HollAnd Advisors

Holland Views – Alibaba (Price: $210, MCap: $569bn, EV $518bn)

Deferred Gratification

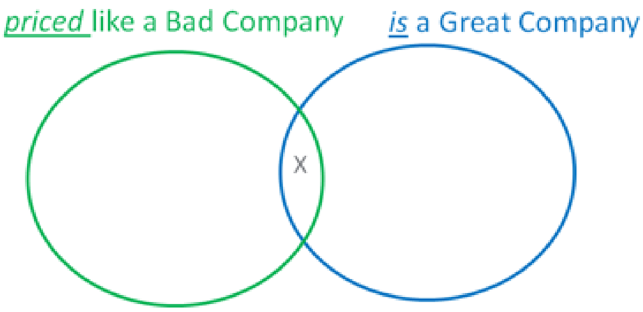
We have spent a fair amount of time listening and reading up on the background and business that is Alibaba and some of its newest competitors such as PDD. We conclude that today investors are being offered a colossus of a businesses at a wonderful price. How wonderful? Well taking a variety of guesses (for they can be little more) as to the value of Ant, Cloud and the Seed/start-up businesses we think the core Alibaba business might well be trading at below 10x EV/EBITA. When we consider that this part of the business is still growing at 17%pa and is by far the slowest growing part of the company it perhaps puts the valuation of the group into context

In search of Perspective

Those looking for a deep dive on Alibaba can stop reading now. This is a piece about perspective, little more.

Alibaba interests us due to the juxtaposition it now finds itself in. It is a business that is still growing very fast and still dominates many of the most important fast growing online Chinese markets, yet it is also a re-investor, innovator and controlled by its founder (well, until very recently at least). That it has been more recently in the cross hairs of Chinese politicians is clearly well known and an often-repeated fact by commentators. We believe this risk to be now more than discounted in the share price. We sometimes simplify our approach as looking for great companies when they are priced like bad ones. Taking the plunge to purchase such companies at a time when others are telling you they are 'bad' can feel psychologically difficult. In the case of Alibaba, we have to accept it does not just *feel* bad for there may be also risks we cannot foresee or control. But what we are looking for however in this job is mispriced bets, and that is what we think we have found. We cannot guarantee its outcome, but we see the odds as very good vs the price we are being asked to pay vs the growth we are being offered.

Fig.1: What we look for



As the great man says: **"Price is what you pay, value is what you get"**

Source: Holland Advisors

Shameless Cloners

Upfront we should state that we are shameless cloners. Whilst looking over someone else's shoulder was something we might not have been proud to do in our younger lives we found new utility in it courtesy of Mr Munger (who else) when we heard him answer a Berkshire AGM question some 15 years back.

Questioner: "*What are the 3 most important things an investor should do Charlie*?'
Munger: *"Look at Spin Outs, invest in cannibals and watch what the smart people are buying".*

Whilst this last point is not the source of all our ideas, it is the source of some. The key word in that sentence is **'source'**. Jumping forward to spring 2021 the cleverest man on the planet[1] makes his first investment for 10 years…

This person invests a lot of money (c.20% of Daily Journal's $200m equity portfolio) in one single stock, Alibaba. This person of course is Charlie Munger once again, a long time China bull and close watcher. What happened next, we think is interesting, very interesting as a great many people then immediately fell foul of the psychological traps Charlie has been talking and writing about for the last 40 years! By that we mean they will quickly set about explaining why HE was wrong to make such a purchase and THEY are right. I.e. because of X, Y, Z… immediately looking for re-enforcement bias of why their own preconceived views on why 'China is risky' and 'China policy intervention now makes it unforecastable and therefore un-investable' and all that jazz etc..

Our thought process is somewhat different. And in truth it goes along the same lines it always does whenever we do a little cloning from someone super smart. Here's what it sounds like inside our heads:

> *"This person is real, real smart, much smarter than us. We have followed them and admired their decisions over many years and they have thought long and hard about this. They know all the information that is out there and they have chosen to invest in this. We wonder why?"*

That's it, nothing more. Disappointing, isn't it? Then we start reading and listening to podcasts and the like and going down all sorts of blind alleys and learning about Jack Ma etc. and we just keep turning the pages

Supporting materials

At the end of this piece, you will find a link to lots and lots of articles, podcasts and videos which we would recommend listening to that give a really good insight into Alibaba. The 'Crocodile on the Yangtze' and the Colossus ones are particularly good.

What follows is not a deep analysis of each business line but a just our views on the risk/reward we assess post the reading and listening we have done. Attached to this email is a summary of supporting documents. These include.

- Our own simple sum of the parts spreadsheet which whilst crude makes important adjustments to the earnings power of this core business and the resulting value we think is on offer
- Also attached are presentation packs and transcripts of a recent earnings call with our notations
- Investors should also listen and look closely at last year's analyst day where a lot of good insight into the business was given

[1] We are prepared to back up that statement sourcing pg.200 of William Green's great recent book **Richer Wiser, Happier**. *"Pabrai chuckles at the memory of hearing Munger appear onstage alongside a Nobel winning scientist who was 'Caltech biggest brain'. That guy looked like a shrimp who didn't know shit. You could see the contrast dumbass on one side, real brain on the other."*

Enough preamble – What do we think?

Alibaba current competitive position is simply huge. The breath of it is simple staggering. It makes Amazon look small and almost weak by comparison. That this market position is in one of the biggest global markets that is still set to grow nominally at strong rates for many years to come should not be overlooked (we doubt Munger has!). Yes, the company has new competitors emerging all the time (e.g. Pinduoduo) and this factor leads to a suggestion that its market position can be somehow lost, but it also shows just how good all these competitors are including the one that started it all and that in many cases still leads: Alibaba. Alibaba has many Phil Fisher type tendencies in that it is constantly growing and investing in new legs of growth for the future (Cloud being an excellent example, but there are many more). As we will allude to later seeing the strength of wider Chinese players and the Phil Fisher/Re-investment growth models in a wider context rather than just looking at Alibaba might be an important conclusion for investors

Importantly, Alibaba (and PDD) are perfect fits for our Scale Economics Shared model. Indeed, when we started to look at the company post Munger's purchase this is what struck us most strongly. We look at lots of ideas that might come from other smart investors but for a great many of them we don't make it past the first few hours, because we see nothing we can relate to. Here the opposite was the case. It was not that they were unknown to us, the model was fast growing yes, and in a different language and geography yes, which creates barriers. But actually, it is VERY familiar. I.e., these (for we have looked at both BABA and PDD) are businesses possessing a powerful scale economics shared business model. As we made these reflections another memory popped into our heads. It was from another Berkshire AGM a few years back when Warren and Charlie were asked what they wish they had done differently. They quickly answered: *'we wished we had looked further afield'*.

In that vein we reflect

For some years now we have studiously looked at local EDLP models of say JDW or Next that might grow at sales at 5% pa if they work hard and intrinsic value at 13% if they allocate well. But what if we could find businesses 'further afield' trading for similar prices that are growing at three times that rate. Yes, we know they come with greater risks and might be harder to analyse in some ways, but the runways for growth could be far far greater…? Superficially these feel like what we are looking at. Indeed, on reading that PDD's markup is a remarkable 0% vs Costco famous 14% - we think that is something to marvel at. Might it not make PDD a future powerhouse far further than its current China base.? For today, we keep our discussion only on $BABA but PDD certainly fits our mould alright!

Re-investment

Those wanting to entertain the idea that Alibaba is a scale re-investment business as we are claiming should take a look at the attached transcript. It is of the recent year end results. Note the highlights we have made on it. It is interesting we think the sheer scale of growth the company is reporting on the one hand and then the comments the company is making about re-investing the coming years profits on the other. What was VERY notable we thought was the share price reaction on the day of this meeting. The shares fell. If Amazon say 4 years ago had made these exact same comments post reporting strong profits and then also talked about re-investment for future growth would its shares have risen or fallen? We ask you to reflect on that for a moment? Four years ago, once its scale model was proven? They would have risen we suggest and done so because by then its investors understood the title of this note-deferred gratification. Ten years ago, maybe not, but four year ago they understood its power fully.

The fall in $BABA both in recent months and on that day this April, we think is perhaps an example of the different mentality that exists amongst the blend of investors in its (Alibaba) shares and those that exist in say Amazon or Costco. And this is what lies behind Charlie's purchase

Charlie's arbitrage

In short, some Chinese investors, we suggest, are not yet as skilled as some of their better business leaders are in deferred gratification. And this is the arbitrage Charlie is trying to take advantage of. Chinese investors on average (we know this statement generalises and apologise for this fact) are traders at heart with a speculative mentality. We know that this borders on condescension for country we have visited only twice, but we hear the sentiment repeated by more than a few of the most highly respected local Chinese investors (Zhang Lei at HillHouse Capital is the best example). By contrast it has taken a very long time for only a small number of experienced western investors to truly understand the deferred gratification concept that lead to the accepted dominance of businesses like Costco and Amazon and the success of those that believed in them. That emerging markets are behind in understanding this, in perfectly normal.

If we have any sort of edge in this area it is not local knowledge or hard work, but only perhaps an ability to spot a powerful mental/business model we have seen before. We think we recognise this in $BABA and $PDD. $BABA we are prepared to highlight at this stage due to:

- Its engrained position in so many markets ala Walmart of old
- Its Phil Fisher 'grow new growth legs' strategy
- **It's replay of the Amazon Cloud playbook,**
- That the value is obvious and pretty much in plain sight.
- Oh! and that Charlie is pointing it out to us.

PDD we might come back to another day

Valuing Baba

We have now spent more than a little time in front of $BABA accounts and presentations and have been interested to see the level of value uncovered in this company, the closer we have looked. We have tried to show this in both our highlights on their recent short presentation pack and in our own valuation spreadsheets in the attachments.

What this section tries to show is just a simplification of this giant business that has cash, equity investments, fast growing (but currently loss making) investments and a hugely profitable capital light high margin cash cow core businesses. The short conclusion of what is below is that by putting what we think are low-balled/prudent values on the non-cash generative businesses, we end up with a rump value for the main Alibaba ecommerce business that is c. 9-10 EV/EBITA unlevered. As we said it in our introduction for a Core division that is still growing 17% pa and is the slowest growing division, we think that is one hell of an entry price into a powerhouse of company

Fig.2 shows our representation of new EBITA disclosure of the business and the scale of reinvestment (or losses). All charts (and assumptions) are viewable in the accompanying spreadsheet.

Fig.2: New Alibaba EBITA and Cost disclosure [2]

2021 Segments (RMB)	old "'core commerce" — "Marketplace-based" Core commerce	New initiatives strategic investments	Cloud	Digital Media	Innovation	Unallocated	GROUP
Revenue	**621146**		**60120**	**31186**	**4837**		**717289**
Income from ops	158981		-9050	-10321	-15502	-34430	89678
Add: share based comp	24356		8861	3281	5162	8460	50120
Add: amortisation	11175		23	922	83	224	12427
Add: fine						18228	18228
adj EBITA (prev disclosure)	194,512						
adj EBITA (new disclosure)	**229,134**	-34622	-166	-6188	-10257	-7518	**170,383**
YoY	17%						
Holland Net Income adj: Segment Losses to add-back to Net Income in grey (a)					-51233		
add back 50% of (a)					-25617		

Source: Holland Advisors, Alibaba

- As Per Fig.2, Baba's new disclosure of 'core commerce' EBITA (what would have been RMB194,512 previously) now also breaks-out what it calls 'New Initiatives' EBITA from that profit line. "New Initiatives" is a catch-all term for its immature business losses and, frankly, new price reinvestment in Grocery/Hypermarket/Logistics and International as per the footnote below.

  Importantly, excluding these reinvestments, the Core Marketplace Commerce business (i.e. the original Alibaba.com, Taobao and Tmall **cash cow** businesses) had EBITA of RMB229,134 (highlighted in pink above) in the last 12 months to March 2021.

Now looking further down the P&L at Net income, we suggest some adjustments in a bid to get to an adjusted group P/E. This is shown in Fig.3. The principle adjustments that we make are to add back 50% of the"seed" business losses (calculated above in Fig.2 and highlighted in grey) and only 50% of the stock based comp. The implied adjusted Net Income suggests **a 19.2x P/E** multiple (for a business that has compounded group EBITA at 29% 2016-21). Again, this 19x P/E includes half the losses of the Seed businesses and assumes that Cloud makes no profit.

Fig.3: Holland Net Income Adjustments

Group (RMBm)	FY 03/16	FY 03/17	FY 03/18	FY 03/19	FY 03/20	FY 03/21	16-21 cagr	
Group adjusted EBITDA						196,842		
Group adjusted EBITA	48,570	69,172	97,003	106,981	137,136	170,383	29%	
yoy		42%	40%	10%	28%	24%		
Group								
Reported Statutory Net Income						**143,284**		
less ANT investment gains						- 66,305		
add back goodwill						12,427		
add back impairments						14,737		
add back **50%** of "Seed" Business Losses						**25,617**		
add back 50% of Share Based Comp						25,060		ex cash
add back CCP fine						18,228	P/E	P/E
Group adjusted net income (ie including cloud, seed and Ant share)						**RMB173,048**	**21.1x**	19.2x

Source: Holland Advisors, Alibaba

Finally, we try discern what valuation multiple the Core Marketplace Commerce earnings (again, the RMB229,134 EBITA referenced in pink above) might be trading-on by stripping out the non-core businesses valuation from the Market Cap.

We do this in Fig.4 by looking at the four key non-core business units on the Balance Sheet (New Retail, Cloud, Ant Financial and Group Cash). The result is very interesting.

[2] "The **New Initiative** businesses, which now include our New Retail businesses, Local Consumer Services, Lazada, Taobao Deals, Cainiao Network and others, represent strategic areas where we are executing to capture incremental opportunities." – Alibaba FY21 results statement

Fig.4: Holland estimate of non-core segment valuation

non Marketplace-based Core Commerce Segments VAL guesses (RMB)						VAL guesses in blue	
					$m	RMB	
1. "Seed" (aka New Retail etc)				$	25,000	160,000	
2. Cloud	now profitable	>$11bn sales run-rate					
Cloud	> 43% m share	sales mult	5.0x	$	55,000	352,000	
							implied P/E
3. Ant Group equity val	Context: 2020 private equity stake sale val **$190bn**			$	150,000	RMB960,000	22x
30% stake	[Shareholder fund H220 mark to market $144bn (from 295bn)]			$	45,000	288,000	
4. Net Cash						324,485	
Capitalised Overheads at	10x					- 75,180	
non-Core Commerce VAL 1+2+3+4				$	163,954	RMB1,049,305	
as % of M Cap						29%	
Group Market Cap Cap				$	569,310	RMB3,643,584	
less: Holland non Core Segments VAL est						-RMB1,049,305	ex cash
Implied 'Core Marketplace' VAL						RMB2,594,279	RMB2,269,794
Core Marketplace-based Core Commerce EBITA						RMB229,134	
Core EBITA Multiple						11.3x	9.9x

Source: Holland Advisors, Alibaba

- Were we to give what we believe are reasonable valuations for **New Retail** (seed) business (say $25bn) + **Cloud** (say 5x sales, a $55bn valuation) + **Ant Financial** stake (say at half its purported 2020 pre-IPO valuation (the $150bn we use) which would imply a c.22x P/E for the Ant business) + **Cash**, these four buckets together would aggregate c.RMB1,049bn (US$163.9bn) as shown above. In other words, about 29% of the Group market capitalisation.

  In turn, such a non-core valuation would imply a rump value for the core (i.e., main 'Marketplace Core-Commerce' business) of RMB2,594bn (or RMB2,269bn ex-cash) also as shown above.

  Comparing this to the reported ('core Marketplace') EBITA of RMB229bn gives a **rump EV/EBITA of just 9.9x**

- For a "core Marketplace" business that is most recently growing at 17% pa (as per Fig.2) and at group level where profits compounded at 29% over the last 5 years, has an unmatched market share position derived from scale and sharing of that scale with customer, in the largest and fast-growing online market in the world - **we think that a remarkable valuation**.

The main reason for the difference between the conclusion of our valuation above and in the attached supporting documents is a) due to adjustments P/L losses from ecommerce businesses that are yet to be profitable and b) other P/L charges.

A word from a colleague

Part way through our readings on Alibaba, we did wonder whether we might be overstating the company's 'exceptionalism' as an innovator. We don't mean to take away from Jack Ma's formidable innovation in the early days as a Chinese internet pioneer and exceptional manager. Ma faced down eBay and grew the business into the dominant e-commerce platform of the entire country.

Rather, we wonder if what we see in Alibaba is actually a country-wide phenomenon in China where Alibaba took its first-mover advantage and leveraged it to perfection. As we look today at PDD, Shein and the myriad of other massive digital-native Chinese businesses – the scale and pace of technology led change is hard to overstate.

As the western world moved from dial-up to broadband to high speed mobile over two decades, China just leapfrogged it all and effectively went straight to mobile. It also went straight to e-commerce (leapfrogging shopping malls too!). The internet has been a great deflationary force for the world, a remover of commerce friction. China offered indigenous entrepreneurs unprecedented scale and much friction opportunity to grease with their mobile-first platforms. Combined with this gigantic captive market (where the established western players were not allowed to enter or compete) was a Chinese culture that was open to change and innovation and dead-set on lifting themselves out of low income. The combination is truly explosive.

In the same vein, and for balance we ought to also note that other Chinese platform companies are engaging in similar SES strategies (especially Pinduouo). 'China tech' en masse looks to be in the midst of a formidable capital cycle. For example, slide 92 of the following link[3] is a reminder that the all the big platforms, not just Alibaba, are investing heavily this year "*to defend and expand their reach"* in China.

Alibaba is a phenomenal company but there is an argument, perhaps, for a Templeton approach of using a select basket of such stocks to participate in the continuation of a trend that looks still to have a long runway of growth ahead of it.

A few analogies

The obvious analogy we would make is between Alibaba and Amazon (+ eBay + PayPal, + Stripe, etc.). If Alibaba is just looked at on straight P/E ex cash valuation the company trades on c.19.2x, but this multiple takes no account for the value of the Ant/Alipay business, nor does it adjust for the value that might accrue to businesses that today are loss-making. (Hence our work above). There are many parts that have value but the most obvious jewel in Baba's crown is its Cloud computing business, with 43% Chinese market share. Our very rough segment valuation assumes that (at 5x sales) it is worth $55bn, yet today, it is at just the tipping point of scale and profitability that Amazon cloud business (AWS) was at in 2016. Munger and a few other US investors can clearly see this analogy, as can Alibaba, hence they are not in rush to maximise the profitability of this division just yet.

A less obvious analogy is perhaps that of Walmart. When doing our reverse engineering of Berkshire's investments over the years, the purchase of Walmart interested us. Buffett and Munger had watched patiently as Sam Walton had grown and compounded capital well for decades, but they only invested when they felt it passed a threshold of valuation that gave them a

[3] https://e46b0d6a-0ebf-4fe8-92ca-0d0f7dae4fd1.filesusr.com/ugd/7a471b_af073b5c77c144768bfe094c542ccb06.pdf

starting point, they could be comfortable with. Soon after looking into Munger's Alibaba purchase, we felt this was a repeat of the Walmart patience story. For all the excitable chat about Ant Financial and Jack Ma we think, that is all Munger is doing. He is balancing off the scale of the opportunity on front of him in $BABA, ie the huge growth runway it has and the huge market power it has. He is then saying what price am I having to pay for all this? Right now, the price looks a fair/great trade-off for what you get for it. That is what good odds are.

Some Reflections

The other day we found ourselves reflecting on the investment prospect that is Alibaba rather more holistically. That is to say against country risk, political risk and where it sits is a world of uncertainty, but opportunity too. We found ourselves noting what it was that turned the tide of sentiment towards the company.

Was it Jack Ma's Speech or the government crackdown on Ant Financial that resulted in its pulled IPO? The following article is a fairly representative mainstream article[4] (from Forbes) on this point.

Clearly these types of articles give a different and important insight that we need to take on board. Has value been taken away from Ant group and Baba since last summer? Yes of course, but is that fact also discounted in the share price too? Is Jack Ma's power being neutered somewhat? Yes. But is he also showing great signs of contrition? Also, yes. We never said this was easy.

Looked at another way- Different or wrong?

Maybe a capital light financial service business that in ten years had grown to be the size of JP Morgan with a small amount of capital should have just been allowed to keep growing without any checks or balances? Would that have been a good thing? Have we seen that type of thing before elsewhere in the world, and if so how did it turn out..?!

There is always a danger that you look at a foreign country through too much of your own eyes and assume that a different way of doing business is a *wrong way* of doing business. The same being said in the case of regulation. Whilst investors in a 2019 capital-light Ant Financial will no doubt feel aggrieved at the requirements made of it going forwards, these policies are not necessarily anti-Alibaba or anti-Jack Ma any more than they are anti-capitalist. However, we concede they do represent a different way of doing business than many in the West are maybe used to. One where the state will step in early if it feels a situation might get out of control, or indeed an individual has. Surely even those of us who are pro free markets and ardent Ayn Rand fans have seen enough of what has happened in financial markets in the last ten years to see that there could be some wisdom in these sorts of actions if taken at face value. I.e. a little early shoring up of fast growing financial services companies might not always be a bad thing.

Crucially **It also does not stop them being good companies into the future**. We note for example that Alipay is the main sponsor of the Euro2021 Football tournament! However, we in the West have no experience of this (ie early regulation) as we have never seen it before as we only ever see 'after the event' type regulation. (Northern Rock, Lehman) Maybe, just maybe Ant Financial comes back much bigger and much stronger X years from now? Maybe, just maybe Alibaba, a long-standing Chinese company that has not just been founded by a ex US Harvard student in time might be looked on a little more favourably by the Nation state it has sat alongside for many decades now.

[4] https://www.forbes.com/sites/georgecalhoun/2021/06/07/the-sad-end-of-jack-ma-inc/?sh=174c2f9f123a

That the company and Jack Ma have been contrite ceding to China's wishes once they realised, they crossed 'the line' we think important. We accept this is a *different place to invest*, but that is different to it being an *impossible place to invest*. All risks after all are there to be priced, ask Ajit Jain. That said, it is probably not somewhere for Michael O'Leary to run a company!

In short

We are not naïve and we enter into this type of investment with our eyes wide open. We see the risks, but we see the opportunity too. What is important is to be objective and in order to do that you have to think and occasionally reflect as we just have above. You also have to consider that you are maybe paying in many cases PEG's of 2x for large US predictable growth companies (i.e. PE of 25x for growth of say 10-12%, if you are lucky). In the case of Alibaba you might be paying a PEG of 0.5x (12x for growth of 20% pa). That is one hell of a risk reward pay off. Only a few years (even months) ago investors were only focused on the growth potential of this business. Seemingly now they can only see its risks. That change of heart set against secular growth appeals to us greatly.

Resources

We read and listened to a lot of great podcasts. Whilst not in perfect order of importance certainly the first 4 or 5 were key to our understanding. Have fun!

- Colossus podcast on Alibaba https://www.joincolossus.com/episodes/59340911/parameswaran-alibaba-a-giant-among-giants?tab=blocks
- Transcript of same podcast https://www.joincolossus.com/episodes/59340911/parameswaran-alibaba-a-giant-among-giants?tab=transcript
- Crocodile in the Yangtze Documentary https://www.youtube.com/watch?v=RkVJNOQ7B74
- Baba 2020 Investor day https://www.alibabagroup.com/en/ir/investorday
- Ant write-up by Marc Rubenstein https://www.netinterest.co/p/ant-financial-the-worlds-largest
- Ant Financial IPO prospectus https://www1.hkexnews.hk/listedco/listconews/sehk/2020/1026/2020102600165.pdf
- HBR https://hbr.org/2018/09/alibaba-and-the-future-of-business
- Global Tech update (China specific from slide 91-96) https://e46b0d6a-0ebf-4fe8-92ca-0d0f7dae4fd1.filesusr.com/ugd/7a471b_af073b5c77c144768bfe094c542ccb06.pdf

Put us down as fans of Alibaba. We are also just blown away every time we come across another company doing great things in scale online in China. Just in the last 3 months we looked at Pinduoduo and Shein – we suspect they won't be the last.

Best wishes

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