

Consumer Discretionary B | Ted Bauer & Kenzie Meyer | Tanner Thompson & Joel Yang



Introduction

ALIBABA - \$BABA - is China's largest e-commerce retail company. Founded April 4, 1999, they provide Business-to-Business (B2B), Business-to-Consumer (B2C), and Consumer-to-Consumer (C2C) sales services via web portals, electronic payment services, shopping search engines, and cloud computing services. Alibaba also owns and operates a diverse array of businesses around the world in numerous sectors. Alibaba is different from Amazon and eBay as they are more exposed to B2B transactions. However, these businesses can be as small as individuals and merchants selling homemade goods. Alibaba is creating an interconnected marketplace that is improving the well-being of China.

Alibaba's mission has always been to make it easy to do business anywhere. Recently, because this mission statement was created in 1999, they have added an addition, **"To make it easy to do business anywhere in this digital era."** We believe that Alibaba has a strong hold in China and the Asian Continent, and they show themselves to be competitors that will not give up if things get tough. Completion is a relatively new thing in China and Alibaba is poised to be a long-lasting leader. They currently control over 80% of the e-commerce market in China.

Recommendation

We recommend a **BUY** for Alibaba due to the overall quality of the business. The diverse market that is the Asian continent makes Alibaba an attractive investment for our fund. With no exposure to the developing regions of the global economy, our portfolio will benefit from a new geographic revenue stream exposure. Alibaba has a strong reputation that is primed to dominate the Asian Retail space.

Investment Thesis

Huge Addressable Market

Alibaba offers a diverse spectrum of services to mainland China as well as the greater Asian continent with goals to spread into the rest of the global marketplace in the near future. The recent management has moved to expand their main retail arm, Taobao. Taobao services around 600 million mostly urban Chinese customers and rural areas of China, through the installation of pickup and drop-off locations for delivery in rural areas of China. With this move, Taobao can effectively double their accessible market size to over **1 billion Chinese users**, more than three times that of Amazon's current user base.

Diverse Market Exposure

The breakdown of main areas of revenue exposure for Alibaba:

Chinese Retail/Wholesale Exposure - Core Commerce

Alibaba is divided into three core businesses in China: 1688.com, Taobao, and Tmall. Alibaba is the middle man in China's emerging e-commerce industry.

Taobao	This is the largest C2C retail platform. It is like eBay and has successfully squeezed eBay out of China in 2006, and just recently Amazon as of 2019 as they will stop selling from within China. The sellers on Taobao website are mostly merchants and small businesses.
Tmall	Tmall is the largest retailer for B2C transactions in China. Many items sold on Tmall are listed on Taobao, which helps create a connected marketplace. This platform has nicer brands sold by manufacturers and allows you to manage a custom "store front."
1688.com	This is the main B2B wholesale business segment within China. Product turnover annually is \$20 billion USD. This website services businesses who need to sell their goods to other businesses in bulk.

	1688.com caters to individuals and businesses from all around the world and is the number one website when looking for wholesalers and suppliers in China. Many Taobao stores get their supplies from 1688.
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International Retail/Wholesale Exposure - Core Commerce

These services are offered to the large emerging market that is most Asia as well as the world.

AliExpress	AliExpress offers a global retail service with access allowed in a large variety of languages. Amazon sellers often use this service to stock up on low cost product to increase margins. This marketplace is often used in the United States.
Lazada	Lazada is a southeast Asian e-commerce company. It is the largest e-commerce site in Malaysia, Vietnam, Indonesia, Singapore, Thailand, and the Philippines.
Alibaba.com	This is the main B2B arm for international commerce and is in fierce competition with Amazon for market share globally.

Other Services

Alibaba offers a diverse range of services including digital media and entertainment, travel, food, health, and more.

AliHealth	This service helps consumers get in contact with medical professionals and track their personal health data. AliHealth is a Hong Kong based company whose majority controlling owner is Alibaba.
Ant Financial	An affiliate financial services provider with an application allowing investing, savings and payment from your phone. The app Alipay is seeing growth in the US as Walgreens is now accepting Alipay at over 7,000 locations. All transactions hosted by Alibaba go through Alipay, their version of PayPal. It oversees the largest money market fund in the world at over 1 trillion yuan in assets. The world's largest online payment app with more than 400 million users.
AliCloud	China is quickly developing and beginning to have a demand for cloud technology. As more firms grow, the amount of data they must handle increases. AliCloud helps businesses move their data onto the cloud to be stored off-site. These services include elastic computing, storage, database services, security and the list goes on. AliCloud already has a 47% market share of the cloud space in China.
Ele.me	This is a food delivery service allowing customers to order goods on their phone.
Youku	The YouTube of China. It has the largest share of viewers in China.
UC.com	This is the 4 th largest search engine in the world.

Where Alibaba Generates Revenue

Alibaba generates revenues mainly in China. Other revenues come from international exposure of 200+ countries to other Asian markets. Most of that revenue comes from their core commerce arm.

How Alibaba Generates Revenue

Most revenue is generated through Alibaba.com which charges a membership fee to sell items online under a verified basis (Annual fee of around \$3,000 USD). This gold membership separates you from the unverified sellers on Alibaba.com, increasing the trust of the consumer buying the product. Sellers who opt into the membership also must pay a portion of their revenue to Alibaba. Other sources include pay for performance (P4P) revenues on both Taobao, Tmall and Alibaba.com. P4P allows sellers to promote their listings for a cost. This service helps customers (sellers) market their products and promote their on-line store front.

Alibaba is now expanding into more services including banking and health, which brings more revenue exposure as these services come into fruition. One of the strong points in their other services include Alipay. This business is operated by Ant Financial which is partly owned by Alibaba (33% - controlling stake). The founder of Alipay is the founder of Alibaba, Jack Ma.

Key Drivers (CAR)

Both the **challenges** facing businesses and the **actions** of Alibaba are drivers of Alibaba's future performance due to the highly flexible way they do business. The **results** are what will happen if Alibaba stays the course of the actions they have set.

Challenge(s) Alibaba face: DRIVER #1 – (EXTERNAL FORCE(S))

Socioeconomic Changes

- **Globalization**

The internet has opened the world to everyone. Competition now takes place across borders over the internet and Chinese services are slowly moving into international waters. This will surely continue to happen as China enters the free market of the world.

- Three Pillars of Cross-Border Commerce:

1. From the world to China
2. From China to the world
3. From the world to the world

- **Middle Income Growth**

Emerging markets south of China as well as the Pacific Island countries are entering an age of expansion that will fuel Alibaba's growth. China already has over 1 billion consumers. Reaching all of them will ensure Alibaba stays on top of the latest trends in consumer tastes and preferences. With middle income families set to earn more than ever in China, Alibaba has a great foot hold to capture this robust growth in the coming years.

- **Nesting**

More and more people are preferring to stay at home over going somewhere to get something. Delivery services are growing everywhere, and apps are providing more in smaller packages. Alibaba's services this demand with quick and easy service to Chinese consumers as well as International customers.

Action(s) Alibaba is taking: DRIVER #2 – (INTERNAL ACTION(S))

Diversified Retail Exposure

- **Rural Taobao**

As of December 31, 2017, nearly 600 million people in China resided in rural areas. Distribution to these rural areas is challenging and costly. Alibaba has however created Rural Taobao to increase the level of consumption and commerce in rural China. As of March 31, 2018, they have established service centers in over 26,000 villages, to give residents greater access to goods and services, and the ability to sell what they produce to urban consumers. Villagers can place orders at service stations, and the goods ordered online are delivered to the service centers and distributed by local couriers. Rural Taobao is helping improve the quality of life of rural residents and helping reach a greater portion of the market.

- **Targeting Aging Populations**

Chinese age distribution shows about the same number as 45-50-year-old people as there are 25-29-year-old, with a bit of a gap in between the two age groups. Knowing this, Alibaba has moved from the crowded market of trying to service millennials on apps such as their main retail app, Taobao, and is moving to meet the aging population with more age appropriate apps. This shows Alibaba is aware of trends and demographic data and is trying to move with the winds of change in China and meet every consumer with an easy to use app or service. The new services include a simpler interface and the ability for you to chat with your friends and family while searching for items.

- **Beyond Physical Goods**

Consumers more and more want to do business in the easiest way possible. Alibaba is positioning itself with a

broad exposure to any and all forms of retail. Banking, Healthcare, Entertainment, etc. With the motto, "To make it easy to do business anywhere in this digital era," Alibaba is doing as much as they can for the consumer as they know a happy consumer will ensure they return and continue to spend.

Result(s) we see for Alibaba: END RESULTS

Marketplace dominance

- **Current standing of Alibaba**

Alibaba is already a trusted name in China with over 600 million active users. Both businesses and consumers use Alibaba and they will continue to. Amazon and other foreign e-commerce companies cannot keep up with the pace of growth of mainland Chinese retail competitors. With the large number of sellers coming into reality in China, we see more data being available to sellers Alibaba is a powerful force in the rising tide of the Chinese consumer.

- **What Alibaba Will Become**

We see a diverse consumer base in China and its surrounding neighbors, Alibaba is doing everything it can to reach as many of these people as they can. Current age distributions as well as wealth distributions indicate Alibaba is targeting the right people and will grow with the consumer it serves. Alimama, their cloud marketing arm, is beginning to provide data services to their sellers allowing them to track tastes and preferences in a much more manageable way.

Valuation

Absolute Value

WACC calculation (\$ mln)	
Risk-free Rate of Return (China 10-Year Bond Yield):	3.90%
Equity Risk Premium for China:	6.55%
1 year Beta:	1.2
CAPM:	11.76%
Market Value of Equity:	449,022
Market Value of Debt:	13,965
Total market value of equity & debt:	462,986
Equity:	96.98%
Debt:	3.02%
Tax Rate:	30%
After Tax Cost of Debt:	2.45%
Cost of Equity:	11.76%
WACC:	11.48%

		Low	Medium	High	<<<Target Prices
Implied Fair Value		\$140.38	\$155.96	\$172.66	
Implied Exit EBITDA Multiple	55,190	9.6x	11.1x	12.5x	
Implied Perpetuity Growth Rate	18,012	8.3%	8.3%	8.2%	

Relative Value

We used Amazon as a company to compare multiples of Alibaba with. As we can see Alibaba is undervalued relative to Amazon. Both price-to-book and price-to-earnings favor Alibaba from a relative value standpoint. We see that with our DCF, Alibaba may be

COMPS.	P/B	P/E	MKTCP/CB
BABA	6.99x	40.81x	0.69x
AMZN	21.1x	85.71x	2.4x
Average	14.05x	63.25x	1.5x

overvalued from an absolute value perspective which we attribute to possible slower growth in china over the coming years. However, due to the unique standing of Alibaba, we believe relative value should be used to compare them to Amazon. To highlight this, we created a custom multiple taking the market cap of both Alibaba and Amazon and dividing them by their respective customer bases. This shows us that you must pay almost 4 times more for exposure to one customer on Amazon relative to Alibaba.

From this point of view, we will use the target price from our DCF of \$172 and weigh it at 40%. We then will take our target price from our average P/E multiple to arrive at a price of \$225 and weigh it at 60%. This gives us a target share price of \$204.

Risks

Maintaining Current Levels of Growth

- If the US recession hits, China will be exporting less. This would reduce relative demand for good and for jobs, which would in end reduce growth.
- The dependability on their ability to grow their core commerce, cloud computing, digital media and entertainment business, and businesses that they have acquired.

Trust

- The Asian consumer believes these products are quality and serve their purpose. However, there is a stigma in America that these products do not have a high quality and are counterfeit.
- Alibaba is using internet technology and data to combat IP infringement. 95% of takedown requests are processed within 24 hours.

Variable Interest Entity

- It is illegal for foreigners to own stocks in internet commerce in China, i.e., Alibaba.com. However, Alibaba Group Holding is based in the Cayman Islands and that is why they are a part of the New York Stock Exchange. Alibaba.com is a variable interest entity (VIE) of Alibaba Group Holding. A VIE is new company started off of a guaranteed loan from a parent company. The Chinese government likes VIE's because it allows foreign investment in China's growth with no strings attached. However, Chinese courts do not like this because it goes against their beliefs and in the past, they have maintained an attitude that is not favorable for VIE's. With that being said, if the government feels VIE's are no longer in China's favor they could put an end to them.

Management

Jack Ma is Alibaba's lead founder and the executive chairman. From their founding in 1999 until May 2013, Jack served as the chairman and CEO. Jack serves on the board of SoftBank Group Corp., one of Alibaba's major shareholders and owns Ant Financial, which is the creator Alipay.

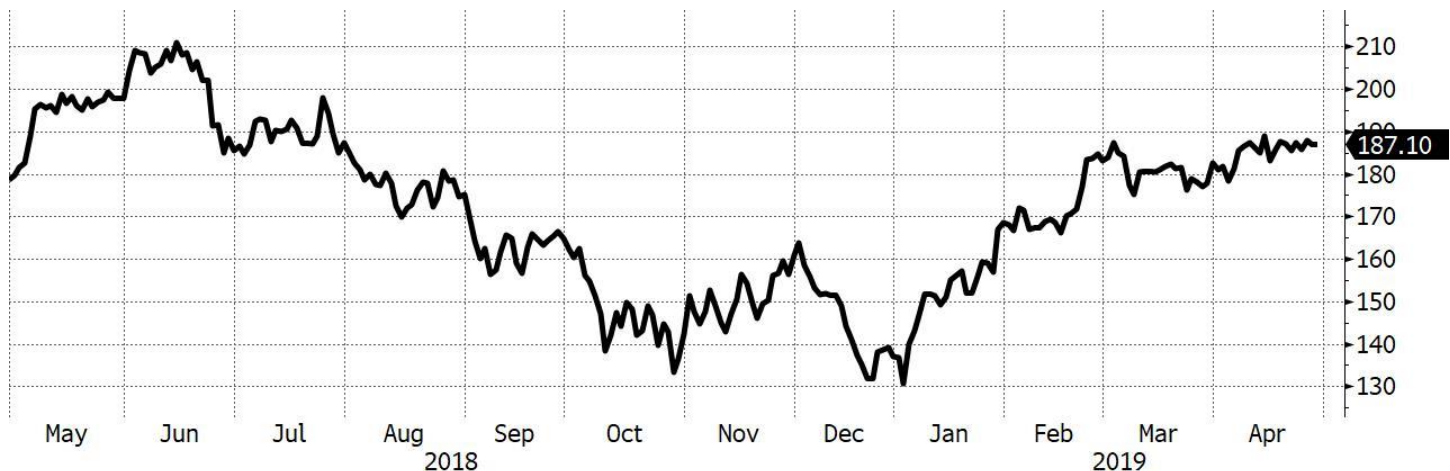
Jack has started his succession plan at only 54 years old. He does not want to die in the office and wants the opportunity to teach others how to become successful. CEO Daniel Zhang will succeed Jack as chairman of the board September of 2020. Jack will remain in frequent communication with the company

Current CEO Daniel Zhang joined Alibaba Group in August 2007 and was named CEO in May 2015. His first role was CFO of Taobao Marketplace and general manager of Tmall. Under his leadership Tmall rapidly became one of the most

important businesses of Alibaba. Tmall became an independent business unit and Daniel was named president. Daniel created China's "Black Friday" known as Singles Day. Sales are three times higher than Black Friday and Cyber Monday combined in the US.

Along with Daniel, there are 20 other executives and 11 board members with the average age of 50 years old. Each of the key management positions are heavily compensated by stock bonuses, which is a positive for the company.

Stock Chart of Past Year Performance



Peer Analysis

Alibaba and Amazon are the two largest e-commerce platforms in the world. Amazon is Alibaba's closest competitor and the other companies we used are near peers. We noticed the unique ability for Alibaba to make such significant revenue with no inventory. This is due to Alibaba serving as a very effective marketer for its sellers, increasing its customer base to benefit its sellers. We also see strong FCF growth and profitability for Alibaba. The operating margin for Alibaba leads its peers due to the assets-light business model. Also, we have seen very strong revenue growth over the past five years at an average rate of 48%, making Amazon look overvalued relatively.

Company	Revenue	5 Yr. R.Gr.%	FCF Gr. %	INV/TA	Op. Margin
BABA	37,825 M	48.62	51.86	0%	27.70
AMZN	262,887 M	25.62	169.83	10%	5.33
EBAY	10,746 M	5.41	-1.69	0%	20.68
JD	69,899 M	46.13	-45.12	21%	-0.57

Ownership of Shares

Top 5 Share Holders			Institutional/Mutual Funds vs Insider Holdings	
Holder	% OS	Shares (MM)	<i>Total Shares Held – 2,592,184,000</i>	
T. Rowe Price Associates, Inc.	2.32%	60,091	Institutional Holdings	40.84%
Baillie Gifford & Co.	1.83%	47,311	Insider Holdings	0.49%
BlackRock Fund Advisors	1.75%	45,238	SoftBank Group	28.00%
The Vanguard Group, Inc.	1.62%	42,069	Altaba	10.00%
Temasek Holdings Pte Ltd.	1.06%	27,369	Unknown Holdings (Probably Insiders)	20.67%