農銀國際
ABC INTERNATIONAL
ABCI SECURITIES COMPANY LIMITED

Alibaba (9988 HK/BABA US)
Cost optimization as priority

- Expect gradual recovery ahead with a focus on boosting spending among existing customers
- Cost optimization is a priority
- Current valuations presents an entry point for long-term investors

Company Report

Rating (SW-share): BUY
TP (SW-share): HK$ 130
Rating (ADR): BUY
TP (ADR): US$ 132

Analyst : Steve Chow
Tel: (852) 2147 8809
stevechow@abci.com.hk

Gradual recovery ahead. After a sluggish 2Q22 with a flat revenue growth and a 31% YoY decline in core net profit, we expect gradual recovery in the near term amid normalized logistics and better macro backdrop, though COVID development will remain a swing factor. The Company would focus on increasing the spending among existing customers instead of expanding new users given its already-high user base.

Prioritizing cost optimization. Amid current soft economic environment, cost optimization has become a priority. Alibaba's non-China commerce businesses (international commerce, local service, Cainiao, cloud, media, and innovation initiatives) collectively reported RMB 66.6bn in operating losses for FY3/22, eroding the RMB 172bn China commerce operating profit during the same period. We see cost optimization potential of these loss-making businesses. Looking forward, we expect operating margin of non-China commerce businesses to improve from -24.1% in FY3/22 to -15.4% in FY3/24E driven by ongoing cost control, mitigating the operating margin drop of China commerce business from 29.1% in FY3/22 to 26.0% in FY3/24E.

Recommendation. Reinitiate **BUY** with SOTP-based TP at HK$ 130 for Alibaba-SW (9988 HK) and US$ 132 for Alibaba-ADR (BABA US), given Alibaba's leading market position in the e-commrece sector. In our view, potential market impact from SoftBank's planned divestment from 23.7% to 14.6% is mitigated by Alibaba's increasing effort on share repurchase. We believe its current low valuation of about 11x FY24E core P/E presents an entry point for long-term investors.

Price (ADR/SW-share)	US$94.7/ HK$91.7
Est. share price return (ADR/SW-share)	39.9%/41.7%
Est. dividend yield (ADR/SW-share)	NA/NA
Est. total return (ADR/SW-share)	39.9%/41.7%
Last Rating &TP (ADR/SW-share)	NA/NA
Previous Report Date	NA

Source(s): Bloomberg, ABCI Securities estimates

Key Data

52Wk H/L (HK$) (SW-share)	190.8/71.0
52Wk H/L (US$) (ADR)	192.9/73.2
Issued shares (mn)	21,185
Market cap (HK$ mn) (all share)	1,943,724
3-mth avg daily turnover (HK$ mn) (SW-share)	5,470
3-mth avg daily turnover (US$ mn) (ADR)	2,689
Major shareholder(s) (%):	
SoftBank	23.7%

Source(s): Bloomberg, HKEx, Company

Results and Valuation

FY end Mar 31	FY21A	FY22A	FY23E	FY24E
Revenue (RMB mn)	717,289	853,062	899,938	1,013,059
Chg (%,YoY)	*40.7*	*18.9*	*5.5*	*12.6*
Net profit (RMB mn)	150,308	61,959	87,284	115,766
Chg (%,YoY)	*0.7*	*(58.8)*	*40.9*	*32.6*
Core net profit (RMB mn)	178,954	143,515	126,229	160,023
Chg (%,YoY)	*26.6*	*(19.8)*	*(12.0)*	*26.8*
Underlying EPS (RMB)	7.0	2.9	4.1	5.5
Chg (%,YoY)	*(2.1)*	*(58.7)*	*43.4*	*32.6*
Core EPS (RMB)*	8.1	6.6	5.9	7.5
Chg (%,YoY)	*23.6*	*(19.1)*	*(10.4)*	*26.8*
Core P/E (x)- ADR*	9.7	12.0	13.4	10.6
Core P/E (x)-SW share*	10.1	13.3	13.9	11.1
ROAE (%)	15.5	5.8	7.8	9.3
ROAA (%)	10.0	3.7	5.0	6.1

1 ADR = 8 ordinary shares
*Excluding share-based compensation, impairments, fair value changes of investment, etc.
Source (s): Bloomberg, ABCI Securities estimates

Gradual recovery ahead; focus on cost optimization

In 2Q22 (1QFY3/23), Alibaba's revenue dropped 0.1% YoY to RMB 206bn while non-GAAP core net profit to ordinary shareholders was down 31% YoY to RMB 31.3bn.

Among business segments, China commerce revenue, which represents core ecommerce businesses and accounted for 69% of total revenue, was down 1.5% YoY during the quarter vs. 11% YoY growth in the previous quarter. GMV of Taobao and Tmall dropped by mid-single-digit during the quarter due to COVID, logistic bottleneck, and economic slowdown. Nonetheless, business started to pick up in June driven by improving logistics and promotional activities. We expect gradual recovery to continue in the near term. Looking forward, the management would focus on increasing the "wallet share" among customers instead of new user acquisition given its already high user base.

Cloud computing revenue, which accounted for 9% of total revenue, grew 10% YoY during the quarter driven by financial services, public services, and telecommunication industries, mitigating softness in online education and internet industries.

Core net profit dropped by 31% YoY to RMB31.3bn due to operating deleveraging vs. 24% YoY core net profit drop in the previous quarter. Core net margin was 15.3% in 2Q22 vs. 22.2% in 2Q21. The company views cost optimization as one of its major priorities currently. In 2Q22, loss-making segments such as local consumer services, innovation initiatives, etc collectively reported RMB13.3bn operating losses, versus RMB41bn operating profit for the China commerce segment, which implies significant cost optimization potential for these loss-making segments.

Financial outlook

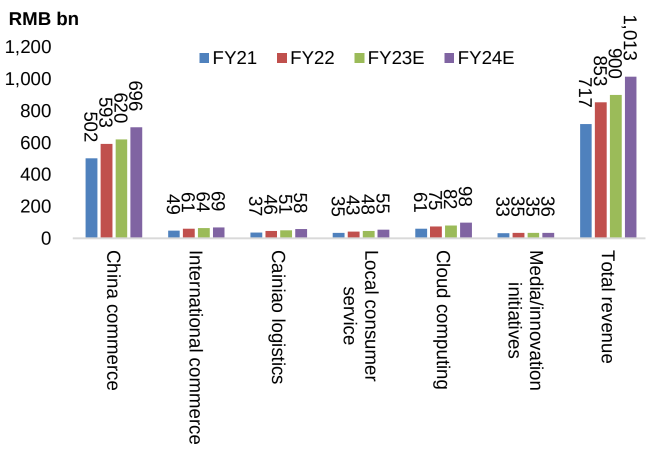
We expect revenue growth to be 5.5% in FY3/23E to reflect soft near-term economic environment but rebound to 12.6% in FY3/24E, implying a 9% CAGR in FY3/22-24E.

China commerce revenue, which consists of the core e-commerce and new retail business, is expected to grow by 5% growth in FY3/23E, factoring in the current economic softness and logistic bottleneck related to COVID measures. The segment's revenue would accelerate to 12% in FY3/24E, assuming a normalized business environment. This implies an 8% CAGR segment revenue in FY3/22-24E on the back of 5% CAGR and 6% CAGR in China GMV and China annual active customers during the same period.

Overall, China commerce is the major growth driver accounting for about 69% of total revenue in FY3/22 and we expect the trend to continue in the near future.

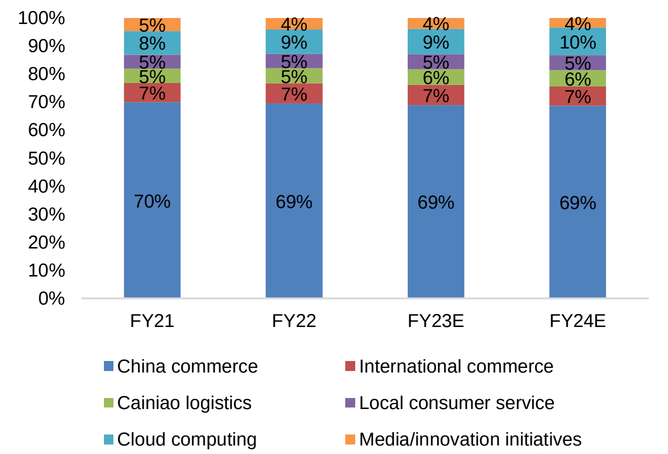
As for other businesses, we expect international commerce to experience a 6% CAGR in FY3/22-24E. We expect Cainiao and local consumer service to expand at 12% and 12% CAGRs in FY3/22-24E. In addition, cloud and median/innovation initiatives would expand at 15% and 1% CAGRs in FY3/22-24E. These businesses collectively accounted for about 30% of total revenue in FY21-22, and we expect its share to remain largely stable going forward.

Exhibit 1: Revenue outlook



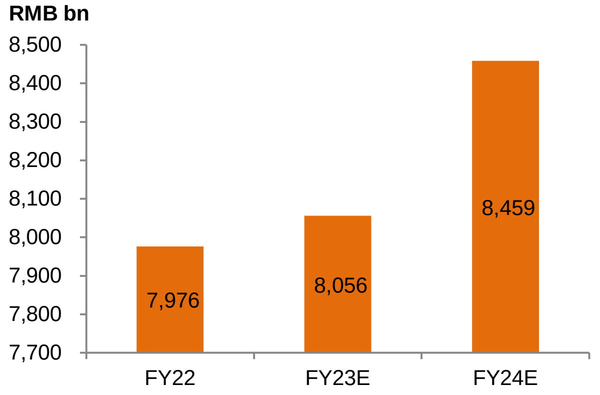
Source(s): Company, ABCI Securities estimates

Exhibit 2: Revenue mix outlook



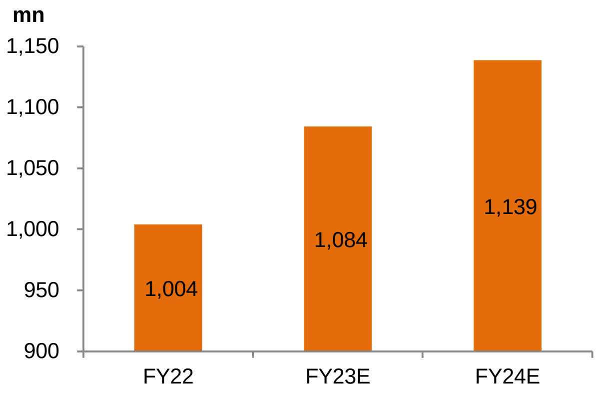
Source(s): Company, ABCI Securities estimates

Exhibit 3: China's annual active customer outlook



Source(s): Company, ABCI Securities estimates

Exhibit 4: China's GMV outlook



Source(s): Company, ABCI Securities estimates

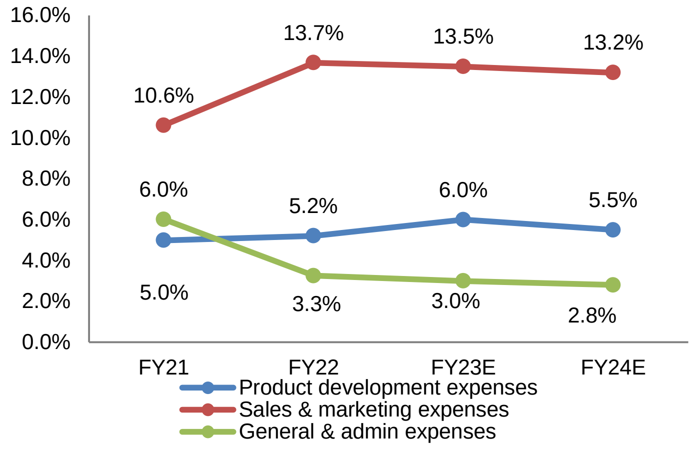
Gross margin: We expect gross margin to decline from 36.8% in FY3/22 to 35.8% in FY3/23E to factor in the near-term softness; it will rebound to 36.7% in FY3/24E on better cost control.

Product development expense: We expect non-GAAP product development expenses/sales ratio be 6.0% in FY3/23E and 5.5% in FY3/24E due to ongoing R&D investments in new services for merchants and consumers to increase loyalty.

Sales and marketing expenses: We expect non-GAAP sales and marketing expenses/sales ratio to drop from 13.7% in FY3/22 to 13.2% in FY3/24E due to cost control and improving economies of scale for new businesses such as new retail, consumer services, among others.

General & admin expenses: We expect non-GAAP general & admin expenses /sales ratio drop from 3.3% in FY3/22 to 2.8% in FY3/24E due to improving economies of scales.

Exhibit 5: Non-GAAP* cost trend (% of revenue)



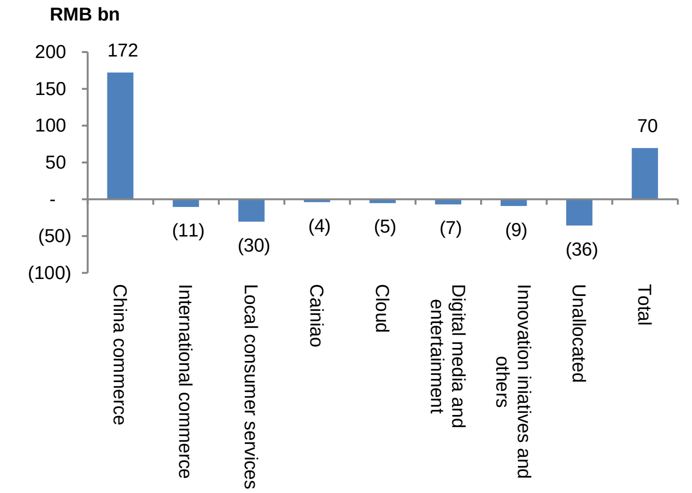
Source(s): Company, ABCI Securities estimates

* Excluding impacts of share-based compensation and other non-operating items

The China commerce segment had a 29.1% operating margin in FY3/22, while other businesses (international commerce, local service, Cainiao, cloud, media, and innovation initiatives) had an aggregated operating margin of -24.1%. Overall, non-China commerce businesses (international commerce, local service, Cainiao, cloud, media, and innovation initiatives) collectively reported RMB 66.6bn in operating losses for FY3/22, eroding the RMB 172bn operating profit in China commerce. In our view, cost optimization potential of these loss-making businesses becomes necessary. In particular, local consumer services reported RMB 30.4bn in operating losses for FY3/22 with a -70% operating margin, making it the segment with the heaviest losses.

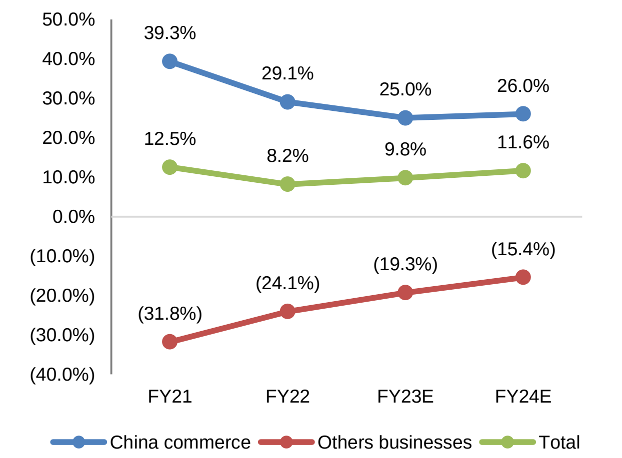
The company views cost optimization as one of its major priorities currently. Looking forward, we expect operating margin of non-China commerce businesses to improve from -24.1% in FY3/22 to -15.4% in FY3/24E driven by ongoing cost control, mitigating the operating margin drop of China commerce business from 29.1% in FY3/22 to 26.0% in FY3/24E.

Exhibit 6: Segment operating profit (FY3/22)



Source(s): Company

Exhibit 7: Segment operating margin outlook



Source(s): Company, ABCI Securities estimates

We expect core net margin (excl. impacts of share-based compensation and other non-operating items) to be 14.0% and 15.8% for FY3/23E and FY3/24E. As a result, we expect core net profit to drop by 12.0% in FY3/23E followed by 26.8% growth in FY3/24E.

Valuation and TP

Reinitiate BUY with SOTP-based TP at HK$ 130 for Alibaba-SW (9988 HK) and US$ 132 for Alibaba-ADR (BABA US), given Alibaba's leading market position in the e-commerce sector.

Alibaba-SW (9988 HK): We set our SOTP-based TP at HK$ 130.

Alibaba-ADR (BABA US): Based on our TP of Alibaba-SW, we set the corresponding TP of Alibaba-ADR at US$ 132 (1 ADR represents 8 shares).

Exhibit 8: SOTP valuation range for Alibaba-SW (9988 HK)

(HKD per share)	Low	High	Remarks
Core business	91	125	11-15x FY3/24E core profit#
Strategic investments	29	29	Book value, ABCI Securities estimates
Total	**120**	**154**	

Excluding contribution of Ant Group
Source(s): ABCI Securities estimates

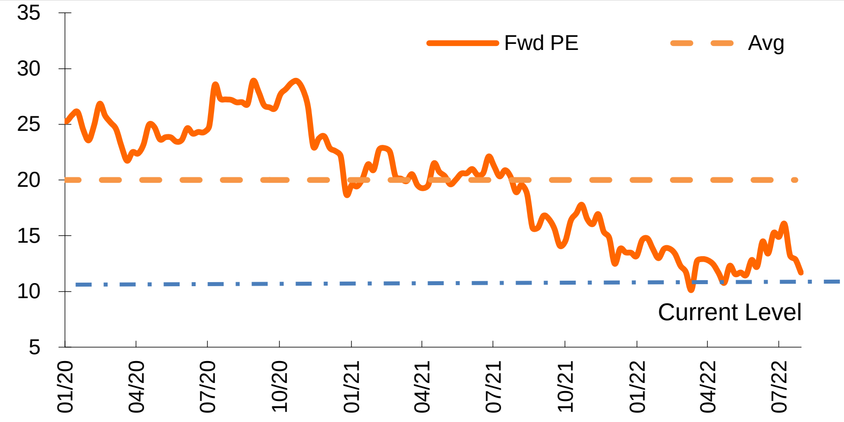
Alibaba's major shareholder, SoftBank, plans to reduce its stake from 23.7% to 14.6% before end-September via physical settlement of prepaid forward contracts it entered earlier with various counterparties. Softbank expects that the physical settlement of these prepaid forward contracts will not result in any additional sales of the shares into the market, as those shares related to these prepaid forward contracts were hedged in the market at the time of the original monetization transactions by its counterparties.

After this round of share disposal, SoftBank still hold 14.6% stake in Alibaba, which could imply further disposal risk in the future. While the likelihood and magnitude of any further disposal is uncertain, we believe such risk is mitigated by the Company's increasing effort on share repurchase, as well as the counter's current low valuation.

The Company has increased its share repurchase effort. In FY3/22, the Company allocated US$ 9.6bn for share repurchase, a significant increase compared to the RMB 118m used in FY3/21. The Company has also upsized its share repurchase program from US$ 15bn to US$ 25bn in Mar 2022, effective through Mar 2024.

The counter has experienced de-rating due to a slew of negative factors including ongoing regulatory concern, COVID impact, potential share disposal by SoftBank, and softened growth in economy. On a positive note, we believe the market has been pricing in those concerns and the counter is currently trading at the low-end of its P/E trading range, which could provide some floor support going forward.

Exhibit 9: Alibaba's fwd core P/E



Source(s): Bloomberg, ABCI Securities

Financial forecast

Consolidated income statement (FY21A-FY24E)

FY Ended Mar 31 (RMB mn)	FY21A	FY22A	FY23E	FY24E
Total revenue	**717,289**	**853,062**	**899,938**	**1,013,059**
Cost of sales	(421,205)	(539,450)	(577,479)	(641,191)
Gross profit	**296,084**	**313,612**	**322,459**	**371,868**
Product development expenses	(57,236)	(55,465)	(65,596)	(69,243)
Selling & marketing expenses	(81,519)	(119,799)	(124,698)	(137,462)
General & admin expenses	(55,224)	(31,922)	(31,372)	(33,465)
Amortization/Impairment	(12,427)	(36,788)	(12,599)	(14,183)
Operating Profits	**89,678**	**69,638**	**88,194**	**117,515**
Interest and investment income	72,794	(15,702)	9,000	9,500
Interest expenses	(4,476)	(4,909)	(5,500)	(5,800)
Other income	7,582	10,523	4,500	5,500
Share of results of equity investees	6,984	14,344	5,000	7,500
Profit before tax	**172,562**	**73,894**	**101,194**	**134,215**
Tax	(29,278)	(26,815)	(20,239)	(26,843)
Profit after tax	**143,284**	**47,079**	**80,955**	**107,372**
Minority interests	7,294	15,170	6,476	8,590
Accretion of mezzanine equity	(270)	(290)	(147)	(195)
Profits attributable to ordinary shareholders	**150,308**	**61,959**	**87,284**	**115,766**
Share-based compensation	50,120	23,971	25,198	29,379
Amortization and impairment	27,164	51,911	22,599	24,183
Gains on disposals/revaluation of investments	(66,305)	21,671	(9,000)	(9,500)
Other non-core items	17,667	(15,997)	147	195
Non-GAAP profits attributable to ordinary shareholders (Core net profit)	**178,954**	**143,515**	**126,229**	**160,023**
Growth				
Total revenue (%)	40.7	18.9	5.5	12.6
Gross Profits (%)	30.2	5.9	2.8	15.3
Operating Profits (%)	(1.9)	(22.3)	26.6	33.2
Net profit (%)	0.7	(58.8)	40.9	32.6
Core net profit (%)	26.6	(19.8)	(12.0)	26.8
Operating performance				
Operating margin (%)	12.5	8.2	9.8	11.6
Net margin (%)	21.0	7.3	9.7	11.4
Core net margin (%)	24.9	16.8	14.0	15.8

Note. Individual items may not sum to total due to rounding differences

Source(s): Company, ABCI Securities estimates

Consolidated balance sheet (FY21A-FY24E)

As of Mar 31 (RMB mn)	FY21A	FY22A	FY23E	FY24E
Fixed assets	147,412	171,806	164,306	166,306
Investments	437,410	443,253	503,253	563,753
Other non-current assets	462,036	441,959	478,360	516,177
Total non-current assets	**1,046,858**	**1,057,018**	**1,145,919**	**1,246,236**
Cash & equivalents	321,262	189,898	224,982	281,876
Restricted cash and escrow receivables	35,207	37,455	39,328	41,294
Short-term investments and investment securities	162,183	265,187	265,187	265,187
Prepayments, deposits & other assets	124,708	145,995	153,295	160,959
Total current assets	**643,360**	**638,535**	**682,792**	**749,317**
Total assets	**1,690,218**	**1,695,553**	**1,828,711**	**1,995,553**
Accrued expenses, accounts payable and other liabilities	260,929	271,460	283,542	291,428
Other payables & accruals	25,486	21,753	22,841	23,983
Borrowings and notes	13,437	8,841	13,841	21,841
Deferred revenue	62,489	66,983	71,995	81,045
Merchants deposits	15,017	14,747	15,484	16,259
Total current liabilities	**377,358**	**383,784**	**407,703**	**434,555**
Borrowings and notes	135,716	132,503	132,503	132,503
Other non-current liabilities	93,510	97,073	100,158	103,398
Total non-current liabilities	**229,226**	**229,576**	**232,661**	**235,901**
Total liabilities	**606,584**	**613,360**	**640,364**	**670,456**
Net current assets	**266,002**	**254,751**	**275,089**	**314,762**
Mezzanine equity	8,673	9,655	9,802	9,998
Equity attributable to shareholders	937,470	948,479	1,060,961	1,206,106
Non-controlling interests	137,491	124,059	117,583	108,993
Total equity	**1,074,961**	**1,072,538**	**1,178,544**	**1,315,099**

Note. Individual items may not sum to total due to rounding differences
Individual items may varies from reported figures due to rounding differences/definition differences
Source(s): Company, ABCI Securities estimates

Risk factors

Violation of the anti-monopoly law in China

According to State Administration for Market Regulation of the PRC (the “SAMR”), Alibaba has violated the anti-monopoly law, which states that a business operator that has a dominant market position is prohibited from restricting business counterparties through exclusive arrangements without justifiable cause.

The SAMR ordered Alibaba Group to cease violating acts and imposed on Alibaba a fine of RMB 18.228bn. The SAMR also issued an administrative guidance, instructing Alibaba Group to implement a comprehensive program of rectification through strictly fulfilling its responsibility as a platform operator, strengthening its internal controls and compliance, upholding fair competition, and protecting the lawful rights and interests of the platform’s merchants and consumers. The administrative guidance requires Alibaba Group to submit a self-assessment and compliance report to the SAMR for three consecutive years.

Market competition

The ecommerce industry is highly competitive, with companies contending on commission rate, promotion discount, brand advertising, technological investment, and more.

Slowdown in ecommerce consumption

As the industry is dependent on consumer spending, any significant slowdown of consumption in China would hamper the Group’s performance. In the long term, we believe consumption growth in domestic market would converge with income growth, which is usually in line with GDP growth.

Non-GAAP financials

Ecommerce platforms generally disclosed the non-GAAP financial metrics, such as the non-GAAP net profit, to supplement its GAAP financial measures. Historically, there were differences between its GAAP net profit and non-GAAP net profit due to inclusion of items such as share-based compensation and other non-core items in the former.

Among these items, share-based compensation expense is related to various factors including price movement of ordinary shares, expected volatility, risk-free interest rate, etc.

While investors tend to exclude these items when performing analysis given their non-cash nature, we believe these non-GAAP financial measures should only serve as references.

Disclosures

Analyst Certification

The analyst, CHOW Sau Shing, primarily responsible for the content of this research report, in whole or in part, hereby certify that all of the views expressed in this report accurately reflect my personal view about the subject company or companies and its or their securities. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this report. I and/or my associates have no financial interests in relation to the listed company(ies) covered in this report, and I and/or my associates do not serve as officer(s) of the listed company (ies) covered in this report.

Disclosures of Interests

ABCI Securities Company Limited and/or its affiliates, within the past 12 months, have investment banking relationship with Alibaba.

Definition of equity rating

Rating	Definition
Buy	Stock return rate≥ Market return rate (~10%)
Hold	- Market return rate (-~10%) ≤ Stock return rate < Market return rate (+~10%)
Sell	Stock return < - Market return (-~10%)

Notes: Stock return rate: expected percentage change of share price plus gross dividend yield over the next 12 months
Market return rate: average market return rate since 2008 (HSI total return index 2008-20 CAGR at 9.2%)

Time horizon of share price target: 12-month

Stock rating, however, may vary from the stated framework due to factors including but not limited to: corporate governance, market capitalization, historical price volatility relative to corresponding benchmark index, average daily turnover of the stock relative to market capitalization of the stock, competitive advantages in corresponding industry, etc.

Disclaimers

Office address: ABCI Securities Company Limited, 13/F Fairmont House, 8 Cotton Tree Drive, Central, Hong Kong.

Tel: (852) 2868 218