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The inscrutability of internet companies

Major internet-focused businesses from China and the US offer insufficient transparency into their workings, believe M&E and BDO, makers of the Hong Kong Stars index. They risk leaving themselves vulnerable to market shifts by remaining so opaque. ***Richard Morrow*** *reports.*

Amazon, Ebay, Tencent and Baidu. The company names bring to mind some of the most technologically savvy brands in the world; businesses that have parlayed their success in exploiting internet preferences to establish highly successful businesses.

There's just one trouble: they aren't keen on scrutiny.

As part of its biennial industry focus, M&E and accounting firm BDO, creators of the M&E BDO *Asiamoney* Hong Kong Stars index, conducted in-depth research into some of Asia and the US' largest and best-known internet companies. They began by utilising the same methodology as for the index, seeking out 235 data points that they could use to identify the management processes, risk management, financial performance and corporate governance of these companies.

The results did not make for particularly happy reading. The companies have been financially quite successful of late, but they tend to provide only the most basic financial report information and corporate governance information. They do not volunteer very much above their legal requirements. It's a surprising miserly approach to information, from businesses whose very business models rely on distributing information from one source to another.

"I have to admit that this is the first sector we have reviewed in which the information is so slim that I wouldn't be comfortable placing any of these companies into the Stars index," says Vivian Chow, a manager for risk advisory services at BDO.

WEIGHING INTANGIBLE FACTORS

The original decision behind M&E and BDO to create the Stars index was to help quantify the importance of good leadership and management processes in businesses; in other words, the intangible factors of success, instead of the physical assets and money within a business.

RANKING OF INTERNET COMPANIES ACCORDING TO INTANGIBLE MANAGEMENT VALUES

	Internet company	Market cap ($m)*	Intangible Mgt Value Score	Relative Management Value ($m)**
1	Ebay	65,970,000,000	0.622	41,065,321,733
2	Tencent	132,380,000,000	0.598	79,134,406,531
3	Amazon	143,680,000,000	0.430	61,822,277,032
4	Baidu	58,920,000,000	0.405	23,859,080,434

* Market cap on 26 May 2014, yahoofinance.com
** Total value of all Management, Business Processes and Financial Performance, ruling out scores related to Strategy (market cap*Intangible Management Score)
SOURCE: M&E; BDO

These intangibles are particularly important in the internet company space, because most of the value of these companies derives from their ability to create new online products to satisfy their customers, not the relatively meagre physical assets they possess. Key value drivers include improved technology, marketing efforts and internal innovation processes.

"Intangibles are all the factors of true success and outperformance in a company," says Bill Cox, founder of M&E. "Companies like auto makers have a certain residue of physical assets and assured success, with a new car make going into production and then being assured of being built and sold for several years. But the product life cycle of internet companies is very short lived and quick; products are constantly being introduced to a market that is also changing fast. It's an intense business with high growth rates and succeeding in it is all to do with intangible management processes."

The four internet companies being tracked by M&E and BDO may possess extremely high calibre management processes, but they aren't willing to let outside investors or the public know much about them. That leaves analysts and investors unable to ascertain just how well run they are, and consequently how well prepared they are to adapt to shifts in market trends and economic volatility.

"The amount of data and information we get about investments into staff training and training hours, internal corporate measurements and efficiency ratios all are better at Brazilian and European companies," Cox says. "The Americans emphasise governance, but fulfilling their legal requirements is not enough. I'm not able to get into the DNA of these companies."

AMERICA'S INTERNET LEADERS

The reticence of Cox and Chow does not come from the financial performance of the companies. Each is profitable and has largely enjoyed strong growth. Tencent, for example grew its revenues from $28.5bn in 2011 to $60.4bn in 2013, while Amazon's rose from $48.1bn to $74.5bn in the same period.

Ebay and Amazon, as US listed companies, provide decent financial performance information, as part of their need to meet the fairly rigorous Sarbanes Oxley disclosure requirements. Both companies offer information on their US Securities Exchange Commission filings, meaning certain areas are transparent, particularly management compensation and financial disclosure.

But that is as far as the companies go. "Neither company has added extra information to their annual reports, and they generally offer little information of their internal processes despite their importance or governance risk financials; instead they focused on their compensation plans. That was as deep as it went," says Cox.

Neither, for example reveals anything on their employee training programmes, which will drive innovation and margins throughout the organisations, or offered any clarity over customer satisfaction rates or employee health and safety data, which can reveal a lot about future revenue and productivity developments.

However, Amazon published the most meticulous account of governance data, while Ebay gained credit for its willingness to adapt to customer feedback. Cox notes the company has a process in which client complaints feed into its management system, and it also allows people at all levels of the company to feed ideas about better operations and new products that are taken seriously and fed into its research and development and risk monitoring divisions.

As a result it enjoys the highest intangible management value score of 0.622 out of 1. This score approximates the value of its operations in relation to its market capitalisation. Cox estimates that this score means its intangible values account for $41.07bn to its $65.97bn market cap. It also has the overall best financial performance score, at 0.91 out of 1.

Amazon, in contrast, has an intangibles score of 0.43, which ranks it in third place, while its financial performance score is also third, at 0.44. Cox notes the company has increased risk due to the fact it needs to retain sizeable physical inventories of its products to pass to customers. It said it had $26.6bn in current assets in 2013, versus $40.1bn in total assets.

"About one fifth of its entire value is in its inventories, which only generate short term cash flow," says Cox.

That said, Amazon outperforms when it comes to its marketing prowess. The study notes that for every dollar it spent in marketing in 2013 it produced $23.76 in revenues, versus just $5.24 for Ebay.

INSCRUTABLE GROWTH

Tencent lies in second place overall in the study, possessing an intangibles value score of 0.598, equivalent to $79.13bn of its $132.38bn market cap, and a second-ranked financial performance score of 0.89.

Both Tencent and Baidu have seen revenues and profits blossom as China's populace increasingly embrace online communication, transacting and leisure.

RANKING OF FINANCIAL PERFORMANCE SCORES

	Internet company	Performance score	Areas of strength
1	Ebay	0.91	Reduction in interest expense, absolute transaction volume
2	Tencent	0.89	Free cash flow, revenues
3	Amazon	0.44	Revenues, cash position
4	Baidu	0.34	Revenues

Note: Measures 29 key areas of Financial Performance figures from Year 2010 - 2013
SOURCE: M&E; BDO

"Tencent is selling game and subscription services and it has strong potential to go into the mobile market, which is good as more people are moving from PC to mobile gaming," says Cox. "Plus China is a stronger growth market for internet companies than the US."

In addition, Tencent offered better and more comprehensive information than Baidu. "They didn't really withhold that much information and their financials are very consistently rising, without any big spikes," adds Cox.

For example the company revealed that it made profits per customer of Rmb94 in 2011, Rmb122 in 2012 and Rmb175 in 2013.

It also enjoys the best overall financial risk score, of 0.34 (where lower is better). This is in large part because it has fee-paying subscribers and a low debt ratio. All in all it looks like a fairly reasonable investment prospect for the index in the future, says Cox.

However, the information disclosure of Tencent and Baidu in particular, lying in fourth place, still leaves a lot to be desired.

"In terms of information we can't see much transparency of the management views on risk assessment and other intangibles," says Tony Lam, an associate in BDO's risk advisory service.

That lack of knowledge means astute investors will have to wonder just how prepared it truly is, and whether it has staying power for the long-term.

THE BENEFITS OF CLARITY

Many investors may shrug their shoulders at the outcome of this assessment, feeling that the immediate revenue and profits growth of these companies is enough to validate investing in them.

But it's worth remembering that these companies trade at such appealing price to earnings ratios because they have managed to stay at the forefront of internet services and entertainment. The best way to ensure they continue to do so – and retain or improve on their market valuations – is by managing themselves to as high a standard as possible. But at this point the companies don't offer enough information to be certain whether they do so.

That does not necessarily make them poor investments, but it does increase the risk attached to buying their shares.

The likes of Tencent and Baidu ultimately stand to benefit by offering more information about their internal operations, corporate governance, internal training and other areas. Doing so would either reassure investors that the companies themselves take these areas seriously or it would highlight areas in which they are deficient and need to improve their prospects. That would ultimately be good for their longer-term viability and market cap valuations. AM