Naspers & Prosus – more musical chairs?

Commentary April 2021

SA equities underperformed developed market equities in April, however for the year-to-date SA continues to outperform by wide margins. A summary of equity returns is set out in Table 1 below.

Table 1. South African and global asset returns for April 2021

SOUTH AFRICA & GLOBAL (ZAR)		Apr-21	YTD 2021
SA Equity	FTSE/JSE ALSI	1.0%	14.2%
Global Equity			
- Developed markets	MSCI World	2.8%	8.4%
- Emerging markets	MSCI EM	0.7%	3.5%
SOUTH AFRICA & GLOBAL (USD)			
SA Equity	FTSE/JSE ALSI	2.8%	15.7%
Global Equity			
- Developed markets	MSCI World	4.7%	9.8%
- Emerging markets	MSCI EM	2.5%	4.8%

Source: Factset

Naspers and Prosus recently announced a proposed voluntary offer to Naspers shareholders to exchange their Naspers shares for Prosus shares. While this occurred in May, Naspers and Prosus are very significant to the South African market therefore we discuss the announcement in this month's commentary.

Brief review

Naspers shareholders will be given the opportunity to exchange their Naspers shares at a small premium of 2.4% based on share prices on 11 May. The transaction is stated to benefit Naspers shareholders by offering a relatively less discounted asset for a relatively more discounted asset. It is further intended to benefit Naspers and Prosus shareholders by closing the discount to Tencent, the Chinese reference underlying asset. This would occur because Prosus will issue new shares to fund the Naspers purchase, increasing its free float and becoming a top 20 stock in Europe, thereby increasing index fund and institutional investor interest. As a by-product, Naspers's free float would fall, decreasing its weight in JSE indices, while Prosus's weight would rise.

By way of background Naspers had traded at a discount to the value of its underlying Tencent holding averaging 35% for some years. Prosus was listed in September 2019. After some initial volatility, Prosus's discount to Tencent averaged 35% while Naspers's discount averaged 50%.

Does it make sense?

Several factors would merit consideration.

1. **Holding company discounts**

Prosus's listing created a holding company while Naspers became the holding company of a holding company. Since holding companies attract discounts, Prosus adopted Naspers's previous discount, while Naspers's discount increased even further as a discount to its underlying asset, Prosus. Perhaps there is no surprise in this outcome and Naspers shareholders have been rewarded with a further discount.

2. Free floats

At the time of the Prosus listing in Amsterdam, it was stated the Prosus price would increase and reduce the discount to Tencent due to Prosus's smaller free float. Today it is said Prosus will attract interest and increase its share price due to its *larger* free float.

3. The exchange premium

Naspers shareholders receive a small premium (2.4%) for exchanging shares, plus any favourable relative price movements from the date of the announcement. The premium itself is unlikely to entice a shareholder to exchange shares. Both Naspers and Prosus have been trading for some time. It would be expected that shareholders who wanted to exchange their shares would have done so.

4. The exchange ratio

The issue of the "premium" above is itself a little disingenuous. Without getting into the technicalities, Prosus is offering Naspers shareholders 2.3 Prosus shares for each Naspers share held. A fairer offer, allowing for the same underlying assets (Tencent etc) and the market value of Naspers's Prosus holding, is 2.7 shares.

5. A less discounted asset for a more discounted one

Naspers/Prosus presents a key benefit to Naspers shareholders being the exchange of a more discounted asset for a less discounted one. The fact is Naspers shareholders had their shares discounted further in the first place by Prosus's creation. This transaction returns them to their previous discount (not quite, per point 4 above). So the "benefit" merely rectifies, to a point, the damage done by Prosus.

Over and above this, one wonders about the benefit of receiving an asset with a smaller discount that never closes. This may not ultimately turn out to be correct, however currently the only benefit Naspers shareholders receive is a small premium to their existing holding, nothing more.

6. Tax liability

As has been widely reported, Naspers shareholders choosing to exchange shares will trigger a CGT event.

7. Summary

In an effort to address the discount Naspers turned itself into the holding company of a holding company. It is now introducing cross-holdings between the two holding companies. This may bring the benefit of reducing Naspers's weight in the index for technical reasons, with a less than commensurate increase in Prosus's weight, without altering fundamentals. There appear to be limited additional benefits. Closing the discount would appear to depend solely on additional index fund demand, since all other investors are aware of the two companies (three including Tencent) and are able to trade them on various exchanges. The argument appears tenuous.

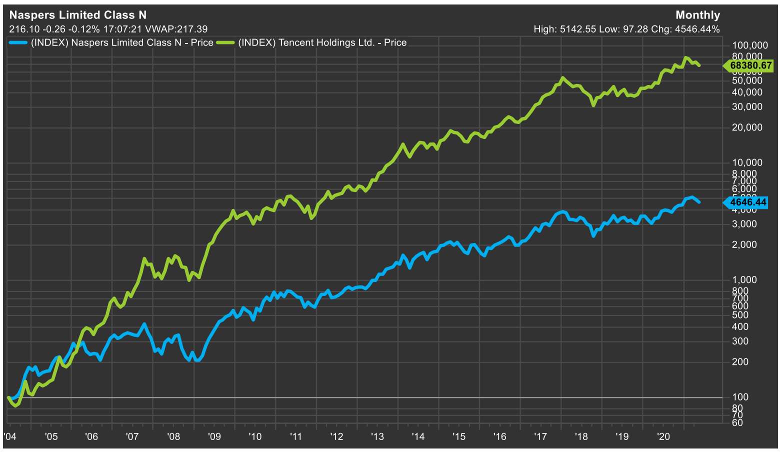
The creation of Prosus has damaged Naspers shareholders. A likely outcome of this latest proposal appears to be *a further increase in the discounts of both shares* due to the additional complexity introduced.

The saving grace through these contortions appears to be the good performance of Tencent which has lifted Naspers and Prosus with their discounts. Tencent is the elephant in the room and we next consider whether Naspers and Prosus are attractive investments at all in relation to Tencent.

Tencent

The performance of Tencent and Naspers, since Tencent's listing, is compared in Chart 1 below in USD.

Chart 1. Cumulative performance of Tencent and Naspers in USD since listing

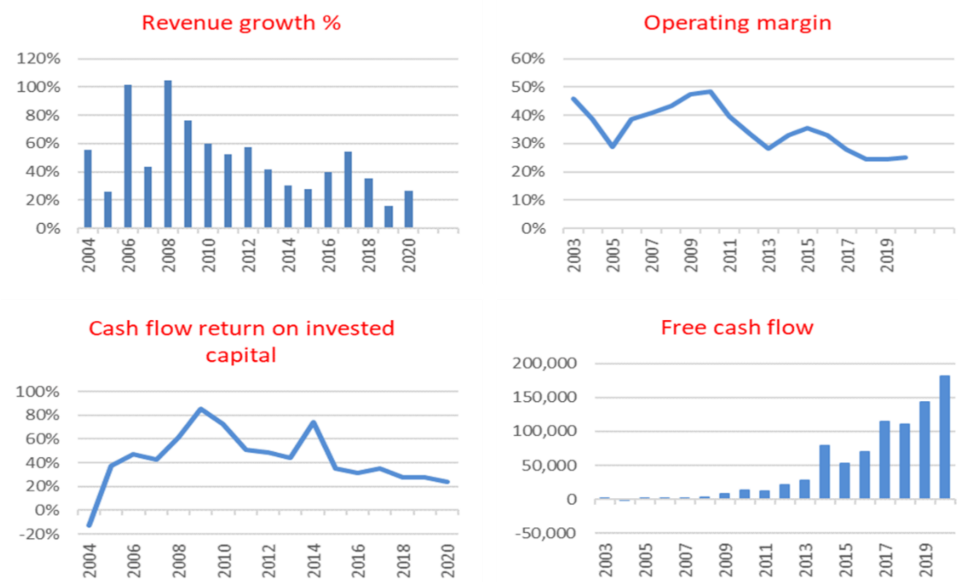


Source: Factset

Tencent has outperformed Naspers since listing, in constant currency terms, by a factor of 15. A different way of appreciating this is to note that since listing Tencent has returned 684x money. Naspers in contrast has returned 46x. For context, private equity funds are considered excellent if they deliver 3x and venture capital funds 10x, admittedly over shorter time periods.

For investors not constrained by domestic benchmarks or exchange control regulations, a clear choice is to not be involved with either Naspers or Prosus and to invest directly in Tencent. Yet even investment in Tencent carries risks. Chart 2 below sets out sample metrics for Tencent since Tencent's listing.

Chart 2. Operating performance of Tencent since Tencent's listing



Source: Factset

Tencent's operating metrics from Chart 2 are declining as the company matures although it will likely remain a good investment for some time. Note however, that Tencent has returned 67x since the financial crisis. Excellent but still 10x less than the return for the full period since listing. The future probably holds good but ever-lower returns, which are then still lower for Naspers and Prosus. In the meantime both the creation of Prosus and now the proposed introduction of cross-holdings bear the distinct hallmarks of investment bank involvement which Naspers/Prosus is buying into, no doubt with large fees attached. This latest proposal is also unlikely to be successful.