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Softbank's buying spree suggests a shift in growth strategy

by Dexter Tan

It is increasingly more difficult to classify Softbank as a telecom company as the firm continues to build a portfolio of large investments outside its core mobile communications business. Last week, the company invested USD 1bn in South Korea's top online retailer Coupang, making it the largest Internet deal in the country's history. The deal with Coupang will diversify the company's revenue stream and expand its current portfolio which includes Banjo in the US, Supercell in Finland, Ola in India, and Kuadi Dache and Alibaba in China. The RMI 1-year probability of default (PD) for Softbank has gradually declined since Aug 2014, reflecting an improvement in credit quality after rising from 5bps in Jun 2013 to 76bps in May 2014.

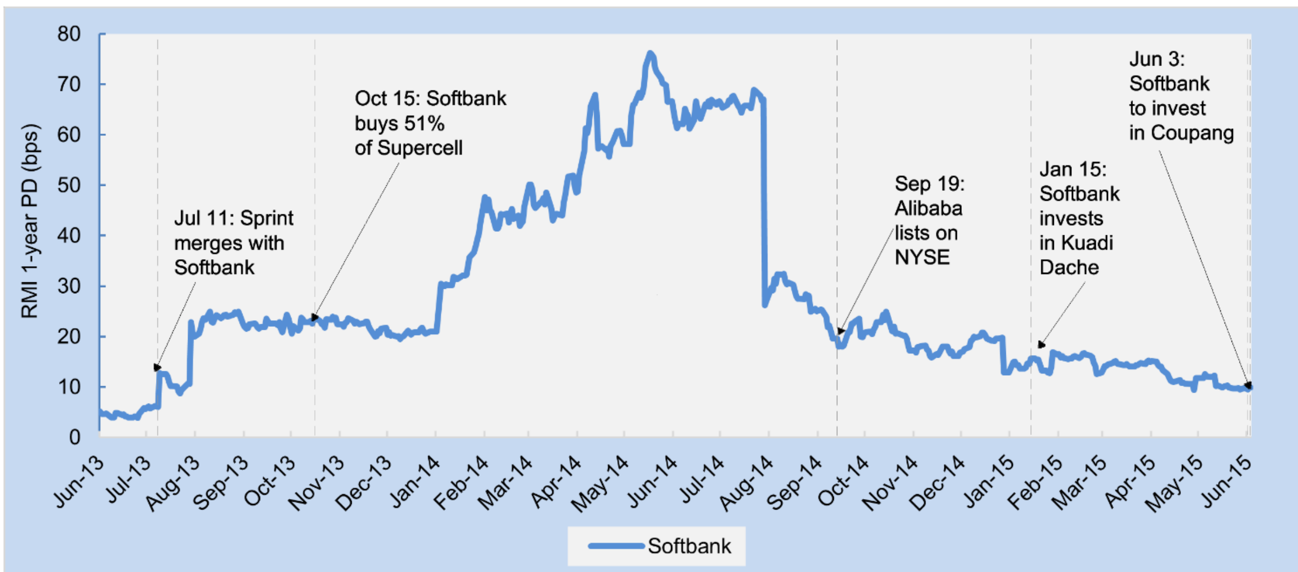

Figure 1: RMI 1-year PD for Softbank. *Source: Risk Management Institute*

Softbank's aggressive investment appetite and inclination for large M&A activity is not new. Softbank started in 1981 as a retail vendor for packaged software for personal computers, but slowly ventured into mobile communications in the subsequent years. The group invested in Japan Telecom in 2004 and launched a tender offer for Vodafone Japan in 2006. In Jul 2013, SoftBank Corp acquired Sprint which propelled the company to become the third largest mobile carrier in the world. In addition, Softbank tried to purchase T-Mobile in 2014 but failed due to regulatory concerns.

The merger with Sprint markedly impacted Softbank's credit profile between Jun 2013 and Jun 2014. Softbank issued a USD 17.1bn bridge loan to finance its USD 21.6bn Sprint acquisition, which was later refinanced with a separate USD 19.1bn loan agreement with 19 banks. The merger was completed in 2013 and Softbank now owns 78% of Sprint. With a significant amount of debt funding on the balance sheet, the deterioration in creditworthiness was reflected in performance credit metrics from Sep 2013. The proportion of net debt to EBITDA, for example, increased from 1.85X (Jun 2013) to 4.02X (Sep 2013) while (EBITDA – Capex) / Interest expense dropped from 11.7X to 2.3X. The RMI 1-year PD for Softbank also increased considerably during this period.

Period ending	Net debt / EBITDA	EBITDA margin (%)	(EBITDA - Capex) / Int expense	RMI 1-year PD (bps)
Jun 2013	1.85X	41.0	11.7X	4.7
Sep 2013	4.02X	38.5	2.3X	24.3
Dec 2013	3.89X	34.0	0.6X	20.9
Mar 2014	3.60X	30.0	0.7X	51.9
Jun 2014	3.58X	26.9	3.2X	65.9
Sep 2014	3.72X	24.8	2.4X	20.0
Dec 2014	4.17X	23.6	1.2X	12.8
Mar 2015	3.97X	24.3	1.2X	15.0

Table 1: Credit metrics and RMI 1-year PD for Softbank. Income statement figures are adjusted to a trailing 12 month period. (EBITDA – Capex) / Interest expense ratio considers the ability of the firm to cover interest expense after it has made the necessary re-investment into core operations. Capital expenditure is subtracted from EBITDA because of the highly capital intensive nature of the industry. Telecom companies usually make significant investment in network infrastructure for maintenance and introduce new services to replace declining and older products. *Source: Bloomberg, Risk Management Institute*

Softbank's decision to adopt IFRS standards from Jun 2013 also affected its credit standing, especially in the areas of accounting for business combinations and liabilities. Procedures under previous JGAAP accounting rules required companies to regularly amortize goodwill when assessing M&A transactions, but there is no such need for regular amortization under IFRS. Softbank now checks for goodwill impairments every fiscal year. Softbank's executives estimated that the transition to IFRS would help boost operating income in FY 2013 by JPY 108bn. More importantly are the credit negative effects of recording liabilities, which resulted in an increased liability of JPY 1.55tn to the balance sheet at the end of Mar 2014. Securitized installment sales receivables from mobile devices, preferred securities issued by subsidiaries, and finance leases conducted before April 2008 would all be treated as liabilities under IFRS but not under JGAAP.

As seen in Table 1, Softbank's acquisition of Sprint did not improve overall EBITDA margins, which dropped from 41% in Jun 2013 to 27% in Jun 2014. Earnings were affected as Sprint lost many postpaid subscribers due to service disruptions owing to ongoing network improvements and intense competition. In Dec 2014, Sprint's new CEO, Marcelo Claure, took drastic steps to turnaround the wireless carriers by introducing a new billing plan that cuts the subscriber's monthly bills in half if they switched over to Sprint. Under the new plan, existing Verizon and AT&T customers would be able to get unlimited text and calls across the US at half the monthly rate they paid earlier.

Although mobile operations account for nearly 90% of Softbank's revenue, the company's strategy moving forward will be focused on Internet companies. In early May, the Japanese telecom giant announced that Nikesh Arora, the former management executive at Google, would be its new president and potential future chief executive officer. Arora joined Softbank in 2014 and was previously in charge of revenue, marketing, partnerships and customer operations at Google. Arora's expertise will help Softbank expand its Internet businesses and continue its interest in fast growing and disruptive online companies.

Softbank's reason to grow its Internet business is likely due to the segment's comparatively high operating income margins. As displayed in Table 2, operating incomes from Internet related activities has generated the highest margins of around 40% constantly. Such activities include internet advertising, e-commerce operations and membership services. Operating margins at Sprint, however have been depressed through fiscal 2014, and have contributed negatively to Softbank's bottom line.

As of	Jun 2014		Sep 2014		Dec 2014		Mar 2015	
Business segment	Revenue	Operating income margin	Revenue	Operating income margin	Revenue	Operating income margin	Revenue	Operating income margin
Mobile communication	3360	19%	3644	18%	4018	17%	4144	17%
Sprint	3497	2%	3614	3%	3600	3%	3594	2%
Internet	397	47%	498	37%	402	45%	416	45%
Fixed-line communication	442	25%	436	24%	435	23%	436	23%

Table 2: Softbank's revenues and operating margins. Figures in JPY bn, unless otherwise indicated. Operating segment margins are defined as trailing 12 month operating income over revenue. *Source: Bloomberg, company reports*

The initiative to invest in Coupang coincided with the divestment of another company. Last Tuesday, Softbank finalized details of reducing its stake in GungHo from 40.2% to 28.4%. After June 24, 2015, GungHo will no longer qualify as a subsidiary of Softbank. The share sale is expected to boost the current quarter's net income by JPY 78bn and the investment in GungHo will be accounted for under the equity method moving forward. On Wednesday, Softbank also announced a JPY 100bn unsecured bond issue to retail investors paying a fixed coupon rate of 1.36% per annum. The bond issuance is small (< 1% of total liabilities of JPY 17tn) and likely to have little impact on the firm's credit profile.

Softbank's most precious golden egg is its stake in Alibaba Group Holdings. The company invested USD 20mn in the Chinese firm many years ago but the market value of this investment has grown to more than USD 84bn as of June 1. The RMI 1-year default benchmark for Softbank dropped sharply in Aug 2014 on the back of a steep rise in the firm's distance-to-default (DTD). DTD is a volatility adjusted leverage measure, and changes in the measure are a significant determinant of RMI 1-year PDs. As a result of Alibaba's listing and the conversion of preference shares into common stock, Softbank booked a sharp increase of JPY 599bn in equity interest in associates during FY 2014.

During the same May conference call that announced the appointment of Arora as President of the company, Softbank said that they are not in a rush to sell their stakes in Alibaba soon. However, that could change quickly if competition in the US telecom sector intensifies. Last week, Dish Networks, the second largest satellite TV company in the US, was reportedly in talks to merge with T-Mobile, the fourth largest telecom group. A completed deal between the two companies would threaten Sprint's third place market position and pressure management to speed up upgrades to its US infrastructure to increase coverage and capacity, as well as deploy Voice over LTE technology.

Besides the prospect of a deal between Dish Networks and T-Mobile, there are two other credit related issues facing Softbank. The IASB and FASB have published a joint standard on revenue recognition – IFRS 15, which would affect how telecommunication companies report sales to customers. The new standard, which requires new extensive disclosure requirements and changes to current processes, takes effect in Jan 2017. Another potential impact is the new IFRS standard on financial instruments accounting – IFRS 9, which has a mandatory effective date of Jan 1, 2018. Under the new guidelines, Softbank may have to revise the measurement approach for impairment by introducing an impairment model based on the expected credit loss, as well as revise the treatment of fair values of financial liabilities.

Technological advancements have changed the manner in how telecommunication companies operate. Fast moving technological trends have generally reduced asset life cycles. Together with increased competition, companies have to constantly innovate to improve shareholder value and maintain strong credit quality. Transmission standards such as WiMax and LTE have created the need for companies to constantly upgrade their networks. At the same time, corporations have to incur expensive product development, marketing costs and stay competitive in terms of pricing. Softbank is no exception. The company has improved its market share in Japan by upgrading its network quality and content. Even though it falls behind Domoco in terms of number of subscribers, the company is consistently ranked the best in terms of connectivity. Softbank is trying to rescue its investment in Sprint, and create a niche revenue stream from online retailing. However, it may take a while for both objectives to be met.

Credit News

Robust payrolls stoke volatile debt markets

Jun 5. The robust US employment data on Friday has capped a week of wild swings in the global bond market. The economic slowdown earlier this year has proven to be a short-term stumbling block in the US recovery, with the creation of 280,000 jobs in May exceeding analysts' expectations. The share of the US population in work hit a post-recession high of 58.4%, reinforcing the case for the Federal Reserve to lift interest rates this year. The German Bunds yield increased surprisingly. This surge indicates that the market felt that historically low yields were at odds with signs of firmer economic activity and expectations of higher future inflation. (FT)

Singapore's worst souring loans since 2009 show Asian contagion

Jun 5. With the slowdown in the Chinese economy and increasing US interest rates, Singapore's worst souring loans in 6 years are showing symptoms of Southeast Asian borrowers struggling to repay under pressure. Banks in Southeast Asia's biggest finance centre have placed 2.3% of their lending books in a "special mention" category. Overdue debt concern is an untimely serious threat to Southeast Asia's economy, just when most of the Southeast Asia's economic growth is slowing down. As fiscal pressures cause loans to fail, some banks may start to retrench their lending activity. (Bloomberg)

IMF warns Fed to hold fire on rate rise

Jun 4. IMF advised the Fed to wait until next year to raise interest rates, and warned that it is difficult for the Fed to justify a lift-off of rate amid so much uncertainty. Despite IMF's forecast of US economic growth of 2.5%, IMF argued that the interest rate hike will be more appropriate in early 2016, as an early interest rate hike may lead to global financial instability, resulting in a slowdown of the global economy. (FT)

The lawsuit machine going after student debtors

Jun 4. Student loans have surpassed credit cards to become the 2nd largest source of outstanding debt in the US, after mortgages. The consumer financial protection bureau has estimated that students and former students, as well as their parents owe an additional USD 150bn in loans from banks and other private lenders, in addition to the USD 1.2tn of student loan balance. The National Collegiate Student Loan Trusts, which are investment vehicles that concentrate on education lending, have sued many students for default, but often lose in court as they have limited evidence to prove their case. (Bloomberg)

Hyundai humbled as investors abandon auto industry's darling

Jun 2. Shares of South Korea's largest carmaker tumbled 10% on June 2 to their lowest close since August 2010, and extended a decline on Wednesday, making Hyundai the worst-performing stock among any major automaker in the past year. The Seoul-based auto manufacturer is facing headwinds as foreign brands catch on in Korea and unfavorable exchange rates undermine its ability to compete against its competitors. Hyundai has missed out on a worldwide SUV boom sparked in part by a decline in gasoline prices. However, it will continue to face some difficulties in a very competitive environment especially with a weaker yen and euro. (Bloomberg)

Malaysia's debt-ridden 1MDB faces central bank probe (Strait Times)

Brazil boosts rate for sixth time as investors doubt Tombini (Bloomberg)

PBOC's failure to lower long rates leads to own operation twist (Bloomberg)

Regulatory Updates

Bank watchdog in Sweden says debt-cutting plan likely to proceed

Jun 5. Sweden's financial regulator said it probably has enough political backing to proceed with a plan that would force households to reduce their mortgage debt. The government intends to change the law and let the regulator introduce a mortgage amortization requirement after a Swedish court ordered it to scrap the measure. However, the regulator doesn't want any changes to its original proposal on amortization rules, since it "could be inflexible and that it could hit new home construction." (Bloomberg)

MAS unveils proposals to strengthen OTC derivatives market

Jun 3. The Monetary Authority of Singapore (MAS) has unveiled proposals to strengthen Singapore's over-the-counter (OTC) derivatives market and to enhance the provision of financial advisory services. It also proposes to introduce a set of risk mitigation requirements for intermediaries that deal in non-centrally cleared OTC derivatives. As for refining the rules governing financial advisory services, MAS proposes to exempt from the Financial Advisers Act (FAA) trading representatives (TRs). Finally, MAS proposes to allow financial advisers to help customers transact in collective investment schemes (CIS) when an investment recommendation on CIS has been accepted by the customers. (Business Times)

UK regulator warns insurers over infrastructure asset risks

Jun 2. Infrastructure assets have been flagged as potentially risky for insurers by a Bank of England (BoE) official. The BoE's Prudential Regulation Authority will monitor insurers' investment in such assets as they search for new sources of income. Insurers' appetite for infrastructure comes as banks are beginning to withdraw from the market. However, the demand for such assets also undermines the yield that they return. The average deal's size rose to USD 549mn in 2014 from USD 329mn in 2010. The rules are underpinned by each insurer having an approved model which is much more complex than in the past to calculate its capital requirements. (FT)

China regulator says amending rules on margin trading, short selling (Reuters)

HK bank regulator calls for more anti-money laundering efforts (Business Times)

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