Alibaba 2014 IPO Case Study

Alibaba began trading on the NYSE on Friday September 19, 2014. At $21.8 billion it was the largest U.S. based IPO in history. On Monday, the company announced that underwriters had exercised an option to purchase additional shares at the $68 IPO price, boosting the total amount raised by Alibaba and its selling shareholders from $21.8 billion to $25 billion. Underwriting investment banks bought an additional 48 million American depositary shares, raising the total number of shares sold in the offering to 368 million, or about 14.9% of the company.

In raising $25 billion, Alibaba's IPO surpassed the 2010 offering from the Agricultural Bank of China, which raised $22.1 billion in its debut on the Hong Kong Stock Exchange. Alibaba was able to sell more shares due to its over-allotment, or "greenshoe," option, which allows underwriters to satisfy customer demand for the stock by obtaining more shares from the company at the IPO price.

Using online resources and the IPO Valuation case study that follows and answer the following discussion questions:

1. Who were the main shareholders of Alibaba prior to the 2014 IPO?
2. How many shares did each sell in the IPO? Why?
3. Why was the IPO listed on the NYSE rather than the Hong Kong or Shanghai Stock Exchanges?
4. What are Alibaba's main strategic business strengths?
5. Weaknesses?
6. Who are Alibaba's main competitors?
7. In which geographical markets does Alibaba dominate?
8. Alibaba recently hired former Goldman Sachs banker Michael Evans to manage its overseas expansion. How important will new markets be in helping Alibaba to maintain its current growth rate?
9. Do you think the initial IPO price fairly valued Alibaba?
10. There has been significant volatility in the price of Alibaba's shares during the past year. How would you explain this volatility?

Alibaba 2014 IPO Valuation

Aswath Damodaran

Alibaba: A China Story with a profitable ending?

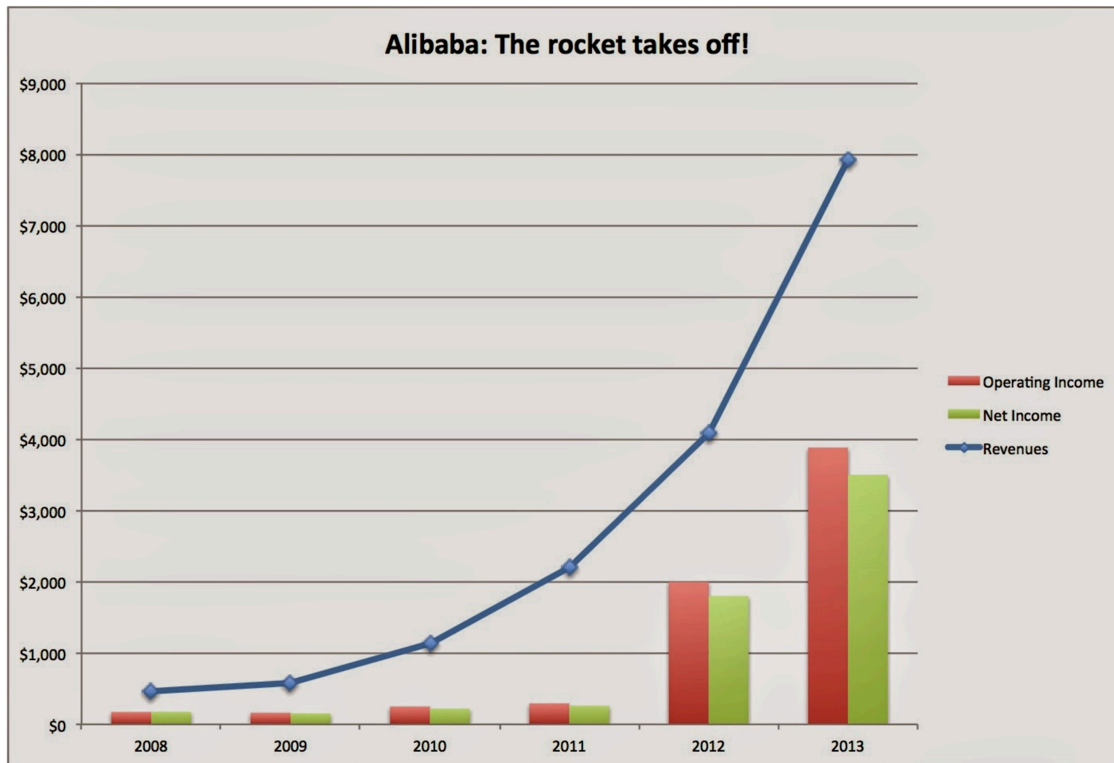
Let me begin with a couple of confessions. The first is that I am not a China expert and what I do not know about the country vastly outweighs what I do. The second is that I start with strong negative biases about the Chinese governance system, political and corporate, that color my assessment of Chinese companies and investments. Having said that, I cannot resist trying my hand at valuing what may be the most valuable IPO in history in Alibaba, but as you review my valuation, keep both my ignorance and biases in mind.

Alibaba: Setting the table

Since I had no exposure to Alibaba and its operations, I started my exploration of the company by visiting their flagship site, TaoBao, a chaotic and colorful hub where both individuals and businesses can offer their goods, used or new, for sale, at fixed or negotiable prices. Though modeled on eBay, Taobao is different on two counts. The first is that it is far more tilted towards small and midsized retailers offering new products for sale than to individuals selling used items. The second is that Alibaba, unlike eBay, does not charge a transaction fee, but instead makes its revenues primarily from advertising.

In 2010, Alibaba opened a new front in its business with TMall, a site for a selective list of larger retailers, playing an expanded role in the process for a larger slice of the transaction pie. On this site, retailers pay a deposit to Alibaba to reimburse buyers who receive counterfeit goods, a technical service fee to cover the fixed costs of carrying the store and a sales commission determined by transactions value. Alibaba also developed Alipay, a third-party online payment platform, akin to PayPal, that has grown in the last few years to dominate the Chinese online payment market. As we value Alibaba for its IPO, though, it should be noted that investors will not be getting a share of Alipay, because it has been separated from the company and will be operated as an independent entity. (Note: As Blake notes in the first comment, there is a clause in the prospectus that specifies that Alibaba will be entitled to 37.5% of the proceeds if Alipay is taken public or sold, with a floor of $2 billion and a cap of $ 6 billion in that value).

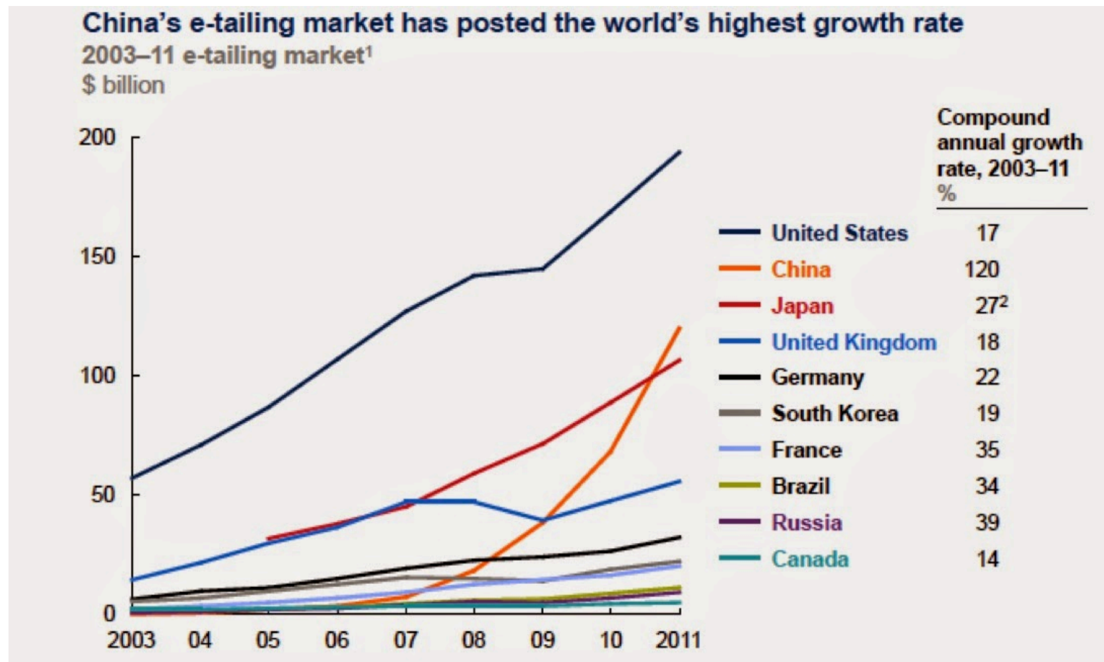
Alibaba has been phenomenally successful both in terms of both helping online retailing find its legs in China and becoming extremely profitable while doing so. In 2013, the company generated almost $4 billion in operating profit on revenues of approximately $ 8 billion and its rapid evolution from small start up to profitable behemoth are traced in the graph below:



Not only have revenues accelerated over the last three years (the growth story), but the company's profitability has surged even more. If timing is everything in going public, you can see that Alibaba has chosen a good time.

Alibaba: Four Steps to Valuation Nirvana
There are four steps to understanding how Alibaba has got to where it is today, where it can expect to go in the future and the risks along the way.

1. Enter a growth market early and mold it to your strengths: In 1999, when Alibaba was founded, online retailing in China was in its infancy. While the largest US online players (Amazon, eBay etc.) either ignored or mishandled the market, Alibaba not only adapted to Chinese conditions but played a key role in the evolution and growth of the Chinese e-commerce market, as China has become the second largest online market in the world, as shown in this comparative graph from this McKinsey's report on the market:



One key difference between the Chinese e-tailing market and US online retail is that the former has historically been much more dependent on online marketplaces (as opposed to retailer-based online sites) largely because of Alibaba's influence.

Future: As Chinese consumers get increasingly comfortable buying online, the expectations are that the Chinese online market will continue to grow at high rates. In its prospectus, Alibaba estimates a compounded growth rate of 27% a year in Chinese online commerce between 2014 and 2018, and that number is in line with estimates made by other services. If these forecasts hold up, the online retail market in China will become the world's largest in the next few years.
Fears: Though there are few who seem to question the China story today, the history of growth in emerging markets is that there are always unpleasant and unexpected surprises on the pathway to prosperity. Investing in Alibaba is an investment in continued growth in China, and any economic or political troubles that operate as speed bumps on that growth will affect Alibaba disproportionately, since it generates almost all of its profits in China and is dependent on growing consumer spending.

2. Differentiate and dominate: The story of how Alibaba beat eBay and Amazon is grist for strategic story tellers, but at its core, there are three reasons why Alibaba won (and eBay lost). The first is economic. By charging no transactions fees initially and depending entirely on modest advertising charges, Alibaba made itself a bargain to retailers, relative to competitors. The second is that Alibaba molded its offerings to Chinese culture and consumer behavior. The Economist's characterization of TaoBao as an online bazaar is apt, since the site is colorful, chaotic and set up for online haggling between buyers and sellers. Third, the site is also attuned to the fact that the Chinese retail market is splintered, with thousands of small and mid-sized retailers who lack visibility, credibility and payment processing skills online and TaoBao offers all of those. The visibility comes from the traffic on the site, the credibility from Alibaba's system of independent

verification, paid for by sellers, and payment processing from Alipay. In 2013, about 75% of all online retail business in China was routed through one of Alibaba's sites. To provide a measure of the sheer volume of transactions on TaoBao and TMall, it is estimated that $5.75 billion merchandise was sold on Chinese online retail sites just on "Singles Day" on November 11, 2013, more than two and half times what US online retailers sold on Cyber Monday, and much of the merchandise was sold on the Alibaba sites. To get a measure of Alibaba's market share online, take a look at the breakdown of the biggest players in the B2C (retailers selling to customers), C2C (customers/small retailers selling to other customers), mobile markets and mobile payments in China:

	B2C		C2C		Mobile		Online Payment
Tmall	**49.08%**	**TaoBao**	**92.59%**	**TaoBao**	**81.45%**	**Alipay**	**49%**
JingDong	18.16%	Paipai	5.56%	JingDong	6.67%	Tenpay	20%
Tencent B2C	5.68%	Eachnet	1.85%	Maimaibao	1.11%	Unionpay	10%
Suning	4.30%			Suning	1.01%	Others	21%
Amazon China	2.72%			Amazon	0.84%		
Dangdang	2.12%			Others	8.92%		
Others	17.94%						

In every segment, Alibaba is not just the leader but an overwhelming one.

Future: The domination of Alibaba creates a network effect, since retailers have to go where the customers are now, and as a consequence, they have to be on an Alibaba site to be noticed. That, in turn, make it easier for Alibaba to attract more customers, as the overall market grows, keeping the cost of customer acquisition low for the company.

Fears: The dark side of having as large a market share as Alibaba does is that almost all of your future growth will have to come from the overall market growing. The size of the Chinese market is also drawing in competitors who are willing to spend significant amounts of money to chip away at Alibaba's market share, with Jingdong (360Buy) and Tencent offering faster delivery and better after-sale service.

3. Don't be greedy: While most online retail transactions in China go through Alibaba sites, the slice that Alibaba keeps for itself is very small. In TaoBao, in particular, its revenues are just advertising charges paid by retailers to list on the site, a very small portion of the total transaction value. In TMall, Alibaba does get a larger slice of the transaction revenues because it charges a transaction fee, but it is still only 0.5 and 1.5% of revenues. While this small share may seem like a negative, it has proved to be one of Alibaba's competitive advantages, since it has made it difficult for competitors to undercut it and offer better deals to customers and retailers.
Future: The question of how Alibaba's slice of overall transaction revenues will change over time, we have to make judgments on the relative growth of TMall and TaoBao. If the former grows faster than the latter, the slice of revenues that Alibaba keeps will increase over time. I was disappointed that Alibaba was not more transparent about the evolving shares of its two market places in its prospectus, choosing to lump them together as China commerce.

Fear: The market, especially in B2C, is getting more competitive, as international players like Amazon and EBay are coming back to the market, chastened by past failures, but perhaps having learned from their mistakes and deep pockets.

4. Avoid pretense: Alibaba seems to generate these revenues with little effort (and marketing costs) and since the company does not aspire to be a technological innovator, its R&D and development costs are negligible. These factors result in the company's most impressive statistic: in 2013 it had a pre-tax operating margin of almost 50% and a net profit margin of close to 40%, high even by any standards.

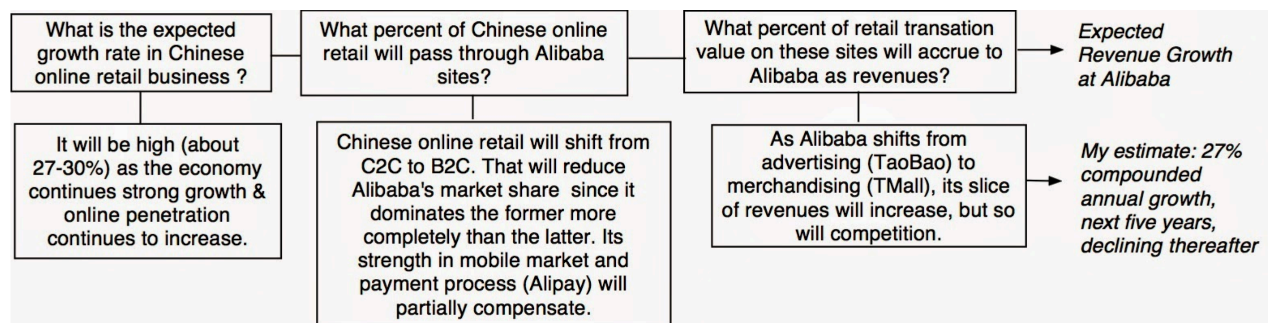
Future: Alibaba's high margins are a result of the network effect (that we referenced earlier) created by its immense market share and its limited ambitions (where it has been willing to settle for a small portion of revenues). While there is nothing to indicate that either will change significantly in the near future, there are signs that the company is getting more ambitious, planning large investments in social media companies and logistics infrastructure.

Fear: Alibaba will have to start working harder (and spending more) to get consumers to continue to use its sites and to keep advertisers on its site. For instance, Alibaba has announced plans to spend billions in building a logistics network to allow for same-day delivery. These investments, while necessary to preserve Alibaba's success, will reduce both margins in the future and cash flows in the near term.

Alibaba: What next?

Alibaba is exceptionally profitable and will probably remain so for the near future. To value Alibaba, though, I had to make judgments on the following parameters:

1. Revenue growth: The expected revenue growth at Alibaba will be a composite effect of three of the four dimensions described in the last section.



In my judgment, Alibaba's revenues will grow at a compounded rate of 27% a year for the next five years, the same rate as the overall online retail market in China, with losses in market share being offset by a more diverse business model allowing it to keep a larger slice of transaction revenues. While that is a steep climb down from last year's growth, note that it is a compounded growth rate and that I am probably understating revenue growth in the first year or two but overstating it in the fourth and fifth year. Starting in year 6, that revenue growth will start sliding down towards a

mature stage growth of 2.63%. With my estimates of growth, Alibaba's revenues in 2024 will be approximately $47.6 billion. To provide perspective, that estimate is 40% lower than Amazon's revenues of $78.1 billion in 2013, about 25% below from Google's revenues of $62.3 billion in 2013 and more than five times Facebook revenues of $8.9 billion in 2013.

2. Operating margin: The stratospheric margin enjoyed by Alibaba currently (of approximately 50%, pre-tax) makes it extremely unlikely that the margin will increase over time and more than like that it will decrease. In fact, while the numbers don't reflect this yet, the news stories about recent investments that the company has had to make in logistics and technology suggest that it is not a question of whether the margin will decline over time but by how much. While the margins at TaoBao will remain high, the competitive nature of the B2C market will put downward pressure on operating margins at TMall. I will be assuming that the operating margin will decline over time down to 40% in 2024. To provide perspective again, Facebook reported an operating margin of 35.6% in 2013 and Google's pretax operating margin in 2013 was 23.4%. I would justify Alibaba's higher operating margin by noting that Alibaba spends far less than either Facebook or Google on R&D or technology. I also assumed that the tax holidays and credits that have kept Alibaba's effective tax rate at close to 10% will start to fade over time, and that the tax rate will move towards the Chinese statutory rate of 25% over time.

3. Investment: If Alibaba plans to ramp up revenues, as I have forecast, it will be called upon to make investments in logistics, technology or social media companies. While it is difficult to be specific about what form these investments will take, the company currently generates $1.93 in revenues for every dollar in capital invested (based on 2013 revenues and capital invested). I assume that for every $2 in incremental revenues in the future, Alibaba will have to invest a dollar in incremental capital. That will still make them more efficient than the typical US company in this space, where the ratio of sales to invested capital is closer to 1.40.

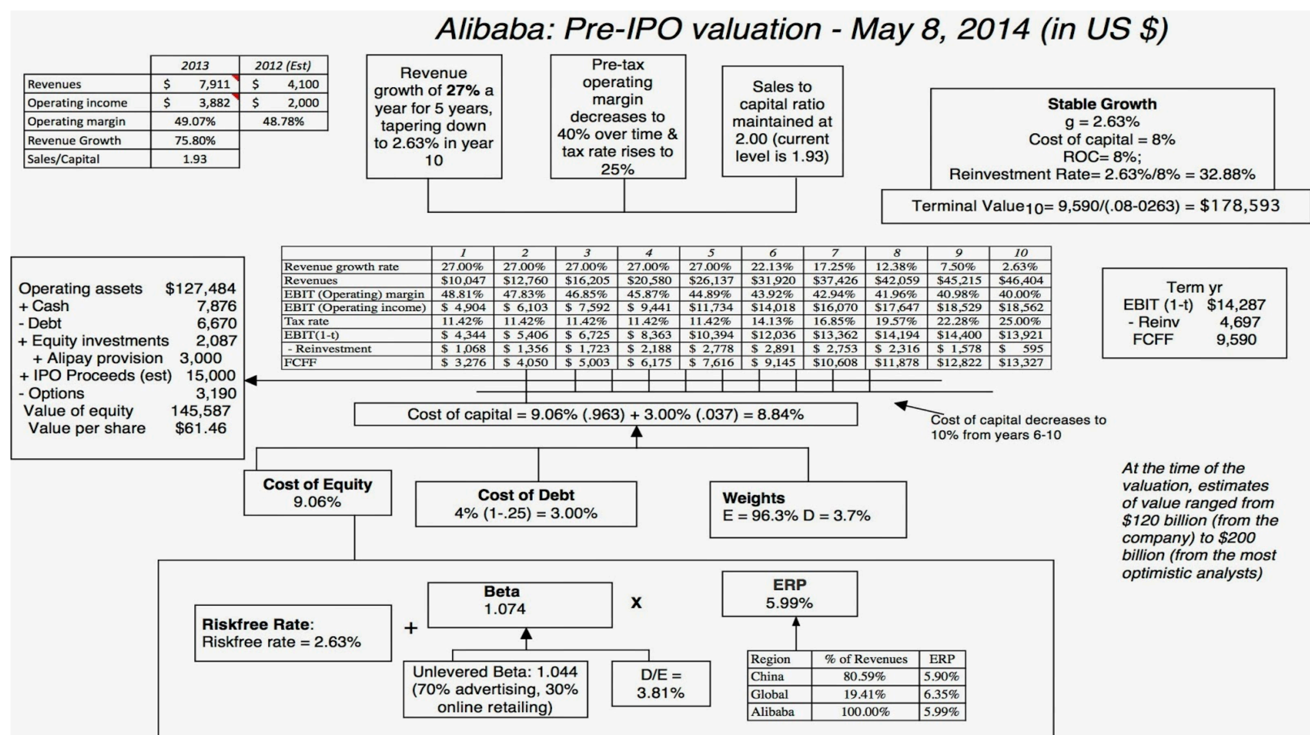
4. Cost of capital: Alibaba's business is a mix of advertising and merchandising (the transaction fees that it charges in TMall). Using a mix of 70% advertising and 30% online retailing as my mix, I estimated a cost of capital, in US dollar terms, of 8.84% for the company, at least for the next five years. As the company matures and growth eases, this cost of capital will decline to 8% by 2024.

5. Cross holdings: Alibaba has made investments in other companies in recent years, primarily because they offer technologies or products that will help Alibaba in its operations. These investments are recorded in the balance sheet at $2,093 million and the five biggest are listed below:

Company	*Business*	*% of equity*	*Value in balance sheet*
Weibo	Social media	18.00%	$586
UCWeb	Mobile Web Browser	66.00%	$506
AutoNavi	Digital Maps	28.00%	$294
Zheijiang	Logistics Infrastructure	43.00%	$270
Shoprunner	Online Shopping Platform	39.00%	$206

Since two of these companies, Weibo and AutoNavi, are publicly traded, I estimated the market value of these holdings and replaced the equity value on the balance sheet with the market values instead. The net effect was small, yielding a corrected value for the cross holdings of $2,087 million. Finally, the liquidity clause in the Alipay agreement entitles Alibaba to 37.5% of the proceeds from any liquidity event associated with Alipay (an IPO or a sale), with a cap of $ 6 billion and a floor of $2 billion on Alibaba's share. Alipay's earnings just from Alibaba in 2013 was $305 million and it likely that it will keep growing over time, suggesting that the value from a liquidity event is likely to yield a payoff to Alibaba that will be closer to $ 6 billion than $2 billion, in case of a liquidity event. That $6 billion, though, has to be adjusted for the likelihood that the entangled nature of Alipay (with Alibaba) will make it difficult to sell the company or take it public as well as the time value of money. Conservatively, I am adding an additional $ 3 billion to Alibaba's value to reflect both of these factors.

<u>The valuation:</u> The value that I obtain for the equity is approximately $130 billion, before IPO proceeds are considered, and in excess of $145 billion with the IPO proceeds built in. The valuation picture, summarizing my inputs, is below and you can [download the spreadsheet]() with the valuation, if you so desire.



	2013	2012 (Est)
Revenues	$ 7,911	$ 4,100
Operating income	$ 3,882	$ 2,000
Operating margin	49.07%	48.78%
Revenue Growth	75.80%	
Sales/Capital	1.93	

	1	2	3	4	5	6	7	8	9	10
Revenue growth rate	27.00%	27.00%	27.00%	27.00%	27.00%	22.13%	17.25%	12.38%	7.50%	2.63%
Revenues	$10,047	$12,760	$16,205	$20,580	$26,137	$31,920	$37,426	$42,059	$45,215	$46,404
EBIT (Operating) margin	48.81%	47.83%	46.85%	45.87%	44.89%	43.92%	42.94%	41.96%	40.98%	40.00%
EBIT (Operating income)	$ 4,904	$ 6,103	$ 7,592	$ 9,441	$11,734	$14,018	$16,070	$17,647	$18,529	$18,562
Tax rate	11.42%	11.42%	11.42%	11.42%	11.42%	14.13%	16.85%	19.57%	22.28%	25.00%
EBIT(1-t)	$ 4,344	$ 5,406	$ 6,725	$ 8,363	$10,394	$12,036	$13,362	$14,194	$14,400	$13,921
- Reinvestment	$ 1,068	$ 1,356	$ 1,723	$ 2,188	$ 2,778	$ 2,891	$ 2,753	$ 2,316	$ 1,578	$ 595
FCFF	$ 3,276	$ 4,050	$ 5,003	$ 6,175	$ 7,616	$ 9,145	$10,608	$11,878	$12,822	$13,327

Region	% of Revenues	ERP
China	80.59%	5.90%
Global	19.41%	6.35%
Alibaba	100.00%	5.99%

The value of the operating assets in Alibaba, based on my assumptions, is $127.48 billion. Adding cash ($7,876 million), the value of cross holdings in other companies ($2,087 million) and Alipay

($3,000 million), netting out debt ($6,670 million) and the value of equity options granted to employees ($3,190 million) results in a value for equity of $130.59 billion. Finally, since this is an initial public offering that will raise money that is going to be kept in the firm (according to the prospectus), I added an estimated $15 billion (the rumored IPO target) to arrive at an overall equity value of $145.59 billion. Again, working with the 2368.67 million shares outstanding, including restricted stock units granted to employees, that works out to a value per share of $61.46/share.

Caveats

Rather than give you the usual caveats, which would be that my estimates are likely to be wrong and that you should make your own valuation judgments, there are four specific concerns I would draw your attention to.

1. Status quo, not disruption: When you invest in young growth companies in big markets, you usually are hoping for disruption, since you need the game to be shaken up for these companies to displace larger, more established players. With Alibaba, though, that is not the case. This is a company that has in large part built the status quo for online retailing in China and benefits hugely from more of the same. Your biggest fear if you are an Alibaba stockholder is of a seismic change in either technology or Chinese consumer buying habits that will undercut Alibaba's network advantages.

2. Corporate governance: Corporate governance at young technology companies is weak and it is toothless at Chinese companies. So, it goes without saying that if you buy shares in Alibaba, you should do so with the expectation that if you do not like the way the company is run, you will have no recourse other than sell your shares and move on. Since that is a conclusion that you would reach if you bought Facebook or Google shares, as well, Alibaba is not that unusual, at least in this sector.

3. Legal Jeopardy: The shares that will be offered in the Alibaba IPO are not shares in the operating company but in a legal entity that is incorporated in the Cayman Islands. That legal entity, structured as a variable interest entity (VIE), owns the operating company in China. The reason for this complex holding structure is that the Chinese government has restrictions on foreign ownership in a wide range of businesses, including retailing, and this structure allows companies to evade those restrictions. The Chinese government is undoubtedly aware of the evasion and looks the other way, at least for the moment, though it does reserve the right to change its mind and challenge the legality of the structure. I am still a novice to the nuances of investing in a VIE, but there are others who know far more than I do and have posted on the dangers. While Alibaba seems to have structured it's VIE with more protections than most, I am still uncomfortable with the notion that my investment value is left to the tender mercies of Chinese regulators and law.

4. The Silent Partner: While much of Alibaba's success can be traced to good management and a favorable market climate, it is also true that almost every successful Chinese company owes part of its success to friends in high places,. While I am not suggesting that the company is guilty of corruption or underhanded practices, it is also true that the Chinese

government has tilted the competitive balance in Alibaba's favor in subtle and not-so-subtle ways especially against foreign competitors. The downside of being a beneficiary of official favors is that Alibaba will be asked to reciprocate at some time or worse still, it (and by extension, its stockholders) may fall out of favor.

What next?

The IPO process is a pricing game, not a valuation one. Thus, it matters little what you or I or even the company think Alibaba's value is today. It matters more what investors, institutional and individual, are willing to pay for Alibaba in this market. Alibaba brings together in one package many IPO buzzwords: it is a company with strategic aspirations, significant growth potential and expansion options in China, creating a perfect storm for sky-high pricing.