Chinese internet stocks benefit from COVID-19

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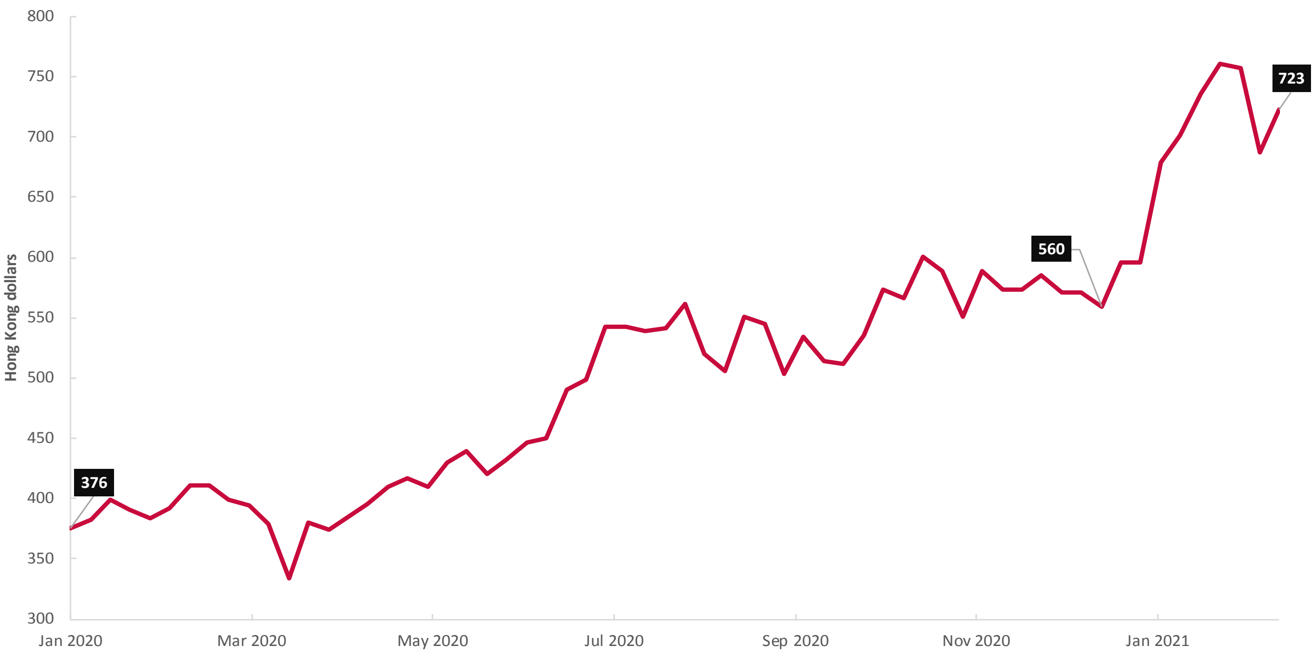
The global lockdowns and restricted mobility imposed in response to COVID-19 proved to be very beneficial for digitally enabled businesses globally and the Chinese internet giants were no exception. The share price of Tencent has run hard since its March 2020 lows, reaching valuations that seem rich. Alibaba, China's largest eCommerce platform, has been held back by a number of regulatory challenges over the same period. This article discusses the salient features of both companies, the factors that have contributed to their share price performance and why Northstar's analysis suggests that there remains value in both stocks with good prospects for further growth.

Tencent: The world's largest venture capital fund

Tencent's sprawling portfolio of internet-enabled businesses include social media, music streaming, e-commerce, online games, cloud computing, fintech and payment systems. Increased activity in these areas since the start of COVID-19 saw Tencent's share price more than double from its trough of HKD 334 in March 2020 to over HKD 700 at the end of February 2021.

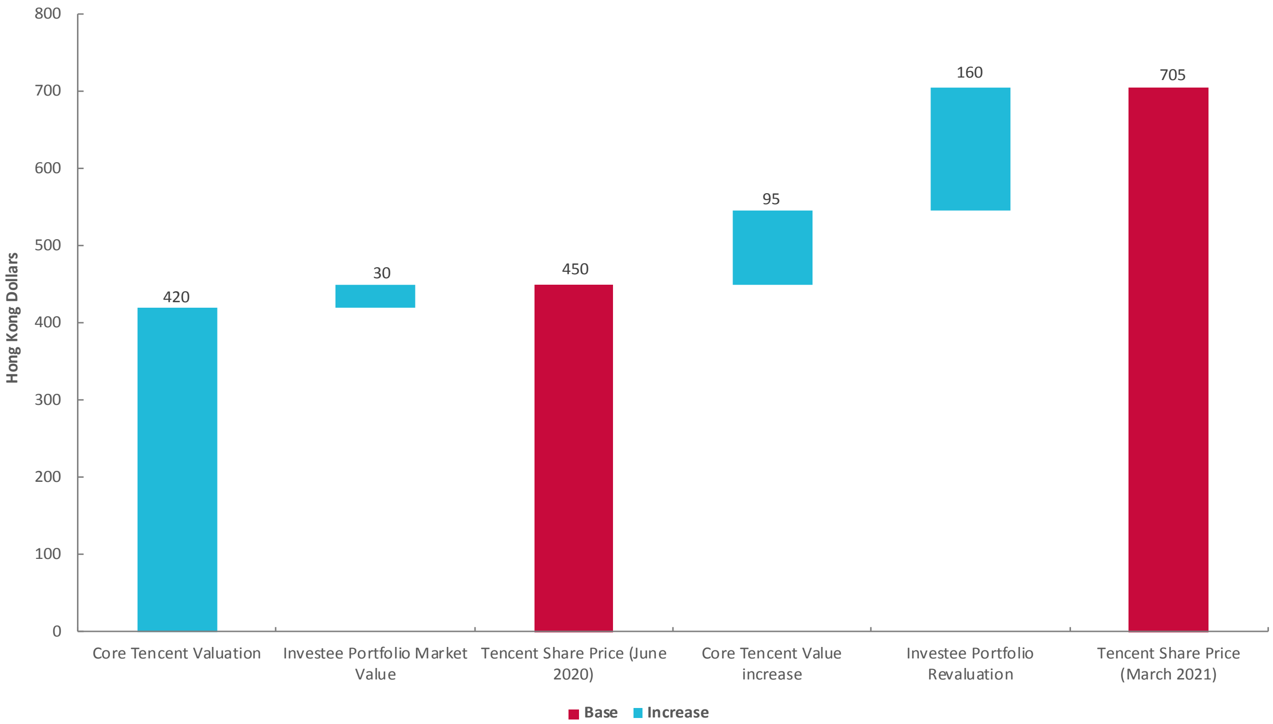
Chart 5: Tencent share price (January 2020 - March 2021)



Source: Capital IQ (March 2021)

This strong run has seen the stock reach a 43x multiple to consensus estimates of 2021 earnings, a 34% premium to its ten-year history. While this certainly seems richly priced, there is more to the story than first meets the eye. In addition to its core businesses, Tencent also holds investments in 1200 companies, a handful of which are separately listed. The growth in this portfolio has been the main driver of the stock's recent good fortune, contributing HKD 160 to the HKD 255 increase in the share price since June 2020.

Chart 6: Tencent investee portfolio driving share price performance



Source: Capital IQ, Northstar Asset Management Estimates (March 2021)

Tencent is far from a passive investor in these companies, installing directors on their boards, assisting them with their advanced technological know-how, integrating them into their applications and connecting them to their massive user base.

Pinduoduo (a social ecommerce company) and Meituan Dianping (a food delivery company), two of the fastest growing multibillion-dollar tech firms in China, are examples of investee firms that leaned heavily on the network effects of Tencent's WeChat to market to a captive audience of 700 million Chinese consumers who spend a quarter of their day engaging with the platform.

While this portfolio of investee companies has driven the majority of the price performance, it does not contribute to group earnings. Stripping out the investee portfolio changes the complexion of the valuation, with Tencent's core business priced at a 32x multiple on 2021 earnings, right in line with Tencent's historical average. We believe that this rating is not unrealistic given the inherent growth potential in the share.

Alibaba: China's Amazon

Alibaba is perhaps best understood as a Chinese version of Amazon, a dominant ecommerce marketplace retailer with a market share of around 60% of all Chinese ecommerce transactions. The company's web portals provide consumer-to-consumer (C2C), business-to-consumer (B2C), and business-to-business (B2B) sales services, as well as electronic payment services, shopping search engines and cloud computing services.

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Chart 7: Alibaba share price (January 2020 - March 2021)

Source: Capital IQ (March 2021)

The share price was something of a laggard in 2020, finishing the year up only 36% from its March trough. However, this relatively subdued performance was due to a material change in the Chinese regulatory environment, which is tightening up to improve competition, following years of a largely laissez-faire approach to their burgeoning tech sector.

Regulatory woes are not new in China, with the country's regulators having previously intervened in the release of video games in 2018/19 which limited the Chinese gaming industry's growth rate to 6% from 33% the year before. The new set of regulations aims to break up existing monopolies and discourage anti-competitive behaviour on platforms. These follow the financial market regulator pulling the plug on the US$34 billion IPO of Ant Financial, Alibaba's 33% held investee, that was planned for November 2020.

Regulatory pressure is bound to be a persistent feature for Chinese technology firms going forward, but in assessing the company's future, one needs to consider the earnings power of a dominant firm like Alibaba and the degree to which any regulation will harm that earnings power.

Alibaba's current valuation affords zero value to their stake in Ant Financial, owners of China's largest digital payment platform with more than one billion users and 80 million merchants. The regulatory issues will affect the earning potential of Ant Financial's lending business but are highly unlikely to render the entire business worthless. There is also potential for an IPO to materialise within the calendar year following Ant's compliance with the regulators' requirements.

The valuation also implies a degradation in the rest of the business, despite the fact that this business produced US$25 billion in free cash last year and is set to increase that number by US$5 billion this year according to management and consensus estimates.

Strong growth likely despite the current headwinds

We remain confident in the growth prospects of both Tencent and Alibaba. While there may be headwinds in the immediate future, these do not detract from the evident scale, dominance and cash generative nature of these businesses.

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