

# Naspers

## The odds on favourite

### **NASPERS IS TRADING AT A 41% DISCOUNT TO THE MARKET VALUE OF ITS INVESTMENT IN TENCENT**

Tencent is a large part of Naspers underlying value. In fact, at current market prices Tencent makes up 170% of Naspers value, with Naspers stake in Tencent equal to R2.15 trillion, while Naspers market cap is only R1.26 trillion. Naspers is trading at a 41% discount to the underlying value of just its investment in Tencent. In other words when you invest in Naspers you are buying Tencent at a 41% discount and receiving the other investments in Classifieds, Food delivery and Fintech for free.

### **TENCENT IS TRADING AT A HIGH PRICE OF 41.9 TIMES EARNINGS (41.9 PE)**

For the 2019 financial year, Tencent earned RMB 9.72 per share. Excluding the fair value gains/losses on investments that are not cash earnings and can be volatile depending on stock market movements, the underlying earnings of Tencent is RMB 8.00 per share (Cadiz calculation). The investment in associates and listed investments value as at 31 December 2019 works out to RMB 45 per share. Deducting this from the share price gives one an effective purchase price for Tencent of RMB 335.52 per share. This share price divided by earnings of RMB 8, results in a PE of 41.9. This is a high price, but is it too high?

### **TENCENT HAS GROWN ITS EARNINGS BY 26% PA OVER THE LAST 10 YEARS**

Tencent operating income has grown by 26% p.a. over the last 10 years, which is less than the revenue growth of 34% p.a. In the latest financial year, revenue grew 20.6%, with operating income achieving a similar growth rate. Thus, Tencent is still growing at a rapid rate. While Tencent has seen the growth rate in Social networks, gaming and advertising slow, the Fintech and Business services segment has received a lot of investment over the last few years and is now achieving strong revenue growth. These businesses benefit from economy of scale advantage and have a large fixed cost base, which lends itself to operating margin improvement and strong barriers to entry once the business reaches scale.

### **TENCENT PRICE IS HIGH BUT NOT RIDICULOUSLY EXPENSIVE**

Tencent current revenue is \$65b. Alphabet 2019 revenue was \$160b, while Facebook revenue was \$70b. Assuming that Tencent can grow at 20% p.a. for the next 5 years would give it revenue of \$134b which is achievable given Tencent's large user base and broad product offering. Given the large upfront expenditure incurred to grow the new segments, it is reasonable to assume that Tencent current operating income margin of 24.6% is low and can improve to around 30%. This will result in earnings increasing from RMB 8 to RMB 23. Given the quality of Tencent's underlying businesses and the potential for continued mid to high teen growth for the foreseeable future, Tencent could reasonably trade at an exit PE multiple of 25. This results in a future share price of RMB 630, keeping the investments at the current value of RMB 45.3 per share.

This scenario will deliver an expected return of 10.6% p.a. for Tencent which is in line with the long-term expected return for global markets. Investing in Naspers enables one to buy Tencent at a large discount and assuming this discount narrows to 15% over time, results in an expected return of ~15% p.a.

### **WHAT IF THE INVESTMENT ASSUMPTIONS ARE TOO OPTIMISTIC?**

A key tenet of Cadiz investment philosophy is to invest when there is an adequate margin of safety which limits the possibility of losing money due to paying more than the fair price for an investment. Assuming revenue grows at 15% p.a. for the next 5 years, while the current operating margin is maintained at 25% and exiting on a 20 PE multiple produces an expected return of -1.1% p.a. for Tencent, and with the Naspers discount narrowing to 25% p.a. the return to a Naspers shareholder would be 2.1% p.a. Not great, but given our favourable view of the business quality, the management team and low financial risk, it does show that one is unlikely to lose capital when investing in Naspers at the current share price.

## **NASPERS HAS ADDITIONAL OPTIONALITY TO DELIVER EXCEPTIONAL RETURNS**

Naspers invests in Prosus, which invests in Tencent. The value of Naspers does not factor in the underlying value of Prosus investments in food delivery, classifieds and Payments/Fintech and does not factor in any upside from Tencent's other investments. Although these investments are currently not profitable and early in their business life cycle, the business models lend themselves to being high return on capital businesses with large economy of scale advantages. It is likely that Tencent and Prosus will ultimately see reasonable return on their current ventures, which provides additional upside for Naspers.

A potential risk is that all of the capital that is being spent trying to expand into the new ventures is unsuccessful but, this is a low probability given our favourable view of managements capital allocation ability.

## **OTHER RISKS TO BEAR IN MIND**

Tencent does not directly own the underlying businesses in China and relies on a contractual arrangement with the current directors to control the business. The Chinese government could decide that these contracts are invalid, which could result in permanent capital loss.

The Rand has weakened considerably due to the recent downgrade to junk status as well as the risk off sentiment due to the coronavirus. Should the Rand strengthen significantly, this could be a material headwind to the expected return over the next 5 years.

COVID-19 should negatively affect the advertising business, but should be beneficial to the Gaming, Social networks, Cloud and business services divisions. This could turn into a headwind should there be a 2nd wave of infections which leads to a longer shutdown and deep economic recession.

## **WEIGHING UP THE RISKS WHEN MAKING INVESTMENT DECISIONS**

This overview should highlight that there is no certainty when making investment decisions. As investment professionals, we weigh up the risk vs the reward for each investment and express this in an appropriate position size in the portfolios. In the 2 May 2020 Berkshire Hathaway Annual Meeting, Warren Buffett said, "I'm a probabilities guy". Weighing up the potential gain vs loss and assessing the odds of being right vs getting it wrong is a key part of investment management. We believe that buying better quality businesses with low financial risk and capable management at an attractive price increases the odds of a favourable outcome. This makes Naspers the odds on favourite to continue delivering attractive returns.