THE LONG VIEW

A closer look at quality

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Skerryvore

With high growth rates and a seemingly long runway, why do we not invest in Chinese tech companies?

Over the course of many conversations with clients and consultants we have been asked why we have so little money invested in China and specifically the Chinese technology sector. The FT recently reported that on average GEM managers had somewhere in the region of 25% of their funds[i] in these companies.

The largest component – at 8.8% of the Emerging Markets Index – is Alibaba, the giant of e-commerce in China. The company estimates that it accounts for $1 trillion US dollars of the total $6 trillion in annual retail sales of consumer goods in China[ii]. We have made an active decision not to own shares in this company and our purpose here is to illustrate the first question in our investment process – Is the business we are looking at of sufficient quality to own for the long term? We thought it might be helpful to use the example of Alibaba to demonstrate our thought processes.

When researching a company, our aim is to establish a pattern of quality in four major areas:

- people;
- franchise;
- sustainability; and
- financials.

We know that there is no such thing as a perfect business but what we are looking for is a track record of integrity, transparency and alignment. Where a company does not meet our quality criteria we will not invest in it, regardless of the price, its position in the index or the seemingly wonderful prospects it may have. As a bank we hold in the portfolio recently put it, 'we are interested in the return *of* capital as much as the return *on* it'.

So, how does Alibaba perform in these four areas?

Quality of people (and our alignment with them)

The right people and cultures form a very important part of what we look for in a business. We look for owners and managers who, among other things, are invested in the company in the same way we would be. We avoid complex control structures and mechanisms that disadvantage minority shareholders. We actively look for evidence of lapses in governance in the history of the company and seek to understand how incentive structures work and what alignment they create for us as minority shareholders.

A study of history reveals that Jack Ma, the founder and up until recently the CEO of the company, span Alipay (now Ant Group) out of Alibaba just before the IPO, making himself the majority shareholder despite the fact that SoftBank and Yahoo! were both shareholders at the time and did not receive compensatory payment.

A compromise was eventually reached in which Alibaba would own 37.5% of the company. The recent IPO of Ant, cancelled at the last minute, was valuing the company at more than $330 billion, showing the huge sums that were at stake. Irrespective of the amounts involved, this event demonstrated a serious lapse in governance by the founder and raised significant questions in our minds about integrity. We also noted that Yahoo's board member resigned just before the IPO, disavowing any responsibility for the contents of the IPO documentation[iii].

With Alibaba, as with other Chinese internet companies, we have run into the problem of control in the form of variable interest entities (VIEs). These quite complex entities allow companies to consolidate financials without ownership and have been used by Chinese technology companies to list themselves on foreign stock markets. This is a grey legal area that appears to circumvent the restrictions on foreign ownership as most of Alibaba's business operates in protected sectors of the Chinese economy. The Alibaba annual report provides a clear summary of the risks these entities present:

If the PRC government deems that the contractual arrangements in relation to our variable interest entities do not comply with PRC governmental restrictions on foreign investment, or if these regulations or the interpretation of existing regulations changes in the future, we could be subject to penalties, or be forced to relinquish our interests in those operations, which would materially and adversely affect our business, financial results and the trading price of our ADSs and/or Shares[iv].

A key part of understanding alignment is how people in a company are paid, and for what. With Alibaba, you could also add the question of who is being paid, noting that the company has 'various equity incentive plans pursuant to which the employees, consultants and directors of our company and/or certain other companies, such as Ant Group, are awarded RSUs, restricted shares or granted options to acquire our ordinary shares'v. This definition, from the annual report, would allow the company to hire anyone as a 'consultant' and pay them in equity. It also highlights the conflict of interest that appears between Ant Group and Alibaba, because it clearly discloses that management of the companies are paid in each other's shares. It is difficult for us to reconcile this fact with another statement in the annual report that 'we [Alibaba] do not hold a majority interest in or control Ant Group or Alipay' (emphasis added)[vi].

In total in the past 36 months, the company has booked approximately $18 billion in 'share-based compensation'. These large payments are excluded from the headline numbers such as 'adjusted EBITA' and 'non-GAAP net income' that are reported and discussed in quarterly disclosures, despite having a real cost. Non-GAAP net income would be 34% lower over this period if they were included. On top of this, there is no clear disclosure of any performance targets.

Quality of franchise

The first, and deceptively simple, question we ask ourselves when looking at a company's franchise is how does it make money? Understanding the drivers of a business gets to the heart of whether the business is being run for the long term. A second question is what, if any, sustainable advantage does the company have to generate reasonable returns on invested capital? If a company does have an advantage, is there an opportunity for growth? A business may have a great franchise but still have run out of room to grow.

How does it make money?

Alibaba is now the largest retailer in the world by reported sales (gross merchandise volume (GMV), an unaudited number), reporting over $1 trillion last year. It doesn't handle any products itself but rather serves as an intermediary, bringing buyers and sellers together in one of several marketplaces including Taobao, Tmall, Alibaba.com, 1688 and AliExpress. Depending on the marketplace, Alibaba may take a percentage of the sales price for matching the two parties, as well as membership fees, advertising revenue and other services.

What sustainable advantage does it have?

For an analyst it is important to understand the economic drivers and validate the numbers. The challenge with Alibaba is threefold.

- First, disclosure is poor. This isn't unusual in high-tech companies but over time Alibaba is disclosing less.
- Second, the business is becoming more complex, with less than half of revenues coming from core Chinese e-commerce. The mix now includes logistics, food delivery, physical retail and digital entertainment.
- Finally, the close ties between Alibaba and Ant Group, including the cross-incentivisation, concern

us because the nature of a financial services company makes cash flows difficult to verify. Ant and Alibaba have different financial year ends so do not have simultaneously audited balance sheets, for example.

Alibaba's success appears to be based on two distinct advantages. The first is a network effect that happens as you bring more buyers and sellers together and the second is that regulations have prevented foreign competition from entering China. The first advantage is under pressure because Tencent, the other internet behemoth, increasingly competes directly with Alibaba, probably driving down returns over time.

Another concern is the change in approach of the Chinese government and regulators to Alibaba and Ant Group, with the recent and sudden cancellation of the latter's IPO. The scale of the company, its pervasiveness in Chinese life and the power and wealth of Jack Ma may be attracting more attention from the government – something that creates risks that are hard to quantify. New antitrust rulesvii may also have an impact, given Alibaba's extensive use of acquisitions to grow.

On top of local challenges, the fact that Alibaba shares are listed in the US brings additional risks. The 2020 annual report notes that the SEC has an open investigation, ongoing from 2016, into the company's consolidation practicesviii. More recently, the US has become more aggressive towards Chinese companies and is looking to allow regulators to access audit data and potentially delist companies that do not comply.

Is there room for growth?

Finally, on growth, looking at the size of Alibaba's GMV relative to the disposable income in China, there are some signs of the business becoming mature. The international business remains around the same size as a percentage of revenues as it was five years ago, which suggests some limits on the business's ability to grow overseas where competition is much stiffer. Much of the growth in its revenue has therefore come from Alibaba's investments, none of which appear yet to have the same kind of returns as their core Chinese e-commerce business, and many remain loss-making.

Sustainability

A key determinant of quality for us is the sustainability of a business, which is defined by how it looks after the interests of all stakeholders. We think about whether a business will not only exist but thrive over the coming decades. The most important place to start here is the study of history. Looking at what a business has done in the past is a more useful indication of what it may do in the future than any glossy sustainability report.

The second area is looking at what the company reports in terms of its sustainability performance. We look for emphasis – what is the narrative that the company is trying to push and why? Next, competitive positioning – is the business positioned better than its competitors and what is the direction of travel? Finally, materiality – is what the company is disclosing and more importantly aiming to achieve material or simply window dressing?

Alibaba's latest sustainability report, published in 2018, is poor by the standards of the companies we tend to own in the portfolio. To start with, it contains some unusual headings, including 'Trust', 'Related Party Transactions', 'Data Privacy', 'Intellectual Property Protection' and 'Asset Ownership in Compliance with Regulations'. This suggests to us that there are issues Alibaba feels the need to address around its governance. There is no disclosure on carbon emissions, packaging or recycling. The report contains no targets and is two years out of date, suggesting to us that sustainability is a low priority for the company.

Quality of financials

Alibaba's success in China is difficult to dispute, but the quality of its financial reporting is more open to debate. Our investment process examines a broad definition of quality of financials, including transparency of accounts, quality of earnings and balance sheet strength. In each of these areas we find challenges.

Transparency of accounts

Almost half of Alibaba's balance sheet is made up of investments and intangible assets. The value of these assets is subject to uncertainty and they are of questionable quality. On several occasions Alibaba has bought large non-controlling stakes in businesses that have at a later date been substantially written up in value. These write-ups pass though the income statement, flattering earnings[ix].

Quality of earnings

Alibaba's financial statements have many details that are not included in the company's quarterly presentations. For example, the free cash flow included in its quarterly presentations is calculated by subtracting capital expenditure and 'acquisition of licensed copyrights and other intangible assets' but not investments in other businesses and acquisitions. In the past three years to September, the company reported around $48 billion in 'non-GAAP free cash flow', but of this around $34 billion was spent on acquisitions and investments. Over the same period, the company has recorded $25 billion in impairments and losses on disposals or revaluation of investments. To us this suggests a significant amount of the supposedly free cash the business generates has been lost through poor capital allocation.

Balance sheet strength

Finally, and perhaps most importantly to minority shareholders, despite the fact the company has generated more than $100 billion in cash from operations and taken in another $30 billion in capital raising and borrowing, nothing has been returned to shareholders in dividends. We tend to view dividends as a sign of quality given that they require actual cash flow to allow their payment and demonstrate that management recognise limits to their investment opportunities. The company has argued that it has bought back around $8.3 billion of shares but this has not been enough to offset the dilution of minorities by around 1% per annum[x].

Summary

At first glance, Alibaba looks an attractive business with a strong track record of growth, a large addressable market and a dominant position. However, looking beyond this we see warning signs around minority shareholder protection and incentives that may create conflicts of interest together with a track record of questionable capital allocation and opaque reporting. How the company treats other stakeholders doesn't appear to be a priority, judging by the sustainability report and historical governance lapses. We are unable to say whether the price of Alibaba will continue to rise, just that it does not meet our definition of quality and would be an unacceptable risk to have in our portfolio.

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i. China regulations spur investors to reassess tech sector', FT (22 November 2020) https://www.ft.com/content/52f48c49-cff3-410c-bd1e-3a10539c6054
ii. Notification to SEC of Resignation letter from Jacqueline Reses (16/09/2014) - https://www.sec.gov/Archives/edgar/data/1577552/000000000014048770/filename1.pdf
iii. Alibaba 20-K filing (9 July 2020), p.46. ADS: American Depositary Shares
iv. RSU: restricted share unit
v. 2020 20-F, p.29: https://www.alibabagroup.com/en/ir/pdf/2020AR_Form20F.pdf
vi. China draws up first antitrust rules to curb power of tech companies, FT, (10 November 2020): https://www.ft.com/content/1a4a5001-6411-45fa-967c-0fd71ba9300b
vii. Alibaba 20-K filing (5 June 2019), p.212: https://otp.investis.com/clients/us/alibaba/SEC/sec-show.aspx?FilingId=13476929&Cik=0001577552&Type=PDF&hasPdf=1
viii. This practice added around $3.5 billion in 2018 and $4 billion in 2019. In 2020 the company carried out a share and asset purchase agreement with Ant Group that added somewhere in the region of $10 billion to interest and investment income. Alibaba 20-K filing (5 June 2019) p.F-57: https://otp.investis.com/clients/us/alibaba/SEC/sec-show.aspx?FilingId=14266295&Cik=0001577552&Type=PDF&hasPdf=1
ix. Five-year Share count CAGR, CapitalIQ

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