JCAP

E-Commerce
China

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Company Update

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Alibaba Group Holding (BABA US)

Insatiable Appetite for Cash

- **Less and less profit**
  Alibaba's profit has declined substantially despite high revenue and turnover growth. Its free cash flow, adjusted for investments in equity investees, is sharply negative. Meanwhile, Jack Ma is selling shares.

- **$3.5 bln more**
  The company has added USD 3.5 bln in paid-in capital in six months. We are astonished at how much cash this company seems to need.

- **Still awarding lots of shares**
  Share compensation continues apace and was equivalent to 60% of net profit in the quarter.

- **Cloudy**
  The cloud computing division and the Cainiao logistics platform continue to make losses despite growing scale and yet are being groomed for IPO. We view Alibaba's thirst for cash as suspicious.

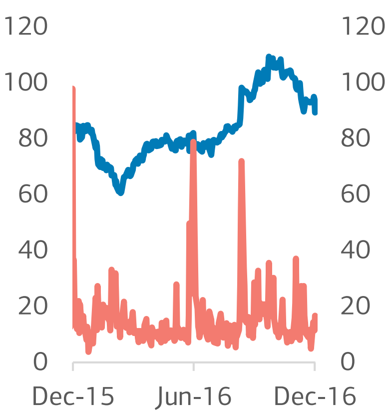
- **Kissing cousins**
  Cainiao and Ant Financial employees are being co-located with Alibaba, and Ant employees receive Alibaba share compensation. Those facts undermine Alibaba's argument to the SEC that these units should not be consolidated.

- **PT: $42.12**
  Our price target of USD 42.12, 55% lower than the current valuation, is based on a 23x P/E ratio attached to an estimated FY 2017 EPS of USD 11.94. We do not expect the stock to reach our target price in 2017 absent a regulatory catalyst.

Alibaba Holdings (BABA US)

Price	USD 86.46
Rating	**SELL**
Price Target	**USD 42.12**
Difference	-55%
Market Cap	USD 223.23 bln
Short Interest	5.6%
Forward P/E	54.24x

Alibaba Holdings (BABA US) last share price in HKD (blue) and volume (pink, in mln shares)



Source: Bloomberg December 1, 2016

More Volume, Less Profit

Despite best efforts to show astounding November 11 results, Alibaba's share price has sunk 5% since Singles Day. Nevertheless, on November 22, Jack Ma registered his plan to sell 2.5 mln shares of Alibaba, a sale that should garner roughly USD 233.6 mln.

The company spends money on investee companies, which are currently losing massive amounts of cash.

Singles Day ended with USD 17.8 bln in Gross Merchandise Volume (GMV) on Alibaba's sites, 32% higher than last year. That would have represented roughly 129% of China's average daily retail sales on and offline. Alibaba said, Alipay processed 1.04 bln payment transactions for BABA sites in a single day, five times as many as Visa processed in all of Q3, and that its Cainiao logistics partners made 657 mln deliveries, 57 times as many as Fedex processes on an average day.

Alibaba, according to its own announcement last March, was already the "largest retail economy in the world." It seems there is nothing Alibaba cannot do, except perhaps get its share price back over USD 100.

Shrinking Profit

The most striking portion of Alibaba's Q2 FY 2017 report (for the period ending September 30) is the diminishment of profitability. Net income in the quarter was RMB 7.62 bln, while the comparable period a year earlier showed RMB 30.8 bln on much lower revenue. Granted, the year-earlier profit included a big one-time write-up of the value of equity investees (as had the previous quarter), so underlying profit did not change much.

But it still looks low. Alibaba is fundamentally an advertising company, which should be hugely cash-generative. It does not hold inventory or provide logistics. An operating margin of 22% is skinny. Additionally, Alibaba benefits from the management of at least USD 120 bln in money market funds, and referral fees and investment gains should give the company a boost.

The note to the 6K reads thus:

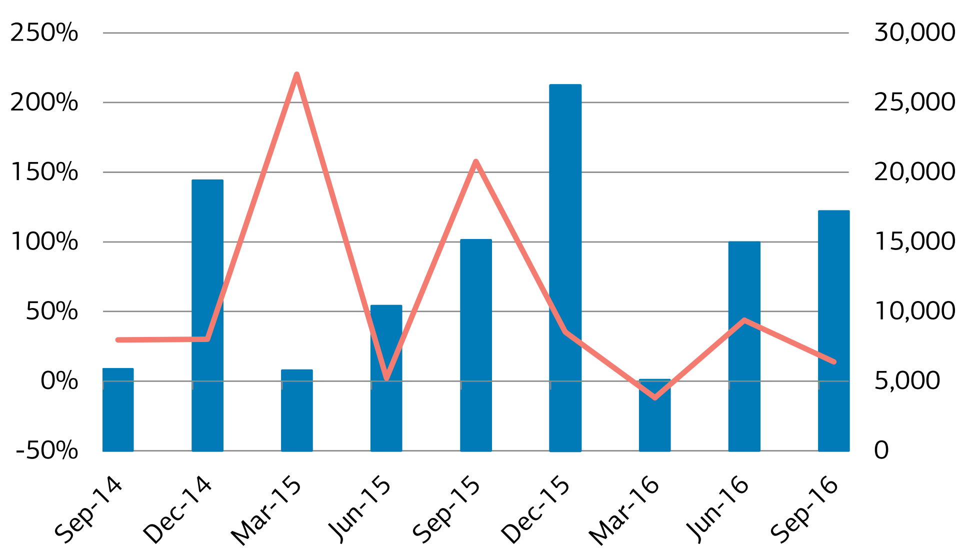
> Diluted EPS in the quarter ended September 30, 2016 was RMB2.97 (US$0.45) on a weighted average of 2,566 million diluted shares outstanding during the quarter, *a decrease of 67%* compared to RMB8.87 on a weighted average of 2,564 million diluted shares

outstanding during the same quarter of 2015 (which included a non-cash revaluation gain of RMB18,603 million, or RMB7.26 per diluted share, arising from revaluation of our previously held equity interest in Alibaba Health). [emphasis added]

Weak Cash Flow

Free cash flow from operations is weak and has risen much less than revenue. But after adjustments, free cash flow looks much worse. It seems more representative of the company's numbers to deduct spending on equity investees from operating income to show actual free cash flow. Once free cash flow is adjusted for spending on equity investees, Alibaba has had negative free cash flow since calendar 2015.

Chart 1. Cash Flow from Operations (mln RMB and % YoY)



Source: Company statements

Alibaba does not require a lot of hard assets, but it does spend money on investee companies. Those investees are losing a lot of money, collectively contributing losses in the recent quarter of RMB 567 mln. Alibaba provided selected segment data in this quarter, disclosing that all the acquisitions since IPO have together lost USD 977 mln. Who knows, the companies may prove valuable in the future but for now, Alibaba is just spending investor capital without return.

Once the spending on equity investees is deducted from the operating cash flow, the free cash flow has been negative since calendar 2015.

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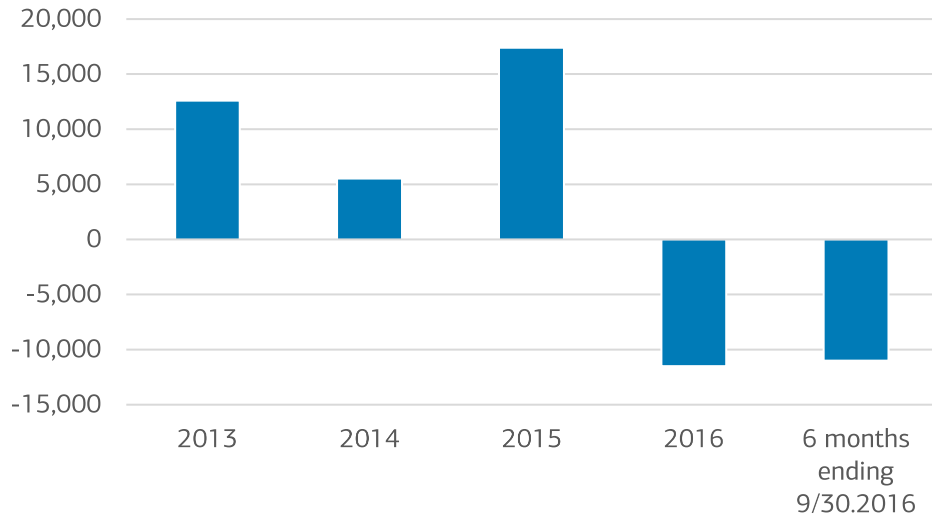
Chart 2. Free Cash Flow Adjusted for Spending on Equity Investees (mln RMB)

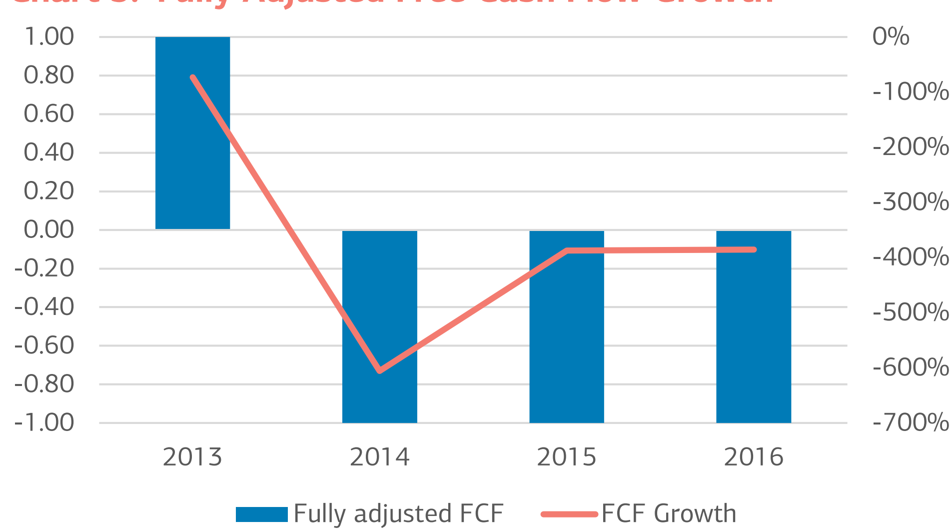


Source: Company statements

It gets worse. Alibaba's balance sheet is bloated with ever-rising goodwill and intangibles. The company vacuums up cash every quarter and funnels it through to these balance sheet items. Intangibles plus goodwill equaled USD 20.29 bln by September 30, 2016, up by nearly USD 1 bln in the quarter. Investment in equity investees stood at USD 17.9 bln. If we deduct those items from cash flows, Alibaba starts to look like a black hole for cash. (The transubstantiation of cash to balance sheet notions is brilliantly explained in the Deep Throat IPO blog.)

Adjusting for changes in goodwill and intangibles, cash flows are sharply negative.

Chart 3. Fully Adjusted Free Cash Flow Growth



Source: Company statements

Losses from the Cainiao network in Q3 were RMB 220 mln, roughly flat on the previous quarter.

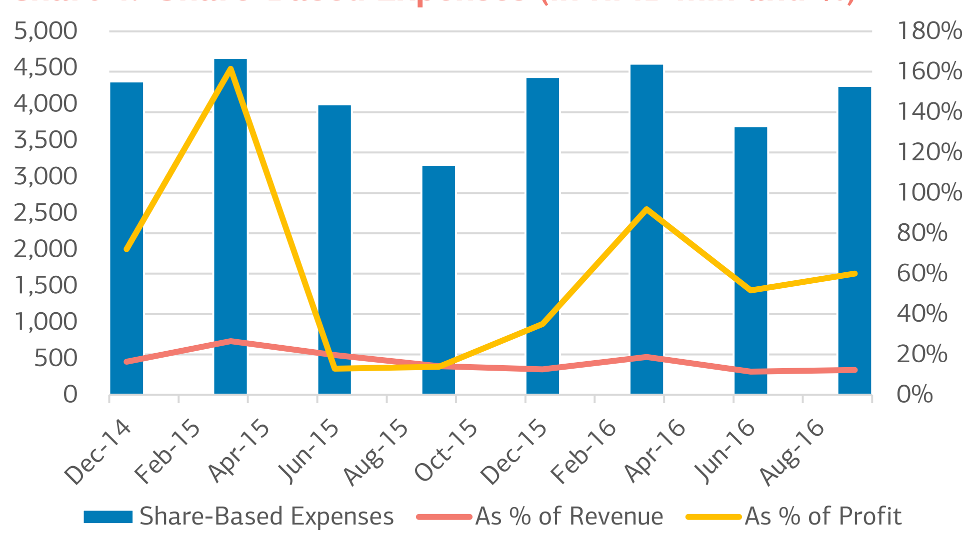
Cainiao Logistics

Alibaba reported that its share of the losses from the Cainiao network in Q3 were RMB 220 mln, roughly flat on the previous quarter. Cainiao and Ant Financial staff are reportedly moving into Alibaba's new Shenzhen offices, undermining Alibaba's claim that Cainiao is an independent company that it does not control. Xinhua reported on November 8 that Cainiao member companies can deliver beverages to rural areas in one day for RMB 3 per case, as opposed to the estimated current average of RMB 14. The same companies that participate in Cainiao perform the delivery now for the higher price, and it is impossible that Cainiao's information platform delivers efficiencies that save 80% of the cost, so losses from Cainiao should rise in the next quarter.

Compensation Expense

Alibaba continued to hand out shares, dispensing RMB 4.25 bln in share-based compensation in the quarter, fully 60% of net income.

Chart 4. Share-Based Expenses (in RMB mln and %)



Source: Company data

Alicloud

BABA broke out its cloud computing division, reporting RMB 1.49 bln in revenue for the quarter and losses of RMB 398 mln, half of the year-ago quarter. Amazon's cloud computing division, by contrast, reported USD 2.57 bln in revenue for the most recent quarter and delivered 67% of the firm's profit.

Currency

We believe that the risk to the Renminbi is entirely on the downside. Should the RMB devalue by 10% or more in 2017 relative to the U.S. dollar, Alibaba could see a sharper share price decrease.

Valuation

We value Alibaba at 23x our expected FY 2017 earnings. We believe, however, that the company's accounts are seriously misleading and the risk associated with the stock is high.

Risks

Alibaba's share price is significantly driven by sentiment and the general belief in the Chinese consumer. Alibaba is being investigated by the SEC. Absent a public announcement or another external catalyst, we see no reason why the company should re-rate.

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