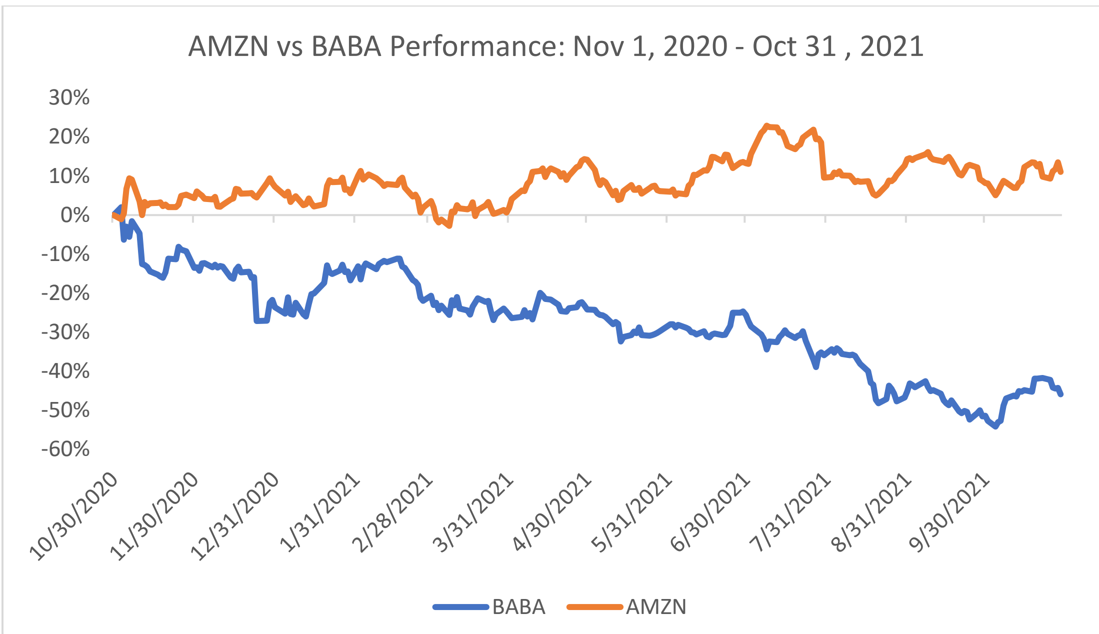
# FOUNTAINHEAD INSIGHTS

## Market Commentary: Making Sense of China: Buy or Sell?

***October 2021***

Alibaba (BABA), a Chinese company primarily focused on e-commerce, is frequently compared to Amazon (AMZN), an American company with a similar focus. They are both well-known, fast-growing brands that dominate in a similar fashion. A significant difference though, at least from an investor standpoint, is where they operate geographically. It is why Jeff Bezos is thumbing his nose at anyone he pleases and happily building rocket ships, while Jack Ma is MIA. It is most likely a material reason why Amazon was able to generate an 11% stock gain over the last year while Alibaba is down a headline grabbing 46%[1].




When analyzing the Tale of the Tape, Alibaba has had faster top line (revenue) growth over the last three years and has generated materially more revenue and net income over the trailing twelve months ("TTM") yet has a valuation roughly 25% that of Amazon. On these very general, high-level metrics, if Alibaba were afforded the same valuation approach of Amazon, it would be valued at roughly 1.5 trillion, a 230% increase from its current valuation[2].

**What is going on? Is Alibaba a buy here? Or a sell? And how may this inform our general thinking about China?**

**Tale of the Tape**

| | BABA | AMZN |
|---|---|---|
| Growth (3y Revenue growth) | 42% | 29% |
| Revenue TTM ($ Billion) | 769 | 458 |
| Net Income TTM ($ Billion) | 148 | 26 |
| Valuation ($ Billion) | 442 | 1,700 |
| Price / Earnings (PE) | 19.4 | 64.8 |

[1] Price performance and Tale of the Tape data comes from Yahoo Finance

[2] We calculated this by dividing BABA valuation by BABA PE and then multiplying by AMZN PE

Peter Zeihan, an author we at Fountainhead like, ascribes governance and population approaches to a respective country's topography and general geographic characteristics. For example, way more manpower has historically been necessary for China to tame their rivers, grow food, and defend their land as compared to other terrains. The population requires centralized planning. The US meanwhile literally has oceans separating it from its enemies, a large, easy to grow breadbasket in a defendable location, and an incredibly navigable terrain. We are really fine individually as minimal infrastructure is necessary to get things accomplished.

With centralized governance, though, comes increased power and control. It is why and how they were able to build the Great Wall of China and why, evidently, they are able to limit their 18 and under population, roughly 280 million people, to three hours of video games a week[3] (an hour each on Friday, Saturday, and Sunday), while I somehow cannot do the same with my 18 and under population of three….

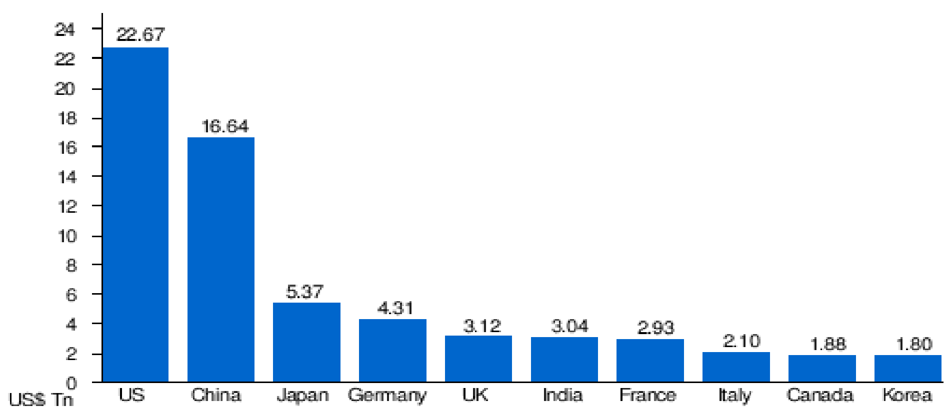
That means that China has incredible capabilities in harnessing their billion plus population in achieving feats simply not possible in the US – like erecting a fully functional hospital in five days[4]. But it also means that they can clamp down on anything leadership believes is necessary with minimal consequences or issues (at least short term and according to their controlled press). And, over the last year or so, China has made a number of decisions that materially negatively affected the consumer facing portion of digital technology. This is the primary reason that Alibaba is down 46% over the last year and why Jack Ma is nowhere to be seen[5].

Widening our lens a bit, the US relationship with China has become quite complicated lately. The narrative over the last few decades was of an emerging power that benefited the US through the manufacture and shipping of ultra-low-cost product. It benefited China in creating a middle class and growing GDP while it benefited the US by meeting demand of its constituents for goods at low costs. Both the US and China won big from globalization.

However, more recently, China has become uncomfortably big for a superpower (that's us!) that has been dominant since WWII. And over the long arc of history, China has predominantly been a large global power so why should they not aspire to get back to that level? So, the relationship between the US and China had already been changing and Covid has simply sped up some of the trends in place.

China is focused on building out a technology infrastructure that matters on a country level, not one that matters on the individual level. Games, video content, and other commerce level businesses do not assist China in defense, in military, in advancing a vision of a larger middle class, or in further innovations perceived for the common good

[6]




[3] China Limits Online Videogames to Three Hours a Week for Young People - WSJ
[4] Coronavirus: How can China build a hospital so quickly? - BBC News – Excerpt: "This authoritarian country relies on this top-down mobilisation approach. They can overcome bureaucratic nature and financial constraints and are able to mobilise all of the resources." – Yanzhong Huang, a senior fellow for global health at the Council on Foreign Relations
[5] It never helps to push back against an authoritarian regime… Why China Turned Against Alibaba's Jack Ma - The New York Times (nytimes.com)
[6] List of countries by GDP (nominal) - Wikipedia

of the nation[7]. It is why Alibaba is not ultimately so important. It is why it is ok to allow Evergrande to fold. On a more worrisome level, it is why a place like Taiwan is so important to China given their semiconductor intellectual property.

The US government meanwhile is moving away from allowing China our technology or supporting China's technology. The US business community is looking for suitable replacements for Chinese manufacturers for a variety of reasons, though as we understand it, there are no immediate easy solutions in terms of pure manpower and expertise.

Given the Tale of the Tape, it is easy to see, based on pure financial metrics, and assuming Amazon is reasonably valued, that Alibaba should be valued closer to $1.5 trillion, a 233% increase from today's value. However, the Chinese government can decide tomorrow that elements of Alibaba's business are no longer legal in China. Or simply to nationalize the business. And that would result in a 100% decline.

Alibaba is a microcosm of the difficulties of analyzing China in the context of investing. It demands attention given its huge size and therefore potential, while at the same time presenting a number of more complex characteristics that diminish that upside.



[7] Read the following for deeper insight into this theory / theme: Why is China smashing its tech industry? - by Noah Smith - Noahpinion (substack.com)