INTUITION
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Naspers / Prosus: the good, the bad, and the complicated

Naspers and Prosus released their results earlier this week. Core headline earnings grew by 45% in US Dollars and other key operational metrics all moved in the right direction. Yet the share price is down 3.3% since their release. That might seem harsh, but there is a reason. That is because, in trying to unlock value for shareholders, the two companies have proposed a complicated share swap agreement which has gone down like a lead turkey with investors. This article tries to get to the bottom of both issues.

Michael Porter

Given that Prosus accounts for almost 100% of Naspers' earnings (apart from Media 24 and Takealot.com), this article will focus on Prosus as the operating entity, but the implications for Naspers shareholders are identical.

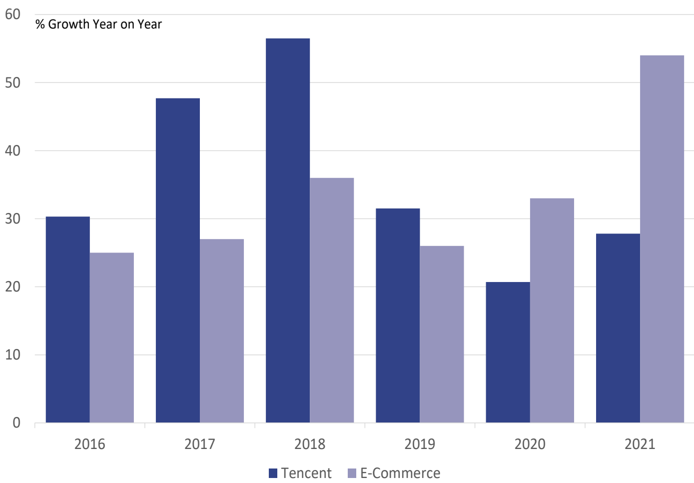
Prosus released their much-anticipated results earlier this week. Operational metrics were generally good across the board, although even they, as a technology company, faced headwinds during Covid. At a glance, group revenue accelerated to 33% (from 23% last year), but importantly, their e-commerce operations (excluding Tencent) grew revenues by 54% (from 33%). Margin expansion saw profits grow by 44%, and encouragingly, the Group generated positive free cash flow of $126m – the first time in many years given that heavy investment into new ventures in prior years has always guzzled cash. That prompted an increase in the dividend (payable as a reduction in capital) from 11 euro cents to 14 euro cents, payable to shareholders in October.

Prosus consists of four key divisions (grouped together as their e-commerce operations), as well as a 29% stake in Tencent and a 27% stake in Mail.ru, the Russian social media platform. The problem is (and has always been) that Tencent is so large that it dominates investor thinking and overshadows all the other operations. This has given rise to a situation where both Naspers and Prosus trade at significant discounts to the value of their underlying operations – as wide as 50% currently. That is a substantial amount of trapped value, and it is a source of great frustration for shareholders, who would like to see that value unlocked. Whilst management has proposed a share swap transaction to try and reduce the discount (more on this later), the key to unlocking value, in our opinion, is for the core e-commerce operations to reach profitability. In that regard, this result was promising.

SPEED READ

- **Group revenue and trading profit for Prosus grew by 34% and 49% respectively for the financial year that ended in March 2021.**
- **Importantly, growth in their e-commerce operations is now outstripping growth from Tencent, an important milestone to unlocking value in the future, in our opinion.**
- **Their proposed share swap between Naspers and Prosus has not been well received, but don't let this distract you from the underlying opportunity.**

PROSUS: DIVISIONAL REVENUE GROWTH



Over the past two years, there has been an important changing of the guard. In the past, revenue growth from Tencent has always been stronger than that from Prosus' core e-commerce operations. That has changed over the past two years. It is an important milestone and one that, if continued, should result in a narrowing of the discount over time.

The first division is Online Classifieds, and it comprises various companies with operations around the world. Popular brand names are OLX and Avito. Despite being the most affected by Covid-19, this division boasts 322 million active users a month around the world and delivered revenue growth of 25%. Profit declined to just $9 million (from $34 million last year), but this was a good effort given Covid pressures in H1. Furthermore, this is the third consecutive year of profitability – a necessary milestone for a separate listing to be considered.

The second division is food delivery – a major beneficiary of Covid given the lockdowns and reluctance of consumers to venture out to restaurants. Prosus has large investments in Delivery Hero, Swiggy, and iFood, amongst others, whose tentacles spread across 69 countries. Gross merchandising value grew by 70%, with those in Brazil performing exceptionally well. Whilst this division is still loss-making due to the high rates of investment required to reach scale, the losses reduced materially from $642 million in FY20 to $355 million this year. It is encouraging that revenue growth is translating into improved margins.

> “We believe that we are close to maximum pessimism towards both of these companies.”

The third division is fintech and payments, anchored by their PayU operations. This continues to benefit from the shift in consumer behaviour to transacting online, as well as the digitization of smaller companies. Total payment value rose by 45% to $55 billion. Whilst this division as a whole is still loss-making (-$68 million), profits from payments are being used to fund and subsidise newer operations, such as Remitly (global money transfers) and their credit providers.

Finally, their fourth division, EdTech (online education), is the newest kid on the block. Some of their investments have been held for several years and were classified as possible new ventures. Covid has accelerated the trend towards online education – both at a secondary and tertiary level – so Prosus has upped its investment into this sector. It is early days for this division, but they estimate that the education market has a total opportunity of $10 trillion. They have invested $3 billion across nine companies/platforms to capture this opportunity. We believe online education is compelling, but are concerned that Naspers is spending a lot of money on as yet unproven opportunities. Time will tell whether these deliver on their promise.

Reducing the discount

As we have already alluded to, management is facing relentless shareholder pressure to unlock value by reducing the discount at which both companies trade to their respective underlying values. Shareholders have been expecting an announcement for ages, but when it came, it was underwhelming. It is a complicated transaction, but in effect, Naspers shareholders are being asked to swap some of their shares for Prosus shares. Whilst this does unlock value (an uplift of between 6% and 10% of net asset value depending on various criteria), and it will also reduce the weighting of Naspers in the JSE All Share Index (a key consideration for management), it also creates a complicated cross-shareholding structure between the two companies. Post the transaction, Naspers will own 57% of Prosus, but Prosus in turn will own 49.5% of Naspers. Older shareholders may remember the cross-holding that existed between Anglo American and De Beers, which was finally unwound in the early 2000s to a resounding cheer!

Tencent has had a weaker period of performance for various reasons; some of them are purely ‘local politics’ in China.

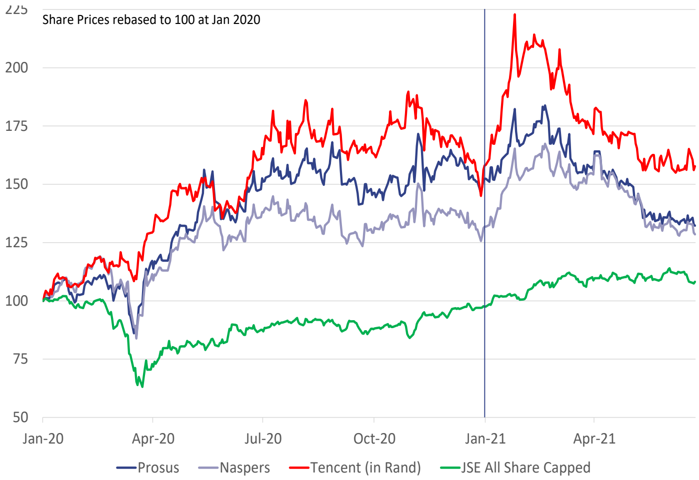
Generally, cross-holdings are not popular, and hence the proposed transaction has been greeted with great scepticism. Management has been exploring ways to unlock the discount for 18 months, and the fact that this is their best solution is an indication of just how complicated the tax and regulatory hurdles are that confront the Group. Shareholders must approve it for the deal to become effective, so the outcome is uncertain. If approved, shareholders will then have the option to either exchange 45% of their Naspers shares for Prosus shares or to do nothing. Unfortunately, like other transactions in the past, this share swap will be treated as a CGT event, so “one size does not fit all.” We will have to assess each client’s position separately to determine the optimal choice.

Despite the good results, both Naspers and Prosus have underperformed the broader JSE this year – and by quite a substantial margin. We ascribe this to various factors:

1. The general underperformance of the technology sector globally after the bull run of 2020.
2. Growing regulatory scrutiny in China, which has put downward pressure on the Tencent share price, despite Tencent itself growing revenues and earnings by 28% and 48% respectively for the year to March '21.
3. Unease and disappointment about the above transaction and the growing disillusionment with management that they are pursuing transactions that feather their own nest rather than truly unlocking value for shareholders.

In conclusion, we believe that we are close to maximum pessimism towards both of these companies. The discounts to NAV are almost at the widest ever, the rand is strong, and recent weakness in Tencent itself makes its own valuation less demanding, especially relative to continued strong growth. Despite the underperformance, we believe that portfolios must have exposure to the combined entity. We liken the situation to a stretching rubber band. The more it is stretched, the more likely that the pressure will be released, and the band will snap back. Management are not popular, but the pressure is relentless and building. At some point, we believe that the "band will snap"and those who have been patient will be handsomely rewarded. In the meantime, we are encouraged that the trends in the e-commerce portfolio are moving in the right direction. 2020 will be remembered for all the wrong reasons, but it was also the year in which the role and perception of technology changed forever. The Group is well positioned to benefit from this strange new world.

SHARE PRICE PERFORMANCE



Both Prosus and Naspers substantially outperformed the JSE last year, but that trend has reversed in 2021 as Tencent has declined 30% from its peak in early February. The fact that Naspers & Prosus have fared worse than Tencent indicates a widening of the underlying discount, despite the improving performance of their e-commerce portfolio.

Naspers / Prosus has quietly become a major global technology investor

Topic: **CANCELLED**

Please note, due to the concerns over the 3rd wave of Covid, Harvard House has decided to cancel our Insight presentations until further notice.

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Natal Midlands	
Date:	TBC
Venue:	Fernhill Hotel Midmar / Tweedie Road Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm

Johannesburg	
Date:	TBC
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am

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HARVARD HOUSE GROUP

3 Harvard Street, Howick, 3290, South Africa

P.O. Box 235, Howick, 3290, South Africa

+27 (0) 33 330 2164

+27 (0) 33 330 2617

@ admin@hhgroup.co.za

W www.hhgroup.co.za

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