it would consider the aforementioned conditions in the process of Softbank KK's listing, we do not think the current ratings will change even after the listing.

Moody's may upgrade its SBG rating due to change in methodology

It is possible that Moody's may upgrade its current SBG rating (Ba1/stable). In May 2018, Moody's announced a report on the rating methodology for "Investment Holding Companies and Conglomerates"—it seems as if the agency had prepared this report in order to utilize the methodology for its ratings on SBG once it becomes an investment firm. According to the report, ratings of investment holding companies are derived from five factors—(1) investment strategy (weighting of 10%), (2) asset quality (40%), (3) financial policy (10%), (4) estimated market value-based leverage (20%), and (5) debt coverage and liquidity (20%). As there are few clear numerical standards to determine the score for each factor (except for [4] and [5]), we think that it is actually quite an arbitrary method. Using my own scoring based on Moody's methodology, we estimate that Moody's rating on SBG would be higher than the current BB zone. We look forward to seeing how Moody's will rate SBG based on this methodology.

Difficult to forecast S&P's rating trends

It is difficult to forecast a change in S&P's rating (BB+/negative). On 26 February, S&P lowered its outlook on SBG from stable to negative because SBG has been accelerating investment in the fund business and its financial policy has become aggressive. As S&P pointed out the possibility of a change in the outlook to stable if interest-bearing debt is reduced via the sale of assets (including the listing of subsidiaries), Softbank KK's listing may have a positive impact on its SBG rating. On the other hand, the pressure for a downgrade is also increasing as investment via SVF has been picking up.

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■ Credit Rating Agencies

[Standard & Poor's]

The Name of the Credit Rating Agencies group, etc

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[Moody's]

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[Fitch]

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- In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction.

In some cases, our company also may charge a maximum of ¥ 2 million (including tax) per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.

- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

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Corporate Name: Daiwa Securities Co. Ltd.

Financial instruments firm: chief of Kanto Local Finance Bureau
(Kin-sho) No.108

Memberships: Japan Securities Dealers Association

The Financial Futures Association of Japan

Japan Investment Advisers Association

Type II Financial Instruments Firms Association