Baidu.com

Rick Munarriz | October 18, 2006

CURRENT PRICE: [BIDU](#) $ 123.73 ↑ $ 2.36 (1.9%) Ćvạ̀ìĠı Ÿr B≈ÃŐĠ ÀÀtiÀtiÀạ̀ vìŅ ò

Baidu.com

- China's Internet economy is booming -- and just 10% of the country's citizens are online so far.
- Market share has surged past Google to reach 62%.
- Message boards and targeted ads open more room to grow.

- Nasdaq: BIDU
- [www.baidu.com](#)
- Ph: +86 10-8262-1188

Recent Price: $44.44-$96.67

When **Baidu.com** (NASDAQ: BIDU) went public last summer, the leading Chinese-language search engine couldn't shake the tag of being "China's Google." That served it well for stirring up interest during an opening-day feeding frenzy that harkened back to the sudsier days of the dot-com bubble. The IPO was priced at $27 but opened at $66 and soared to close at $122.54 on its first day of trading.

Wall Street ultimately sobered up. The Chinese economy was hot -- averaging about 10% annualized growth over the previous few years -- but Baidu was still toiling away in a highly undeveloped paid search market.

There were also fears that too much of Baidu's traffic was the unsavory result of young users looking for illegal MP3 downloads (which made up 20% of the traffic to Baidu at the time). And, of course, we had the inevitable reality that **Google** (NASDAQ: GOOG) was the more likely choice to grow up to be China's Google. Baidu may have gone public just a year after Google's market debut, but it was certainly no Google.

As it turns out, it's been better than Google. Over the past year, Baidu's share of the Chinese search engine market in the booming hotbed of Beijing has grown from 52% to 65%. That growth has come at the expense of Google, whose slice of that market has gone from 33% to 21% -- Google now commands just a quarter of China's search engine queries, while Baidu is serving up a 62% majority. I wouldn't be as bold as to suggest that history may one day refer to Google as America's Baidu -- har, har -- but it's clear that the world's most populous nation has voted for Baidu as its search engine of choice.

In Any Language, It Adds Up

For a company approaching a $3 billion market cap so early in its infancy, a lot is expected financially. Thankfully, Baidu has been up to the challenge. After watching revenue soar 172% to $39.6 million last year, the top line is well on its way to increase a projected 163% to $104.1 million in 2006. Analysts expect Baidu's revenues to surge another 88% and hit $195.9 million next year.

That's pretty darn fast, but guess what? Profits have been growing even faster. Net margins clocked in at a respectable 10.2% in 2004 and improved to 14.9% last year. Through the first six months of 2006, margins have widened to 28.6%.

As we have seen with past *Rule Breakers* picks like **NetEase** (NASDAQ: NTES) and **Shanda Interactive** (NASDAQ: SNDA), favorable tax rates and explosive operating efficiencies can create some amazing profit margins in China. Baidu should be no different, especially as it's working in a niche that is pretty high-margin stuff to begin with.

So it's no surprise that analysts expect earnings per share to outpace top-line growth at Baidu. They see profits climbing 372% this year to $0.85 a share and nearly doubling to $1.69 a share in 2007.

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.

Searching for More Growth

Being the top dog in China has its benefits. For starters, just as we find auctioneers relying on eBay and aspiring video directors turning to YouTube, advertisers know that Baidu is the best way to reach the widest Chinese audience. Baidu now has 90,000 active marketing clients. On average, they find themselves spending more with each passing quarter.

Financial Snapshot

Baidu has other growth vehicles beyond search. Its popular Post Bar site serves up 820,000 message boards. The company also has a Baidu Union program that's similar to Google AdSense, recruiting third-party content sites that rebroadcast Baidu's targeted ads in exchange for a piece of the action. Success in one part of Baidu's business is often the catalyst for growth throughout the company, and that's a beautiful thing when it's executed as well as Baidu has been able to in its brief public life.

I don't see any major acquisitions on the horizon. Maybe it will be willing to snap up the interest in a failed outsider (like Tom Online is rumored to be doing with eBay in China), but Baidu doesn't need secondary growth vehicles when its prospects for organic growth are superb.

The Foolish Bottom Line

Remember when the cynics called Google overpriced two years ago when it went public at $85 a pop? What happened there? Google obliterated bottom-line targets. Analysts jacked up estimates; Google topped them again. Even the most ardent of bears at the time would snap at the chance to buy Google at $85 today.

We're seeing that with Baidu. The company has beaten net income estimates in all but one quarter since going public. Along with the company's own upbeat outlook, analysts have found themselves perpetually raising the bar that Baidu appears to be clearing with ease.

Back in March, I crunched the numbers as I was writing about Baidu for our *International Stock Report*. At the time, analysts were expecting Baidu to earn $0.47 a share this year and $0.85 a share come 2007. Well, Baidu went on to earn nearly all of that 2006 target in the first two quarters alone! The 2007 target has now become this year's target, and next year's target has been doubled.

Even if you look back just three months, analysts figured that Baidu would earn only $0.74 a share this year and $1.28 a share next year. Where will we find ourselves in six months? Twelve months? Two years?

This may be an unpopular pick. Over at Motley Fool CAPS, the majority of all-stars believe the stock will underperform the market, and the stock has a paltry one-star rating. That's OK. Rule Breakers often start out being ridiculed for being overpriced, even by some pretty sharp visionaries. I've seen this before -- like Google circa two summers ago. Baidu is in the perfect position to defy the naysayers again.

China is hot, but this isn't just a heat-seeking missile. There is value in Baidu shares even at $3 billion. **Yahoo!** (NASDAQ: YHOO) paid $1 billion last year for a 40% stake in China's AliBaba.com e-commerce site. Online marketplaces are great, but there's a reason Google is valued much higher than **eBay** (NASDAQ: EBAY). Search is where the ad money is at. Search is where the opportunity to penetrate deeper rests. For instance, Baidu has followed the example set by Google and Yahoo! in creating its own desktop search application. Providing a popular software application in a nation where citizens are buying their first computers cannot be emphasized enough. Baidu matters. Baidu is penetrating.

Fundamentals keep improving. The Chinese economy keeps improving. With GDP of just $6,800 per resident, we haven't even scratched the surface of what each consumer in a nation 1.3 billion strong would be ultimately worth to a company like Baidu -- and for the advertisers who will turn to Baidu to reach them.