4 reasons to skip the Alibaba IPO frenzy

CBS MoneyWatch
By Erik Sherman
September 18, 2014

With the Alibaba IPO expected to happen this week, individual investors have been cooler to trying to find shares than they were when Facebook (FB) and Twitter (TWTR) went public. However, as the hype reaches a crescendo, many may still be tempted to see if they can get in on the action.

Aside from the normal disadvantage that people face when it comes to IPO investing, Alibaba has some particular twists that make the stock an undesirable choice for the retail investor, according to a number of experts that spoke with CBS MoneyWatch. Here are their reasons to sit this one out, at least for now:

Governance puts you at a disadvantage

Corporate governance isn't usually an investor's first concern, but Alibaba is a special case. As Harvard Law School professor Lucian Bebchuk noted in The New York Times, "insiders have a permanent lock on control of the company but hold only a small minority of the equity capital." It means a small group has total control of Alibaba. "With an absolute lock on control and a limited fraction of the equity capital, the Alibaba insiders will have substantial incentives to divert value from Alibaba to other entities in which they own a substantial percentage of the equity," Bebchuk wrote.

"You have some pretty significant corporate governance risks, and [founder and executive chairman Jack] Ma has somewhat of a history of not being very nice to investors," said Duncan Rolph, managing director at Los Angeles investment firm Miracle Mile Advisors, to CBS MoneyWatch.

Furthermore, the IPO is not for Alibaba Group itself, but a separate entity that has a profit interest in the former. "When you have a revenue interest in a business solely controlled by someone else, he can do what he wants to do," Rolph said. "If he wants to cut your revenue interest like he has in the past under some circumstances, he can do that and you don't have a lot of recourse."

Valuation may be too high

At last count, the IPO price for the shares is in the $66 to $68 range, reflecting strong demand among institutional investors and a high corporate valuation. But is the valuation reasonable?

On one hand, according to ratings agency Rapid Ratings, the fundamentals of Alibaba's business are good. "I think Alibaba at its core is a very strong company," said CEO James Gellert. On the firm's 100-point scale, Alibaba has a 71, a point ahead of Facebook and 30 points ahead of its e-commerce rival Amazon (AMZN), which has a relatively lower rating because its profits are too

thing. "Amazon revenue is nine times that of Alibaba. Alibaba's net profit is almost 30 times that of Amazon."

But stock prices depend on factors other than performance. "The way we do valuation is we take the earnings and look at some price/earnings of comparable firms," said Amiyatosh Purnanandam, professor of finance at the University of Michigan. That's because having no shares yet, Alibaba can't have its own price/earnings ratio.

But the comparable firms' stock prices and P/E ratios are based in part on low interest rates in the U.S., which diverts investor interest from bonds to stocks. More stock buying pushes up stock prices for all companies, including the ones used to set an initial P/E ratio for Alibaba. If interest rates go up, there's a probability that stock prices fall across the board. Purnanandam said, "It could be moderate or more than moderate in decline."

Growth to justify the valuation will be hard to maintain

Purnanandam also points the importance that growth will play in Alibaba's valuation and share price. "This kind of valuation can be justified only if Alibaba can grow at 35 percent year over year for a relatively long period of time," he said.

Alibaba has expanded significantly over the last few years. "Often companies grow at a rapid rate before the IPO," he said, "but more often than not these growth rates do not continue in the long run. Either [Alibaba has] to make sure new competitors are not able to compete in China, or they have to step outside of China and compete with the Amazons of the world. They want to grow in India, but India has its own local company which is growing bigger and bigger."

In countries like the U.S., the model of solely being an intermediary between consumers and many small suppliers might not work. For example, Amazon has an effective marketplace, but largely because it has developed its own efficient sales and fulfillment system, which brings in many buyers. Should Alibaba find sustaining growth to be difficult, its valuation could plummet.

Getting shares, even though proxies, is too expensive

Virtually all of Alibaba's shares will be snapped up by large institutional investors. That means retail investors will have to buy shares from the secondary markets at increased prices or find a way to own shares through an intermediary, such as an exchange traded fund (ETF), a company such as Yahoo (YHOO) or Softbank (SFTBY) that already owns shares, or through a mutual fund.

According to Rolph, EFTs will be a poor option. "You have a lot of the larger ETFs that are traditionally index ETFs which are not going to hold Alibaba," he said. Smaller ETFs that do focus on IPOs will likely buy most of their shares through the secondary markets after the IPO. That leaves individuals no better off than if they did the same thing themselves.

Using a proxy like Yahoo or Softbank at the moment is also a poor choice, according to Barry Randall, chief investment officer of Crabtree Asset Management and a portfolio manager at

Covestor. The pricing of those stocks has already taken their respective Alibaba investments into account, so the chance of seeing a big bump when shares are generally available is low.

Randall said a mutual fund is actually the worst way to specifically get a part of the payoff the IPO might provide. Only the biggest funds will get a substantial allotment of shares, which would mean in the range of 1 percent. "If you managed to get everything you asked for, you'd be getting $130 million of stock." But that would barely be more than 1 percent of the value of such a mutual fund, so forget a sudden return on the investment.

According to Randall, the best way to cash in on the deal is to wait until Yahoo's stock price stabilizes after the Alibaba IPO. In Wall Street's estimate, Yahoo has had virtually no value outside of its stakes in Alibaba and in the separate Yahoo Japan. "The company is essentially worthless and would be immensely attractive to a private equity firm to leverage the firm because it's still cash positive," he said.

The strategy would be to purchase Yahoo shares after all the Alibaba IPO hoopla calms and then hold them until someone buys out Yahoo and breaks it up.