J O Hambro Capital Management Group

Emerging Markets Spotlight

James Syme, JOHCM Global Emerging Markets Opportunities Fund

"Alibaba: We reiterate OW rating and raise our TP to USD 270"
Broker report, February 2018

Different perceptions of the value of an asset are at the heart of capital markets and are the key to active investment management. For any given investment process, there will be periods when the consensus view seems to be completely unjustifiable and must be opposed. For us, this is such a time. Here are three significant mispricings in the current emerging market asset class, in our view, all relating to the very largest stocks in the asset class.

Firstly, the disconnect between Chinese internet company Tencent and its South African shareholder Naspers. We feel that the Tencent business model is one of the strongest in the world. Whilst its total addressable market is smaller than Facebook's, its core business continues to grow revenues successfully without overly relying on advertising. Against this, though, is the degree to which the share price has outrun earnings. Tencent reached over 40x 12-month forward consensus earnings, which is around the level that has historically formed the upper limit to the stock's valuation range.

The valuation situation is different at Naspers, a South African holding company with a 33.2% stake in Tencent. Naspers trades at a very deep discount to its underlying net asset value. At the end of January, Naspers traded at an improbable US$62bn discount to its stake in Tencent alone. That negative US$62bn covers US$3.8bn of other quoted holdings, US$1bn in net debt, and various media and internet assets in emerging markets, including pay television and e-commerce.

Secondly, Samsung Electronics, which has, since 2015, delivered incredibly strong operational performance across its business units and a highly positive set of corporate governance reforms. That might be expected to have been reflected in the stock's valuation, especially with the run-up in the overall price/earnings multiple of the emerging market asset class, but that has not been the case. From 2010-2015, Samsung Electronics traded at an average price/12-month forward earnings discount to the MSCI Emerging markets index of 22.2%, but in the last year that has expanded to 46.8%, with Samsung Electronics at 6.9x 12mf earnings, and the index at 13.0x.

Thirdly, within the group of companies that constitute the Alibaba group, the cloud computing business is thought by other analysts to have a valuation that we cannot comprehend. The strong performance of Alibaba shares in 2016 and 2017, well ahead of the growth in underlying earnings, partly reflects increasing confidence in the newer business units the group has launched, including the cloud computing business. That unit had, in the fourth quarter of 2017, revenues of RMB 3.6bn (US$553m), up 104% on a year earlier. Unfortunately, the growth was not accompanied by profitability. The reported operating margin for the quarter was -22.0%, down from -19.2% a year earlier. How much might a loss-making business with an annualised US$2bn revenue stream be worth?

A review of published analysts' estimates reveals some robust estimates, with an average valuation for the unit of US$60bn. It is this approach to company valuation that has helped Alibaba reach a market capitalisation of US$523bn. Our portfolio has benefited substantially from the run-up in Alibaba's share price, but we cannot justify continuing to hold the stock and have sold our position.

The portfolio's largest active positions are overweight Naspers and Samsung Electronics, and underweight Tencent and Alibaba. We are as confident in these positions as in any we have ever held. We are invested in our strategy alongside our clients. Nothing can out-run its fundamentals forever.