

Investment idea



Company: BlackBerry Limited (TSX:BB)

Industry: Technology / Hardware, Storage and Peripherals

Share price (as of 03/06/2016): \$7.26

Position: Short equity – Recommend selling

Thesis: Shrinking product portfolio, limited chances of turnaround, risk of hasted and poorly executed acquisition strategy, accounting methodology questions

Company description

- BlackBerry Limited is a Canadian company which develops and sells smartphones under the BlackBerry brand name worldwide. It also develops and offers enterprise mobility management and mobile security software as well as a portfolio of enterprise software solutions and services that could be deployed across a range of ecosystems and devices.
- Company was formerly known as Research In Motion Ltd – it changed its name in 2013.
- Historical financials are outlined in Appendix 1.

Strategic thesis

A difficult strategic positioning

- Established competition in all segments: BB is facing established competition from large companies across all business segments. Example competitors include:
 - Microsoft, Citrix, SAP, IBM in Enterprise Solutions & Services ('ESS')
 - Apple, Samsung, Microsoft, HTC, Lenovo in Devices
 - Apple, Google, Microsoft in Mobile OS
 - Facebook, Microsoft (Skype), Apple (iMessage), Tencent (WeChat) and SnapChat in Messaging
- Lack of proprietary ecosystem: BB cannot push its software products by bundling them with proprietary and widespread OS (as Apple or Google do) or mobile device. As a consequence it has to rely on commercial agreements with 3rd party which consequently weakens its bargaining power.

An operationally challenging situation

- Integration of acquisitions: BB performed 7 acquisitions over the last 2 financial years, which may create integration issues. In particular Good represents a sizeable activity expected to generate a significant share of BB's revenues in the future although this acquisition is outside of BB's historical core business.
- Success of turnaround expected to be limited at best: Consensus expects BB's EBITDA to half by 2019, reaching \$209m vs. \$474m today¹ and net income will remain negative throughout the period – up to (\$229m) excluding Exceptionals. The Street therefore does not believe in a short-term turnaround. The diversity and low relative robustness of valuation methods used by brokers should also raise an alarm – see Appendix 2.

A weakening product portfolio

- No clear synergies between products: Although security aimed at B2B customers is a common denominator, BB's product range is currently perceived as a series of independent items rather than a coherent group. Analysts have been widely using a SOTP valuation methodology as a consequence.
- Risk of moving to 'one-trick company status' in medium-term: SAF revenues will structurally go to 0 in the medium-term. Furthermore, BB's attempt to revive its hardware business by launching the Priv is currently proving unsuccessful – BB's share of the smartphone market is c. 0.2% in FY16² and only 600k units of the Priv were sold by the end of February 2016 - and the division is currently unprofitable³. TechRadar⁴ perceives BB's offer to be uncompetitive and the

¹ Source: CapitalIQ

² Source: Goldman Sachs

³ Source: RBC Capital Markets

⁴ Technology-specialised website with more than 20 million readers per month

move as too late – see Appendix 3 – and the premium smartphone market is already well occupied by Apple and Samsung.

- Unclear monetisation of Technology Solutions (BTS): BB has invested in research related to the Internet of Things over the last few years but the way to generate revenues from these investments appears unclear.
- Limited in-house R&D capabilities: BB's growth is expected to come from businesses that have recently been acquired (e.g. Good Technology) at the expense of in-house R&D capabilities. The vast amount of available cash may further incentivise management to look for (expensive) acquisition targets to try to bridge the R&D gap, which is a risky strategy.
- Cost cutting in R&D: BB has been winding down its R&D investment effort in an industry where innovation is paramount – see Appendix 4.

Too much cash kills cash

- Suboptimal past use of cash: In FY2016 BB completed 4 acquisitions for a total consideration of \$724m and total non-cash assets acquired of \$1,008m. On the latter amount \$540m, i.e. more than 50%, was recorded as goodwill which may indicate that BB significantly overpaid these acquisitions.
- Possible suboptimal future use of cash: BB is in a distressed situation and sitting on a very large war chest (\$2.4bn of cash & equivalents and short-term investments). If disappointing results continue (which is likely according to consensus), management may decide to use this cash to accelerate the acquisition pace, increasing the risk of overpaid investments offering limited growth prospects and synergies with existing business lines – notwithstanding the integration issues as mentioned in another point. An activist investor could argue that the best use of the cash that BB could do would be to return as much as possible (i.e. bank debt covenants permitting) to shareholders.

Accounting concerns

- Extensive use of short-term assets: In FY16 BB purchased \$2.8bn and sold \$3.1bn of short-term assets. The ratio of 'Short-term investment activity' relative to sales has soared over the last 3 years – see Appendix 5.
- Questionable long-term value of Intangibles: As we will see in the 'Valuation' section, Intangible Assets make a significant share of Shareholder's Equity. Nonetheless, in 2015 and 2016 BB reviewed its patent portfolio and decided to cease enforcement and abandon legal right and title to patents with a net book value of \$34m and \$136m respectively. If we expect Net Intangible Assets write-offs beyond Amortization to be a recurrent practice in the future we should apply a discount to equity's current book value.

Valuation

- Net income was negative in FY16 and is expected to remain negative at least until FY19 according to consensus. A P/E valuation approach is therefore not relevant.
- I therefore decide to value BB using a Net Asset Value approach. Balance sheet as per the latest quarterly/annual report is as follows:

Assets	USDm	Liabilities and shareholder's equity	USDm
Cash and Cash Equivalents	957	Accounts Payable	270
Marketable Securities/Short-Term Investr	1,420	Accrued Liabilities	368
Accounts Receivable	338	Accrued Litigation and Related Expense	0
Other Receivables	51	Income Taxes Payable	9
Inventories	143	Deferred Revenue	392
Other Current Assets	102	Current Portion of Long-Term Debt	0
Total current assets	3,011	Total current liabilities	1,039
Investments	197	Long-Term Debt	1,277
Restricted cash	50	Deferred Income Taxes	10
Capital assets	412	Income Taxes Payable	0
Intangible assets, net	1,213	Total non-current liabilities	1,287
Goodwill	618	TOTAL LIABILITIES	2,326
Other Assets	33	Share Capital	2,448
Total non-current assets	2,523	Retained earnings (deficit)	768
TOTAL ASSETS	5,534	Paid-in capital	0
		Other	-8
		Total equity	3,208
		Total liabilities and shareholder's equity	5,534

- Using current assets to repay debt, and regrouping some of the items, we obtain the following split for shareholder's equity:

	USDm		USDm
Cash, Equivalents and ST investments	1,090	Net current assets	685
Working Capital Requirements	211		
Other Net Current Assets	-616		
Investments	197	Tangible investments	659
Restricted cash	50		
Capital assets	412		
Intangible assets, net	1,213	Intangible investments & Goodwill	1,831
Goodwill	618		
Other Assets	33	Other Assets	33
		TOTAL EQUITY	3,208
		Avg. Number of shares (m)	526.3
		Book Value per share (\$)	6.10
		<i>Tangible Book Value per Share (\$)</i>	<i>2.62</i>
		Latest share price (\$)	7.26
		<i>Implied P/BV ratio</i>	<i>1.19x</i>

- From there we can outline two scenarios, which both lead us to recommend to short the stock:
 - If we believe that current market valuation for BB shares is justified, if we value Net current assets, Tangible Investments and Other Assets at book value and if we assume Goodwill has not been affected (given that the major acquisitions were carried recently), we conclude that Intangible Investments should carry a market value of \$1,826m, i.e. 1.5x Book Value. We believe this valuation level to be unrealistic.
 - We could build a worst case scenario where all Intangible Assets are written off – although unlikely this scenario is not impossible. In this case the tangible book value per share is \$2.62 i.e. only 36% of the current share price.
- For me BB falls in the category of 'zombie stocks', i.e. stocks whose value is primarily justified by the detention of non-core assets – cash & equivalents in the case of BB. This category also includes YHOO.

Catalysts

- Inevitable closure or sale of devices (i.e. hardware) segment will trigger a significant restructuring cost and will downgrade the EBITDA multiple applicable to the firm given its sole reliance on software products.
- Further write-off of intangibles and/or goodwill impacting net asset value and subsequently share price.
- Re-rating of Internet of Things product line.
- Corporate customer defection, especially given BB's current difficulties.

Non-comprehensive list of areas for further due diligence

- Robustness of Intangible Assets & Goodwill valuation: We would need to have a deeper and more informed look at the valuation method used for Intangible Assets. We could also analyse the historical evolution of Intangible Assets and Goodwill write-offs to assess whether this has been a recurrent practice.
- Analysis of short-term investment activity: We would need to understand the rationale for such a significant activity.
- Analysis of customer base: The reliance of BB on a handful of key customers may fasten the re-rating process if one or several of those customers decide to defect.
- Review of B2B partnerships

Appendix 1: Historical financials
USDm unless stated
Income Statement

	2012	2013	2014	2015	2016	1Q16	2Q16	3Q16	4Q16
Sales	18,489	11,092	6,813	3,335	2,193	658	491	557	487
YoY	(7.1%)	(40.0%)	(38.6%)	(51.0%)	(34.2%)	(31.9%)	(46.4%)	(29.8%)	(26.2%)
Cost of sales	11,090	7,556	4,376	1,708	1,174	327	290	307	250
Gross Profit	7,399	3,536	2,437	1,627	1,019	331	201	250	237
R&D	1,537	1,484	1,210	641	407	124	104	94	85
SG&A	2,515	2,024	1,765	709	534	149	125	136	124
Amortization	571	721	606	298	220	65	56	50	49
Other	9	0	0	0	0	0	0	0	0
Operating Income	2,767	(693)	(1,144)	(21)	(142)	(7)	(84)	(30)	(21)
% Operating Margin	15.0%	(6.2%)	(16.8%)	(0.6%)	(6.5%)	(1.1%)	(17.1%)	(5.4%)	(4.3%)
Other Income/(Expenses)	21	15	(21)	(77)	(59)	(16)	(12)	(16)	(15)
Earnings (Loss) Before Taxes	2,788	(678)	(1,165)	(98)	(201)	(23)	(96)	(46)	(36)
Tax	589	(344)	(454)	(53)	(74)	5	(30)	(31)	(18)
Net income - recurring (incl ESOs, amort)	2,199	(334)	(711)	(45)	(215)	(42)	(91)	(47)	(35)
Stock-based compensation	70	78	68	50	59	14	14	14	17
IPRD, other	0	0	0	0	29	0	11	18	0
Income tax effect	0	0	0	0	0	0	0	0	0
Net income - pro forma (excl ESO/legal)	2,269	(256)	(643)	5	(127)	(28)	(66)	(15)	(18)
% Net income margin	12.3%	(2.3%)	(9.4%)	0.1%	(5.8%)	(4.3%)	(13.4%)	(2.7%)	(3.7%)
Extraordinary gain (loss), after tax	(1,035)	(316)	(5,162)	(259)	(56)	96	142	(74)	(220)
Net income - GAAP	1,164	(650)	(5,873)	(304)	(271)	54	51	(89)	(238)
Memo: EBITDA	4,290	1,225	126	673	474	157	79	132	106
EBITDA/Sales	23.2%	11.0%	1.8%	20.2%	21.6%	23.9%	16.1%	23.7%	21.8%

Balance Sheet

	2012	2013	2014	2015	2016	1Q16	2Q16	3Q16	4Q16
Assets									
Cash and Cash Equivalents	1,527	1,549	1,579	1,233	957	1,165	1,447	1,123	957
Marketable Securities/Short-Term Investments	247	1,105	950	1,658	1,420	1,799	1,573	1,175	1,420
Accounts Receivable	3,062	2,353	972	503	338	470	330	380	338
Other Receivables	496	272	152	97	51	93	66	45	51
Inventories	1,027	603	244	122	143	133	142	144	143
Other Current Assets	697	1,219	1,160	554	102	282	200	145	102
Total current assets	7,056	7,101	5,057	4,167	3,011	3,942	3,758	3,012	3,011
Investments	337	221	129	316	197	293	277	350	197
Restricted cash				59	50	59	56	58	50
Capital assets	2,748	2,395	942	556	412	519	468	449	412
Intangible assets, net	3,286	3,448	1,424	1,375	1,213	1,281	1,166	1,413	1,213
Goodwill	304	0	0	76	618	96	97	607	618
Other Assets	0	0	0	0	33	0	0	0	33
Total non-current assets	6,675	6,064	2,495	2,382	2,523	2,248	2,064	2,877	2,523
TOTAL ASSETS	13,731	13,165	7,552	6,549	5,534	6,190	5,822	5,889	5,534
Liabilities and shareholder's equity									
Accounts Payable	744	1,064	474	235	270	149	195	269	270
Accrued Liabilities	2,382	1,842	1,214	658	368	466	389	402	368
Accrued Litigation and Related Expense	0	0	0	0	0	0	0	0	0
Income Taxes Payable	0	0	0	0	9	0	0	0	9
Deferred Revenue	263	542	580	470	392	464	366	430	392
Current Portion of Long-Term Debt	0	0	0	0	0	0	0	0	0
Total current liabilities	3,389	3,448	2,268	1,363	1,039	1,079	950	1,101	1,039
Long-Term Debt	0	0	1,627	1,707	1,277	1,550	1,322	1,317	1,277
Deferred Income Taxes	232	245	32	48	10	48	13	17	10
Income Taxes Payable	10	12	0	0	0	0	0	0	0
Total non-current liabilities	242	257	1,659	1,755	1,287	1,598	1,335	1,334	1,287
TOTAL LIABILITIES	3,631	3,705	3,927	3,118	2,326	2,677	2,285	2,435	2,326
Share Capital	2,446	2,431	2,418	2,444	2,448	2,459	2,446	2,454	2,448
Retained earnings (deficit)	7,913	7,267	1,394	1,010	768	1,078	1,109	1,018	768
Paid-in capital	0	0	0	0	0	0	0	0	0
Other	-259	-238	-187	-23	-8	-24	-18	-18	-8
Total equity	10,100	9,460	3,625	3,431	3,208	3,513	3,537	3,454	3,208
Total liabilities and shareholder's equity	13,731	13,165	7,552	6,549	5,534	6,190	5,822	5,889	5,534

Cash Flow Statement

	2012	2013	2014	2015	2016	1Q16	2Q16	3Q16	4Q16
Net Earnings (Loss)	1,164	(646)	(5,873)	(304)	(208)	68	51	(89)	(238)
Amortization (includes depreciation)	1,523	1,918	1,270	694	616	164	163	162	127
Deferred income taxes	(5)	87	(149)	62	(105)	2	(31)	(38)	(38)
Non-cash transaction	0	0	0	0	0	0	0	0	0
Loss/Gain on write-down of capital assets	0	0	0	135	195	12	29	5	149
Loss/Gain on foreign currency translation of long-term debt	0	0	0	0	0	0	0	0	0
Write-down of investments	355	335	0	0	0	0	0	0	0
Foreign exchange gain/loss	0	0	0	0	0	0	0	0	0
Other	(12)	38	3,266	117	(414)	(141)	(227)	1	(47)
Share based payments	97	86	68	50	60	14	14	14	18
Net changes in working capital items	(210)	485	1,259	59	113	15	111	(42)	29
Net Cash From Operating Activities	2,912	2,303	(159)	813	257	134	110	13	0
Income Tax Reduction	(2)	(11)	(13)	8	0	0	0	0	0
Change in Restricted Cash	0	0	0	(59)	12	0	3	1	8
Issuance of Share Capital and Warrants	9	0	3	6	4	1	0	2	1
Financing Costs	0	0	0	0	0	0	0	0	0
Government Funding Received for Capex	0	0	0	0	0	0	0	0	0
Share buybacks	(156)	(25)	(16)	61	(93)	0	(47)	(10)	(36)
Capital dividend paid	0	0	0	0	0	0	0	0	0
Excess tax benefits from share-based compensation	0	0	0	0	(1)	0	0	0	(1)
Repayment/Issuance of Debt	0	0	1,250	0	0	0	0	0	0
Net Cash From Financing Activities	(149)	(36)	1,224	16	(78)	1	(44)	(7)	(28)
Acquisition of Investments	(355)	(296)	(229)	(802)	(326)	(77)	(50)	(148)	(51)
Proceeds on Sale or Maturity of Investments	376	227	284	515	301	1	65	75	160
Acquisition of Long-Term Portfolio Investments	0	0	0	0	0	0	0	0	0
Acquisition of Capital Assets	(902)	(413)	(283)	(87)	(28)	(11)	(10)	(4)	(3)
Acquisition of Intangible Assets	(1,438)	(1,005)	(1,080)	(421)	(70)	(11)	(20)	(12)	(27)
Acquisition of Subsidiaries/other	(779)	0	0	0	0	0	0	0	0
Business Acquisitions	(226)	(60)	(7)	(119)	(698)	(53)	0	(636)	(9)
Proceeds on sale and maturity of short-term investments	550	779	1,925	2,342	3,146	532	1,066	1,076	472
Acquisition of Marketable Securities	(250)	(1,472)	(1,699)	(2,949)	(2,764)	(574)	(839)	(678)	(673)
Other	0	0	49	348	0	0	4	(4)	0
Net Cash From Investing Activities	(3,024)	(2,240)	(1,040)	(1,173)	(439)	(193)	216	(331)	(131)
Effect of Exchange Rate Changes on Cash and Cash Equivale	(3)	(5)	5	(2)	(16)	(10)	0	1	(7)
Change in Cash	(264)	22	30	(346)	(276)	(68)	282	(324)	(166)
Cash - beginning of period	1,791	1,527	1,549	1,579	1,233	1,233	1,165	1,447	1,123
Cash - end of period	1,527	1,549	1,579	1,233	957	1,165	1,447	1,123	957
<i>Memo: Free Cash Flow</i>	<i>572</i>	<i>885</i>	<i>(1,522)</i>	<i>305</i>	<i>159</i>	<i>112</i>	<i>80</i>	<i>(3)</i>	<i>(30)</i>

Appendix 2: Recent broker target share prices and valuation methodologies

Broker	Date	SP target (\$)	Methodology
RBC Capital Markets	05-mai	8.00	Software @ 11x EBITDA / SAF @ 0.8x CY17E EBITDA / Nominal value for hardware
Imperial Capital	18-avr	7.50	Software @ 3.2x FY17e rev. / SAF DCF / Hardware @ 0.2x FY17e rev.
GMP	04-avr	7.60	8.5x FY17e EBITDA
Credit Suisse	04-avr	6.00	Net Asset Value of \$3.0bn
Wells Fargo	04-avr	7.25 to 8.00	FY17e rev.: Software @ 3.0x / SAF @ 0.1x / Hardware @ 0.5x PLUS cash
Goldman Sachs	03-avr	6.00	n.a.
JP Morgan	03-avr	8.00	CY16e rev.: Software @ 3.0x / SAF @ 0.5x / Hardware @ 1.0x PLUS cash discounted 15%
Deutsche Bank	03-avr	6.50	DCF (11% discount rate, 3% growth rate)
Bank of America	03-avr	6.00	2x P/S on FY17e rev.

Appendix 3: BlackBerry Priv Review conclusion by TechRadar

“Don't get me wrong – I really, really like the BlackBerry Priv. It's a great high-end Android phone, especially when you consider who's made it.

Finally we have a BlackBerry smartphone with all the apps you want, with a screen you can actually enjoy videos and games on, and an interface that's far more familiar and intuitive (for the general public at least) than that on the BlackBerry 10.

Trouble is, I wanted to love the Priv – and this is a phone that BlackBerry really needs people to love if the company's ever going to get back into the consumer hardware market – but I just don't.

The flakey performance and absence of a properly premium design, coupled with a price tag which makes it more expensive than the established Android flagship players, makes the BlackBerry Priv very difficult to recommend over its closest rivals.

It's by far the best phone BlackBerry has produced in recent years – but once again I can't help but feel that it's just too little, too late.”

Appendix 4: Historical evolution of R&D 'effort' between FY12 and FY16

<i>USDm</i>	2012	2013	2014	2015	2016
R&D costs	1,537	1,484	1,210	641	407
Acquisition of intangibles	1,438	1,005	1,080	421	70
Total R&D and intangibles 'effort'	2,975	2,489	2,290	1,062	477

Source: Annual reports

Appendix 5: Historical evolution of short-term investment activity

<i>USDm</i>	2014	2015	2016
Proceeds on sale and maturity of short-term investments	1,925	2,342	3,146
Acquisition of Marketable Securities	(1,699)	(2,949)	(2,764)
Average of absolute values	1,812	2,646	2,955
<i>In % of revenues</i>	27%	79%	135%

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