Buy Baidu

Rick Munarriz | February 25, 2015 | Buy Recommendation

CURRENT PRICE: BIDU $ 123.73 ↑ $ 2.36 (1.9%) [illegible]

It's safe to say that **Baidu** (NASDAQ: BIDU) has a special place in *Rule Breakers* history. The stock has been a 24-bagger since our original recommendation in October 2006, the most successful pick we've ever made. We re-recommended the stock two years later, and that position has gone on to post a market-thumping return of 550%. With success like that, you could argue we've long been overdue for a third recommendation. So this month, we're rectifying that and adding to our biggest winner.

Baidu is naturally a much different company these days than it was as a young dot-com darling. A good portion of the growth we were looking forward to back then has played out. Much more of China's population has come online. And rather than battling **Google** (NASDAQ: GOOGL) these days, it's facing off against the far less menacing **Qihoo 360** (NYSE: QIHU), the distant silver medalist in the world's most populous nation.

But one important fact remains: Baidu remains China's undisputed leader in search. And it's getting better all the time at translating its dominance into revenue.

We're willing to trade speed for power as a Rule Breaking company matures — and as you'll see, today's Baidu is anything but slow. Read on to learn why this big winner isn't done delivering for investors like us.

Time Changes

We're no longer in the early stages of China's Internet revolution. An encouraging 46% of China's population has access to the Internet these days, up sharply from a penetration rate in the high single digits when Baidu went public a decade ago. That may seem to cap the upside here, but we accept that. Baidu is playing a different game now, and we're approaching it as a tech titan commanding a market cap north of $73 billion.

The upside to this kind of change is that there are fewer uncertainties surrounding Baidu. For instance: China's government may always be restrictive, but investors no longer fear that it will shut down access to the Internet.

Baidu's stock dipped earlier this year after its fourth-quarter results disappointed some investors. Revenue soared a hearty 48%, but net income rose by a lower-than-expected 16%. Investors have accepted that revenue will grow faster than profitability in the near term, but after three quarters of watching Baidu beat Wall Street's targets, they wanted more. Some expense items including content and promotional costs have grown a lot faster than revenue as Baidu ramps up its investments in businesses outside of search.

WHAT IT DOES

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

WHY BUY

- Business strengths from our original recommendation have gotten stronger, with a dominant market share and new opportunities.
- Margins have been challenged as Baidu expands into lower-margin areas outside of search, but strong bottom-line growth should resume in the future.
- This stock has lived up to — and surpassed — lofty valuations before.

KEY DATA

- **Headquarters:** Beijing, China
- **Website:** www.baidu.com
- **Sign of a Breaker:** Top Dog and First Mover
- **Market Cap:** $73 billion
- **Cash/Debt:** $9.2 billion / $4.1 billion
- **Revenue (TTM):** $7.9 billion
- **Earnings (TTM):** $2.1 billion
- **Revenue (2011/'12/'13):** $2.30 billion / $3.58 billion / $5.27 billion
- **Earnings (2011/'12/'13):** $1.05 billion / $1.67 billion / $1.73 billion
- **Recent Price:** $208.06

BUYERS GUIDE

- **Industry:** Internet
- **Size:** Large cap
- **Region:** China
- **Risk:** 9 out of 25 (see all our stocks here)
- **Crushability:** Jawbreaker (see the full scale here)
- **Most similar to:** Google, Yandex, and Sohu.com

Data as of 2/24/2015

We're fine with that. Baidu is making all the right moves to help it grow its top line today, planting the seeds for bottom-line growth tomorrow.

Making It in Mobile

There's also the mobile challenge, which Baidu has met head-on — and passed with flying colors.

Baidu has diversified into several new areas, but it continues to revolve around selling online advertising and expanding its distribution. Online marketing revenue accounted for 98.9% of its revenue in 2014. There was a time when investors felt that Baidu would be a victim of the shift in computing consumption. The world — and China in particular — was relying more on smartphones and tablets to surf the Web, performing functions that only PCs used to achieve. Smartphones surpassed PCs as China's online vehicle of choice in 2012, but Baidu was still seen as tethered to desktop and laptop search.

So Baidu got busy, making the most of its huge cash balance and resources to remain relevant. It bought 91 Wireless, a leading mobile-apps marketplace operator, and it broadened its reach into everything from streaming video to travel portals.

Baidu had to sacrifice its once envy-inspiring profit margins to make that shift happen. Its net margin, which peaked at 46.9% in 2012, fell to 32.9% in 2013, slipping again to 26.9% last year. The market normally rolls its eyes at declining margins, but accelerating top-line growth finds Baidu making up the difference in volume. Total revenue soared 53.6% in 2014, after climbing 43.2% a year earlier.

Risks and When We'd Sell

Mobile usage has been harder to monetize than traditional PC traffic. Investors saw that during the third quarter of 2014, when Baidu's mobile traffic surpassed visits from PCs for the first time, but mobile revenue only accounted for 36% of the mix in that period. That metric improved to 42% during the fourth quarter, but if advertisers don't grow to value mobile leads the way they do traditional PC-based marketing campaigns, it may lead the market to reassess the benefits of the mobile revolution as it pertains to the paid-search and online advertising leaders.

Valuation is also a concern. Baidu is trading at 35 times trailing earnings. That's not cheap, especially when the larger and less risky Google is fetching a multiple near 27. Baidu is growing faster, and it has historically traded at a premium to the market in general and Google in particular. However, as long as margins continue to contract at Baidu, we will have to deal with the fact that higher expectations could mean greater volatility.

Analysts see margins continuing to narrow through 2015. They see revenue climbing 39% this year, with earnings per share rising only 19%. For what it's worth, that trend is expected to stabilize next year, with Wall Street pros eyeing a roughly 33% pop in revenue and profitability come 2016. This is why investors are putting up with the shrinking margins now. But if things don't improve next year, that patience will wear thin.

We'll also want to keep an eye on Qihoo 360. It launched its platform three years ago, and it already is reportedly up to roughly 30% of the PC search and 10% of the mobile search market. However, Qihoo hasn't been able to successfully monetize that traffic, and it wouldn't be a surprise if its share of the market begins to slip — and its user base diminishes — once it starts wallpapering its search engine with ads.Baidu has been able to grow its revenue despite Qihoo nipping at its heels, but the latter's move toward mobile remains a development that bears watching.

The Foolish Bottom Line

Does Baidu have another 24-bagger run in it over the next nine years? Dare to dream ... but we doubt it. That's OK. This company is handling the next stage of its evolution smoothly, and there's no reason a bigger and smarter Baidu can't continue to beat the market.

We're kicking ourselves a little for not making our third recommendation sooner. But great companies give you multiple opportunities to buy them — and we think Baidu is a great company offering a great opportunity.

- **Are you buying Baidu?** Take the poll on our Baidu discussion board!
- **Talk about it!** Our Baidu discussion board is open for business.

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David Gardner owns shares of Baidu, Google (A shares), Google (C shares), and Yandex. Karl Thiel owns shares of Google (A shares) and Google (C shares). Matthew Argersinger owns shares of Yandex. Simon Erickson owns shares of Baidu. Tim Beyers owns shares of Google (A shares) and Google (C shares). Tom Gardner owns shares of Baidu, Google (A shares), and Google (C shares). The Motley Fool owns shares of Baidu, Google (A shares), and Google (C shares).

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