

Alibaba Group Holdings Limited (NYSE: BABA)

Deja-vu: Has investors misinterpreted BABA?

- We notice the pessimism on BABA has hit a new high, just like pessimism on Tencent hit a new high in 2018.
- We believe the clash from new social eCommerce platforms is exaggerated and investors have underestimated the potentials of DingTalk and AliCloud. We further believe BABA's offline business is an asset, not a liability.
- We reiterate BUY on BABA and raise TP to US\$281

Major concern goes with BABA's online retail

BABA's online retail revenue is divided into two parts: customer management revenue (CMR)/advertising and commission, reflecting two user demands: browse/online shopping and transactions. Both demands are facing increasing competition: 1) The new rising traffic platforms, especially Douyin and Kuaishou, are helping customers to "discover" products. 2) By offering low take rate and aggressive subsidy, PDD is becoming an option for eCommerce transaction. For an extended period, BABA has been vigilant about new front-end traffic pool, and has been involved in battles with a long list of potential competitors, like Taobao (or individual Taobao Agency), Baidu, Weibo, Tencent, etc. But now BABA is facing a much more complicated situation: 1) DAU of Douyin and Kuaishou has reached more than 700 mn, almost 70% of total China internet users; 2) eCommerce infrastructures like logistics, payments, and eCommerce merchants, are well-developed, so agencies and third party service providers could quickly help any platform with extra traffic to start an eCommerce business; 3) China's retail market is transforming from a seller's market to a buyer's market, which means there is an oversupply of products. Hence, platforms with extra traffic have been gaining more bargaining power. (TBC)

Summary financial data

Highlights	F2019A	F2020A	F2021E	F2022E	F2023E
Revenues (Rmb mn)	376,844	509,711	676,962	831,635	957,671
Non-GAAP operating profit (Rmb mn)	105,302	137,136	199,378	241,653	273,478
Non-GAAP EPADS (Rmb)	37.3	56.0	58.4	74.6	99.4
GAAP EPADS (Rmb)	30.2	59.2	46.8	53.1	71.8
EBITDA margin	31.9%	32.9%	36.4%	35.9%	37.3%
P/E (non-GAAP)	40.5	27.0	25.9	20.3	15.2
Free cash flow yield	2.21%	4.12%	3.87%	4.36%	5.48%

Source: Bloomberg, Blue Lotus (as of Jul. 7, 2020)

BUY

HOLD

SELL

Target Price: US\$ 281

Current Price: US\$ 240

RIC: (NYSE: BABA)

BBG: BABA US

Market cap (US\$ mn)

643,850

Average daily volume (US\$ mn)

3261

Shares out/float (m)

2683/N.A.

Source: Bloomberg, Blue Lotus (as of Jul. 7, 2020)

Key Changes

	New	Old	Diff
BLRI Recommendation	BUY	BUY	-
BLRI Target Price	US\$ 281	US\$ 250	9.20%
F2020E EPADS (US\$)	8.00	8.00	-
F2021E EPADS (US\$)	8.77	8.35	5.02%
F2022E EPADS (US\$)	11.6	10.7	8.41%

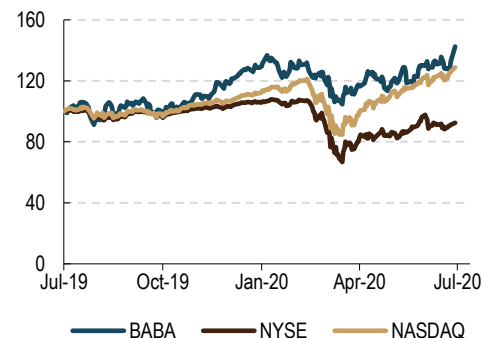
Source: Blue Lotus (as of Jul. 7, 2020)

BLRI vs. The Street

No. of Bloomberg Recommendations	62
Target price vs. Bloomberg mean	17.2%
1-year-fwd EPS vs. Bloomberg mean	5.05%
Bloomberg recommendation	4.95

Source: Bloomberg Recommendation, Blue Lotus (1=SELL,5=BUY) (as of Jul. 7, 2020)

Price performance and volume data



Source: Bloomberg (as of Jul. 7, 2020)

Research team



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Blue Lotus Capital Advisors Limited

Financial Summary – Alibaba Group Holdings Limited

Fiscal year ends 31-Mar

Exhibit 1. Income statement

(RMB mn)	F2020A	F2021E	F2022E
China retail marketplace GMV	6,589,000	7,462,170	8,432,277
Net revenues	509,711	676,962	831,635
Cost of revenues	(282,367)	(355,592)	(434,187)
Gross profit	227,344	321,370	397,448
Operating expenses, GAAP	(135,914)	(176,149)	(226,372)
R&D cost	(43,080)	(64,647)	(73,569)
Sales marketing cost	(50,673)	(71,908)	(86,975)
General administrative	(28,197)	(27,594)	(47,040)
Other items	(13,964)	(12,000)	(18,788)
Operating profit, GAAP	91,430	145,221	171,076
Share based compensation	31,742	42,157	51,790
Operating profit, non-GAAP	137,136	199,378	241,653
Interest income and inv. income, net	75,491	18,456	24,859
Other income/cost	7,439	-	-
Pre-tax profit, GAAP	174,360	163,677	195,935
Income tax	(20,562)	(34,372)	(41,146)
Net income, GAAP	140,350	126,263	152,751
Net income, non-GAAP	132,479	155,431	207,639
Number of ADS, diluted (mn)	2,523	2,533	2,543
EPADS, GAAP, diluted (RMB)	59.2	49.2	59.3
EPADS, non-GAAP, diluted (RMB)	56.0	61.4	81.7
Gross margin	44.6%	47.5%	47.8%
Operating margin, non-GAAP	26.9%	29.5%	29.1%
Net margin, GAAP	27.5%	18.7%	18.4%
Net margin, non-GAAP	26.0%	23.0%	25.0%

Source: Alibaba Group, Blue Lotus (as of Jul. 7, 2020)

Exhibit 2. Balance sheet

(RMB mn)	F2020A	F2021E	F2022E
Cash and restricted cash	204,594	261,263	326,750
Short-term invest. And inv in sec.	15,189	17,189	19,189
Prepayments and others	79,950	100,682	122,936
Total current asset	299,732	379,135	468,875
Property and equipment	192,160	235,314	284,743
Investment in securities, non-current	530,754	636,772	760,114
Land use rights	28,599	34,657	42,238
Intangibles, goodwill and others	341,172	346,163	350,574
Prepayments, non-current	38,232	48,147	58,789
Total assets	1,430,650	1,680,188	1,965,332
Bank borrowings	7,356	7,356	7,356
Income tax payable	23,665	31,092	37,781
Accrued expense	158,897	200,103	244,332
Deferred revenue	39,104	48,550	55,485
Merchant deposits	15,576	22,041	28,740
Total current liabilities	244,599	309,143	373,693
Long term debt	35,427	35,427	35,427
Deferred tax liabilities	38,110	48,104	57,345
Total non-current liabilities	73,537	83,531	92,772
Additional paid in capital	231,783	231,783	231,783
Retained earnings	438,891	605,758	808,222
Total equity	935,696	1,111,603	1,332,799
Total liabilities and equity	1,430,650	1,680,188	1,965,332

Source: Alibaba Group, Blue Lotus (as of Jul. 7, 2020)

Company Description

Since 2013, Alibaba Group has become the largest online mobile e-business company by GMV in the world. Alibaba operates several subsidiaries. Taobao Marketplace, the largest C2C platform in the world, whose GMV accounts for 61% of China's market share in 2019. Taobao Mall, the largest B2B2C platform in the world, its GMV account for 33% of China's market share in 2019. Alibaba Cloud Computing, the largest public cloud computing company in China, occupying 43% of China's market share in 2018, owns one-third of Ant Finance, including AliPay, which is the largest online payment platform in the world occupying 54% of China's market share in 2019.

Industry View

We estimate China's eCommerce market to grow by 19% in 2020, after growing 24.5% in 2019. We estimate traditional eCommerce and social eCommerce sub-sectors to grow 13% and 45% in 2020, respectively, and we expect the total online retail market to grow to RMB 13,488 bn in 2020.

Exhibit 3. Cash flow statement

(RMB mn)	F2020A	F2021E	F2022E
Net income	140,350	126,263	152,751
Adjusted for			
Depreciation & amortization	30,605	48,967	65,533
Share based compensation	31,742	42,157	51,790
Amortization of intangible assets	17,820	18,817	18,788
Changes in			
Loan receivable	-	-	-
Restricted cash and escrow	(50.0)	(50.0)	(50.0)
Prepayments and others	(31,574)	(30,647)	(32,895)
Income tax payables	5,980	7,427	6,688
Merchant deposits	4,814	6,465	6,699
Accrued liabilities and deferred rev.	49,495	50,652	51,163
Cash from operations	247,987	269,854	321,270
Capex, PPE	(49,643)	(67,146)	(90,871)
Purchase of intangibles	(13,027)	(17,667)	(15,261)
Cash paid for equity investment	(102,406)	(122,887)	(147,465)
Acquisitions of AFS and HTM	(10,000)	(10,000)	(10,000)
Other cash paid in investing	(66,353)	5,125	8,403
Cash from Investing activities	(241,429)	(212,575)	(255,193)
Cash from financing activities	(458)	(610)	(590)
Change in cash	6,100	56,669	65,487
Cash at beginning	198,494	204,594	261,263
Cash at end	204,594	261,263	326,750

Source: Alibaba Group, Blue Lotus (as of Jul. 7, 2020)

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DingTalk may be the major catalyst

- Lower take rate doesn't mean higher margin:** In our previous research, we found PDD's products within "10 bn subsidy plan" are usually 15%-20% lower than average price across the internet. Investors may worry that if PDD's take rate continues to be 20% lower than Taobao and Tmall, how should BABA handle the situation. According to our industry check, this theory overlooks PDD's lower ASP and higher logistic cost. One key difference between shopping on Tmall and PDD is that PDD merchants cannot ship an user's multiple products in one parcel, which certainly increase their logistics cost. In general, merchant's net margins are lower on PDD compared with Tmall. (See Exhibit. 4) We see those low-to-mid tier merchants, and merchants who are willing to sacrifice price but aim to have a large number of sales, have a better chance on PDD. Tmall is still the most preferred platform for top-tier merchants and non-standard products, like apparel. We argue that three major platforms will reach to a balance-of-power because of their core products categories: Taobao and Tmall for non-standard products and mid-to high tier brands, JD is for electronic devices, whereas PDD is more for white-label products, including food and daily groceries.
- Live streaming couldn't fully replace traditional eCommerce:** Live streaming shows strong momentum this year, with an estimate of 120% YoY growth, and may reach to about RMB 1 trillion GMV. We agree that live streaming will bring a lot of impact to the sector, but it doesn't mean Douyin and Kuaishou will replace BABA as users' first stop to discover products. After all, 50% of the eCommerce live streaming market still belongs to Taobao. And, eCommerce live streaming is changing more from flash sales model to shopping guide mode, meaning that more small-to-mid performers are using live streaming to introduce products. Taobao will benefit more from the trend because it has enriched product supplies. Also, eCommerce is a business that involves several key factors that may impact customers' decisions, including price, quality, post-sale services, and logistics. Live-streaming eCommerce may be most efficient in price, but it couldn't be compared with traditional eCommerce in other factors. For example, the return rate of shoes could be only 3%-5% in offline stores, but it could be 15%-20%/35%-40% on Tmall and Taobao live streaming, according to our industry checks. That's why we found in our previous report that eCommerce live streaming is more suitable for certain categories, like apparel or food, but very few electronic devices merchants could do well in live streaming.
- Investors may underestimate DingTalk and Alicloud:** In a recent Alicloud conference, BABA management announced that there will be more synergy between DingTalk and Alicloud. Investors tend to view DingTalk as a video conference or enterprise messaging tool just like ZOOM, but we think DingTalk has much more potential: 1) 2019 SAAS industry market size was about USD 280bn, and China market takes USD 17bn-20bn of the share. Potential SAAS market in China could be large, but was set back by several bottlenecks previously, including non-standardized requirements from enterprises, lack of super apps, and users' changing behaviors to mobile. DingTalk is one of the few apps that might grasp the opportunity of merging mobile internet and SAAS together, and is growing to be the first super app within the sector. 2) DingTalk has unique competitive advantages over Enterprise Wechat. First, Dingtalk was the most popular software for online collaboration in 1H2020 due to the outbreak of COVID-19. Dingtalk has 110mn DAU as of May 2020 vs Enterprise Wechat's 25mn. Since Enterprise Wechat does not

Some merchants suggest that they are re-focusing on Tmall and Taobao now because their results on PDD are not satisfying.

DingTalk might be the first super app in China's SAAS market.

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have an implanted video conference function, most of the users chose DingTalk over it for online meeting and studying. 3) DingTalk is building its ecosystem in which more functions other than messaging and access rights are ramping up. In Dingtalk's working portal, we have already seen lots of enterprise software being published, such as attendance check, internal review, online coordination, etc. Most than 90% of the top used models are paid projects developed by 3rd party developers. Alicloud has established a plan of recruiting more than 5,000 engineers this year in order to build a complete developer ecology system on Alicloud and DingTalk. If we treat Dingtalk as a super app that provides both online meeting and mobile SAAS services, we may use Zoom and Salesforce to help with determining its value. By comparing DAU and registered customers between Dingtalk and ZOOM/Salesforce, and assuming value per user/customer of Dingtalk is 25% of its US comparable, we value Dingtalk at US\$59 bn. Our estimate for Alicloud valuation is US\$91bn. Alibaba's Ding+cloud ecology worth US\$153bn, approximately 21% of its total value(see Exhibit. 7-8 for Dingtalk and Alibaba Group's valuation).

- **BABA's other businesses are also under the spotlight:** Critical investors could find defects in almost all BABA's businesses: 1) BABA is more involved in offline retail businesses, like Tmall supermarket and Freshippo. Meanwhile, Eleme's market share still lags behind Meituan. Some investors question whether there is much synergy between offline and online businesses. 2) BABA has been investing in almost all Chinese logistic companies, but all these companies are closely cooperating with PDD. 3) Youku Tudou will continue to be in a tough environment, considering the user time spent has been shifting to short video platforms, and the likely merge between Tencent Video and iQiyi. Some investors doubt whether BABA's strategy of forming an ecosystem and creating synergy among business segments still works, and whether the new management could find a way to break the siege. The better-than-expected performances of "Tencent Clans" within eCommerce, including PDD, Meituan, JD, and SE, intensify people's concerns.
- **If BABA is wrong, then why are JD and Meituan right?** Investors praise Meituan's expansion in various new offline businesses, and compare that with Amazon's evolution. Investors also see JD's investment in logistics and warehouses to be its deep moat, and vote for Dada's IPO to support JD's expansion in new retail. Yet, although BABA also shows a lot of progress in building Freshippo, upgrading RT-Mart, and merging with Eleme, investors are more suspicious toward a "heavier" BABA. From BABA's management perspective, going offline is a necessary step. China's online retail penetration is only 30%, and most easy-to-be-penetrated categories have already been digitalized. Fresh food and offline retailers are the next potential market yet to be transferred. BABA needs to be "heavy" for its future growth. BABA's recent launch of "1 hr delivery" product aims to push for more synergy between online and offline, and among various offline related business segments. We think going offline is a bumpy-but-necessary step. New retail (including Freshippo, Tmall supermarket, and Intime) contributed RMB 25.5bn revenue in 1Q2020, representing a growth rate of 88% YoY. New retail takes about 27% of BABA's core commerce revenue, compared to 17% of 2019. BABA has been testing several new projects, like Freshippo Mini, targeting customers who are more sensitive to price. Mini stores are reported to have positive margin, 7 of them are in Shanghai and 2 are freshly opened in Beijing in July. As of July 2020, there are a total of 213 Freshippo stores and 9 Mini stores in operation. We estimate Freshippo stores' GM/OPM could reach to 15%/7%, and Freshippo Mini's GM/OPM could be

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20%/12% after two years' operations. BABA plans to build 100/100 additional Freshippo stores/Minis by end of 2020.

- BABA also make progress in online gaming and several other areas:** It's wrong to conclude that BABA is becoming conservative, and we see BABA is making progress in several other businesses, like online gaming: 1) BABA's online gaming business under entertainment continues to show more upside. The first strategy game <Romance of the Three Kingdoms: Strategy Edition> was published in Sep. 2019 and remains a top 10 game in China's IOS gross billing ranking. The second turn-based RPG game <The Three Kingdoms Fantasyland>, which was published in Jun. 2020, also entered the top 10. We estimate that these two games could together bring about RMB 500-800 mn gross billing every month. We see the successful publishing of two games with different genres demonstrates BABA's breakthrough in online gaming. BABA acquired Ejoy, a game studio founded in 2017 by a group of NetEase former veteran game designers and gained much progress in online game talents and development experience. 2) BABA's new businesses, like Quark search app (60-100K DAU) and Chang'Ya online music app (300-400K DAU) show that the company is still nurturing innovative businesses. With 20 mn DAU and RMB 200 bn annual GMV, BABA's Xianyu remains China's largest secondary-goods platform and is one of the few products successfully combining an online community and eCommerce.
- Yesterday once more:** What BABA experienced today could be compared with what Tencent experienced in 2018. There used to be a lot of vague theories about Tencent, which now no one ever mentions. People used to worry about game regulation approval, but the general theory is game regulation helps sector consolidation, hence Tencent is benefited. People used to worry about Bytedance's competition and wonder whether short video will destroy all text-image platforms. But now people are more focused on Douyin and Kuaishou's eCommerce, which in theory should be a much smaller business compared with advertising and live streaming. Some investors also showed less confidence in Tencent to-enterprise businesses and argue that Tencent doesn't have the "gene." There also used to be a popular thesis suggesting that Tencent management is "investment-driven" but ignores its core business growth. As Tencent-clan companies' market value climbs to historical height now, people now turn to see Tencent's investments are smart and necessary. What helped Tencent to get out of dilemmas should be attributed to Wechat, by that time still had extra traffic that could be leveraged to its allies and trade for monetization. It might be actually a good thing for BABA to go through such a tough period. Good companies need to go through ups and downs. We still see BABA as a company with huge potential.
- Valuing BABA at \$281 per share:** We use ZTO,YTO,STO/Meituan/Amazon International/AWS/IQ to conduct valuation of Alibaba's Cainiao logistics/Local consumer/Inter. retail and wholesale/Alicoud/Digital Media segments. By giving P/S ratio of 8.0/7.0/3.0/12.0/4.0, We value these segments at US\$ 27bn/30bn/15bn/103bn/16bn respectively. 16.0 P/E ratio is used to value China retail and wholesale at US\$ 456bn/17bn respectively. The implied share price is US\$ 281 per ADS, compare to previous US\$250 per ADS. The major catalyst of valuation increase is from BABA's Cloud/DingTalk business. We increased Alicloud's valuation by US\$65bn and Dingtalk is newly added for valuation purpose (US\$59bn).

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Exhibit 4. P&L on PDD vs Tmall of a low tier grocery merchant(left) and a mid-to-top apparel merchant(right)

	PDD	Tmall		PDD	Tmall
ASP	15	25	ASP	70	150
Discount	5%	5%	Discount	30%	5%
COGS	60%	64%	COGS	34%	33%
-S&M	12%	8%	-S&M	11%	23%
- Search ads	12%	8%	- Search ads	10%	18%
- Other ads	0%	0%	- Other ads	1%	5%
-Commission	0.40%	2%	-Commission	0.60%	5%
-Logistic	20%	15%	-Logistic	6%	4%
Net margin	3%	6%	Net margin	18%	30%
Net income	0.45	1.5	Net income	12.6	45

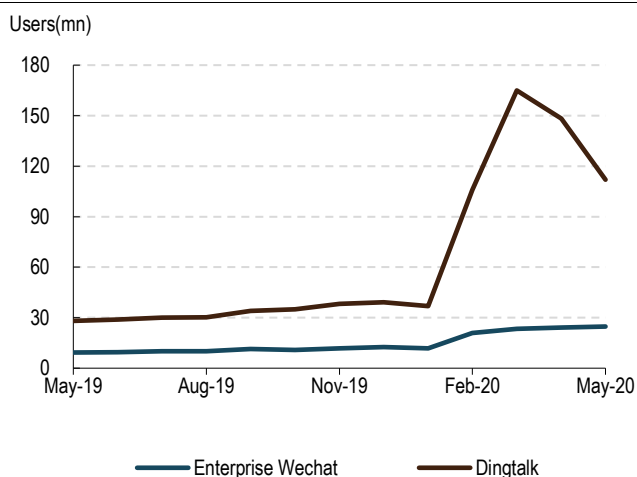
Source: PDD, Tmall, Blue Lotus industry checks (as of Jul. 7, 2020)

Exhibit 5. Comparison between long haul and last mile eCommerce

	Long Haul eCommerce			Last Mile eCommerce	
Platforms	Taobao, Tmall, PDD	JD, Tmall, Tmall supermarket	Meituan, Eleme	JDDJ+Dada, Meituan and Eleme non-food delivery, SF Rush, etc.	Miss Fresh, Freshppio, Pupu supermarket, etc.
Warehouse/Product Supply	N/A	eCommerce Warehouse	Restaurant	Supermarket	Self-built shop, front-end warehouse, mini warehouse
Delivery time	2 days to 1 week	half day to 1 day	30 minutes	1-2 hours	1-2 hours
Products	Apparels, Eletronic devices, Groceries, etc.	Eletronic device, groceries, FMCG	Meals	Fresh food, groceries	Fresh food
Distance	>100 km	50KM-100KM	<3KM	<5KM	<3KM
2019 GMV (RMB)	8 tn	2.6 tn	600 bn	200 bn	50 bn
2019 daily order	158 mn	17 mn	35 mn	8 mn	1.8 mn
ASP per order (RMB)	138	420	47	80	76

Source: Alibaba Group, JD.com inc, Meituan Group inc, Blue Lotus (as of Jul. 7, 2020)

Exhibit 6. DAU comparison, Dingtalk vs Enterprise Wechat



Source: Questmobile, Blue Lotus (as of Jul. 7, 2020)

Exhibit 7. Valuation of Alibaba by segment

	Valuation method/comparables	Market Cap(USD, bn)
Core Commerce		
-Cainiao logistics	8.0 P/S ratio (ZTO, STO, YTO)	27
-Local Consumer (Eleme)	7.0 P/S ratio (Meituan)	30
-China retail	16.0 P/E ratio	456
-China Wholesale	15.0 P/E Ratio	16
-Inter. Retail+whole sale	3.0 P/S ratio (Amazon International)	15
-Others	3.0 P/S ratio	4
Cloud	12.0 P/S ratio (AWS)	132
Digital Media	4.0 P/S ratio (IQ, Tencent Videos)	15
Innovation (Amap+Dingtalk)	See Exhibit 8	59
Total		754

Source: Alibaba Group, Blue Lotus (as of Jul. 7, 2020)

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Exhibit 8. Dingtalk valuation estimate

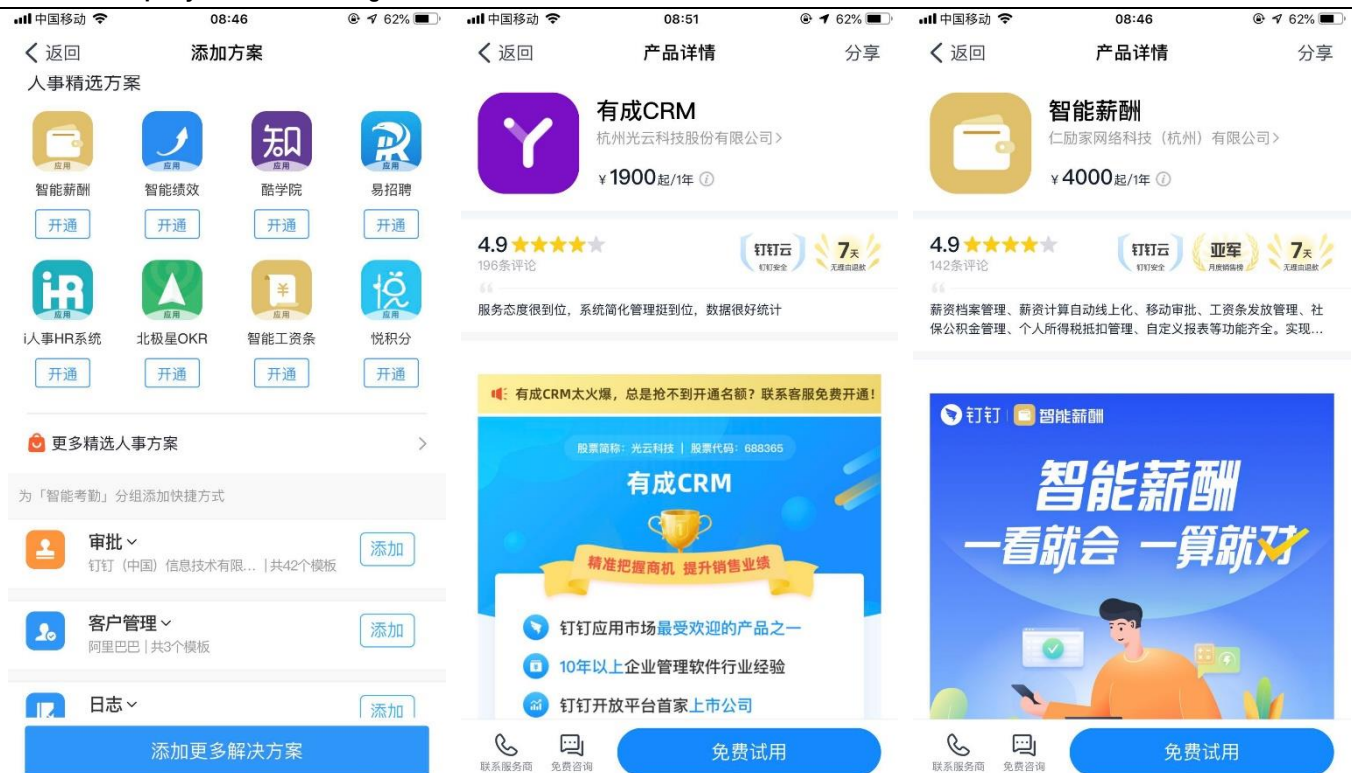
	DAU(mn)	Value/user	Market Cap(mn)		Paid customers	Value/customer (mn)	Market Cap(mn)
Dingtalk(Online Meeting)	112	\$164.09	\$18,378	Dingtalk(Mobile SAAS)	140,000	\$0.29	\$40,476
Zoom	112.5	\$656.36	\$73,840	Sales Force	150,000	\$1.16	\$173,470

Source: Bloomberg, Zoom Video Communications Inc, Salesforce.Com Inc, Blue Lotus (as of Jul. 7, 2020)

* We assume that Dingtalk's 7 million enterprise customers have a pay ratio of 2%

** Currency: USD

Exhibit 9. 3rd party software on Dingtalk



The image shows three screenshots from the Dingtalk mobile app. The first screenshot displays a grid of various HR and management software solutions, each with an '开通' (Open) button. The second screenshot shows the product details for '有成CRM' (Youcheng CRM), including a 4.9-star rating, 196 reviews, and a price starting at ¥1900/year. The third screenshot shows the details for '智能薪酬' (Smart Salary), also with a 4.9-star rating and 142 reviews, and a price starting at ¥4000/year. Both product pages feature promotional banners and '免费试用' (Free Trial) buttons.

Source: Dingtalk, Blue Lotus (as of Jul. 7, 2020)

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