Vivendi undervalued?

By Gareth Brown **in our one-man Vienna office**

In our deathly-quiet new European HQ, I've spent much of the past 6 weeks deconstructing holding companies listed in France, Germany, Belgium, Switzerland, Italy and elsewhere. It's an area that offers promise for the value seeker. Two such holding companies have already found positions in the Intelligent Investor International Fund.

Another holding company that I have been considering is French entertainment and telecommunications conglomerate Vivendi. I'd briefly covered it in mid-2012 for Share Advisor members in the special report Ripe for the picking. But, as warned at the time, that wasn't a detailed analysis founded in deep research. One of my investing heroes, Seth Klarman of Baupost Group, bought more than €300m of Vivendi stock sometime in 2011, and still holds it (or at least he did at 31 December 2012). Like almost every other stock in the world, the price is up since the report mid last year (by about 15%), but I was keen to sink my teeth into this complicated French dog's breakfast seeking bargains for the fund.

The group owns a diverse and mostly strategically unlinked group of telecom and entertainment assets. There's French number-two telco SFR, Universal Music Group, pay-TV content and distribution conglomerate Cable+ Group, Brazilian upstart telco GVT, a 61.5% stake in über-successful games maker Activision Blizzard and a 53% stake in Moroccan telco incumbent Maroc Telecom.

There's a lot to like. Many of individual assets clearly have significant value, while the hodgepodge combination surely confuses and deters potential investors. And, importantly, there's a level of urgency about unlocking value at both a board and major shareholder level. The Maroc Telecom stake is likely to be sold any day now and GVT might soon follow.

I won't regale you with my full sum-of-the-parts analysis. For the most part, I agree with much of what's been printed in other analyses published by more bullish investors—I'd recommend Ben Strubel's recent Seeking Alpha article Vivendi Group: Ugly But Undervalued as a starting point.

I'll instead focus on why we've ultimately decided not to take a position at this stage.

1. SFR's valuation. Vivendi acquired full control of SFR by paying €7.75bn to Vodafone in 2011 for its 44%. It implied a valuation of €17.6bn for SFR, making it Vivendi's most valuable asset. But the company has suffered significantly since the acquisition, particularly at the hands of listed upstart Iliad—which is stealing broadband market share and created a mobile phone business from scratch, amassing an 8% French market share in less than 12 months. It's predominately low-revenue customers being poached for now. But the effect on SFR is real, lower market share (from 32% to 29% in a year in mobile), pricing erosion, lower margins and lower profits. Most analyses I've read mark SFR as worth at least €15bn. I'm not confident enough to say that they're right, another year like 2012 and they'll be wrong. Not knowing the French telco industry well, my response is to demand a bigger margin of safety—€15bn is my

‘blue sky’ valuation, with the ‘base’ and ‘dirt cheap’ valuations significantly lower.

2. It’s not worth going into Cable+ Group in great detail, it’s too complicated. The short version, though, is that the meatiest part of that group is the 80%-owned division Cable+ France. In the June special report, I wrote that recent purchases (in 2009 and 2010) by Vivendi of minority stakeholders in Cable+ France implied a valuation for Vivendi’s 80% stake in that division alone of around €6bn. That was jumping the gun. Deep in fine print land at the back half of one of the last few annual reports, I learned that the minority sellers had a put option related to a merger of assets a few years earlier. In other words, the implied valuation is based not on a price where Vivendi felt it was buying an *underpriced* asset, but where the sellers thought they were selling an *overpriced*one. It’s a big difference. Further evidence is offered by the fact that the remaining 20% shareholder in Cable+ France wants out and has so for some years, and the prices being discussed suggest a significantly lower valuation. I have no doubt Cable+ France and the entire Cable+ Group is worth a lot of money but, with less to hang our valuation hat on, my enthusiasm has waned.

3. The net debt position in most sum-of-the-parts valuations I’ve seen is wrong, and the mistake doesn’t fall in their favour. At 30 December 2012, Vivendi’s balance sheet revealed debt of €17.8bn, offset by cash of €3.9bn, for a net debt position of roughly €14bn. From a solvency/liquidity/safety perspective, this is broadly the right number to use. For a sum-of-the-parts valuation, though, it’s wrong. Most of the debts on Vivendi’s balance sheet are the obligations of its fully owned subsidiaries or the parent company. Most of the cash, however, is the fully consolidated cash position of partly-owned subsidiary Activision Blizzard. There is no Vivendi bank account with a few lazy billion lying in it.

This is not evil, it’s perfectly proper and unavoidable accounting treatment. But to rely on the reported net debt distorts a sum-of-the-parts analysis. Most of the subsidiary valuations in the sum-of-the-parts analysis are estimates of enterprise value (ie, valuing the business regardless of how its financed, dealing with issues like debt and cash at the end). But both Ben and I use current market price as the base case for the listed partly-owned assets Activision Blizzard and Maroc Telecom. Activision Blizzard’s substantial net cash is already reflected in the market price of its shares, and so to count the cash there and in the consolidated net debt position is to double count. I’ve deducted €3.3bn from my valuation to avoid double counting Activision-Blizzard’s huge net cash pile, but added €0.6bn so as to not double-deduct Maroc Telecom’s debts.

4. Furthermore, none of the recent analyses I’ve looked at adequately account for another outflow. Vivendi and Liberty Media have been in court for years over a matter not worth going into. Vivendi lost. Just after the 31 December 2012 balance date, Vivendi delivered a bank guarantee of €975m to Liberty Media as instructed by the courts. There might be appeals, but it would be crazy not to deduct €1bn from our sum-of-the-parts in recognition.

While I think there could be plenty of upside in Vivendi still, my ‘dirt cheap’ valuation ends up significantly below today’s share price of €16, actually closer to €10. And we only want a dog’s breakfast if it’s priced accordingly. Obviously, Seth Klarman thinks I’m being too conservative somewhere, and he’s probably right. SFR, Cable+ Group and Universal Music being the likely candidates. But, for now, Vivendi sits on my watchlist. I’ll sharpen the calculations if, all things being equal, the stock drops closer to €12. In terms of things not being equal, I’m looking for unexpectedly good asset sale prices and signs of turnaround at SFR as further reasons to look closer. The hunt moves on.