Baidu.com

Rick Munarriz | August 20, 2008

CURRENT PRICE: BIDU $ 123.73 ↑ $ 2.36 (1.9%) Ćvẹ̀uG̀ | Ẏṙ Ḃ≈ǍŐǴ ÀAūǍủÀạ ṿủṆ ủ

Why Buy:

- Strengths from our original recommendation have gotten even stronger, with a growing market, dominant share, and new opportunities.
- China has passed the United States with a quarter-billion people online.
- This stock has lived up to -- and surpassed -- lofty valuations before, so don't miss another chance to invest in the growth still to come.

What It Does

Baidu.com is the far-and-away leader in China's Internet search market.

Key Company Data

Headquarters: Beijing, China

Website: www.baidu.com

CAPS Rating: 3 Stars (41.15 out of 100)

Sign of a Breaker: Top Dog and First Mover

Market Cap: $10,991.5

Cash/Debt: $280.1 / $0

Revenue (TTM): $356.1

Earnings (TTM): $118.5

Revenue (2005-07): $46.5 / $122.1 / $254.1

Earnings (2005-07): $6.9 / $44.0 / $91.6

Recent Price: $321.01

Data as of 8/15/08
Dollar amounts in millions except recent price.

True story: When **Baidu.com** (NASDAQ: BIDU) beat analysts' expectations a few weeks ago -- something that China's leading Internet search engine has gotten in the habit of doing -- David Gardner got a little too excited. As he told me: "When the company announced outstanding earnings once again and zoomed up like 50 bucks that day, I was crowing -- crowing partly under the assumption that Baidu was already a double rec in *Rule Breakers*. To my horror, we had only picked it once."

Baidu has certainly received a lot of love since its original recommendation in our November 2006 issue. As part of the Rule Breakers Core, it embodies our service's quest for disruptive innovation, and we think it's well on the way to long-term success. During the Motley Fool Advisor Roundtable, David picked Baidu as his favorite stock for 2008 -- a call echoed by *Income Investor*'s James Early and *Global Gains*' Bill Mann, who also named Baidu as *their* favorites from among our Foolish advisors' top picks.

Not bringing Baidu back for a *Rule Breakers* encore may have been an oversight, but that ends today.

So Far, So Great

When a stock nearly quadruples in less than two years, it's going to turn heads. Now I have no choice but to turn mine as well, looking back to see if my catalysts for recommending Baidu remain intact.

My 2006 Baidu buy thesis rested on three points:

- China's Internet economy was booming, with just 10% of the country's 1.3 billion citizens online.
- Despite **Google**'s (NASDAQ: GOOG) presence in China, Baidu was holding onto a whopping 62% market share.
- New efforts in online message boards and targeted ads held promise for incremental growth.

Baidu is looking good on all three fronts. China finally lapped the United States in Internet use this summer. More than 250 million Chinese now routinely surf the Web, according to the China Internet Network Information Center -- but that's just a fifth of the country's population. China's Internet boom grew 56% over the past year alone, but it still has plenty of room to run before it reaches the 71% market penetration of the United States.

The latest iResearch data finds Baidu commanding 74% of China's Web traffic and 61% of search engine marketing spending. Google -- a Rule Breaker in its own right -- draws only 26%. In other words, Baidu is still this market's top dog, with plenty of leeway to turn its search results into revenue. And since my original recommendation, it's added even more features to its search portal, tiptoed into the Japanese search engine market, and started work on a consumer-to-consumer auction marketplace.

Baidu went three-for-three on my investment thesis, and it's looking even better today than it did two years ago.

The Value of Baidu

No matter when they bought, few investors would call Baidu a disappointment. The company's revenue and earnings have increased quickly, and its margins continue to expand, if you back out the recent costs from its foray into Japan. Baidu has topped Wall Street estimates in nine of its first 12 quarters as a public company, and the lone shortfall was by pocket change. This company is built to outperform.

Of course, investing in China presents a degree of geopolitical risk, despite the warm fuzzies of the Olympics. There are also market innovation risks for a Web search technology that's still in its infancy. But the most tangible risk for high-flying stocks like Baidu tends to be valuation.

Two years ago, I summed up Baidu's valuation like this: "Trading recently at the $87 mark, the shares may seem outlandishly priced at 483 times last year's earnings, richly priced at 102 times this year's earnings, and yet reasonably cheap at 51 times next year's earnings given Baidu's speedy growth spurts."

Here's how we stand today: Trading recently at the $320 mark, the shares may seem outlandishly priced at 132 times last year's earnings, richly priced at 73 times this year's earnings, and yet reasonably cheap at 45 times next year's earnings given Baidu's speedy growth spurts.

The point in simply filling in those blanks is to show that investors who scoffed at buying Baidu at 51 times earnings two years ago missed out on a stock that has more than tripled. Will you make the mistake of passing on Baidu at 45 times next year's profit target? And since we're talking profit targets, remember that Wall Street is *still* raising its expectations for Baidu. Over the past three months, analysts' 2009 earnings projections have climbed from $6.56 a share to $7.13.

Searching for More

Baidu may not be growing as quickly as it once did, but it's no slouch. Revenue and adjusted profits roughly doubled in the latest quarter. It closed out the period with 181,000 advertisers, a Rolodex 41% fuller than it was a year ago. Revenue is growing substantially faster than that, meaning sponsors are spending more -- a lot more -- on online advertising.

That trend will continue, as Baidu caters to more of the 1.3 billion people living in China and perhaps even the wealthier 300 million Chinese nationals living elsewhere. The growth figures look staggering: While China's GDP gains 8% to 9% a year, advertising in China grows 15% to 20%, and online advertising grows 40% -- projected to reach $4.3 billion by 2011.

Baidu reports that more large companies are signing on, forming a stable base of customers that can take advantage of bundled offerings. A new feature called My Marketing Center brings Baidu's database into view, allowing clients to use market and industry trends to create more successful ads. Better ads will lead to better advertisers -- and even more of an edge for Baidu.

Wherever China meets the Internet, Baidu is there, and investors still have the opportunity to profit from the growth of both. So don't worry, David and my fellow Breakers: We've started our rerec chapter, but Baidu's great growth-stock story is just getting started. True story.

For more, join us on the RBS: Baidu.com discussion board.

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