Insight

3 July 2015

Recommendation summary

The value of Naspers is possibly the most irreconcilably contentious debate between bulls and bears in the local stock market. Bears argue along these lines: outrageously expensive, in a bubble, a price earnings multiple of 106x, dot.com boom madness, sell, the short of the decade, a fall into the abyss is but one final fool buyer away. Bulls argue along these lines: who cares about a price earnings multiple of 106x, it is a signal of investor confidence, a buy for a slice of the China century, a super normal growth miracle. Valuing Naspers is not quite so straightforward as using a PE ratio as it tells us little in isolation. My argument for some time has been that Naspers is not particularly expensive in relation to a reasonable assumption on business development, new ventures and organic evolution of the existing asset base. If the assumption is wildly optimistic then a correction would be in order at some point, not least in its largest investment Tencent. But absent a busted flush, an outright collapse is unlikely. Trading Buy and Portfolio Buy maintained with fair value at R2200 and target price at R2400.

Naspers

Valuation conundrum

A PE ratio in isolation tells us very little – it is simply a numerator (the share price) over a denominator (an accounting number we call earnings). It is insufficient on its own to prove or disprove whether something is cheap or expensive. This is especially the case with Naspers.

Much of the earnings are from equity accounted investments in which Naspers has no management control – for example 33,8% of Tencent and 29% of Mail.ru, both listed.

There are numerous minority stakes in unlisted companies such as 30% of Abril in Brazil, 18,3% of Flipkart in India, 33% of Level up!, 21,5% of Avito in Sweden, 27,8% of Vtex in Brazil, 29,7% of Neralona in Russia and 26,1% of SimilarWeb in Israel.

Naspers has majority ownership of two key cash generating assets in particular. MultiChoice and Novus together I estimate will make around R12 billion in EBITDA for the year ending 31 March 2016.

MultiChoice and Novus are by far the largest cash contributors to Naspers and their importance way exceeds their market value, which in many respects gets hidden or ignored within the group.

This cash is very important as the equity accounted investments, whilst valuable from a market value point of view, don't pay the rent.

The top line and EBITDA look impressive at first glance – R132,5 billion in revenue and R26,1 billion in EBITDA for the year ended 31 March 2015. This assumes equity accounted investments are proportionately consolidated.

So let's take Tencent for example. The proportionate share of revenue is R47,9 billion. That is about RMB27 billion or 34% of what Tencent actually generated in revenue. For the year ended December 2014 Tencent generated RMB78,9 billion in revenue, an increase of 30.5%.

Similarly with EBITDA. Naspers records R19,8 billion from Tencent which is about RMB11,2 billion and compares with the RMB32,7 billion earned in 2014.

To put Tencent in perspective, the revenue and EBITDA in F2014 was the equivalent of $12,7 billion and $5,3 billion respectively for a margin of 41,4%.

Once the associates and joint ventures are backed out, Naspers reflects revenue of R73,1 billion and EBITDA of R6 billion rather than R26,1 billion. Trading profit is R3,2 billion. This is after ecommerce has made a loss of R6 billion and corporate services have cost R338 million.

Most of that revenue is generated by Video entertainment at R42,4 billion (largely MultiChoice) and Print media at R12 billion (including Novus at R4,2 billion).

The only cash banked up until 31 March 2015 from equity accounted investments was R1,06 billion. That is largely dividends from Tencent.

Tencent declared an annual dividend of HK$0,36 for 2014 which is the equivalent of $435 million, up from $290 million the prior years. Naspers shares in those dividends to the extent of $147 million and $98 million respectively.

My forecasts for future Tencent dividend payments are below.

Tencent dividend payments	RMBm	USDm	ZARm (R12)
F2014 (actual)	2 700	436	5 226
F2015	3 608	582	6 983
F2016	4 739	764	9 172
F2017	6 115	986	11 835
Naspers dividend income	ZARm at ZAR12 to USD		
F2014 (actual)	1767		
F2015	2360		
F2016	3100		
F2017	4000		

Operating cash flow was R6,47 billion for the year which together with the R1,06 billion in dividend income resulted in cash generated from operating activities of R7,54 billion. Net cash generated after interest and tax was R1,67 billion. Net interest paid is R2,82 billion. Other calls on cash included tax at R3,84 billion, capex of R3,28 billion and finance leases of R932 million. Free cash, after dividends received, is minus R515 million.

The cash flow situation and investment for growth strategy also explains the modest dividend that Naspers pays at 470 cents per listed N share, up 11% this past year and six times covered. The cash outflow on that is R1,9 billion. After withholding tax the yield is a modest 0,2%.

So we have cash generated of R1,67 billion against which there is a net R6,02 billion used for investing. R1,14 billion came in from the listing of Novus.

The balance sheet reflects net debt of $3,2 billion or R39 billion with cash offset of R14,6 billion of which R6,3 billion is in South Africa.

Development spending continues to subtract considerably from earnings, R2,64 billion for F2015. And so the traditional businesses, such as MultiChoice and Novus, are invaluable contributors to Naspers. Without that there would be a cash constraint on investment in etail, classifieds, online and payments, etc.

Earnings are thus depressed by the ecommerce investment. Core headline earnings of R11,22 billion, up 30% this past year, would have been around R14 billion if ecommerce had broken even. Similarly, trading profits would have been over R9 billion excluding equity accounted investments.

The equity accounted assets contribute R14,09 billion to those adjusted headline earnings. Tencent is the largest at R14,59 billion, Mail.ru contributed R983 million and there were losses from other investments of R1,48 billion.

Tencent’s earnings contribution in isolation is therefore 3615 cents per share – which is 30% more than the adjusted group EPS. But again, this is not mirrored by a commensurate cash flow contribution.

The value of ecommerce lies in the future. The investment is being expensed and detracting from profits. Revenue last year grew 36%. If this is a R50 billion a year revenue cluster in the next few years, yielding a margin of say 30%, then we have a potential R15 billion profit. Even if I discount this to R5 billion for a present value EBITDA it suggests a potential future worth of R100 billion at a 20x multiple.

If and when ecommerce kicks in then earnings will be considerably enhanced. But that will still mean that equity accounted results will remain a meaningful part of the earnings of Naspers.

A price earnings multiple therefore takes no account of this future earnings stream. There are a combination of loss making and profit making assets so the share price over the earnings per share is inflated.

There is capital employed not earning its keep just yet. The return on opening equity that Naspers made in 2015, excluding abnormal gains, was 11%. This is paltry for such profitable assets. Even on an adjusted basis it was 17%, still quite low. Tencent made 41,8% ROE in 2014.

Mail.ru generated a 51% EBITDA margin in F2014 and Tencent a 41% EBITDA margin. The MultiChoice South Africa business generates an EBITDA margin of 36%.

If ecommerce had generated a similar performance to these other assets in 2015 rather than generating losses the addition to profits would have been in the order of R15 billion. At the bottom line, this would have resulted in return on opening equity increasing to over 35% on an adjusted earnings basis. It would also have resulted in EPS increasing from 2782 cents to about 5800 cents, roughly doubling EPS.

The official statutory EPS for the year is 3475 cents, which includes R5,61 billion in remeasurement gains which are non-cash. Excluding this and other non-cash items, headline adjustments and amortisation of intangibles results in adjusted earnings per share of 2782 cents.

The headline EPS of 1792 cents is the official EPS that the JSE would use but is not entirely representative of the underlying operating result. And it is this that gives the PE ratio of 106x.

Let's rather contrast that with Tencent as a listed entity and without the noise that comes from equity accounting within the Naspers result.

For the year ending December 2014, Tencent earned RMB2,58 per share. There are 9,376 billion shares in issue and the net result was RMB24,22 billion. This year I anticipate RMB3,54 in EPS or RMB33,2 billion in earnings – up 37%. EBITDA for Q1 2015 was up by 47,5% with adjusted net income up by 35,8%.

The table below shows the dramatic difference between the Naspers PE ratio and the Tencent PE ratio. Naspers is on a PE of 106x or 68x on an adjusted basis. Tencent is on a trailing PE of 48,5x based on a share price of HK$156,5 and a forward PE of 35,4x.

If I had to assume ecommerce kicking in and contributing fully in 2016 (an unlikely scenario) then the Naspers adjusted PE drops to 33x.

If one wishes to use a PE as a gauge, then the fully consolidated results of Tencent are a far better yardstick of relative value and in keeping with a business growing at over 30% for the foreseeable future.

NPN share price cents			
190 000			
Price earnings ratio	F2015	F2016	
Attributable EPS	54,7	82,2	
Headline EPS	106,0	82,2	
Adjusted EPS	68,3	53,4	
Tencent EPS	52,6	40,1	
ecommerce hypothetical per above		32,8	
		HKD	RMB
	700:HK	156,5	125,2

Tencent RMB	EPS	DPS	PE ratio
F2014 (actual)	2,58	0,29	48,5
F2015	3,54	0,38	35,4
F2016	4,65	0,51	26,9
F2017	6,00	0,65	20,9
CAGR	32%		

I have included my updated sum of the parts and discounted cash flow estimates for valuation purposes which uses a mix of valuation metrics.

Tencent's valuation on a sum of the parts basis I estimate at approximately HK$198, about 25% more than the current share price. The Naspers share of that is R970 billion or R2355 per share at an exchange rate of R12 to the US dollar.

On a free cash flow valuation, with terminal value on EBITDA, I arrive at HK$233 per share. This translates to R2660 per share.

I am getting to an indicative valuation of R233 per share for MultiChoice, about R10 per share for Novus, R38 for mail.ru at the current deflated market cap, and a present value of R243 per share for ecommerce.

Net of debt and head office costs I get to an indicative value for Naspers of R3136 per share. Assuming a fair value discount of 30% that gives me a price of R2195 per share.

This calculation indicates the Tencent proportion of market value falling to below 85% from around 100% now. If anything that may be too conservative in respect of the other assets and it is feasible for these to be possibly as high as 70%.

Naspers has both a high nominal price at R1900 (the highest on the JSE) and a high valuation at R785 billion or about 7% of the total JSE market value. We can be thankful that Naspers is not a Berkshire Hathaway at $206 000 per share.

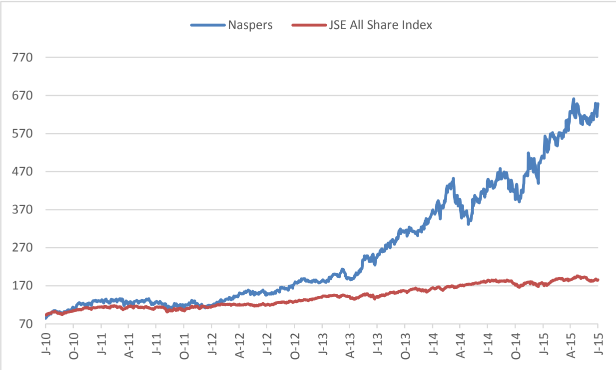
Whilst Naspers appears pricey that does not mean it is a poor investment or does not offer further upside nor is this a true reflection of what normalised and hopefully sustainable earnings could be like once the developmental assets start contributing.

Tencent sum of the parts	RMBbn F2016 earnings	PE target	RMBbn value	RMB per share	HK$ per share
Social networking	11,5	32,0	368	39,2	49,1
Online gaming	25,0	20,0	500	53,3	66,7
Online advertising	7,5	32,0	240	25,6	32,0
Other	0,0		300	32,0	40,0
Cash			75	8,0	10,0
Total	44,0	33,7	1 483	158,2	197,7

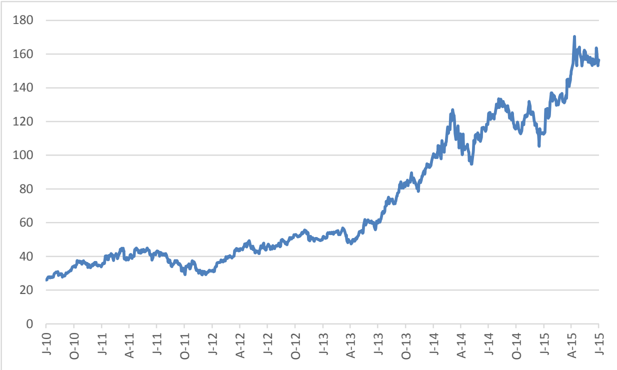
Shares in issue billion		USDbn	239
	9,376	ZARbn (R12)	2 870
		NPN % share	970,2
Free cash flow RMBbn		NPN cps	2355
Terminal EBITDA	140	Tencet market cap 700:HK	
Terminal EBITDA multiple	20	HK$ bn	1,467
NPV of cash flows	200	US$ bn	189,3
Terminal value	2 800	ZAR bn	2 291
NPV of terminal @13%	1 400	NPN 33,8%	774,2
Total enterprise	1 600	Per NPN share	1 879
Net cash	75		
Equity valuation RMB bn	1 675		
Equity valuation HK$ bn	2 094		
HK$ per share	223		
Equity valuation in USD bn	270		
Equity valuation in ZAR bn (R12)	3 242		
Naspers share in ZAR bn	1 096		
NPN cps	2660		

Multichoice	
EBITDA Rbn	10
Multple x	12
Equity value Rm	120
Naspers share Rm	96
Per NPN share R	233
Novus	
Market value Rbn	5,3
Naspers share	4,0
Per NPN share R	9,6
Mail.ru	
LSE market value $bn	4,5
Naspers share 29%	1,3
Naspers value in ZAR at R12	15,7
Per NPN share R	38
Ecommerce	
Future sustainable revenue Rbn	50
Sustainable EBITDA margin	30%
EBITDA Rbn	15
Discounted to PV	5
Multiple	20
Value ascribed	100
Per NPN share R	243
Net debt and head office Rbn	25
Total value Rbn	1 292
Per share R	3 136
Fair value on 30% discount R	2 195

Naspers and JSE All Share Index based to 100



Tencent share price in HK$



Naspers share price in ZAR cents