

Baidu: Undervalued cyclical revenue growth acceleration and margin expansion story

Executive Summary

- Following several years of sustained revenue share loss, Search’s digital advertising revenue market share has stabilised, having seemingly retained its core advertising customers.
- With China’s economic growth recovery, Baidu is perfectly positioned to accelerate its core marketing revenue growth, which is also a high-margin operation.
- Baidu is set up for significant group margin expansion as the higher-margin core marketing business returns to positive annualised growth and it continues to expand AI Cloud margins.

By-line

In this insight, we analyse Baidu’s search query and digital advertising revenue market share trends, revenue growth outlook, margin expansion potential, and current valuation levels.

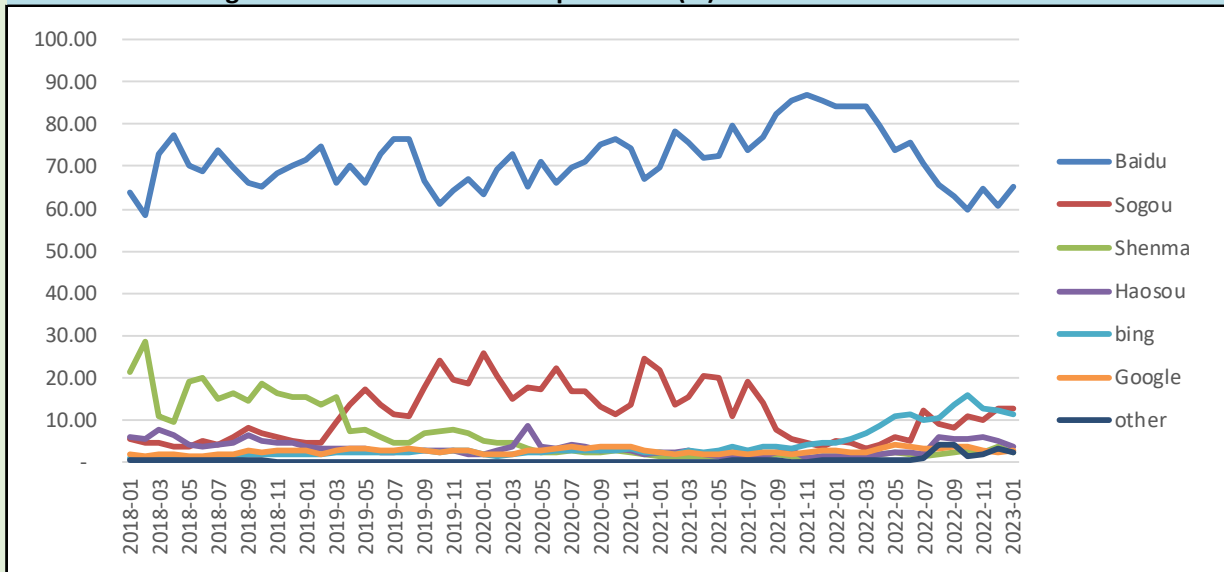
Detail

Baidu, which remains the dominant search engine in China with >80% mobile search query market share, has steadily lost digital advertising revenue share over several years to the Ecommerce and Social Network platforms. However, we have seen Search’s market share stabilise at roughly 10% since late 2020 having seemingly retained its core advertising customers and industries. With China’s economic growth recovery, Baidu is perfectly positioned to accelerate its core marketing revenue growth, which is also a high-margin operation. This revenue mix effect, coupled with improvement in margins at its peripheral non-marketing operations, should boost near-term operating margins and drive significant earnings growth acceleration. In this insight, we analyse Baidu’s search query and digital advertising revenue market share trends, revenue growth outlook, margin expansion potential, and current valuation levels.

Industry Overview

Although Baidu certainly remains the dominant search engine, by search query market share, it did lose some market share during 2022, mostly to Bing on desktops, consoles, and to a lesser extent on tablets. It appears the market share loss has stabilised, for now, and we need to keep in mind that the all-important mobile platform market share remains well above 80% for Baidu.

Chinese search engine market share across all platforms (%)

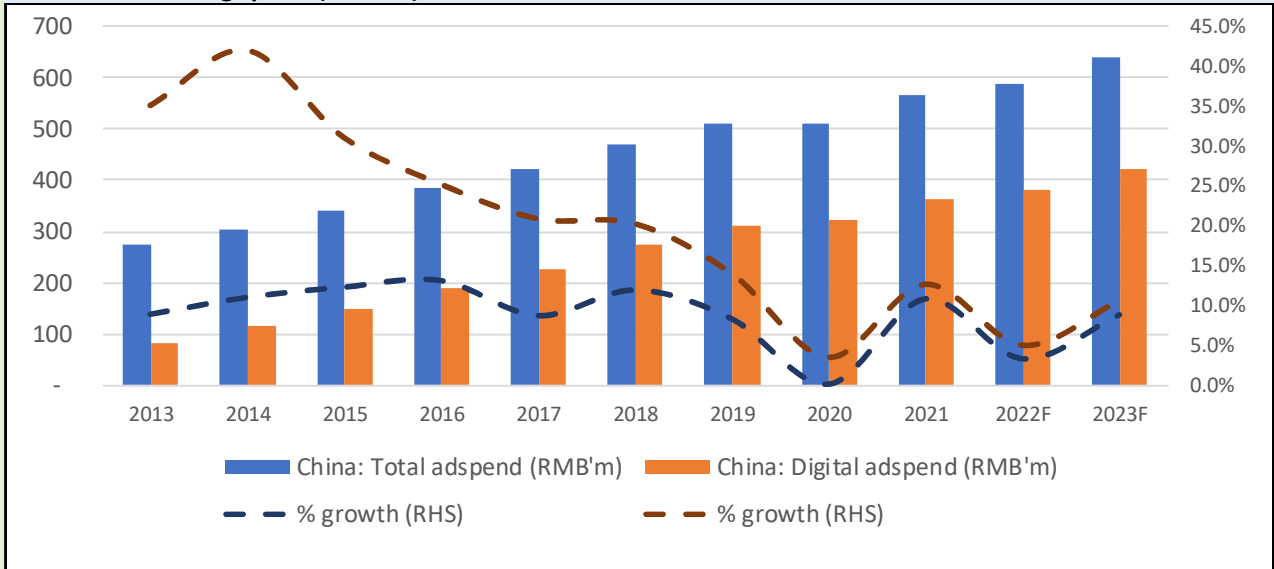


Source: statcounter

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Shifting the focus to digital advertising revenue share, according to MagnaGlobal, the second largest ad market in the world, China (contributing 15% of global advertising revenues), will re-accelerate in 2023 (+7% to \$128 billion) following a historically weak performance in 2022 (+3%) due to the zero COVID policy crippling the economy, and regulatory restrictions slowing down digital media.

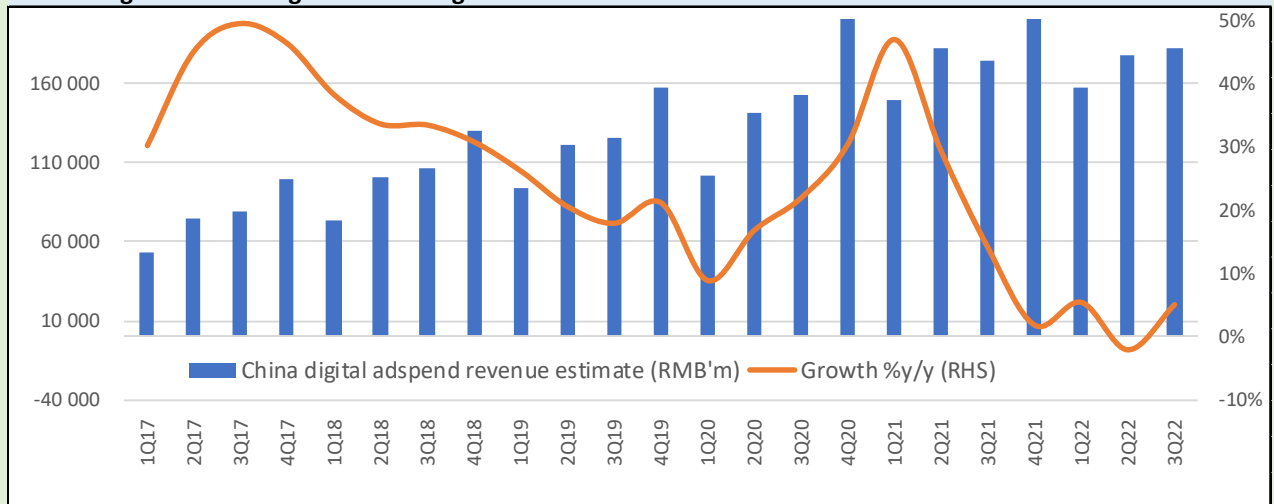
China: Advertising spend (RMB'm)



Source: MagnaGlobal, iResearch, FactSet financial data and analysis, my estimates

According to our internal, bottom-up focussed, estimate of digital advertising revenue growth in China, we can see that digital ad revenue growth bottomed during 2Q22 and returned to positive y/y growth during 3Q22 despite significant macro headwinds.

China: Digital Advertising revenue and growth



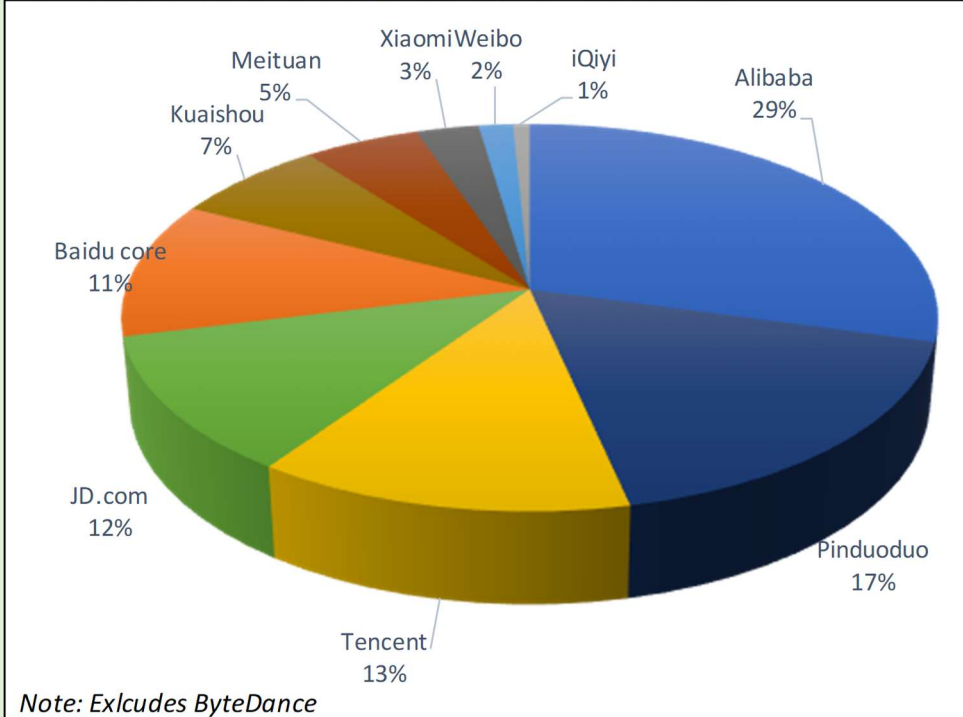
Source: Company data, FactSet financial data and analytics

Note: Excludes ByteDance

Alibaba Group still dominates the market followed by Pinduoduo, Tencent, and JD.com whilst Baidu's core operations command only an 11% share. Note that this excludes the contributions from the various ByteDance platforms, which likely command >30% revenue share.

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China: Top 10 Digital advertising revenue generators (3Q2022)



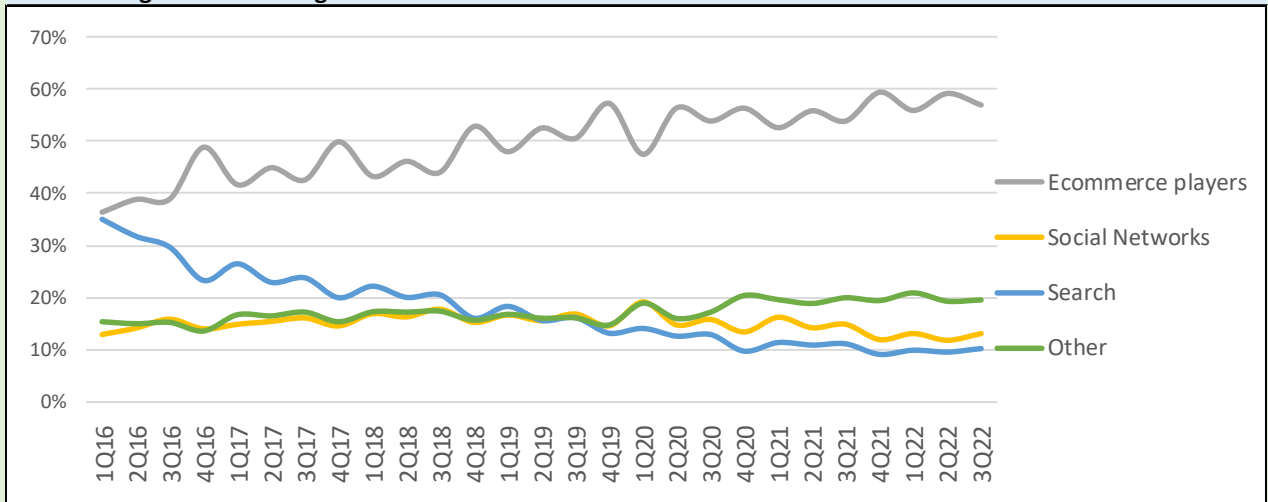
Note: Excludes ByteDance

Source: Company data, FactSet financial data and analytics, My estimates

Note: Excludes ByteDance

Following a multi-year period where Search has consistently lost digital advertising revenue share to the Ecommerce and Social Network platforms, we have seen Search’s market share stabilise at roughly 10% since late 2020 having seemingly retained its core advertising customers and industries. This bodes well for future Search-related digital advertising growth in a period where we should see a recovery in domestic GDP growth.

Relative Digital Advertising Revenue Market share %

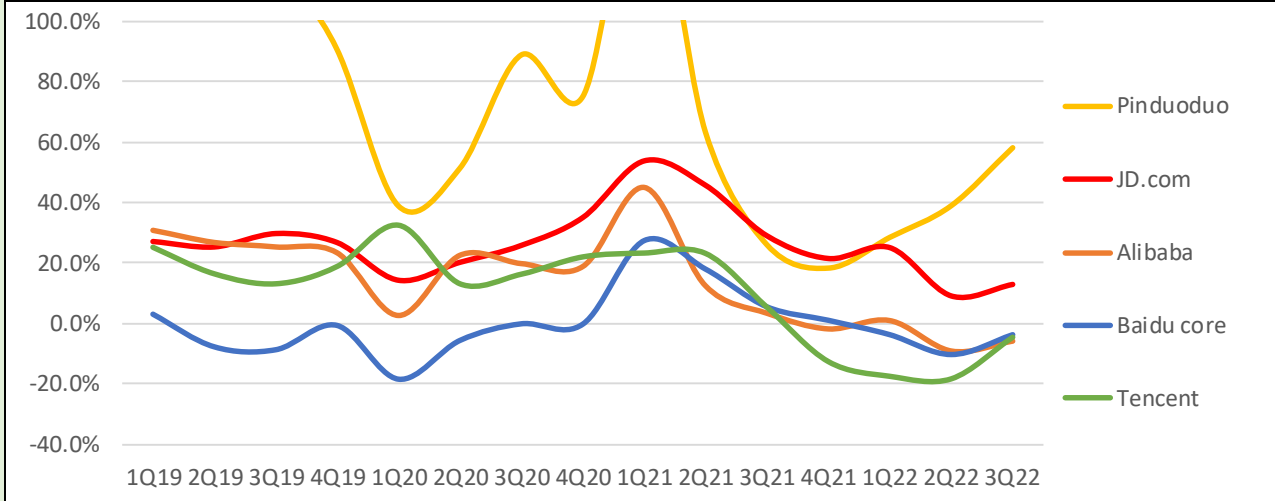


Source: Company data, FactSet financial data and analytics, my estimates

This stabilisation in market share can be seen with more granularity by looking at the individual company contributions. Although Baidu’s core search business has struggled with declining ad revenue during 2022, this was echoed by Tencent and Alibaba Group.

Digital Advertising revenue growth (%y/y, local currency)

Calendar quarters



Source: Company data, FactSet financial data and analytics, My estimates

Growth outlook

Baidu’s core marketing-related revenue, which still contributed 72.9% of its core revenue during 2022, was significantly impacted during China’s macroeconomic slowdown, as expected, declining by 6%/y/y in 2022. With the re-opening of the Chinese economy, during 1Q2023, management has already seen a recovery from the trough, particularly in its main verticals of healthcare, travel, business services and lifestyle. More importantly, the recovery has continued after the Chinese New Year and management remains confident that they will continue to leverage any macro recovery to accelerate ad revenue growth.

“As we look beyond Q1 and into the latter part of 2023, we’re confident that our ad business will benefit from China’s reopening and macro recovery. And with that, we look forward to demand recovery from advertisers, which should provide a significant boost to our ad revenue.” Robin Li, Co-Founder, Chairman & Chief Executive Officer, Baidu.

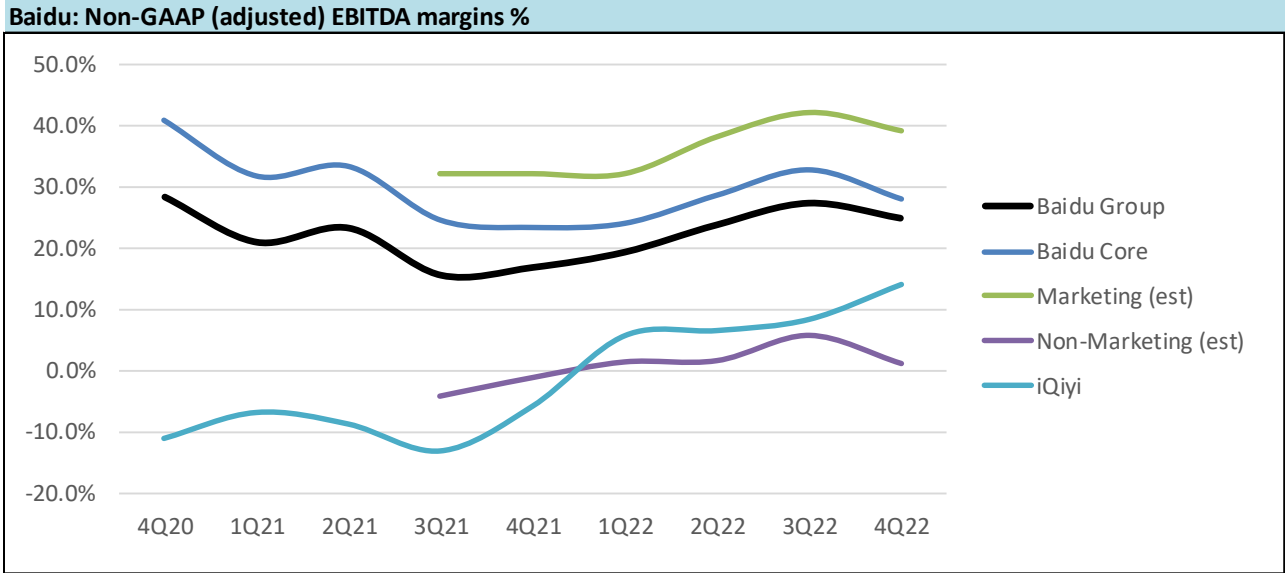
During the macroeconomic slowdown, it has been the non-marketing business segment which has driven growth, mainly through its AI Cloud offerings. Despite a weak, covid-impacted, 4Q2022 management anticipates resuming cloud project implementation as business operations return to normal which should accelerate AI Cloud revenue growth once again.

Baidu Revenue (RMB'm)	1Q21	2Q21	3Q21	4Q21	1Q22	2Q22	3Q22	4Q22
Baidu Core	20 483	24 041	24 661	25 978	21 378	23 160	25 239	25 654
Growth %	34.2%	27.0%	15.3%	12.4%	4.4%	-3.7%	2.3%	-1.2%
Marketing	16 300	19 000	19 500	19 100	15 700	17 100	18 700	18 100
Growth %	27.3%	17.3%	6.0%	1.1%	-3.7%	-10.0%	-4.1%	-5.2%
Non-Marketing	4 183	5 041	5 161	6 878	5 678	6 060	6 539	7 554
Growth %	70.0%	84.4%	73.2%	63.4%	35.8%	20.2%	26.7%	9.8%
AI Cloud	2 700	3 275	3 629	4 904	3 900	4 290	4 500	5 100
Growth %	55.0%				45.0%	31.0%	24.0%	4.0%
Intelligent Driving and other	1 483	1 766	1 532	1 975	1 778	1 770	2 039	2 454
Growth %	106.4%				19.9%	0.3%	33.1%	24.3%
iQiyi	7 968	7 608	7 589	7 389	7 277	6 657	7 471	7 593
Growth %	4.2%	2.7%	5.6%	-0.9%	-8.7%	-12.5%	-1.6%	2.8%
Group Net Revenue	28 134	31 350	31 921	33 088	28 411	29 647	32 540	33 077
Growth %	24.8%	20.4%	13.1%	9.3%	1.0%	-5.4%	1.9%	0.0%

Source: Company data, my estimates

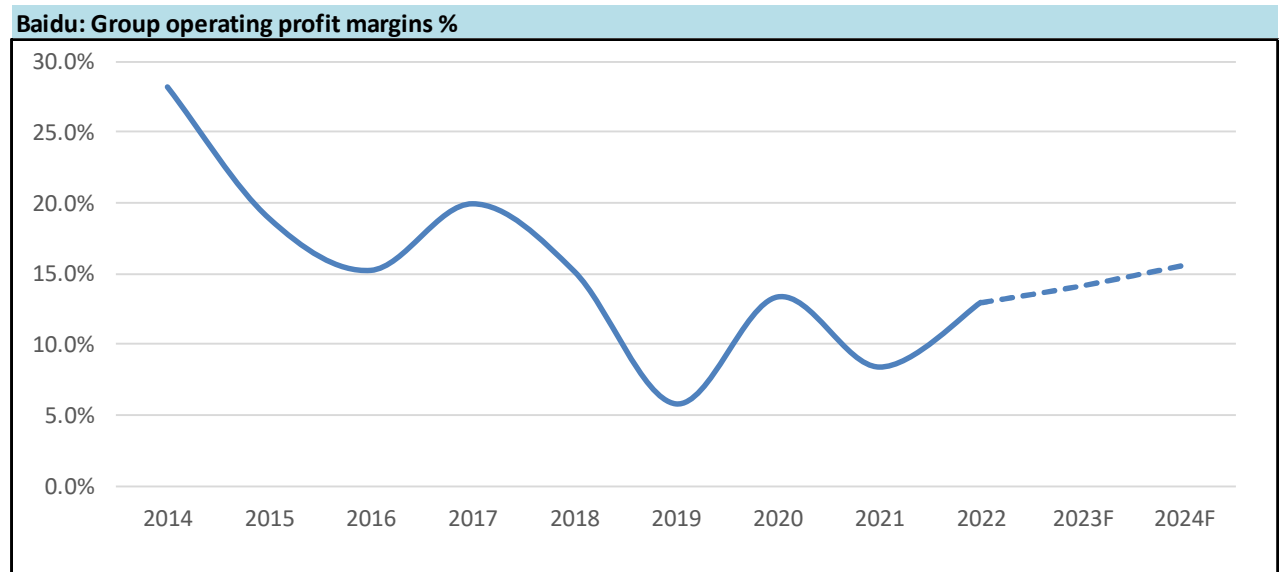
Management has also used the macro slowdown to streamline operations (reduced headcount by ~8%) and make the cost base more efficient, although a lot of these gains have come from a reduction in content cost, which could easily be argued can be increased again should iQiyi want to boost subscriber numbers and market share through increased original programming.

Nonetheless, based purely on revenue growth mix change, Baidu is set up for significant group margin expansion in the near term as we see the higher-margin core marketing business return to positive annualised growth. One of management’s key priorities for 2023 is also to continue expanding margins for AI Cloud.



Source: Company reports, my estimates

Current sell-side consensus estimates are for group operating margins to expand to 14.2% in 2023F and 15.6% in 2024F, which I believe is conservative based on Baidu’s historical performance and the significant operating leverage available, not only in the core marketing operations, but also the peripheral AI Cloud, Intelligent driving, and nascent ChatGPT-like Ernie Bot integration across the organisation.



Source: Company reports, FactSet financial data and analytics

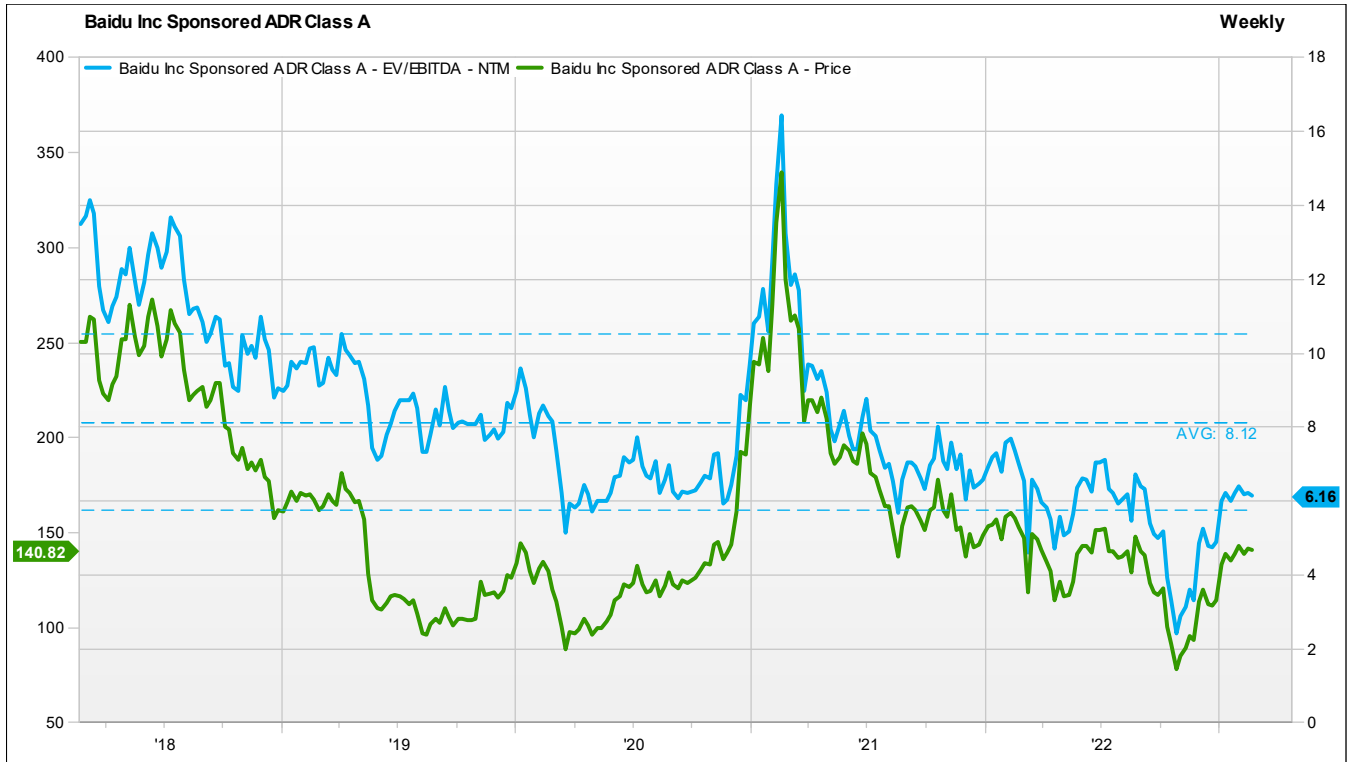
“So, looking forward to the year 2023, we will remain very disciplined in spending, and we will continue to balance the revenue growth and margin, as we are building a long-term sustainable development

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for the whole organization... Mobile ecosystem should continue to generate high profits and cash flow in the future, which is our foundation. And for AI Cloud, we aim to continue to expand our margins.”
Rong Luo, Chief Financial Officer, Baidu.

Valuation

Baidu currently trades on a 6.2x NTM EV/EBITDA multiple, which is nearly one standard deviation below its 5-year historical average trading range.



Source: FactSet financial data and analytics

If we were to strip out its largest listed investments, [iQiyi](#) and [Trip.com](#), at market value, as well as the book value of its core net cash, which includes roughly RMB120bn worth of short-term investments, Baidu’s core business trades on only 4.3x 2023F EV/EBITDA which is at a significant discount to its global peer group.

Current implied Core Search multiples				
	EV/EBITDA		P/E	
	2023F	2024F	2023F	2024F
Baidu core	4.3	3.9	17.0	15.0
Baidu core (ex-cash)			9.1	8.1
<i>Alphabet</i>	10.4	9.1	17.8	14.9
<i>Naver Group</i>	17.0	14.6	28.2	23.2
<i>Z Holdings</i>	9.7	8.6	15.4	26.3

Source: Company data, FactSet financial data and analytics, my estimates

The Baidu share price should further be supported by its newly announced \$5bn share buyback program, through December 2025, which is underpinned by a strong balance sheet (net cash at roughly \$15.8bn) and stable cash flow generation (generated \$16.8bn in free cash flow during 2022) from the core operations.

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Baidu SOTP valuation				
Segment	RMB'm	HK\$'m	HK\$/share	Method
Baidu Core	283 473	323 546	115	9.5x normalised NTM EV/EBITDA
iQiyi	26 465	30 207	11	Market Value
Trip.com	19 068	21 763	8	Market Value
Other investments	45 179	51 566	18	Book value
Net cash (Baidu core only)	114 882	131 122	47	Book value
Minorities	-5 456	-6 227	-2	Book value
Equity Value	483 610	551 976		
	Shares (m)	2 809.0		
	Fair Value/share	196.50		
	% upside	40%		

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