SoftBank

& its Multi-Billion Dollar hit from BAD BETS

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Getting Started

SoftBank Group Corp. Vision Fund business lost **USD 17.7 Billion** last fiscal year after writing down the value of investments, including WeWork and Uber.

SoftBank's Masayoshi Son has gone from being a visionary identifying start-ups with great potential like Alibaba to the point where he's **questioned about his judgment**.

With the fund having poured Billions of dollars into money-losing companies like WeWork, Uber and Oyo, Son and his cohorts have been left without a return on their giant investments.

While rational investors may look into business model , Son, in his words, looks for **spark in the entrepreneur's eyes**. While looking for spark may work when it comes to finding a life partner, it sure isn't the best strategy when it comes to partners in Investments.

In this article we aim to see where does SoftBank's investments stand with this gut driven strategy and how Softbank chooses to ignore major red flags time and again which as a rational investor you should not.

Without further adieu, let's start the journey on this roller coaster ride which only goes down.

Uber

Softbank's Relationship with Uber dates back to **2017**. Uber's valuation was touching new all-time highs when SoftBank decided to invest Billions of dollars in the world's most valuable start-up.

Softbank purchased **USD 8 Billion** worth of Uber's secondary shares from early investors and employees in January 2018 at a discounted valuation and introduced USD 1.3 Billion as fresh capital for a **17.5 %** stake. SoftBank bought shares from existing investors for USD 48.77 and purchased new shares at just under USD 33 hoping this start-up would be **another Alibaba** (something Masayoshi Son very conveniently believes for any other start up he invests in). SoftBank's investment valued Uber at roughly **USD 70 Billion**. Every start-up is not Alibaba, or Amazon, at least not Uber. Now, where does this USD 70 Billion valuation comes from is a mystery.

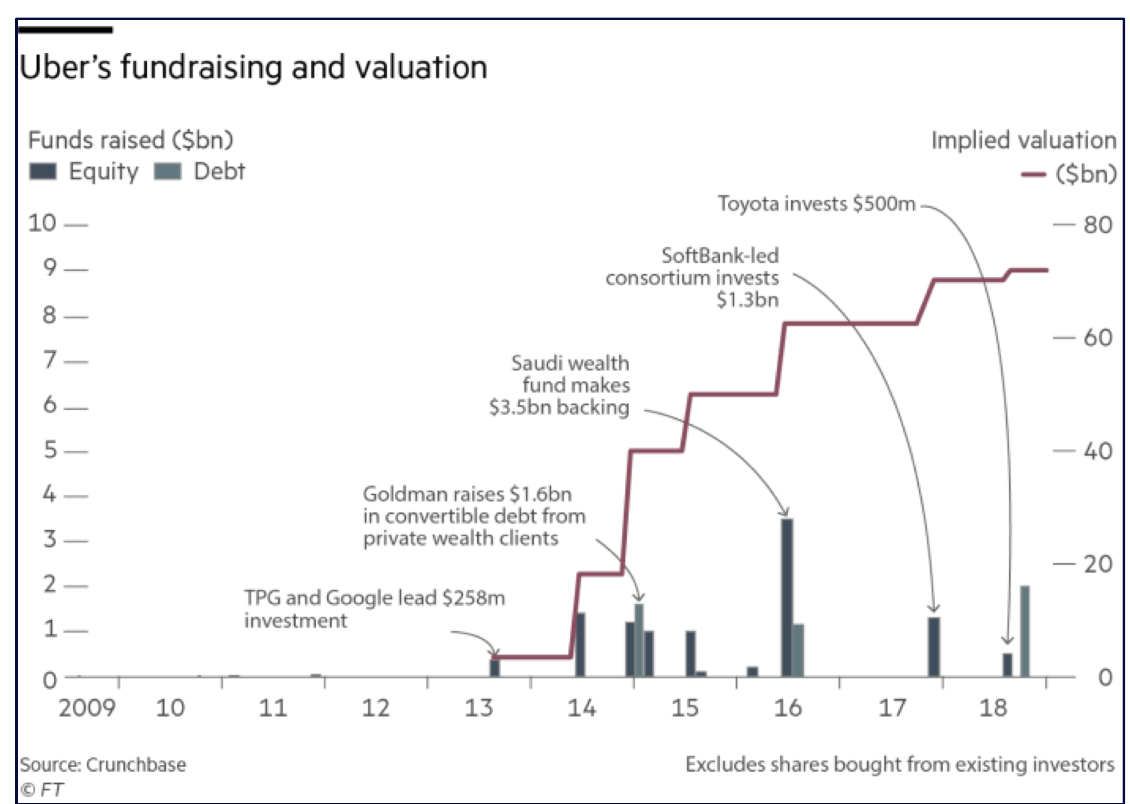
As soon as Uber went public, its **real valuation** came into picture. Stock prices dropped as the investors saw beyond the fancy business model of Uber and analysed what profits it holds for its shareholders. And without a doubt, there were none. For Uber has been **swimming in losses** ever since it started its business in 2010.

Fast forward to today, Uber's share price still revolves around **USD 33 a share with a market value of USD 58 Billion** and is still a proud owner of losses reported every quarter, every year, time and again. Out of the famous USD 17.7 Billion loss of SoftBank's Vision Fund, The drop in Uber's share price was responsible for USD 5.2 Billion of its losses in the period. Uber **loses 25 cents on every dollar it brings in**. In fact, research from Recode shows Uber loses an average of USD 1.20 on every ride.

What is wrong with losses, you may ask. Doesn't every other start-up make losses in the beginning until they build their base in the Industry to rise and shine? Well, that's the issue, Uber is **no longer a start-up**, it has been in business for the last 10 years.

Yes, 10 years of business, with no profitability.

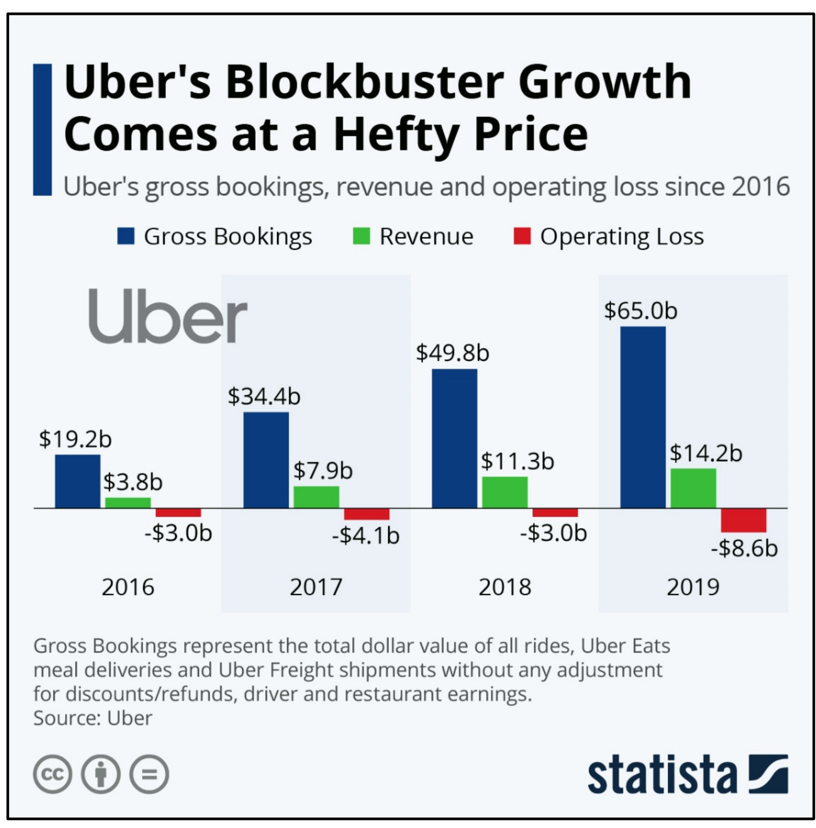
If that doesn't give you a **red flag** what will? But I'll still point out all the red flags just in case you decide to get your rose-coloured glasses off.



For someone who has already invested a lot of money in it, hope lies in the future, that somewhere sometime Uber will become profitable.

Let me tell you a story of a room full of investors. First they are explained about an investment in a project, the project faces high competition and is unlikely to make profits for the next 5 years. The investors look at each other, they take a second, and all of them vote not to invest. Then, the missing piece of the puzzle is revealed, that being, that already a huge investment has been made in the past. More than half of the investors, now, vote in favor of the investment.

What happened? It's simple, when your money is already poured into a project, you no longer see it in the same way. A **bad investment** may turn into **hope**, hope that someday it's going to bring back the money you invested. But will that ever be the case with Uber? For that let's see what is wrong with Uber now. Why is it in losses and if these losses could ever be turned around.



Uber is a **ride hailing app.** It doesn't own any cars of its own but instead provides a platform for drivers to connect with people who want to travel and in turn take whooping **20% share** as its cut with **little investment** in any assets. Seems like a fancy business model. But fancy business models don't make a business profitable. If I had to put it in one line, **"Uber is a cash burning machine."**

As I had mentioned, only 20% of the revenue goes to Uber. The rest **80%** goes straight to the **drivers**. This 20% is not enough to cover its expenses which explains the huge losses that Uber makes. Uber has to spend a lot on **promotion** owing to the tough competition in the space. And then there are the **administration costs** including employees' salaries that it has to cover.

That is how the magical effect of leverage works when you increase the scale of your business. But, Uber doesn't fall in that category. It's unable to cover its operating costs which are variable in nature and a lack of fixed cost component would not help resolve the issue in the future. When revenues rise, so will the operating costs.

What I am trying to say is the scenario you see now, will hold true for the company in the future. So why doesn't Uber do something about its **profit margin**? Glad you asked. The answer is simple. It can not. It can neither increase its revenue nor decrease its costs because of the high bargaining power of buyers as well as the suppliers that prevails in the ride-hailing apps Industry.

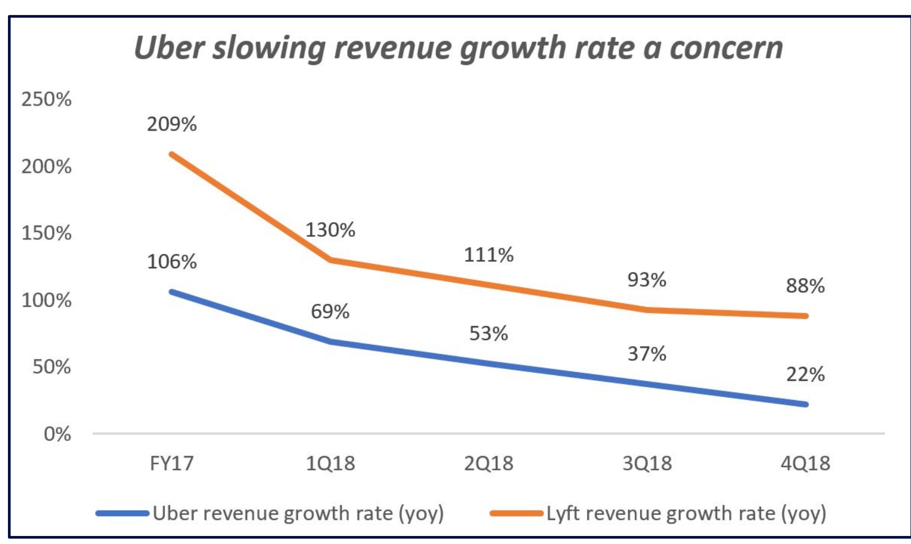
There is lot of **competition** in the Industry with Lyft, Ola and Didi providing similar kind of services. On top of that, the entry cost is not high, making the competition not just fierce, but never ending. So, if you sat down to do a Porter analysis for the Industry, don't be surprised if it's the saddest thing you see after Elon Musk USD 14 Billion losing tweet.

The fierce **competition, similar features and low switching costs** gives the high bargaining power to consumers. You can have 5 ride sharing apps on your phone and go with whichever one gives you a lower price. What does Uber offer that'd make consumers stay on its platform if it raises prices?

Let's look at the **supply side** now. It is easy to join Uber and other ride-hailing companies as a driver. Anyone and everyone with a car can be a driver. The bargaining power of drivers is low but likely rising. Every time Uber tries to cut driver's share it receives huge backlash. So, **cutting costs** is also not a great option.

With the current business model Uber is a **loss making machine**. What could help it grow? It might be cargo, or it might be autonomous driving (definitely not food delivery which faces furious competition of its own).
But not so much, if it keeps killing people with its self driving cars, like it did in Arizona.

Unless they start owning vehicles or find a new model or maybe somehow reduce the switching costs of customers so it can increase prices (which is easier said than done) Uber will never be the investment Softbank so blindly sees it to be.
For now, if you do see all the red flags, **Uber is a bad bet**.



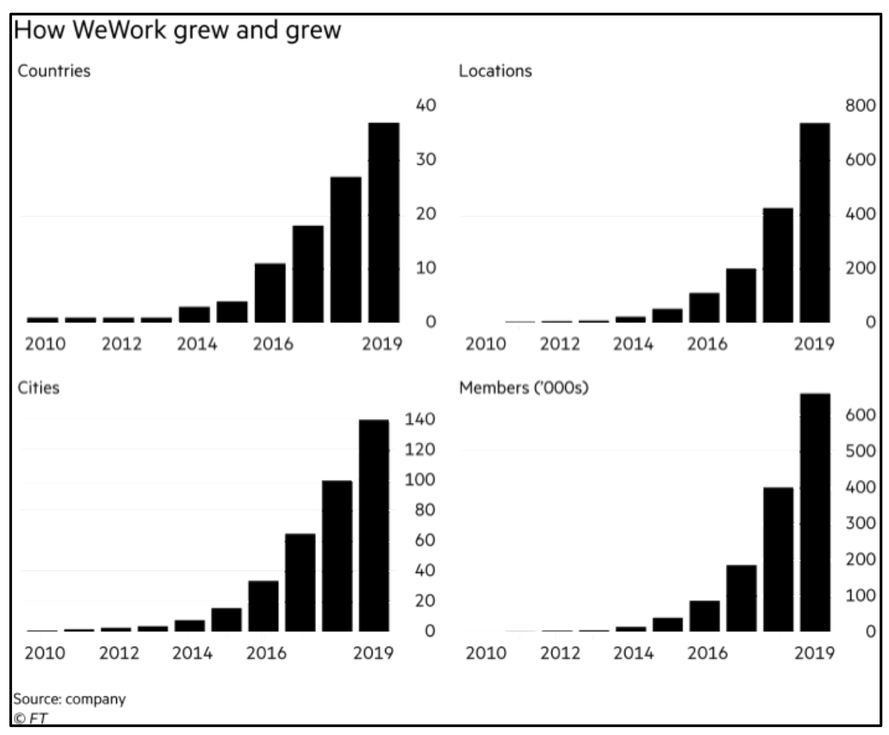
"Uber's growth is slowing down, and the costs are not slowing down," Allon, professor of Operations, Information & Decisions, Wharton University said.

wework

WeWork, with its pinball tables, meditation rooms and beer on tap, went beyond simply offering **short leases** to start-ups in need of flexibility. It would offer a physical **social network** to a generation of millennials wondering whether there was more to life than their screens. However, the poster boy of the co-working segment **lost** more than **USD 40 Billion in valuation**-from USD 50 Billion to USD 8 Billion-in less than a year. It was an implosion unlike any other, but one that was not altogether unexpected.

How WeWork Grew & Grew?

WeWork is a **low margin** business, meaning its service sells for very close to the price that it costs the company to get the real estate it leases out. WeWork had consistently promoted itself as "**asset light**": its buildings leased from developers, then, after being **subdivided, rented out on a short-term basis**. So it's **a simple real estate company** doing nothing different except adding the word community building to it, (giving it the valuation it nowhere deserves). But because of its pretensions to being a **technology company**, the offering to tenants is **famously flexible**: you can rent month to month and can easily expand or shrink your space according to your needs. For WeWork, this means that the revenue can vary substantially over a year but would still have its own lease payments to contend with. The company is essentially **renting long** and **subleasing short.** The amazing interior designing that you see at a WeWork workplace does not come cheap and on top of that there are commonplaces for people to enjoy, spaces that bring no revenue, spaces that still cost a lot (property rates in US are not a joke).



So, the **business model** is **extremely** flawed ,that's no mystery. How SoftBank chooses to ignore it is one. How does it project the demand for short term renting to keep spaces occupied? WeWork uses **machine learning** to project demand. And that makes it a technology company. Because of course, that is all you need to call yourself a technology company these days to get funding from investors such as SoftBank.

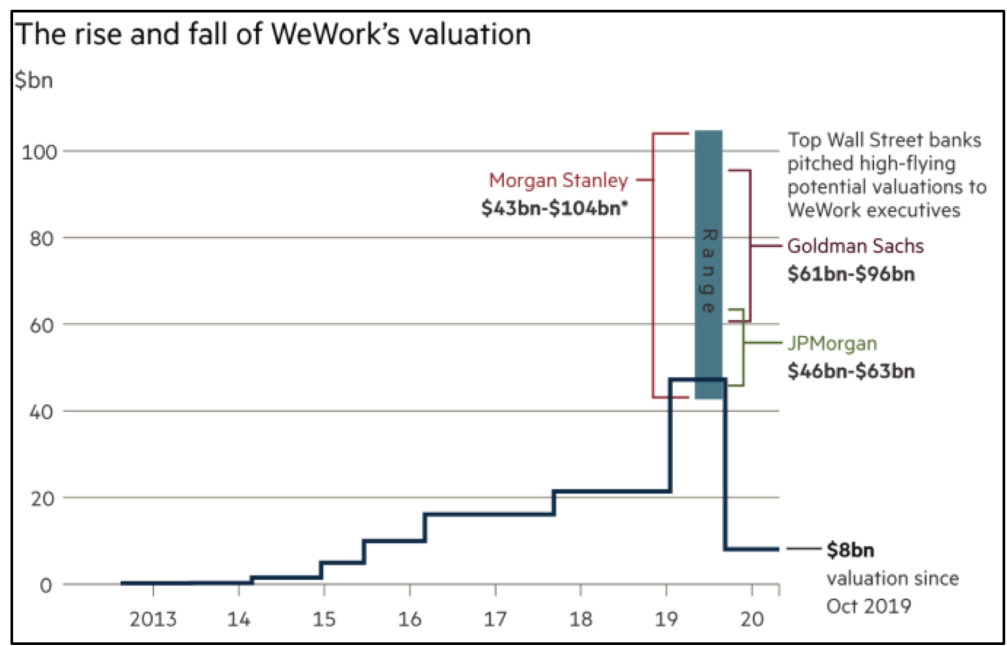
Neumann liked to boast that it took just **28 minutes** for Son to decide to buy into WeWork because that's all the time you need when your investment decisions have nothing to do with analysing business models. In 2017, SoftBank & its USD 100 Billion Vision Fund invested USD 4.4 Billion at a USD 20 Billion valuation — one of the largest investments in a private company in history.

In 2018, SoftBank committed another USD 4.25 Billion, making WeWork one of the world's leading "unicorns": start-ups that had achieved price tags in the Billions of dollars without going public . Because one bad bet was not enough.

WeWork had surfed a unique economic moment: the financial crisis had left swaths of prime office space empty and laid-off workers were starting afresh as "gig economy" freelancers. With interest rates at historic lows, private markets boomed as investors chasing higher returns competed to fund a new generation of founders. This is the opportunity WeWork capitalized on. But in their search for the next Amazon, these financiers valued disruptive but loss-making companies in ways that stock market investors barely recognized.

What led to the fall of WeWork?

If a unique market moment propelled WeWork's rise, what dragged it back down were forces that have reasserted themselves throughout business history: hubris, greed and the gravitational pull of cold, hard cash.

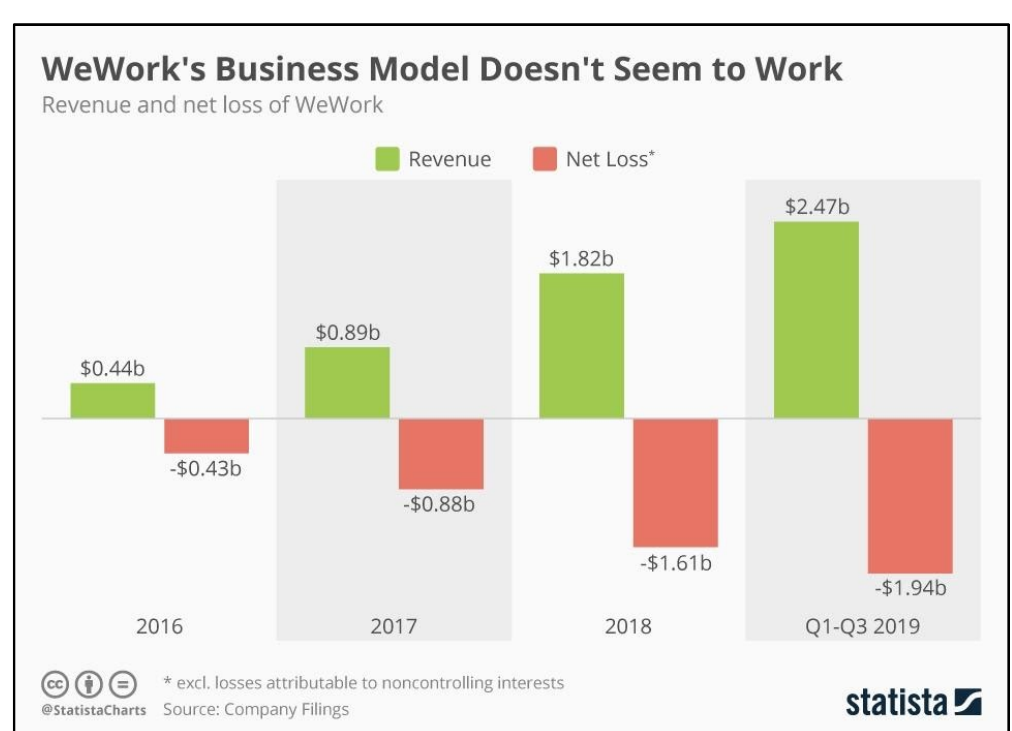


Until August 14th last year, everything was going well for WeWork. With revenue growing more than 100 per cent each year along with rapid expansion across the US and rest of the world, the brand was ready to go public.

But soon after it filed its S-1 paperwork with the Securities and Exchange Commission (SEC), things began to unravel. The paperwork showed WeWork had hundreds of **Millions of dollars of debt**, which reportedly caused investors to question the company's USD 47 Billion valuation, and whether the company's business model was working. Wait, aren't tech-companies low on borrowing? Real estate companies buying assets on lease are not. And that is exactly what WeWork is, a real estate company with a **questionable business model** and inflated valuation. The public seemed to have seen what Son did not including massive amount of its losses—reportedly more than USD 200,000 every hour—immediately became apparent. There were issues simmering within, like massive cash burn, **questionable corporate governance structure** and a bloated **valuation driven purely by SoftBank** funding rather than true market perception. On top of that, the founder selling his shares just before the IPO does not give a lot of confidence to the investors either.

The result? After rapid **drop in valuation**, WeWork had to shelve its IPO indefinitely, amidst layoff considerations and the eventual resignation of the maverick Adam Neumann as CEO.

As mentioned before, WeWork's business model is entirely flawed making it **another loss making machine** being funded by SoftBank's on demand money showers.



Now, what was Neumann supposed to do with so much money that he raised with his story telling capabilities? Invest in totally **unrelated business** including one that operates in creating artificial waves. Don't bother to ask, I don't have an explanation for this and neither does Neumann. Maybe it was the hope that some business was going to be profitable because this co-working space business was not going to be. But Neumann did not care about profitability, he didn't with his previous start-up and he didn't this time either as long as his pockets were full. Neumann may be a smart story teller, but he sure isn't a man of ethics.

According to The Wall Street Journal, Neumann made Millions on the side by **leasing buildings** he partly owned back to WeWork and he cashed out USD 700 Million in stock options before the company's IPO. Neumann attempted selling a USD 60 Million private jet and paying back the USD 5.9 Million the company paid him to use the word **"We" as a trademark.** Added to this was the highly chaotic way in which the company functioned, with a multi-class stock structure that gave Neumann **20 votes** to every one vote regular shareholders, which due to investor pressure, got reduced to a ratio of 10:1, which was still very high.

The **bubble** eventually burst and the start-up once valued at USD 47 Billion (purely based on Neumann's story telling power of building a community that learns and grows together), was now worth less than USD 5 Billion.

As Damodaran's IT theory rightly points out, if IT does not affect your cashflows, IT does not affect your value. IT is merely a weapon of distraction.

WeWork failed to measure their execution capability at every step of their expansion, instead of making decisions based on hype and bias.

One of the biggest lessons to be drawn from the WeWork story is the fact that the DNA of co-working industry lies in **real-estate** and not in tech. Tech can enable a community to survive, but real-estate is the basic transactional currency one is dealing with here, and it is important to realize its cycle and operate the business accordingly.

A great **problem-solving idea** is not enough to drive **a business's profitability**.

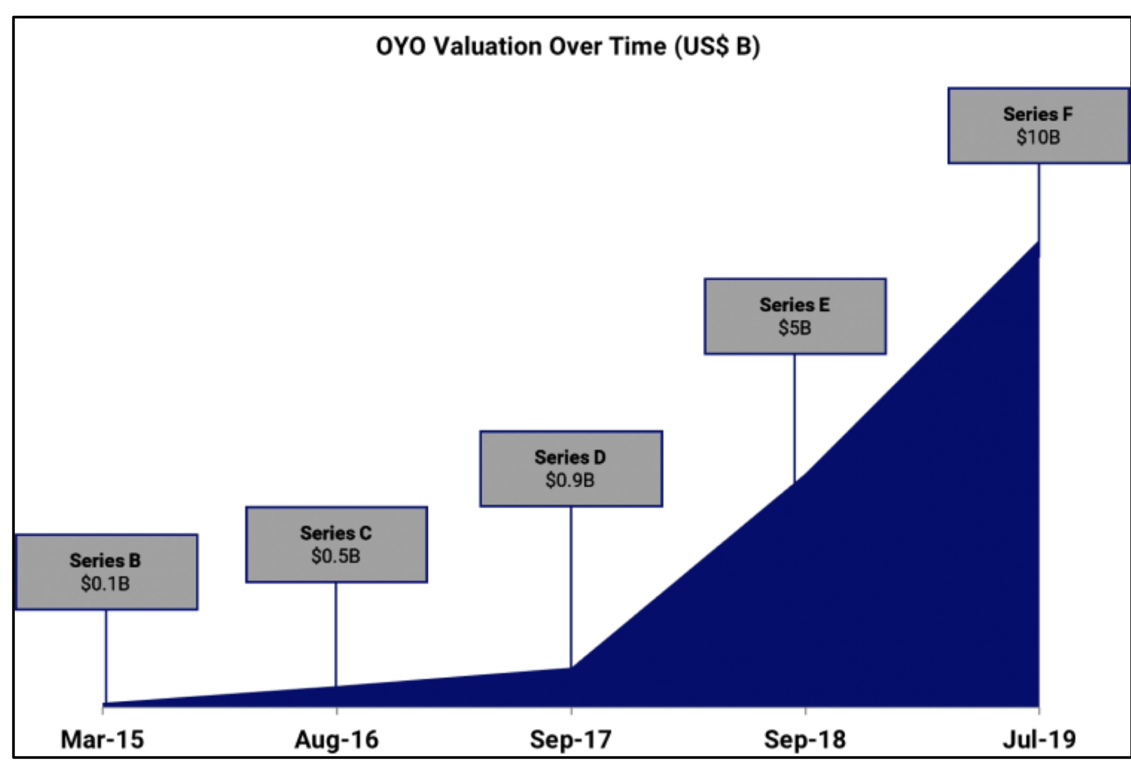
> **"How do you change the world? Bring people together. Where is the easiest big place to bring people together? In the work environment," WeWork's messianic former CEO & co-founder Adam Neumann said.**

SoftBank invested USD 100 Million in Oyo in 2015. It has been the **lead investor** in every round since then. SoftBank poured USD 162 Million in 2016, USD 250 Million in 2017 but **the big break** came in 2018 when it poured USD **1 Billion**. SoftBank owns **42%** of the start-up that stands at a valuation of USD 10 Billion. Yes, that's right. But is Oyo really worth a USD 10 Billion, or is it another bubble that's going to burst in Softbank's face?

Spoiler alert. It's the latter.

The hotel chain has been reporting net losses for several years in a row. Losses increased from USD **52 Million** in FY18 to USD **335 Million** in FY19, according to the company. So, the start-up has been swimming in losses for the past few years and still stands at a 10-unicorns valuation, it must have a great growth potential right? I wish that were true, but considering how Oyo has been operating for some time, that seems like a distant dream.

It's not a rare sight that start-up valuations are **a progeny** of its founder's story telling powers. Mr. Ritesh Aggarwal had been no different, giving Oyo the valuation it has today. Aggarwal believed Oyo was on its way to becoming the largest hotel chain in the world by 2023 (by room inventory) led by three pillars: customers, employees, and the leadership team. All of which are shaking enough to bring everything down with them, but we'll get to that later.

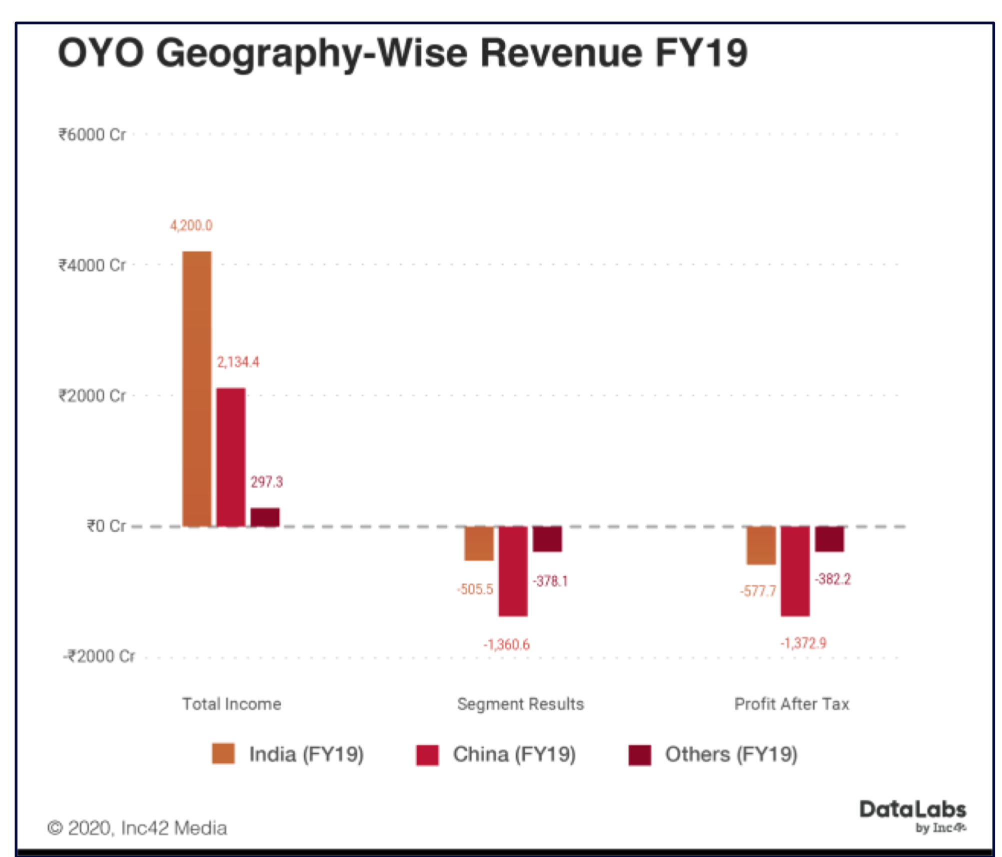


When the founder and investor have a mutual understanding when it comes to living in a myth bubble, it is **a red flag**. And Oyo has **no shortage** of red flags. It raises a very important question, till when can you run on a great idea that solves an important problem when there are no profits to run the same? You don't really have to care about profits when there's money being poured on you as and when you want. Which is why we see a similar **care-free attitude** in Softbank's invested start-ups, as if profitability is an optional thing you can think about when it's convenient for you. Oyo being no different.

The new CEO Rohit Kapoor, hinted that Aggarwal's ambition may be out of reach now: "Everybody has a right to change their plans" and I cannot agree more.

What is wrong with Oyo? It started with a great idea, solving an important problem of **standardized hotel** for the **middle-income group.** Of-course now it's everywhere and for everyone.

How does it provide the hotel rooms at such **low prices**? Oyo makes deals with hotels, renovates their room, so they meet the minimum service standards that they promise to their customers, to get the INR 1500 room ready and make them available to the customers at say a INR 1000 per night. Who pays for the INR 500? It's not the hotel owners for sure. Oyo pays it from its own pockets, which is not a big deal when your pockets are large and your pocket money comes from large investors such as SoftBank, Sequoia Capital and Lightspeed Venture Partners. two of which **sold half their share for USD 1.5 Billion** by the way. Guess who? (Hint: It's not SoftBank).



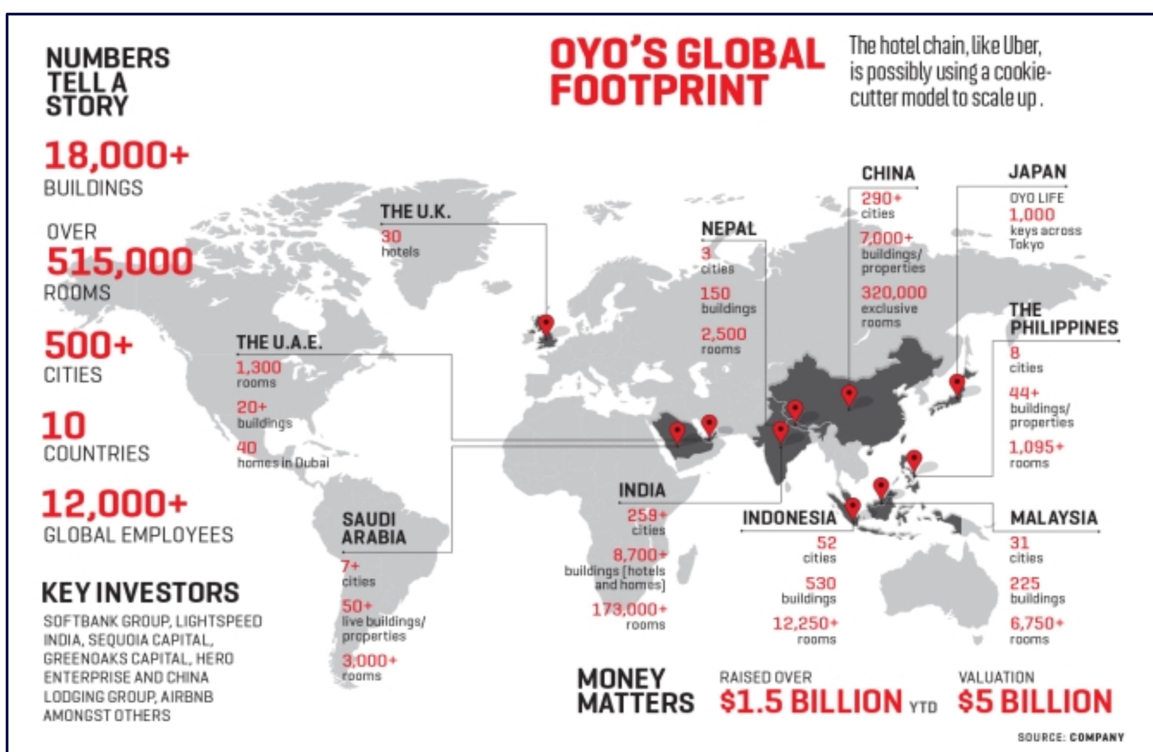
(I don't have to point it out I guess, it's an obvious red flag. But there's another, while these investors were backing out, the then CEO was purchasing shares at higher prices from the shareholders, from money raised through debt, and inflating the valuation of the company. What can I say, ethics is not Oyo's forte).

So, what does Oyo get out of burning cash? **Market share**. And that is Oyo's business model. **Burning cash of investors and building scale**.

Over the past seven years, Oyo has gone one by one to **23,000-plus hotels**. They have Hotels in China, US, Japan and Indonesia.

Oyo has not just been expanding with its hotel chains. It's been **diversifying** with co-working, co-living, student housing, and weddings. This includes Oyo Townhouse, Silver Key, Capital O, Edition O, Palette Resorts and Oyo Flagship. It's not as bad as WeWork's totally unrelated diversification spree. But Oyo could just be playing with its valuation with operations in different segments which makes it difficult to value it. For when you can't arrive at a fair number on your own, you accept the number that the company gives you.

The rate at which Oyo is expanding is almost **unreal**. It is said that the faster you grow, the faster you fall. In the wake of expanding, it has **lost** its **quality**, made **customers unhappy**, **hotel owners infuriated**, and employees, well **out of jobs** and that does not give a very good impression of the leadership team. So, the three pillars that Aggarwal mentioned don't really have a base to stand on. And when the pillars fall, they take everything down with them.



Let's talk about the **first pillar**. The **customers.** If you have ever gone through reviews of Oyo, you would know that the customers are fed-up. Oyo has been unable to provide the quality it so conveniently promises to the customers. A **lack of 100% control** on the quality that the hotel owners provide is a major reason for the same. It might improve with Oyo's new **franchise model**, but what would be the point when all your customers are already gone. The last time I stayed in an Oyo in Mumbai, I thought never to take it again. If this is the service I'm getting after paying a 1000 bucks a night, might as well pour a little more money and get a decent hotel room instead. The rooms that it puts on the website are way different from the rooms that customers have to live in, and sometimes they don't even exist. Yes, you can book a room from Oyo only to come with your bags to the reception and wait for the hotel owner to tell you to go back where you came from, for they are not associated with Oyo anymore.

A common strain in complaints of **poor quality of rooms** and services is one thing. But Oyo has reached another level when it comes to **customer dissatisfaction**. In order to pump up the number of hotels on the website, it doesn't take down the hotels with whom the contract has ended. But till when can you play **dirty tricks** to make your investors happy by butchering your source of revenue?

The **Hotel Partners** are not happy either. The anger and dissatisfaction among hotel partners continue to swell. Reports suggest that nearly **500 hotel partners**, of about 20,000, have snapped ties with the company since April 2019, alleging **hidden charges** and lack of **transparency**. Every now and then a hotel owner complains of Oyo cheating on them. The firm is also accused of using free lodging as **bribes** to avoid investigation from authorities. According to a hotel association member, Oyo could have perhaps avoided many of its troubles by just operating at a low key. It is no secret that this rapid expansion has not been handled well by them. That's where the second pillar falls, **the employees**. Oyo gives unrealistic targets to its employees to get hotel owners on board. And in order to do so they hide information from hotel owners to make them sign contracts that come right back to them in form of **law suits**.

Now all of this doesn't give a very good impression of the **Leadership team** with its missing moral spine which, I don't know how to put it delicately, is doing a terrible job. So, where does Oyo stand with its **3 falling pillars**? Oyo will need to make a lot more changes. Its business strategy requires a shift from a singular focus on scale to operational efficiencies, improving customer experience and workforce training. But with all these red flags hoisted on its 3 falling pillars, it would not take a very large pin for the **Oyo bubble** to burst.

"Oyo is a WeWork in the making," says Santosh Rao, head of research at New York-based Manhattan Venture Partners. "They need to slow down and pull back." he added.

Conclusion

SoftBank's investment in Companies such as WeWork, Uber and Oyo raises important questions about its investment thesis.

If you have a start-up with a great idea and spark in your eyes (when it comes to Softbank, it's a necessity and not an option) and are looking for a Billion dollar investment. Son will ask, but what if I give you USD 10 Billion instead? What can you do with that?

Softbank investment theory is simple. Pour so much money on a company, that it leaves all its competitors in **dust, thereby creating monopolies**. And when your fancy business model gets an unlimited supply of capital, no longer do you have to care about profitability right? Is it still even necessary for businesses to run? Because if it is, no one gave a memo to WeWork, Oyo and Uber for sure.

Where does SoftBank stand with this toxic investment theory and judgement based on gut? You can try to analyse that from the ruins of its many investments. **USD 17 Billion loss** is not a small deal.

But more than that what one tends to ignore here is Softbank's tendency to ignore red flags, blinded by the same spark that flashes from the eyes of these goal-driven entrepreneurs.

For the rational Investors reading this article, does an entrepreneur's charisma blind your judgement too? What is the first thing you look for when you seek to invest? Is the business model and its profitability something you tend to sideline when it comes to the strong words of a goal-driven founder? These are questions you should ask yourself.

In the end I'd just like to say, don't see your investments with rose coloured glasses or all the red flags will seem to be like regular flags.

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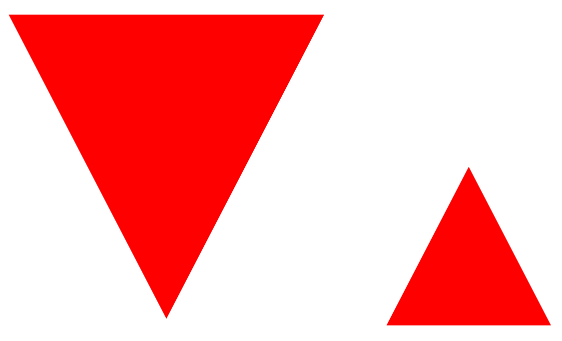

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