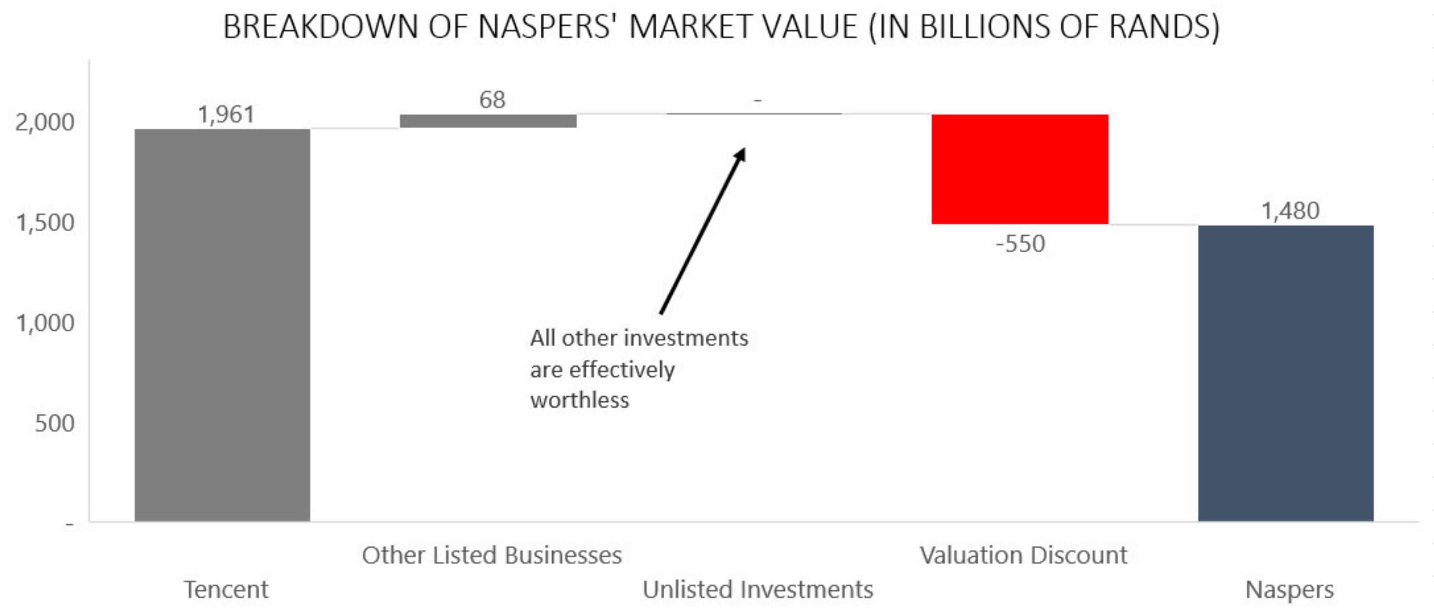
July 2019

Mind the gap: How Naspers is trying to close its valuation discount

Few people could have imagined that the largest company[1] in South Africa, a country largely built on the extraction and processing of raw materials, would be a global internet and high-technology business making most of its money in China. Naspers has come a long way since its humble beginnings as the publisher of "De Burger" and "De Huisgenoot" back in 1915. The business has made several ground-breaking and innovative investments to diversify away from its declining core publishing business. They launched M-Net in 1985, paving the way for Multichoice to become South Africa's largest pay-TV company, while other Naspers subsidiaries like AutoTrader, Media24 and Takealot have become household names.

What really put Naspers on the map, however, was a $32million investment in Chinese start-up Tencent in 2001. Today, Naspers' 31% holding in Tencent is worth around $130billion, which has catapulted the business from 5% of the Johannesburg Stock Exchange (JSE) 5 years ago to around 20% today. In the process, the rise in value of Naspers has created incredible wealth for South African investors. But Naspers has largely outgrown our market to the extent that further value unlock is difficult to realise.

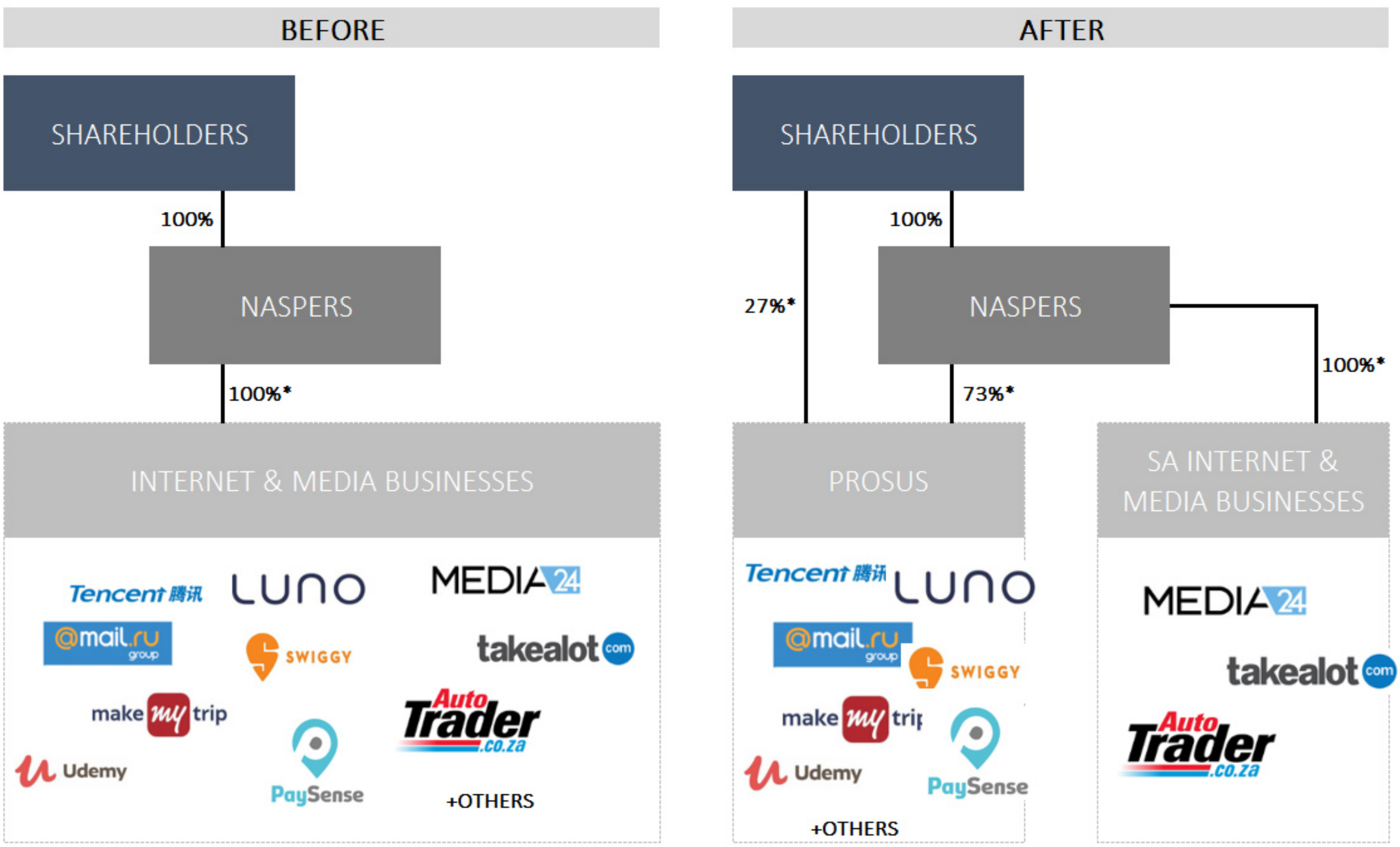
To explain what we mean by this, consider the term "don't put all your eggs in one basket", which is simply an argument for diversification. Large, institutional investors in South Africa follow investment guidelines that discourage them from holding concentrated positions in single stocks. Most investors would argue that 20% in a share (i.e. Naspers' weight in the index) is well beyond the realm of prudent investment principles. As such, funds will typically hold less than the index weight and tend to sell Naspers shares as the value rises, both of which create a drag on the share price regardless of what Tencent is doing. This has assisted in creating a valuation gap between what Naspers is worth and what its share in Tencent is worth. The latest estimation is that this valuation gap is over R500 billion, which also implies that all their other investments (like Takealot) are worthless. The chart below illustrates the value of Naspers' investment in Tencent, versus Naspers' own market capitalisation:



This is not the only reason for the valuation discount. Activist investors have also taken exception to the dual shareholding structure and have questioned who actually calls the shots at the company. The dual shareholding structure effectively allows for two classes of shares, unlisted A shares and listed N shares. This is not an uncommon arrangement, but what makes investors nervous is that every A share carries 1000 votes to the 1 vote every N share carries. This is a legacy from the days when Naspers was primarily a media business and is supposed to protect the integrity and independence of published content from malignant forces buying up shares and exerting influence. Today it is credited for allowing management to make long term decisions, instead of focussing on the short term as public companies often do. The structure effectively renders 67% of the voting power in the hands of the A shareholders, with 54% held by only two entities - Naspers Beleggings and Keuromstraat 30 Beleggings. These two companies are known to consult with one another on voting and their management and shareholding are relatively opaque.

Clearly, it would be in the best interests of shareholders for management to do something about both the structural limitations of our local market and the shareholding concerns. Their focus thus far has largely been on the former. The first solution was to sell $10billion worth of Tencent shares, which they completed in 2018. The proceeds from the sale will be allocated to fintech investments and, albeit small, can be seen as a means for the business to diversify away from Tencent. The second solution was to spin out Multichoice into a separate JSE-listed entity in January 2019. Today, Multichoice has a market capitalisation of R58billion, whereas it was effectively valued at zero before the transaction. While these solutions clearly unlocked value for investors, the valuation gap persists.

In March 2019, Naspers announced a much more elaborate plan in an effort to address the structural limitations. The proposal will see all the company's global internet investments (including Tencent and Russia's Mail.Ru) separated out into a new entity called Prosus, which will have a primary listing on the Euronext stock exchange in Amsterdam and a secondary listing on the JSE. Naspers intends to retain a 73% shareholding in Prosus and the rest will be issued to existing shareholders to be traded openly. Management hopes that the new structure will close the valuation gap in several ways: by attracting more international capital through the Dutch listing; by enabling direct ownership in the global internet businesses via Prosus; and lastly, by reducing Naspers' weight on the JSE. The current and proposed new business structure will look like this:



*Note, Naspers/Prosus doesn't necessarily own 100% of every underlying business

The board first released a circular in May and a revised circular in July 2019 which provides more clarity on the proposed transaction insofar it affects investors. Understanding the proposal is vitally important for shareholders, firstly because they must vote[2] on it, and secondly because shareholders have to elect which entity they want to be awarded new shares in. The vote will take place after Naspers' annual general meeting on the 23rd of August, and if approved, Prosus is expected to list in Amsterdam on the 11th of September 2019.

The proposal works like this: Naspers will issue and list 1.6 billion Prosus shares on the Euronext exchange, of which 27% will be made available to existing shareholders through a capitalisation[3] issue. This capitalisation issue offsets the reduction in asset value in the existing Naspers share as the internet assets are carved out. (i.e. the sum of the parts before and after will be the same). As mentioned, the remaining 73% of the shares will be retained by Naspers. Existing shareholders are given a choice to either take up new shares in Prosus (Option 1), which is the default option, or to take up new shares in Naspers instead (Option 2). Investors who want to take up shares in Prosus will be issued with 1 new Naspers M share for every 1 Naspers N share they currently own. The Naspers M shares will then be converted to Prosus N shares on the 16th of September 2019. Investors choosing the second option will be issued with 0.37 additional Naspers N shares for every 1 share they currently own and will therefore have no direct exposure to Prosus, but will retain indirect exposure by virtue of Naspers' 73% shareholding in Prosus.

The table below lays out the process for a hypothetical investor with 1000 Naspers N shares:

OPTION 1: DEFAULT OPTION

EXISTING INVESTMENT	CAPITALISATION ISSUE	CONVERSION	NEW INVESTMENT
◦ Hypothetical shareholder: ◦ 1000 Naspers N shares	◦ Existing shareholders awarded: ◦ 1000 Naspers M shares ◦ i.e. 1 M share for every N share owned	◦ Automatic conversion into Prosus shares by: ◦ Selling 1000 Naspers M shares ◦ Buying 1000 Prosus N shares	◦ Hypothetical shareholder: ◦ 1000 Naspers N shares ◦ 1000 Prosus N Shares

OPTION 2: INFORM NASPERS IF YOU WANT THIS OPTION

EXISTING INVESTMENT	CAPITALISATION ISSUE	NEW INVESTMENT
◦ Hypothetical shareholder: ◦ 1000 Naspers N shares	◦ Existing shareholders awarded: ◦ 370 Naspers N shares ◦ i.e. 0.36986 new N shares for every N share already owned	◦ Hypothetical shareholder: ◦ 1370 Naspers N shares

We don't yet know the share price that Prosus will list at, but there shouldn't be an immediate benefit between electing to participate in either the new Prosus or Naspers offering. While we would expect the share price of Naspers to drop to accommodate the creation of Prosus, there should be no immediate change to the overall market value of the investment as a result of the proposal. There are nuances to the two options however, with both immediate and longer-term consequences that investors should consider:

- Tencent will remain the dominant source of value for both Naspers and Prosus at first, but Naspers will have exposure to different businesses which may have an impact on valuations (the SA businesses). Hence, it is not unreasonable to expect that the two options will yield different outcomes over time.
- Prosus has been deemed a domestic share by South African authorities by virtue of its secondary listing on the JSE. This means that it won't count towards South African investors' offshore allowance for tax purposes. Investors can trade Prosus shares in Rands on the JSE.
- There is a material tax consideration for investors who do participate in the Prosus issue (i.e. Option 1 above). While a capitalisation issue in itself does not trigger a tax event, converting the Naspers M shares into Prosus N shares is seen as a transaction in the eyes of SARS (a sale of the M shares and purchase of the N shares). Worse yet, the base cost of the new shares is deemed to be zero. This implies that investors will be subject to capital gains tax (CGT) on the entire value of their Prosus shares in the current tax year following the conversion in September. Investors who took up Naspers shares instead will be exposed to a similar CGT liability on their newly issued shares, but this will only be triggered when the shares are sold in future.

The table below shows the estimated CGT liability[4] of the hypothetical investor mentioned before. The hypothetical investor's 1000 shares are valued at R3.5million (R3500 per share), which makes the value of the Prosus take up roughly R945 000 (i.e. 27% of the investment). In this scenario, the investor is expected to take a haircut of around 15% of their investment in Prosus through CGT.

	Base Cost	Investment Value	Taxable Gain	Tax on Gain
CGT Liability*	0	945,000	945,000	144,800
**Assuming a 40% marginal tax rate*				

In terms of their optionality, investors essentially have three questions to ask themselves: Firstly, will growth come from SA focused Naspers or globally focused Prosus (despite the large Tencent exposure in both)? Secondly, do I want exposure to a holding company, or a holding company of a holding company? If the new structure is unsuccessful in alleviating the discount, there is the possibility of a double discount in Naspers (i.e. discount in Prosus and a discount in Naspers). Lastly, whether I am comfortable to realise a tax liability in this financial year or defer the payment down the line, and whether the shift into Prosus offsets my CGT charge through better performance over time.

Will the proposed structure work? Only time will tell. The efforts of management over the last few years do appear to have had a positive impact on the valuation gap, which declined from R800billion in 2017 to around R500billion today. Yet, many of the issues that concern investors remain. Prosus will be included in the JSE indices, so instead of having one large entity in Naspers, we will now have two slightly smaller entities which in combination will likely be bigger than Naspers was to start with, if the structure is successful in closing the valuation gap. So, the new structure appears to do little to improve the concentration risk on the JSE. The concern around the dual share structure and voting rights remain and have effectively been replicated in Prosus. For the valuation gap to be meaningfully reduced, Prosus shares need to attract international investors. While it is in a better position to do so from Amsterdam, the business will need to pass the threshold of investors in a world increasingly focussed on corporate governance, management accountability and transparency, which is difficult to demonstrate within the current structures.

---

[1] By market value.

[2] Note that this relates to direct investors only. Investors in Naspers via a unit trust will not have to participate in the vote as the fund manager will vote in your stead.

[3] This is where a company issues new shares and distributes it to existing shareholders at no cost to the shareholder.

[4] We would advise direct investors affected by the CGT event to seek advice from a professional tax practitioner to determine the extent of their liability

EST. 2001

BESPOKE

FINANCIAL SERVICES

July 2019

data provided by Reuters and Datastream

31 July 2019

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
FTSE/JSE All Share Index (ALSI)	ZAR	-2.7%	9.6%	2.2%	5.6%	5.2%	12.1%	11.3%	11.9%
FTSE/JSE SA Listed Property	ZAR	0.1%	4.8%	0.1%	-3.7%	5.0%	12.0%	13.7%	13.2%
SA All Bond Index (ALBI)	ZAR	2.2%	6.9%	8.1%	8.8%	8.2%	8.8%	7.8%	6.9%
SA Cash Index (SteFI)	ZAR	1.8%	4.2%	7.3%	7.4%	7.1%	6.5%	0.2%	0.3%
Balanced Benchmark	ZAR	-0.7%	9.0%	5.9%	6.5%	7.3%	11.9%	7.5%	7.5%
SA Inflation (1 month lag)	ZAR	1.3%	2.7%	4.5%	4.7%	5.0%	5.2%	1.3%	1.3%
GLOBAL MARKET INDICES									
Global Equity (Datastream World)	USD	1.1%	18.0%	4.2%	11.0%	7.7%	10.5%	11.7%	13.1%
Emerging Markets Equity (Datastream EM)	USD	-2.5%	9.5%	-1.8%	8.8%	2.2%	4.9%	15.8%	17.2%
Global Bonds (Barclays Global Bond Index)	USD	3.6%	4.9%	5.4%	0.7%	0.9%	2.0%	5.4%	5.6%
Global Cash	USD	0.6%	1.5%	2.6%	1.8%	1.2%	0.8%	0.3%	0.2%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	-2.7%	9.6%	2.2%	5.6%	5.2%	12.1%	11.3%	11.9%
Global Equity (Datastream World)	ZAR	0.0%	16.3%	12.8%	11.9%	13.8%	17.2%	15.5%	13.9%
Emerging Markets Equity (Datastream EM)	ZAR	-3.6%	7.9%	6.3%	9.6%	8.1%	11.3%	13.6%	12.8%
SA All Bond Index (ALBI)	ZAR	2.2%	6.9%	8.1%	8.8%	8.2%	8.8%	7.8%	6.9%
Global Bonds (Citigroup)	ZAR	2.4%	3.3%	14.1%	1.4%	6.7%	8.2%	14.3%	13.7%
COMMODITIES									
Gold (US Dollars)	USD	11.3%	11.4%	16.8%	1.9%	2.1%	4.3%	13.0%	16.3%
Gold (Rands)	ZAR	10.0%	9.8%	26.4%	2.7%	8.0%	10.7%		
CURRENCIES									
Rand / Dollar	ZAR	1.1%	1.5%	-8.2%	-0.7%	-5.8%	-6.1%	15.6%	15.0%
Rand / GBP Pound	ZAR	7.1%	5.3%	-1.0%	1.9%	0.8%	-2.9%	16.5%	14.7%
Rand / Euro	ZAR	1.8%	4.0%	-3.0%	-0.6%	-1.9%	-3.6%	14.6%	13.4%

Spot Rates		31-Jul-19	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US$	Rand	14.17	14.10	13.10	10.72	7.84	6.16
Rand/GBP	Rand	17.36	17.95	17.18	18.09	12.98	9.99
Rand/EUR	Rand	15.78	16.06	15.33	14.34	11.11	6.60
RATES							
Libor 6m $	US$	2.21	2.20	2.53	0.33	0.93	5.71
Repo Rate	Rand	6.50	6.75	6.50	5.75	7.50	13.65
Prime	Rand	10.25	10.25	10.00	9.00	11.00	17.50
All Bond Index Yield	Rand	9.46	9.25	9.22	8.46	8.85	NA
COMMODITIES							
Gold ($/oz)	US$	1,427.68	1,412.30	1,222.01	1,286.06	934.30	255.80
Platinum	US$	873.00	818.00	831.00	1,472.00	1,189.00	343.75
Oil (Brent Crude) $	US$	64.71	66.87	74.46	104.63	70.28	19.58
INFLATION							
SA Inflation	%	4.5	4.5	5.1	6.4	6.7	NA

Fundhouse is a leading investment adviser specialising in fund research, ratings and portfolio construction services. We help clients manage investments on behalf of the end investor. Our experienced team understands the complexities of the fund management world. We apply this knowledge alongside a client first mindset to improve the outcome for the end investor.

Fundhouse was founded in 2007 by professionals from the investment management industry. We currently operate from offices in the United Kingdom and South Africa, where we cover the local and global fund industry first hand. Our business is 100% independent and owner managed which means we can offer objective advice and services in the best interests of our clients.