THE SOFTBANK-WEWORK END GAME: SAVIOR ECONOMICS OR SUNK COST PROBLEM?

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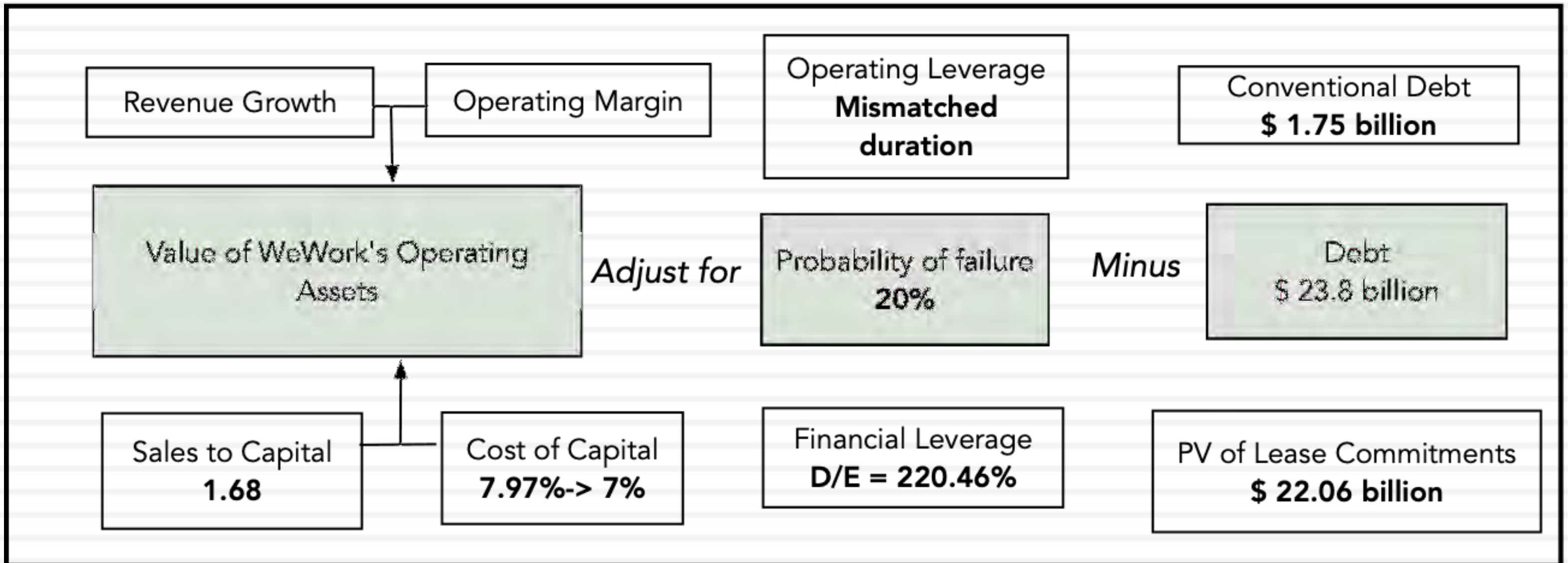
The WeWork Saga (Continued)

- Since my pre-IPO post on WeWork, where I valued the company ahead of its then imminent offering, much has happened.
  - The company's IPO collapsed under the weight of its own pricing contradictions/
  - Softbank emerged as the savior, investing an additional $ 8 billion in the company, and taking a much larger stake in its equity.
- As the WeWork story continues to unfold, I am more interested in Softbank than in WeWork, largely because its actions cut to the heart of many questions in investing.

My WeWork IPO Valuation (Sept 9, 2019)

WeWork IPO Valuation on September 9, 2019



Value of Equity in WeWork Today (in $ millions)

		Target Operating Margin				
	Revenue Growth (& 2029 Value)	*5%*	*7.50%*	*10%*	*12.50%*	*15%*
Revenue Growth Rate	*40% (2029 Revenues = $30.4 bil)*	$ (25,448)	$ (19,564)	$ (13,718)	$ (8,254)	$ (2,811)
	50% (2029 Revenues = $50.2 bil)	$ (26,941)	$ (17,428)	$ (8,568)	$ 257	$ 9,056
	60% (2029 Revenues = $80.5 bil)	$ (28,469)	$ (14,108)	$ (161)	$ 13,749	$ 27,652
	70% (2029 Revenues = $126.0 bil)	$ (30,113)	$ (8,542)	$ 12,958	$ 34,430	$ 55,870
	80% (2029 Revenues = $192.7 bil)	$ (32,261)	$ 291	$ 32,764	$ 65,210	$ 97,620

The IPO Postscript

- Soon after my post, the ground shifted under WeWork, as a combination of arrogance (on the part of VCs, bankers and founders) and business model risks caught up with them, and the IPO was delayed, albeit reluctantly by the company.
- That action, though, left the company in a cash crunch, since it had been counting on the IPO to bring in $3 billion in capital to cover its near-term needs.
- In conjunction with a loss of trust in the top management of the company, created a vicious cycle with the very real possibility that the company would implode.

The Softbank Rescue Package

- Equity Buyout: A tender off of $3 billion in equity to buy out of existing stockholders in the firm to increase its share of the equity ownership to 80%. In an odd twist, Softbank contended that, after the financing, *"it will not hold a majority of the voting rights… and does not control the company… WeWork will not be a subsidiary of Softbank. WeWork will be an associate of Softbank"*.
- Added Capital: Softbank would provide fresh debt financing of $5 billion and an acceleration of a $1.5 billion equity investment it had been planning to make into WeWork in 2020, giving WeWork respite, at least in the short term, from its cash constraints.
- Neutering of Adam Neumann(at a cost): A severing of Adam Neumann's leadership of the company, in return for which he will receive $1 billion in cash, $500 million as a loan to repay a JP Morgan credit line and $185 million for a four-year position as a consultant.

The Big Questions

- What motivated Softbank to invest so much more in a company where it had already lost billions?
- With mark-to-market rules in effect at Softbank, how will accountants reflect the WeWork disaster on Softbank's books?
- Is Masa Son a visionary genius or an egomaniac in need of checks and balances?
- Since Softbank is a holding company, deriving a chunk of its value from its perceived ability to find start-ups and young companies and convert them into big wins, how will its value change as a result of its WeWork missteps?

1. Sunk Cost or Rescue Mission

- A corporate rescue: There are some who would argue that Softbank had no choice, since without an infusion of capital, WeWork was on a pathway to being worth nothing and that by investing its capital, Softbank would avoid that worst-case scenario.
- A Sunk Cost Problem: Softbank is investing $ 8 billion in WeWork, not because it believes that it can generate more than amount in incremental value from future cash flows, but because it had invested $7.5 billion in the past.

Resolving the Question

- The rescue may have helped it avoid a near term liquidity meltdown, but it has taken a highly levered company whose only pathway to survival was exponential growth and made it an even more levered company with constrained growth.
- Masa Son claims that "(t)he logic is simple. Time will resolve . . . and we will see a sharp V-shaped recovery," in WeWork, but I don't see the logic, time alone cannot resolve a $30 billion debt problem and there are enough costs in non-core businesses to cut to yield a quick recovery.
- To those who would counter that Softbank has a lot of money to lose and smart people working for it, note that the more money you have to lose and the smarter people think they are, the more difficult it becomes to admit to past mistakes, exacerbating the sunk cost problem.

2. Fair Value Accounting

- It is fair price accounting, not fair value: Softbank wrote down its WeWork investment by $4.6 billion but the reason for the write-down, though, was not a reassessment of WeWork's value, but a reaction to the drop in the pricing of the company's equity.
- With the pricing coming from Softbank: Softbank was setting the pricing, at both the $47 billion pre-IPO, and the $8 billion, post-collapse.
- Too little, too late: Given that the write down was based upon pricing, not value, the market knew that a write off was coming and approximately how much the write off would be, which explains why even multi-billion write offs and impairments usually have no price effect, when announced.
- With dangerous feedback effects: Companies still seem to think that these accounting charges are news that moves markets and take actions to minimize them.

3. Smart Money or Stupid Money?

- I hope that this episode will put to rest the notion of smart money, i.e., that there are investors who have access to more information than we do, have better analytical tools than the rest of us and use those advantages to make more money than the rest of us.
- The ”smart money” view leads us to assume that anyone who makes a lot of money must be smart, and Masa Son would have been classified as a smart investor, and wealthy investors funneled billions of dollars into Softbank Vision funds, on that basis.
- The WeWork misadventure does not Masa Son a stupid investor, but it does expose the fact that he is human, capable of letting his ego get ahead of good sense and that at least some of his success over time has to be attributed being in the right place at the right time.

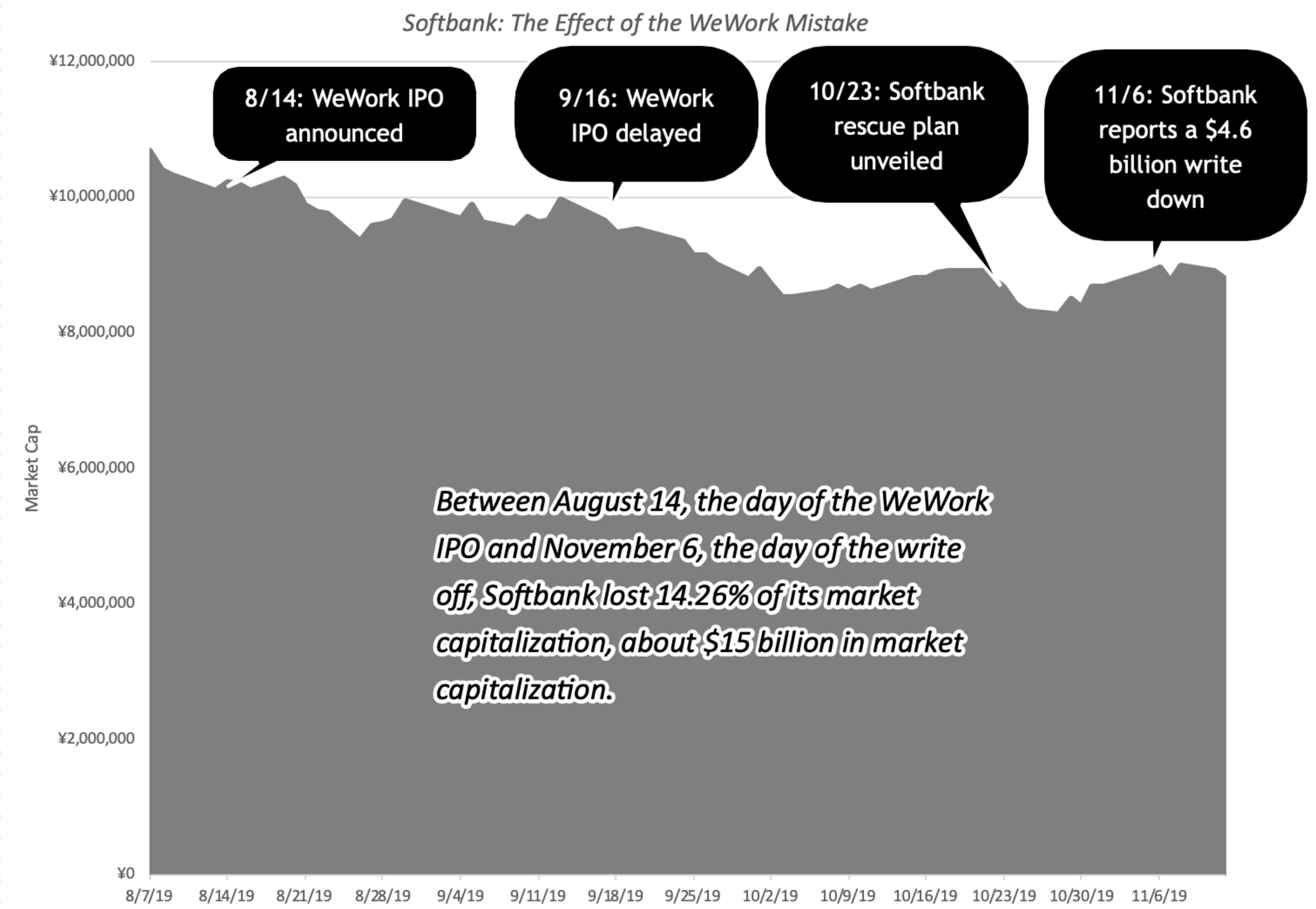
Humble or Arrogant Money?

- I think that investors are better grouped into humble and arrogant, with humble investors recognizing that success, when it comes, is as much a function of luck as it is of skill, and failure, when it too arrives, is part of investing and an occasion for learning.
- Arrogant investors claim every investing win as a sign of their skill and view every loss as an affront, doubling down on their mistakes.
- If I had to pick someone to manage my money, the quality that I would value the most in making that choice is humility, since humble investors are less likely to overpromise and overcommit.

Masa Son: A humbragger?

- His past: Anyone who makes three hundred year plans and things that bigger is always better has a God complex, and success feeds that arrogance.
- Penance?: I would like to believe that the WeWork setback has chastened Mr. Son, and in his remarks to shareholders this week, he said the right things, stating that he had "made a bad investment decision, and was deeply remorseful", speaking of WeWork.
- Words? However, he then undercut his message by not only claiming that the pathway to profit for WeWork would be simple (it is not) but also asserting that his Vision fund was still better than other venture capitalists in seeking out and finding promising companies.
- Judgment day: Masa Son may need a few more reminders about humility from the market, since neither his words nor his actions indicate that he has learned any lessons.

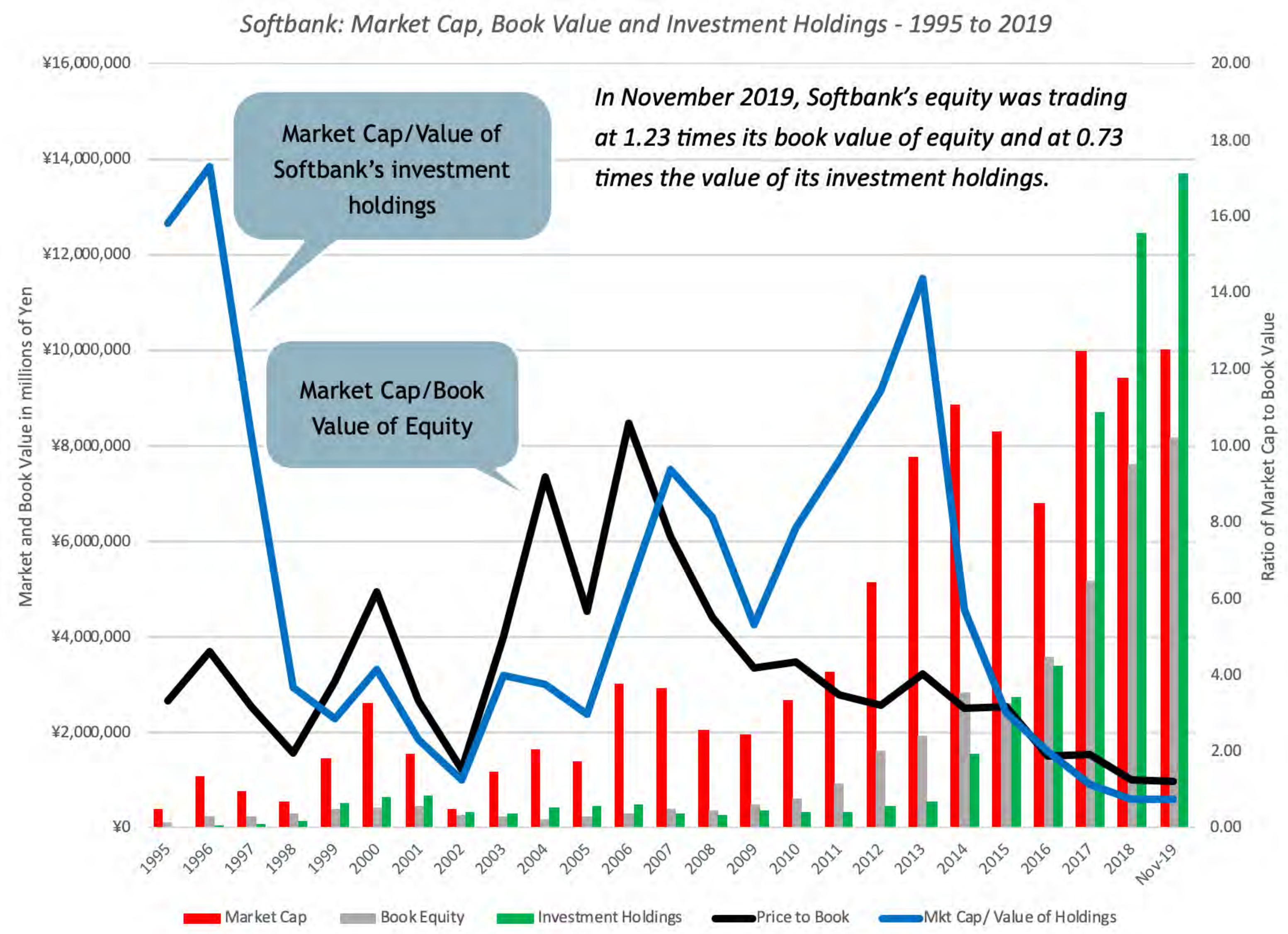
4. Softbank: The WeWork Effect



Disproportionate reaction?

- Softbank is a holding company for investments in other companies and many of Softbank's most recent investments have been in young, private companies like WeWork.
- With these investments, the pricing attached to them by Softbank, in its financials, comes from recent VC funding rounds and their valuations reflect trust in Softbank's capacity to pick winners and WeWork hurts on both counts.
  - First, investors are more wary about trusting VC pricing, especially if Softbank has been a lead investor in funding rounds, since that is how you arrived at the $47 billion pricing for WeWork in the first place.
  - Second, the notion of Masa Son as an investing savant, skilled at picking the winners of the disruption game, has been damaged, at least for the moment and perhaps irreparably.

A measure of trust



What now?

- The price to book ratio continues its march towards parity, with the market capitalization at 123% of the book value of equity in November 2019. In fact, if you focus just on Softbank's non-consolidated holdings, public and private, note that the market capitalization of Softbank now stands at 73% of the value of just these holdings, most of which are marked to market.
- While it looks like a great deal, there are two considerations that may affect your decision.
  - The company has a vast amount of debt on its balance sheet that has to be serviced, potentially putting your equity at risk
  - You are getting Softbank (and Masa Son) as the custodian of the investments. If you have lost faith in Masa Son's investing judgments, you may view the 27% discount that the market is attaching to Softbank's holdings as entirely justifiable and steer away from the stock.
  - As for me, I don't plan to own Softbank! I don't like grandiosity, and Masa seems to have been soaked in it.