



Baidu Inc (BIDU)

China's No. 1 Search Engine
Wounded Eagle – Great Value Opportunity
Target Price at end 2017: US\$316 (+87% upside)

Adeline Chong (MIFFT2016)



Background

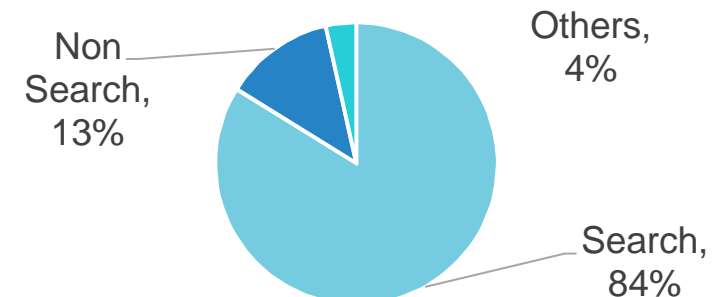
- No. 1 Search Engine in China for online (>80% revenue share) and mobile (>40% revenue share)
- Founded in 2000 by CEO Robin Li (21% share)
- Its core business is search advertising

Industry with strong structural tailwinds

- 1) Shift from print to online advertising in China
- 2) Increased internet penetration: China at 52% vs US at 89%

Summary	BIDU US			
Share price (US\$)	168.71	Upside	Date	
Target price (US\$)	316	87%	End 2017	
Shares (m)	346			
Market cap (US\$m)	58,424			
USDCNY	6.57			
MI (US\$m)	617			
Debt (US\$m)	5,289			
Less:Cash (US\$m)	(10,859)			
EV (US\$m)	53,470			
	FY03/16			
	LTM	2016E	2017E	2018E
EBIT (US\$m)	1,785	1,604	2,367	3,392
EV/EBIT	30.0	33.3	22.6	15.8
EPS (US\$)	14.38	4.48	6.53	9.18
P/E	11.7	37.6	25.8	18.4
Short interest	1.39%			

2015 Revenue Breakdown





Baidu Inc (BIDU)

High quality business

Wide Economic Moat

- Network effects from market dominance: Difficult for competitors to replicate/ break.
- Customer captivity: Habit coupled with Lack of strong comparable substitutes

The Proof?

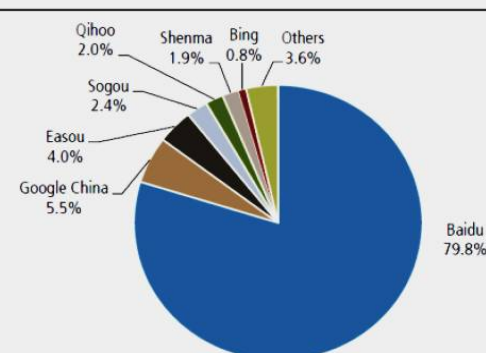
- High ROTC and operating margins

Metrics	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Ave
ROTC	1825%	150%	433%	835%	1567%	1260%	1063%	3523%	1046%	-2837%	887%
ROE	22%	31%	34%	31%	42%	41%	38%	26%	23%	39%	33%
EBIT Margin	19%	27%	36%	34%	47%	50%	42%	29%	25%	15%	32%
Core Search EBIT Margin	31%	31%	34%	36%	50%	52%	50%	48%	47%	51%	43%

- Market leadership and growing market share

<u>China Online Search Market Share by Revenue</u>	Competitors	2009	2012	2015
	Baidu	77%	79%	81%
	Google	13%	16%	9%
	Qihoo 360	3%	2%	5%
	Sogou	2%	3%	4%
	Others	5%	1%	1%

Figure 14: Major mobile search engine market share by usage (July 2014)



On 2 May 2016, Chinese government announced that Baidu was investigated for its medical advertising practices after the death of a 21 year old student Wei Zexi.

What happened after:

Share price plunged ...



Sell side equity analysts downgrade ...

12M target share price cut by 8%

Credit analysts follow suit...

Moody's downgrade Baidu's rating outlook from positive to stable (A3)

Market consensus/ Variant Perceptions

Investor concerns

- 1. Lower earnings potential:** Will Baidu's economic moat and growth be severely impaired?
- 2. Reputational risk:** Will users abandon Baidu after this incident?
- 3. Regulatory risk:** Is this the start of more regulations to come for Baidu?

Variant Perceptions

- Short term impact. Baidu's economic moat remains intact
 - Ignores optionality on O2O initiatives
 - Valuations look cheap even under worst case scenario, offering a high margin of safety
-
- Low probability. It is hard for users to switch away from Baidu
 - Not the first time this has happened
-
- Low probability. Government's supportive stance towards nurturing domestic internet champions
 - Higher government scrutiny could lead to higher barriers to entry for the industry

Valuations

- Sum of The Parts Valuation
 - Search business valued using target forward P/E multiple of 20x in 2018
 - Trigger event impact: Incorporated a 10% decline in online marketing customers..
 - Other businesses' valuation obtained using reported valuation estimates
- **Target price of US\$316 at end 2017 offers +87% upside.**

<u>Sum of The Parts Valuation (US\$m)</u>	<u>Total Value (FY18)</u>	<u>Stake</u>	<u>Pro Rata Value (FY18)</u>	<u>Value/ share (FY18)</u>
Core Search	94,169	100%	94,169	272
iQiyi	2,800	100%	2,800	8
Ctrip	19,946	22%	4,308	12
O2O: Nuomi	1,800	100%	1,800	5
O2O: Baidu Takeout	2,500	55%	1,375	4
Enterprise value			104,452	302
Minority Interest			617	2
Net Cash			(5,571)	(16)
Equity value - End 2017			109,406	316
Number of shares				346
Current share price				168.71
Upside				87%

Conclusion: Baidu is a Wounded Eagle with a wide economic moat and structural tailwinds trading at attractive valuations. Recommend to BUY.



Baidu Inc (BIDU)

Wounded Eagle – Great Value Opportunity
Questions?



Some background to the Trigger Event ...

- On April 2016, Wei died after receiving alternative treatment for a rare form of cancer at the Second Hospital of the Beijing Armed Police Corps. He found its promoted result on Baidu.
- In his last days, he wrote about his experience on Zhihu (China's Quora) "***What do you think is the greatest evil of human nature? - Baidu***"

Public outcry

- Social media: "***A Young Man Died in the Hands of Baidu and Military Hospital***" on Wechat
- State media: "***Without consumers' trust, the firm won't last long***" on People's Daily, "***...massive and growing disconnect between Baidu and its CSR***" on Xinhua

Investigation: Baidu amends search criteria, removed 2,518 hospitals (1 million medical firms in China) and 126 million medical ads and sets up RMB1m protection fund

Baidu

Metrics	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Ave
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Core Search EBIT Margin	31%	31%	34%	36%	50%	52%	50%	48%	47%	51%	43%

Sohu

Metrics	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Ave
ROTC	167%	114%	4216%	558%	2212%	-1526%	-311%	132%	-101%	147%	561%
ROE	17%	16%	41%	29%	25%	23%	15%	6%	-17%	8%	16%
EBIT Margin	18%	17%	38%	40%	38%	33%	23%	13%	-9%	6%	22%
Sogou EBIT Margin	NA	NA	-223%	-238%	-141%	-17%	-14%	-9%	-8%	17%	-79%

Qihoo 360

Metrics	2009	2010	2011	2012	2013	2014	2015	Ave
ROTC	75%	862%	410%	60%	202%	245%	324%	311%
ROE	-49%	383%	4%	10%	13%	21%	21%	58%
EBIT Margin	14%	16%	11%	15%	24%	19%	14%	16%
Internet Services EBIT Margin	14%	16%	11%	NA	NA	NA	NA	13%

Valuation

Company Comp Set										
Company Name	P/E	Forward P/E	Forward P/E	Forward P/E	EV/	EV/EBIT	EV/	P/ Tangible	P/ Book	P/ Book
		(FY16)	(FY17)	(FY18)	EBITDA	Revenue	Book	Book	Value	Value
Baidu, Inc. (NasdaqGS:BIDU)	11.7x	37.6x	25.8x	18.4x	19.7x	30.1x	5.0x	6.0x	4.6x	
China Search Players										
Sohu.com Inc. (NasdaqGS:SOHU)	NM	NM	NM	73.5x	2.3x	6.0x	0.4x	1.6x	1.3x	
Qihoo 360 Technology Co. Ltd.	30.5x	21.4x	21.4x	14.5x	29.8x	47.8x	5.3x	12.8x	7.5x	

Core Search Valuation Assumptions

Core Search Valuation	2013	2014	2015	2016E	2017E	2018E
Search Services (CNY m)						
Revenues	29,590	43,727	55,667	49,600	63,835	72,676
% growth		48%	27%	-11%	29%	14%
Online Marketing Customers	753,000	813,000	1,049,000	944,100	1,227,330	1,411,430
% growth		8%	29%	-10%	30%	15%
ARPU (RMB)	39,297	53,785	53,067	52,537	52,011	51,491
% growth		37%	-1%	-1%	-1%	-1%
Operating PBT						
	14,179	20,548	28,118	24,800	31,917	36,338
% margin	48%	47%	51%	50%	50%	50%
% growth		45%	37%	-12%	29%	14%
Effective Tax rate	15.4%	14.4%	14.8%	15%	15%	15%
Net Income	11,995	17,580	23,963	21,080	27,130	30,887
			Target multiple	15.00	18.00	20.00
			USDCNY	6.56	6.56	6.56
			Equity value (US\$m)	48,201	74,442	94,169

Sensitivity Analysis

End 2017 Target Price						
Online marketing customers growth (FY16E)						
		-30%	-20%	-10%	0%	5%
ARPU (FY16E)	-2%	253	283	313	343	358
	-1%	255	286	316	346	361
	0%	258	288	319	349	364
	1%	260	291	321	352	368
	2%	262	293	324	355	371
End 2017 Upside						
Online marketing customers growth (FY16E)						
		-30%	-20%	-10%	0%	5%
ARPU (FY16E)	-2%	50%	68%	86%	103%	112%
	-1%	51%	69%	87%	105%	114%
	0%	53%	71%	89%	107%	116%
	1%	54%	72%	91%	109%	118%
	2%	55%	74%	92%	111%	120%

Income Statement											
For the Fiscal Period Ending	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	12M Mar 2016
Currency	CNY	CNY	CNY	CNY	CNY	CNY	CNY	CNY	CNY	CNY	CNY
Revenue	838	1,744	3,198	4,448	7,915	14,501	22,246	31,802	48,495	64,037	67,133
Other Revenue	-	-	-	-	-	-	60	142	557	2,345	2,345
Total Revenue	838	1,744	3,198	4,448	7,915	14,501	22,306	31,944	49,052	66,382	69,478
Cost Of Goods Sold	194	537	955	1,616	2,149	3,897	4,876	9,142	15,288	22,814	24,951
Gross Profit	644	1,208	2,243	2,832	5,766	10,604	17,430	22,802	33,765	43,568	44,526
Selling General & Admin Exp.	250	411	660	804	1,089	1,693	2,501	5,174	10,382	17,076	18,065
R & D Exp.	79	141	286	423	718	1,334	2,305	4,107	6,981	10,176	9,990
Other Operating Expense/(Income)	52	109	200	-	-	-	1,572	2,330	3,598	4,644	4,744
Other Operating Exp., Total	381	661	1,146	1,227	1,807	3,027	6,379	11,610	20,961	31,897	32,799
Operating Income	263	547	1,097	1,605	3,959	7,577	11,051	11,192	12,804	11,672	11,727
Net Interest Exp.	42	49	48	33	67	336	759	861	1,364	1,321	1,287
Other items	4	20	20	46	35	(103)	156	164	316	478	501
EBT Excl. Unusual Items	309	616	1,164	1,683	4,061	7,809	11,965	12,217	14,484	13,471	13,515
Gain (Loss) On Sale Of Assets	-	-	-	-	-	-	-	-	-	24,436	24,436
EBT Incl. Unusual Items	309	616	1,164	1,683	4,061	7,809	11,965	12,217	14,484	37,907	37,951
Income Tax Expense	12	(13)	116	198	536	1,189	1,574	1,829	2,231	5,474	5,608
Earnings from Cont. Ops.	297	629	1,048	1,485	3,525	6,620	10,391	10,388	12,253	32,432	32,343
Extraord. Item & Account. Change	5	-	-	-	-	-	-	-	-	-	-
Net Income to Company	302	629	1,048	1,485	3,525	6,620	10,391	10,388	12,253	32,432	32,343
Minority Int. in Earnings	-	-	-	-	-	18	65	163	944	1,232	859
Net Income	302	629	1,048	1,485	3,525	6,639	10,456	10,551	13,197	33,664	33,202
Pref. Dividends and Other Adj.	-	-	-	-	-	-	22	32	53	329	329
NI to Common	302	629	1,048	1,485	3,525	6,639	10,456	10,551	13,197	33,664	33,202
NI to Common Excl. Extra/ Unus	297	629	1,048	1,485	3,525	6,639	10,456	10,551	13,197	9,229	8,766
Per Share Items											
Diluted EPS	0.87	1.81	3.02	4.27	10.1	18.99	29.89	30.11	37.49	96.09	95.17
Diluted EPS Excl. Extra/ Unusual Items	0.86	1.81	3.02	4.27	10.1	18.99	29.89	30.11	37.49	26.34	25.13
Weighted Avg. Diluted Shares Out.	345.1	347.2	347.2	347.8	349.2	349.6	349.8	350.4	352.0	350.3	348.9

Balance Sheet											
Balance Sheet as of:	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	12M Mar 2016
Currency	CNY	CNY	CNY	CNY	CNY	CNY	CNY	CNY	CNY	CNY	CNY
ASSETS											
Total Cash & ST Investments	1,226.6	1,601.3	2,674.2	4,575.3	8,181.3	14,179.1	32,484.9	38,426.6	56,831.3	68,309.3	71,346.1
Total Receivables	33.7	102.7	141.7	221.8	427.3	949.8	1,383.0	2,722.8	4,361.8	6,413.2	3,605.8
Prepaid Exp.	3.9	10.0	11.2	8.0	33.3	31.8	143.9	484.5	743.8	342.3	-
Deferred Tax Assets, Curr.	1.7	2.6	5.6	9.2	86.5	121.4	160.3	286.8	-	-	-
Restricted Cash	-	-	-	19.5	38.3	483.4	395.0	259.5	413.0	96.0	229.9
Other Current Assets	12.8	8.9	19.8	9.1	15.9	82.7	107.0	848.9	1,686.5	3,072.8	4,416.2
Total Current Assets	1,278.7	1,725.5	2,852.5	4,842.9	8,782.4	15,848.2	34,674.1	43,029.2	64,036.5	78,233.7	79,598.1
Net Property, Plant & Equipment	191.7	678.9	789.7	997.6	1,622.4	2,694.0	3,887.9	5,370.3	8,705.4	10,627.1	10,489.5
Long-term Investments	-	15.4	12.3	14.3	288.0	734.4	803.5	634.8	3,544.9	37,958.6	38,299.5
Goodwill	47.3	51.1	51.1	63.7	63.7	2,419.5	3,877.6	16,864.4	17,418.9	15,395.6	15,395.6
Other Intangibles	136.8	136.9	125.8	122.6	115.8	978.8	1,587.7	3,630.3	3,574.4	3,334.6	3,421.2
Deferred Tax Assets, LT	5.8	15.7	26.5	33.8	30.8	52.1	53.3	97.9	944.1	1,008.2	1,269.0
Other Long-Term Assets	7.7	32.3	80.1	82.2	145.3	613.6	784.9	1,359.0	894.0	1,295.6	1,678.8
Total Assets	1,668.1	2,655.9	3,938.0	6,157.0	11,048.4	23,340.5	45,668.9	70,985.8	99,118.1	147,853.3	150,151.6
LIABILITIES											
Accounts Payable	0	0	16.5	31.0	48.7	100.5	236.4	517.9	602.7	1,054.9	18,815.2
Accrued Exp.	53.6	117.0	197.4	294.2	507.8	932.0	1,593.0	3,582.0	6,267.9	7,951.2	-
Short Term Debt	-	-	-	-	95.7	189.7	2,203.5	388.5	2,317.8	1,120.9	1,183.0
Curr. Income Taxes Payable	38.0	56.4	84.5	147.7	295.4	452.4	425.3	428.8	624.8	334.1	-
Unearned Revenue, Current	147.9	271.9	426.3	649.9	1,138.4	1,671.5	2,226.2	3,281.8	4,979.8	6,355.8	6,346.2
Other Current Liabilities	61.5	185.9	124.6	277.0	465.8	1,060.5	1,552.0	2,833.9	5,477.9	9,285.9	137.8
Total Current Liabilities	301.0	631.2	849.3	1,399.7	2,551.8	4,406.5	8,236.5	11,032.8	20,270.8	26,102.8	26,482.1
Long-Term Debt	0	0	0	0	86.0	2,308.0	9,737.8	17,270.3	23,466.9	33,950.2	33,778.1
Unearned Revenue, Non-Current	2.8	0.3	0	0	5.0	19.9	190.0	376.5	39.6	17.4	18.0
Def. Tax Liability, Non-Curr.	-	-	-	-	-	131.6	289.5	1,200.3	1,143.8	3,441.3	3,409.5
Other Non-Current Liabilities	7.0	3.0	-	4.2	-	148.9	-	440.6	144.6	125.9	108.8
Total Liabilities	310.8	634.5	849.3	1,403.9	2,642.8	7,015.0	18,453.8	30,320.5	45,065.7	63,637.6	63,796.4
Additional Paid In Capital	1,088.2	1,171.6	1,218.4	1,426.1	1,557.3	1,771.8	2,095.3	3,056.4	3,650.6	6,402.3	6,744.6
Retained Earnings	302.8	931.7	1,979.8	3,440.5	6,965.7	13,604.3	24,038.2	34,525.4	47,701.3	74,659.4	76,525.8
Comprehensive Inc. and Other	(33.7)	(82.0)	(109.6)	(113.5)	(117.4)	(84.4)	(78.3)	843.1	(279.5)	(806.1)	(967.1)
Total Common Equity	1,357.3	2,021.4	3,088.7	4,753.1	8,405.6	15,291.7	26,055.2	38,424.9	51,072.4	80,255.7	82,303.4
Minority Interest	-	-	-	-	-	1,033.8	1,159.9	2,240.3	2,980.0	3,960.1	4,051.8
Total Equity	1,357.3	2,021.4	3,088.7	4,753.1	8,405.6	16,325.5	27,215.1	40,665.3	54,052.4	84,215.7	86,355.1
Total Liabilities And Equity	1,668.1	2,655.9	3,938.0	6,157.0	11,048.4	23,340.5	45,668.9	70,985.8	99,118.1	147,853.3	150,151.6

Cash Flow										
For the Fiscal Period Ending	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Currency	CNY	CNY	CNY	CNY	CNY	CNY	CNY	CNY	CNY	CNY
Operating cash flow	440.8	935.2	1,741.6	2,264.5	4,700.5	8,178.8	11,996.0	13,793.0	17,937.2	19,422.4
Capital Expenditure	(127.5)	(569.1)	(459.1)	(438.7)	(963.5)	(1,866.2)	(2,339.8)	(2,768.8)	(4,831.5)	(5,250.3)
Cash Acquisitions	(43.3)	(14.1)	-	(12.0)	-	(1,945.9)	(820.5)	(13,201.1)	(328.9)	(332.7)
Sale (Purchase) of Intangible assets	(38.1)	(13.3)	(17.7)	(11.4)	(12.6)	(476.3)	(226.6)	(912.2)	(1,563.7)	(2,524.2)
Unlevered free cash flow	231.9	338.7	1,264.8	1,802.4	3,724.4	3,890.4	8,609.1	(3,089.1)	11,213.1	11,315.2
Debt repaid	0	0	0	0	0	0	(291.7)	(2,228.3)	(420.5)	(2,316.7)
Levered free cash flow	231.9	338.7	1,264.8	1,802.4	3,724.4	3,890.4	8,317.4	(5,317.4)	10,792.6	8,998.5
Issuance of Common Stock	32.8	40.7	32.9	40.4	38.8	23.2	57.0	156.3	192.8	225.2
Repurchase of Common Stock	-	-	(68.5)	(24.4)	-	-	-	-	-	(6,377.0)
Debt raised	-	-	-	-	86.0	2,358.7	9,690.3	8,255.7	8,088.3	12,667.8