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Alibaba: Is it a steal?

Investment summary:

- Alibaba is a Chinese e-commerce giant with businesses that include web portals, online retail and payment, a shopping search engine as well as cloud computing.
- Thursday brings the expected pricing of the c. $24bn IPO, the biggest ever in the US. Shares will start trading on the NYSE on 19 September. Press reports indicate demand for shares has been strong despite concerns over Alibaba's unusual corporate governance structure, which founder Jack Ma had to address with a statement in the company's IPO-related regulatory filings.
- On 15 September, Alibaba said it had raised the price range for its American depositary shares to between $66 to $68/share (the initial range was $60-$66/share).
- We see the following as key drivers: growth in China smartphone, social media and internet usage. It offers global investors an entry point into the lucrative China e-commerce market. As it is more of a marketplace rather than an out-and-out retailer, Alibaba offers less inventory risk. It also has stakes in Alipay and Weibo.
- Chinese e-commerce is expected to continue growing and as Alibaba controls c. 57% of the market, any increase in size should be beneficial. So, although certain reports suggest Alibaba is losing market share, we believe that as the size of the pie increases, its revenue has the potential to continue growing.
- However, the company faces challenges including slowing China growth, which is a concern, as is the fact that it is an unknown brand outside China. In the US it faces strong competition from established players, while issues around poor corporate governance and regulatory risk have also been raised.
- Nevertheless, despite this, Alibaba has shown robust growth and managed to increase its revenue at an incredible rate over the past 5 years. We expect growth to continue in the years to come (albeit at lower levels).
- Adjusted EBITDA is forecast to continue growing at rates in line with revenue. Estimates expect a temporary pull back in the FY15 adjusted EBITDA margin, after which it will expand to over 54%.
- Diluted EPS is expected to come in at CNY0.124 for FY15 and CNY0.134 for FY16, while Alibaba trades on a 12-month forward P/E of 33.4x (currency taken at spot of CNY6.14/$1). This is comparable to peers such as Baidu (FY14 P/E=35.0x) and Tencent (FY14 P/E=37.1x). Utilising these comparatives, Alibaba would be valued at $70.75-$75.01/share.
- We recommend investors add the share to their portfolio but we note that demand for the IPO has been so strong that it will be difficult to get shares this late in the game. Thus, we suggest another way to access Alibaba is through Yahoo! or Softbank - both are likely to remain in focus ahead of (and even beyond) the Alibaba listing, and both have significant stakes in the company.

Alibaba vs peers comparison:

Company	Mkt Cap ($)	P/E	12M fwd P/E	RoE	DY	Rev - 1 Yr (% Chg)	EPS-1 Yr % Chg)
Alibaba	*166 947.2*	*34.62*	*33.40*	*159.67*	*na*	*52.11*	*170.38*
Amazon.com	151 437.0	862.53	81.28	1.86	na	21.87	na
Baidu Inc ADR	75 580.9	39.10	26.96	31.49	na	43.21	0.69
eBay	64 059.0	na	15.87	-0.55	na	14.03	8.91
Facebook	196 869.6	82.70	39.85	15.44	na	54.69	3 000.00
Google Inc A	395 017.6	29.57	19.62	15.14	na	19.23	11.31
Groupon	4 651.9	na	42.88	-18.94	na	10.25	-40.00
LinkedIn	26 103.6	na	85.35	-0.71	na	57.21	14.29
Tencent	149 544.5	44.96	30.61	34.42	0.20	37.69	21.52
Yahoo! Japan	22 399.6	18.66	17.44	21.97	na	12.62	9.96
Yahoo! Inc	42 479.5	36.88	31.94	9.25	na	-6.14	-60.73
Zynga Inc - CL A	2 705.5	na	116.51	-7.78	na	-31.84	82.14

Source: Bloomberg, Anchor Capital

Global Ideas is a newsletter published three times a week (Monday, Wednesday and Friday) and available only to clients of Investor Campus and Anchor Capital. The key objective of this newsletter is to provide ideas for investment in the global investment universe.

We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watch-list, which is continually reviewed and updated.

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Background:

Alibaba is a Chinese e-commerce giant with businesses that include web portals, online retail and payment, a shopping search engine as well as cloud computing. The company was founded in 1999 when Jack Ma started the website Alibaba.com, which was initially used as a business-to-business portal to connect Chinese manufacturers with buyers globally. The Group's consumer-to-consumer portal called Taobao (similar to eBay), features c. 1bn products and is one of the most visited websites globally. *Wikipedia* notes that Alibaba Group sites account for over 60% of parcels delivered in China. In 2012, two of Alibaba's portals together handled CNY1.1trn ($170bn) in sales (more than eBay and Amazon.com put together), while Alibaba also accounts for c. 80% of online sales in China.

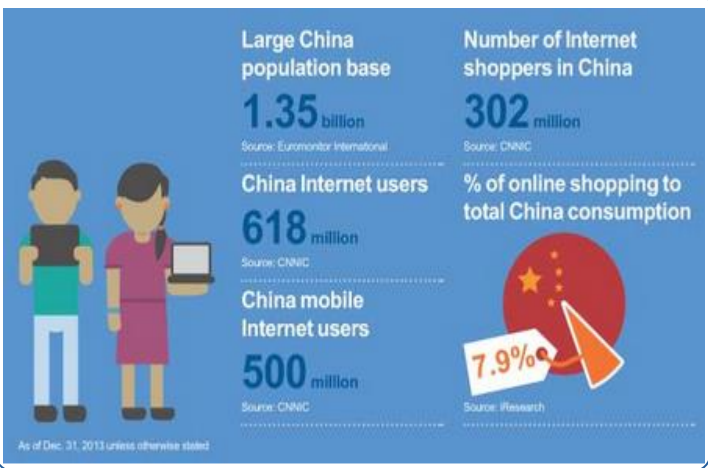
The company previously primarily operated in China but in September 2013, Alibaba said it was seeking an initial public offering (IPO) in the US after a deal could not be reached with Hong Kong regulators. The group now plans to list in New York this month in an IPO that could value the company at $155bn - the largest in US history.

Company overview:

Alibaba has almost single-handedly turned China into the world's second-largest e-commerce market (after the US). Besides e-commerce, it sells logistics and Internet services to vendors, and receives payments from affiliated businesses such as its payment processor Alipay (similar to eBay's PayPal). Alipay has over 300mnn users in China, and it processed c. $660bn in transactions in 2012. Alibaba also owns two retail sites 1) Taobao, which features products sold by smaller merchants similar to third-party sellers on Amazon.com and eBay; and 2) Tmall, which offers brand-name products. The company has a c. 19% stake in Chinese microblogging site Weibo (similar to Twitter), which generated $188mn in FY13 revenue. Weibo has around 130mn monthly active users and successfully listed on the NASDAQ on 17 April 2014, raising $286mn and becoming the first listed Chinese social media network.

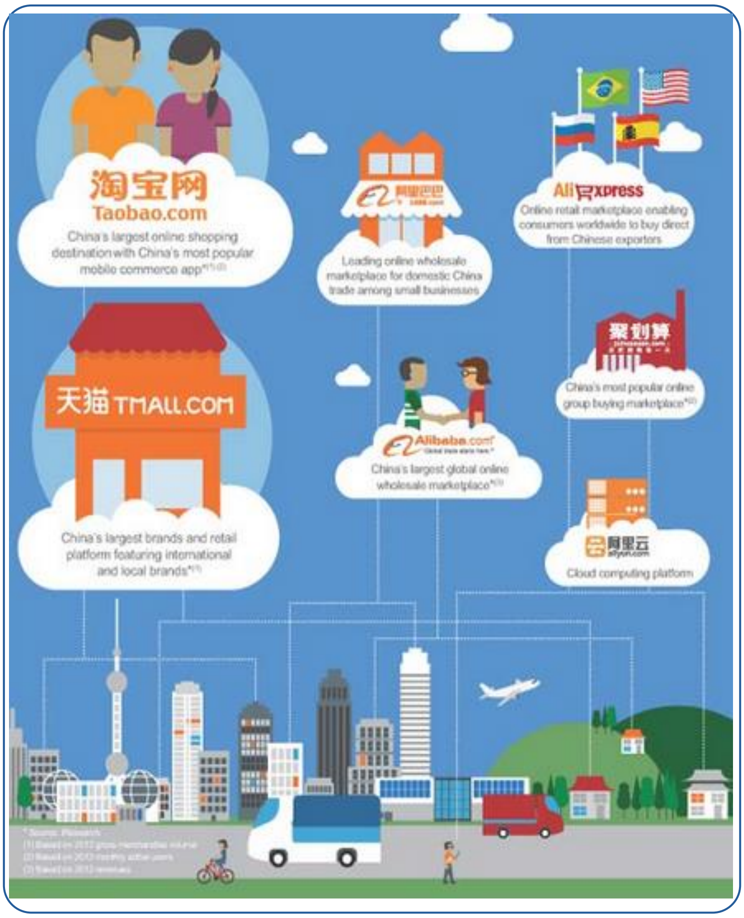
Below we highlight Alibaba's user base and what it does using graphics the group included in its regulatory filings.

Powerful demographic trends driving growth:



Source: Company data

Alibaba's major businesses:



Source: Company data

The largest online and mobile e-commerce company in the world:

Source: Company data

Alibaba's IPO:

Alibaba expects to offer 320.1mn shares when it list in New York on Friday (19 September). The share offering will likely raise over $25bn— the biggest IPO ever valuing the company at c. $168bn. It will list under the code BABA. Initially the IPO price was to be $60-$66/share, but on Monday (15 September) in a regulatory filing with the Securities and Exchange Commission (SEC) , Alibaba raised the price range for its American depositary shares to between $66-$68/share. To put the size of the IPO in perspective we highlight that Facebook, the previous biggest US listing, raised $16bn with its IPO. Other large recent US IPOs include Visa ($19.65bn in 2008) and General Motors (GM - $18.1bn in 2010) -*see figure below*.

Top-10 US IPOs to date (market value in $bn):

In billions	Amount raised	Market value at IPO
Visa (2008)	$19.65	$42.53
General Motors (2010)	18.14	49.50
ENEL (1999)	17.41	54.85
Facebook (2012)	16.01	81.25
Deutsche Telekom (1996)	13.03	50.11
AT&T Wireless (2000)	10.62	58.85
Telstra (1997)	10.00	30.53
Kraft Foods (2001)	8.68	53.79
British Gas (1986)	7.70	7.94
Banco Santander (2009)	7.52	50.44

Source: Wall Street Journal

In terms of shareholding, Alibaba's founder is selling 12.75mn of the 206.1mn shares he owns (or c. 0.5% of his 8.8% stake in the company). His stake is valued at between $765mn and $841mn based on the price range listed. Alibaba co-founder, Joseph Tsai, owns 83.5mn shares, or 3.6% of the company and will sell 4.25mn shares or 0.2% of his total. SoftBank, owns 34.1% of the company, and said it had no plans to sell down its stake. Yahoo owns 523mn shares, or 22.4% of the company and will be selling 121mn shares, or 4.9% of the company. The amount they're selling is valued between $7.26bn and $7.99bn.

Other major stakeholders in the company include a unit of the China Investment Corp., cited in the filing as Fengmao Investment Corp., which is selling 14.2mn shares, or 0.6%. It holds a 2.8% stake. Private-equity firm Silver Lake owns 58.9mn shares, or a 2.5% stake, and it plans to sell 4.1mn shares. Alibaba is also allowing employees and other individuals close to the company to buy some shares in the IPO. In the filing, the company said it will set aside up to 6% of its shares in what it called a friends-and-family plan.

Alibaba 2Q14 results:

Alibaba's 2Q14 results (released in August) showed that Chinese online shoppers were migrating to mobile devices in droves as the company reported significant growth in mobile-derived revenue (showing mobile monetisation to be on a very strong upwards trajectory). Alibaba also reported accelerating revenue growth driven by Chinese shoppers who use the site to buy via their phones and other mobile devices. Overall, revenue came in at $2.5bn (a 46% YoY increase), while net income close to tripled to $1.99bn vs the same period in 2013. Alibaba also said that it generated c. $395mn in mobile revenue for the quarter (up tenfold from the same period in 2013). Mobile transactions quadrupled in the June quarter from a year ago, to $27bn, and accounted for nearly one-third (vs 12% a year ago) of its total $81bn in gross merchandise volume. Although quarterly earnings surged to $2bn vs $705mn a year ago, it was boosted by a one-time gain from prior investments, and the company's costs rose 68% in the quarter to $740mn.

Alibaba's operating profit margin dropped to 43.4% from 50.3% in the same quarter last year. Ahead of the IPO, the company has made a number of acquisitions and other investments to bolster its mobile presence, including acquiring Chinese mobile-Web-browser developer UCWeb.

Alibaba quarterly mobile revenue:

Source: Company data

Alibaba mobile revenue as share of overall revenue:

Source: Company data

Positives:

We see the following factors as key growth drivers for the company:

1. Growth in China smartphone usage: The adoption of mobile phones is a segment showing robust growth in China (as Alibaba's latest results testify). Many people who haven't had Internet access before, now have access to mobile phones. Research firm, *IDC* forecasts over 450mn in 2014 smartphone sales for China. Many of these smartphone buyers will be new to mobile and will be shopping online ***/cont...***

Positives continued…for the first time, as Chinese e-commerce businesses increasingly move to mobile. Although the e-commerce market is growing quickly in China, web sales still only account for a fraction of all retail transactions meaning there is significant growth potential. According to *iResearch*, only 9.1% of all retail transactions are expected to take place via the Web in 2014 (vs 7.9% in 2013). This is (conservatively) forecast to jump to 11.5% by 2016—up c. 46% in 3 years. Compares that with the US, where online transactions are expected to account for 60% of all retail by 2017 (*Forrester Research*) and it gives an indication of the huge potential for growth. In addition, we note that since the end of 2013, Alibaba's mobile monthly users have grown c. 38%. Here we note however that in the mobile space Alibaba has a strong competitor in the form of Tencent.

2. Growth in internet usage in China: Following on from the point above, we highlight that, overall, data released by the *China Internet Network Information Centre* shows only 46% of the Chinese population is currently online. Considering the huge population and when compared with 83.2% of the US and 88.9% of the UK (according to *IDC data*) then the growth potential in this respect is enormous.

3. Growth in social media in China: Social media is also driving e-commerce sales in China with many consumers in dependant on social networks for product photos or reviews. In this regard Alibaba has moved to capture that traffic by making large investments in social networking. In April last year it invested $586mn in Weibo, one of China's leading social networks, with around 144mn active users. This network now has an Alibaba button integrated into user posts, allowing shoppers to buy goods without even navigating away from Weibo. The partnership between Weibo and Alibaba is expected to continue evolving to the benefit of both companies and Alibaba recently invested a further $486mn in the company.

4. Entry into the lucrative China e-commerce market: Many market commentators view Alibaba as the perfect way for investors to access China's fast-growing e-commerce sector. *China Briefing* estimates that e-commerce in China will be worth $540bn by 2015, and by 2020 worth more than e-commerce in the US, the UK, Japan, Germany and France combined. The Chinese government has a target to connect 1.2bn people (85% of the population) to 3G or 4G mobile internet by 2020. A number of foreign firms which have attempted to gain a foothold in the lucrative Chinese market have failed - eBay has withdrawn from China, while Wal-Mart and Best Buy are still struggling to compete with local firms. Recently Shoprunner, a US Amazon.com rival, struck a deal with Alibaba which saw Alibaba buy a 39% stake in the company. In exchange for allowing Alibaba to supply US goods to Chinese consumers, Alibaba will assist its expansion into China.

5. Less inventory risk: Because Alibaba is more of a marketplace listing instead of an out and out retailer it faces less inventory risk.

6. Alipay: In August Alibaba restructured its agreement with payment-platform Alipay's parent company Small and Micro Financial Services, whereby Alibaba is now entitled to a one-time payment of up to 37.5% of the value of Alipay in the event of its sale or listing (thus eliminating a $6bn cap on its potential gain if the payment processor or its parent go public). In its filing Alibaba stated that the removal of the previous cap "significantly [increases] the potential future financial benefits to us," . Also, previously, Alibaba earned 49.9% of Alipay's pre-tax income but, under the new agreement, Alibaba will receive 37.5% of the entire associated group's pre-tax income, including income from the loan business it transferred. Sanford C. Bernstein estimates Alipay's worth at $50bn-$70bn, plus an extra $25bn-$40bn for the small-business lending unit that Alibaba injected into it in August. All of this means that Alipay is a very valuable part of Alibaba's business which could prove even more valuable to the company in future, especially taking into account that the banking industry in China is still relatively underdeveloped.

7. Weibo: Alibaba is Weibo's second-largest shareholder, with a 32% stake. The Chinese Twitter's opening share price was $16.27 when it listed in April 2014 and it is now trading at around $24.34 - up c. 20% since listing with a market cap of $3bn+. Although the share has been under pressure on the back of growth concerns since the listing, T.H. Capital in September initiated coverage with a buy rating saying it believed the two issues weighing on the price (concerns around user growth and the potential for monetisation) were being addressed, adding "... as such the revenue potential can be realized in the near future,..". While rival Tencent's WeChat seemed to plateau at 650-700mn registered users in China, Weibo has seen an increase in user levels including 1.6bn download times as of 12 August representing growth of 84% since the start of 2014. In 2Q14, Weibo also reported a 30% YoY increase in monthly active users to 156.5mn.

Negatives:
There are also very real risks that Alibaba faces including:

1. China growth: Perhaps the biggest concern for Alibaba is unrealistic expectations for the Chinese consumer market. Although China's economy is growing at a rate most countries only dream of, the growth rate has continued to decelerate over the past few years with the *IMF* in July lowering its growth forecasts to 7.4% and 7.1%, respectively. *The World Bank* also estimates that over 27% of Chinese residents live on less than $2/day. This statistic makes it unrealistic to believe that this 27% will move to shopping online within only a few years. Since the company already has a 80% market share in China, at this stage, they can really only grow in line with the market there.

2. An unknown brand outside China: Although not as well-known outside China, Alibaba sold more merchandise (in terms of value) in 2012 than eBay and Amazon combined. By 2016, it expects to surpass Walmart as the number one global retailer. Despite this the company will still need to prove itself to US consumers and investors. *Barrons* highlights that for some time now, Chinese stocks that trade in the US have underperformed, adding that as of end-March 2014, a portfolio of Chinese-listed stocks on US exchanges trailed the S&P 500 by over 10% in the past year. Over the past five years, the S&P 500 returned c. 150%, but the portfolio of US-listed Chinese stocks returned under 60%. …

/continued

Negatives continued…It could be this underperformance is a reflection of the unease investors feel over disclosure, governance, and operations in the protected markets of Chinese companies.

3. Competition from established players: Added to the point above we note that Alibaba is now entering markets that have well-established players (Amazon.com, eBay etc.) already operating. The average American does not know the company and it will definitely be a challenge for Alibaba to try and develop their presence in the US. Establishing itself will take time and Alibaba will not be a market leader within a year.

4. Alipay: Although we highlighted Alipay under growth drivers we do highlight a number of regulatory risk factors popping up related to Alipay. First, the Industrial and Commercial Bank of China (ICBC) restricted trade with Alibaba's online payment arm to only one branch meaning that numerous branches will no longer compete to offer Alipay the highest yield. This implies Alipay's revenues will be negatively affected from an interest rate standpoint. At the same time ICBC and other Chinese banks (Bank of China Ltd, Agricultural Bank of China Ltd and China Construction Bank Corp), recently restricted customers spending on Alibaba (and Tencent's online payment services). Regulators in China have also been discussing draft regulations to govern the Internet banking industry in the country, including setting limits on how much people can spend on individual purchases and transactions between bank accounts and online finance services.

5. Sales details:
A report from *Bernstein Research* released earlier this year cited concerns about Alibaba's sales totals. The report implied the numbers could differ materially from actual sales in that it possibly included fees or shipping, and failed to back out refunds. Because the company's gross merchandise volume is enormous at $270bn, this means even a 2% variance is a shortfall of more than $5bn.

6. Poor corporate governance? *Forbes* highlights that corporate governance issues are proving problematic for Alibaba as the company is relying on a partnership structure that allows 28 senior management executives to nominate members of the board for shareholder approval. If a nominee is not approved, Alibaba management partners can select a second board member, who would then serve a one-year interim term. *Forbes* believes that this unusual structure could be read in two ways. On the negative side it is a way for management to maintain control of the company while on the positive side it could be a way for Alibaba's Jack Ma and his founding team to continue having a major influence on its culture — the culture that has made the company a successful, money-making e-commerce giant.

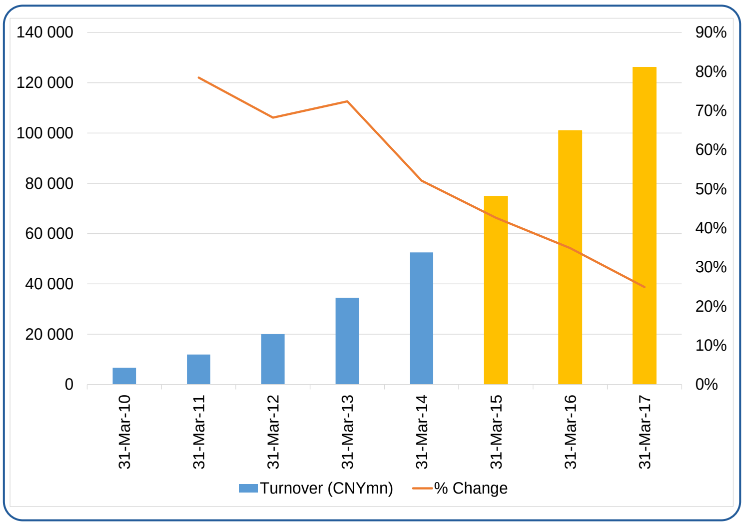
7. Concerns around risks listed in the prospectus:
There are several risks listed in the company's prospectus, with the more notable ones being:

- Alibaba will rely on exemptions from certain corporate governance requirements under the NYSE and the NASDAQ (being a foreign company). For example, the company has said it was not required to have a majority of its board be independent, to have a compensation committee made up of independent directors etc.
- The company does not have to file reports and financial statements with the SEC "as frequently or as promptly" as US companies. In effect saying shareholders have less protection than they would under the Exchange Act rules applicable to US companies.
- In the prospectus Alibaba says that the "Alibaba Partnership," (including members of management) has the right to nominate a majority of the company's directors with its two major shareholders, SoftBank and Yahoo, expected to agree to vote their shares in favour of the partnership's nominees at each annual meeting."
- Despite buying shares in the US, investors may have to answer to China in terms of taxation if Alibaba is deemed a "resident enterprise" in China, dividends or gains on its common shares would be subject to Chinese taxation.
- Alibaba could be scrutinised under an anti-monopoly law in China that took effect in 2008, with two enforcement agencies regulating monopolies and with action by these agencies increasing significantly over the past few years.
- Since Alibaba does most of its business in China, audits by PricewaterhouseCoopers, which prepared the audit report included in the prospectus, are not subject to full inspection by the Public Company Accounting Oversight Board. This, it said, may cause shareholders to "lose confidence in our reported financial information and procedures and the quality of our financial statements," ...

<u>Conclusion:</u>

Alibaba has managed to grow its revenue at an incredible rate over the past 5 years and we expect this growth to continue in the years to come (albeit at lower levels). Historically, revenue has grown at a 3-year compound annual growth rate (CAGR) of 64.0%, while the forward 3-year CAGR is estimated at 33.9%.

<u>Alibaba revenue growth:</u>

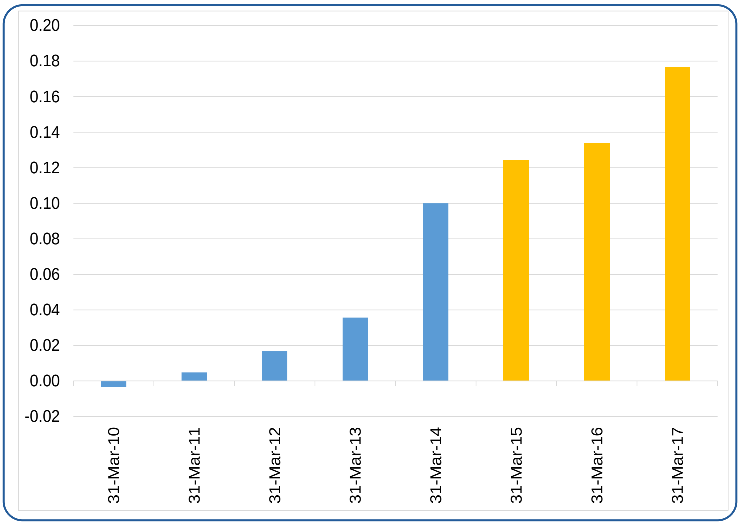


Source: Company data, Anchor Capital

Based on the *Online China Bloomberg report*, Chinese e-commerce is expected to continue growing. As Alibaba controls approximately 57% of the market, any increase in size should be beneficial for the company. Although certain reports suggest that Alibaba is losing market share, we believe that as the size of the pie increases, its revenue has the potential to continue growing. Over and above the e-commerce online market, Alibaba dominates 86% of the mobile commerce market in China. China has nearly 1bn mobile phone users with c. 50% having access to mobile shopping facilities (i.e. internet connectivity, smart phones etc.). In addition, Alibaba has five of the top-10 downloaded apps in China.

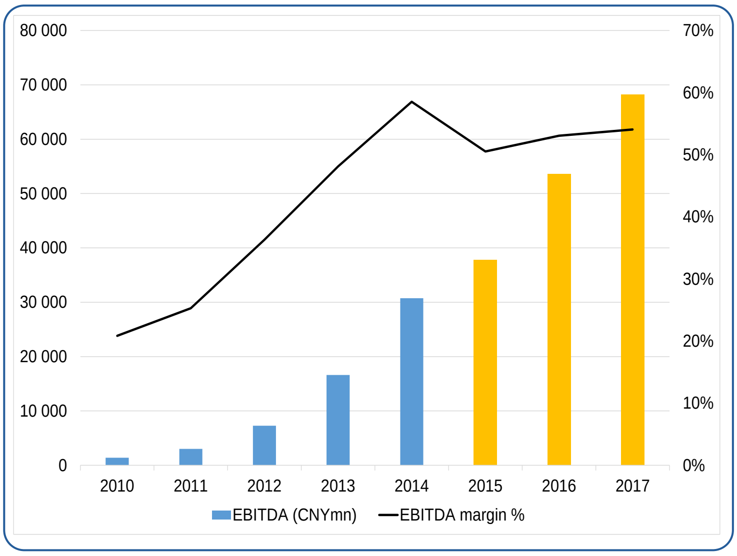
The group's adjusted EBITDA is forecast to continue growing at rates in line with revenue, with estimates expecting a temporary pull back in adjusted EBITDA margin in FY15, after which it will expand to over 54%.

Alibaba diluted EPS (CNY):



Source: Company data, Anchor Capital

Alibaba adjusted EBITDA:



Source: Company data, Anchor Capital

On Monday (15 September) Alibaba announced in a filing with the SEC that it had raised the price range for its American depositary shares to be between $66 to $68/share (from between $60 and $66/share), on the back of strong demand from potential investors. Press reports indicate that during the IPO roadshow founder and chairman Jack Ma said the company would spread its business aggressively into the US and Europe following the listing. If the company is able to successfully replicate elsewhere what it has done thus far in China, there is no doubt that it would be a share to own. Although it does face challenges in its new markets, the company's positives and drivers far outweigh the negatives. We would recommend investors add the share to their portfolio. However, since the IPO looks to be significantly oversubscribed one way to access Alibaba share is through Yahoo! or Softbank. Both are likely to remain in focus ahead of (and even beyond) the listing, with Yahoo! owning a c. 23% stake in Alibaba, while Japanese telecommunications group, Softbank, has an even larger c. 32% stake .

Alibaba has also grown attributable net income by more than 100% in each of the past 5 years. This growth is expected to slow to a forward 3-year CAGR of 20.9%. As the business grows we believe changes to costs will impact the growth rate and margins. The CAGR from 2011 to 2017E is 82.4%.

Diluted EPS is expected to come in at CNY0.124 for FY15 and CNY0.134 for FY16, while Alibaba trades on a 12-month forward P/E of 33.4x (currency taken at spot of CNY6.14/$1). This is comparable to peers such as Baidu (FY14 P/E=35.0x) and Tencent (FY14 P/E=37.1x). Utilising these comparatives, Alibaba would be valued at $70.75-$75.01/share. News reports indicate a comparative metric price of $80/share. eBay is on a 12M forward P/E of 15.87x , whilst Amazon is at an extreme 12M fwd P/E of 81.28x, according to *Bloomberg*. Return on equity (RoE) is currently 159.7%, dropping to 37.7% in FY15.

Bryan Rudd/ Marco de Matos

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