This Is What Is Wrong With Alibaba's Earnings

Feb. 10, 2024 2:20 AM ET**Alibaba Group Holding Limited (BABA) Stock**, **BABAF Stock**42 Comments18 Likes

Early Retiree
6.69K Followers
Follow

Summary

- Despite apparently ticking all the right boxes, Alibaba continues to drift lower.
- At first sight, the company is dirt cheap, but there is quite obviously something wrong.
- In this article, I will highlight some of the key issues with Alibaba’s fundamentals, some of which matter even for the long term.

Chesnot/Getty Images News

What is wrong with Alibaba?

In my last review of Alibaba (NYSE:BABA) earnings I focused on "hallucinations". However, already back in April 2023, when I had warned that Alibaba would remain cheap for a long time, I had asked myself whether it was me who maybe was hallucinating something, as the overwhelming majority of analysts took the other side of the trade.

But in the end, the stock became only cheaper and underperformed the S&P 500 by a whopping 45%. Those bullish analysts were evidently missing something.

This time may be no different: Right after Alibaba's Q3/24 results, a lot of enthusiastic Buy ratings were issued.

When I look at Alibaba's earnings materials, I intuitively associate a famous Woody Allen scene from Take the Money and Run: He prepares for a date, showers, grooms himself at the mirror, leaves his apartment - but suddenly he comes right back in, and as the camera zooms out, it reveals he forgot his pants.

Alibaba ticks all the right boxes: Announces IPOs, buybacks, even a dividend, has great FCF, a gigantic net cash position, talks AI, future growth prospects, etc. - but once you consider the full picture something is still wrong.

Alibaba Q3/24 earnings review

The company clearly felt the impact of a sluggish Chinese economy and, most importantly, of its growing competition. Key segments that make up over half of Alibaba's revenues and more than its entire net earnings like Cloud, Taobao and Tmall barely grew. In contrast, the strongly growing international commerce segment did so at a hefty cost, growing its losses almost 5-fold. As a result, total net profits were down 4% even on an adjusted basis and below consensus. After factoring in mark-to-market changes from equity investments and large impairments mainly relating to Sun Art and Youku, net profits were down 69%.

Adjusted EBITDA came in roughly flat, while free cash flow felt the impact of higher capex and working capital additions and was down 31% YoY. For the first nine months, FCF was flat at $20B. If Q4 brings in similar FCF as in Q4/23, for the full year Alibaba will rake in $25B of FCF, flat YoY, corresponding to 14% of its market cap.

In Q3, share-based compensation was down 30% YoY.

To assuage investor concerns, management increased its buyback authorization by a huge $25B, which means that over the next three years the total amount available for repurchases stands at over $35B or 20% of the company's market cap. (At least in theory - see below.)

As explained during the Alibaba Q3/24 earnings conference call, there are some limitations to buybacks, as the company's cash cannot be used entirely offshore. Still, management intends to use buybacks to bring total shareholder returns to roughly the same level of Treasury Bills: 1.4% of dividend yield plus about 3% of equity reduction.

At this point, we have Woody Allen nicely dressed up - not George Clooney, but, well, at least a clean look.

Zoom out on Alibaba's Q3/24 earnings

Over the past few years, most investors have gone from expecting Alibaba to be George Clooney (or the Amazon (AMZN) of China) to being ok with getting Woody Allen. Now they seem to be preparing for being ok with Woody Allen without pants.

In fact, Alibaba was expected to grow earnings by the double-digits for many years, but it is not growing anymore.

Several of its manifold ventures have suffered large impairments. Competition is on the rise, and if competition managed to bother almighty Alibaba at home, it certainly has more than a shot to do so internationally as well. It is probably just a question of time.

In the meantime, Alibaba is trying to fortify its first-mover advantage by pouring more and more money into its international activities. A few years ago, in the ZIRP days, investors would have stopped reading the press release after the GMV and revenue data. Today, they look at net earnings as well. And they highly doubt the final result will justify those expenses.

For example, in Europe concerns regarding the large inflow of Chinese small-ticket items are growing: They are eluding import duties, often don't correspond to European safety standards and overall represent clearly unfair competition for Europe's own manufacturers. So tighter regulations might curb future growth for international Chinese e-commerce players.

We can always rationalize the current situation and put the blame on the general economy, the CCP, geopolitical tensions, the need for growing AI investments to bolster future returns, etc. - but the fact is that Alibaba's Cloud and Chinese e-commerce businesses have lost market share. Actually, they have lost far more market share than (the few) sceptical investors had expected. - How can we be sure that the trend is reversible? Why shouldn't it accelerate?

There hasn't been a lack of distractions for Alibaba management, many of which self-inflicted: Think about the botched Ant Group IPO, the continuous management reshuffling, the first announced, then mostly retracted IPO plans. Management now says that market conditions are not right. But were they right one year ago? Chinese stocks and Alibaba were in the doghouse long before those multi-IPO plans were announced. So why is management backpedalling? We just don't know.

Many investors point to the huge FCF and the net cash position. How much of this cash will be actually given back to shareholders? In 2023, Alibaba spent $9.5B for a 3.3% net reduction of the share count. It currently has the equivalent of 2.5B ADS outstanding, which means the 3.3% reduction corresponds to 85m ADS. Yet the company repurchased a total of 112m ADS in 2023. The difference of 27m ADS were just neutralizing share issuance. Hence, we might argue that instead of paying ~$85 per ADS (9,500/112), the effective cost was $112 per ADS (9,500/85).

As a note aside, many investors overvalue the value-generating effect of share repurchases. If done at fair value, the net effect of share repurchases on intrinsic value per continuing share is exactly zero, as cash on hand owned by continuing shareholders is exchanged for a greater slice of the business.

Since I expect objections, just look at this simple example: Company Onehundred, Inc. has 100 shares outstanding, its business is worth $100 and it has net cash of $100. Therefore Onehundred's fair value and market cap is $200 or $2 per share. If the company repurchases 50% of shares outstanding for $100, the continuing shareholders still own the entire business worth $100, but no net cash anymore. Consequently, each of the remaining 50 shares is worth $2 - the same as before the massive buyback.

To be accretive, repurchases need to be done substantially below fair value. - But what if management effectively always pays 30% more than market value as in the case of Alibaba? Investors should probably consider that, over time, those share repurchases are more likely to destroy some value.

At this point I would expect the objection that, during the past few quarters, share-based compensation has come down enormously (roughly 50% YTD). Right, but this is mainly due to the current lower market value of the awards granted. In other words: The same number of awards were granted, they were just worth less - at the moment of issuance. But if you are a bull and believe the stock will go up, the effective value of these grants will increase as well. To neutralize their effect, management will need to spend a growing part of its FCF.

A look into Alibaba's future

At this point we have the full picture of Woody Allen dressed up, but without pants. Sure, he can slide into a pair of trousers and meet the girl, but will the date be a success? - We certainly have many reasons to be doubtful.

Personally, instead of factoring in a 20% share count reduction over the next 3 years, I believe half of this number is probably more realistic - which is actually in line with management guidance of 3% per year.

Given the sickening volatility of the stock and the unpredictability of the business, coupled with general concerns regarding China, a total return of 4-5% is obviously not enough. Investors want far more, which means Alibaba needs to grow net earnings from here.

It has squandered a lot of money on ventures like Sun Art which it now wants to exit. But issues like these should be considered part of the game - and part of the reason why until a few years ago the fast evolving tech space used to trade for relatively low multiples compared to its growth rates. It was simply deemed to be too unpredictable and at least some huge capital allocation mistakes had to be factored in.

Investors don't need Alibaba to trade for 30x earnings to make a killing. If Alibaba traded for just 14x its FCF, it would double from here. The only question that matters is how it can get the multiple to expand.

First of all, as we have seen, a haircut to FCF is appropriate, as 25-50% of it (depending on the stock price) will simply go into the neutralization of share issuance.

Assuming no growth, but just steady FCF generation over the next three years, Alibaba will roughly generate $75B of FCF and use $35B of it to buy back 10% of its shares. In addition I assume it will pay in total ~$4 of dividends per share, for a total of $10B. Therefore, three years from now, net cash will have increased by $30B. If the stock traded for 10x FCF, it would stand at $111 per ADS, i.e. from today shareholders would get a very decent total return of roughly 50%.

The 10x FCF multiple actually is not that much of an expansion from today's 7.2x, since the projected accumulation of additional net cash would be worth 1.2x on its own.

Given the very conservative - if not outright bearish - assumptions underlying my projection, it is pretty evident that Alibaba is cheap. To improve its multiple, investors will need to see steadiness and predictability - not only of the general environment and Chinese regulations, but perhaps most importantly from the company itself. If management continues to act erratically and/or geopolitical tensions and/or regulatory interventions continue to weigh on sentiment, expect investors to stay cautious.

In order to make more than just a decent return, Alibaba also needs to grow earnings. Currently, investors have the impression that the company is embarking in a major investment phase and are not willing to pay up for the promise of later profits, given past experiences and the general geopolitical picture. I believe this attitude is unlikely to change quickly and therefore keep my Hold rating, although I acknowledge that the risk/reward is starting to look asymmetrical at the current valuation.

Given how intertwined the Alibaba story is with general political issues, I strongly advise against trading the stock on any kind of short-term "signals". While in general a bad idea for any stock, in the case of Alibaba negative news of all sorts can surface any minute of every day and make you lose your pants for real.

Editor's Note: This article discusses one or more securities that do not trade on a major U.S. exchange. Please be aware of the risks associated with these stocks.