Taking opportunities

A powerful tool for creating an economic moat is the “network effect”. This occurs when an increasing number of users increases the value of a product or service.

Well known examples of companies benefitting from the network effect are Facebook, Visa and Microsoft. Amazon is another powerful example. Around 50% of all product searches now originate on its website in the USA. As more consumers use the platform, more vendors join in order to gain access to said consumers. This results in a broader range of products and better choice, leading to a better customer proposition. The virtuous circle is established. New entrants often struggle to attract enough users to allow effective competition with incumbents, creating a competitive advantage.

Alibaba, commonly referred to as the “Amazon of China”, is primarily known as an e-commerce operator. Alibaba holds around 58% of the market in China, 3 times the size of the next largest player, JD.com. China is an extremely attractive market, with 1/5th of the world’s population, a growing middle class and the technological infrastructure in place to support widespread adoption of e-commerce. A tech savvy populace has seen online retail penetration reach over 20%. We believe that as the economy shifts towards an increasingly consumer driven model and with the population’s wealth rising, the market will continue to grow for many years to come.

Whilst in the US and Europe the tech giants are facing scrutiny over their dominant market positions, we believe that the Chinese government is much more sympathetic to the idea of national “champions”. The government has shown a willingness to work with large domestic technology companies to harness their market power rather than to curtail them.

One of the features of companies that benefit from strong network effects tends to be high levels of profitability and strong cash flow. This occurs because as the size of the network increases, so does its value, however, the costs to maintain it do not increase at the same rate. This allows companies to invest in new business ventures which will capitalise on the existing network user base and so increase the revenue potential of each participant. These factors often make these companies very attractive to investors and have over recent years resulted in extremely lofty valuations.

Sure enough, Alibaba has developed Alipay, a mobile payments service and a cloud computing business. Alibaba currently has dominant market share in both markets, with c.54% in mobile payment and around 45% in Cloud. Going hand in hand with the growth in e-commerce, the mobile payments market in China is already worth over $16 trillion. Similarly, as China’s online activities increase, the demand for Cloud infrastructure is also growing. Both businesses benefit from access to Alibaba’s existing network of customers, enabling cross selling of products and services.

Alibaba sold off this year alongside many other Chinese technology companies as tension between the United States and China escalated. Moreover, Altaba, one of the company’s largest shareholders, has sold its position due to itself being liquidated, creating selling pressure on the shares. These factors resulted in Alibaba trading at close to its lowest valuation since it’s IPO in 2014.

We believe that these circumstances have not affected the long-term growth prospects of the business. Alibaba generated the vast majority of its revenues in China and is not materially affected by the trade wars. Instead, we saw an attractive entry point into a company which is forecast to grow substantially faster than the market for a significant number of years.

In addition, we see a near term catalyst of a secondary listing in Hong Kong, which we believe may drive a re-rating. Alibaba is currently only listed in the USA and a Hong Kong listing would open the company up to Chinese mainland investors. Locally listed Chinese stocks have historically traded at a premium to their US listed counterparts.

The unusual set of circumstances that led to Alibaba trading at such a discount gave us the opportunity to own one of the most exciting technology names in the world, operating a hugely valuable network. Opportunities to buy these types of companies at sensible prices have been few and far between in recent years and so, recognising value when we see it, we grasped it with both hands.

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