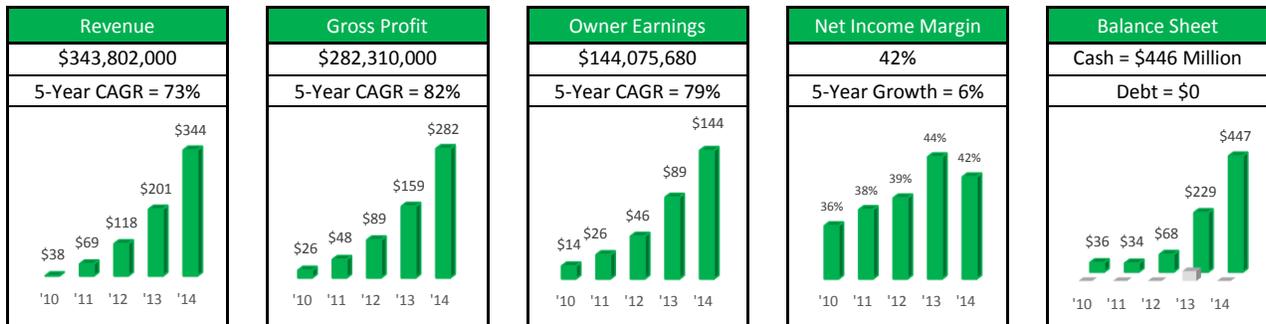




Autohome Inc.  
November 18, 2015

## General Overview

Autohome Inc. (ATHM) owns the number one website in China for independent reviews on all makes and models of passenger cars released dating back to 2005. The company’s professional staff of over 200 content writers create more than 440 professional content pieces, 1,500 photos, and 20 video clips per day for various makes and models of automobiles. The extensive database of information has created the number one online destination for approximately 4.5 million daily visitors. In addition to coverage on every model vehicle released in China since 2005 the site also has more than 12.4 million registered users that participate in 1,800+ online forums creating a abundance of information for automobile owners throughout the car ownership life cycle. The company generates revenue by selling online advertising and subscription services to automakers and dealers across China.



## Purchase Logic

In the last 5 years ATHM has seen explosive growth with revenue and earnings compounding at a rate of more than 70% per year. During this timeframe the company signed up over 80% of the automakers in China as advertisers on their website. In addition to auto manufactures, ATHM has also signed roughly 20,000 independent auto dealers into annual subscription agreements for lead generation. Dealerships in China report that anywhere from 30% to 60% of all qualified leads come through the subscription service of ATHM - making it a must have for all independent dealers. In the last twelve months ATHM has earned more than \$170 million in income and is still in the early innings for growth. In the next twelve months the company will likely increase the price of the subscription service paid by dealerships by nearly 30%, sign up an additional 2,000 independent dealers, and win additional wallet share of automakers advertising budget. We anticipate owner earnings in the next twelve months to exceed \$200 million dollars. At our time of purchase ATHM had \$537 million in cash, zero debt, for a net purchase price of roughly 15x earnings. This is a sensational price for a business growing more than 30% per year with a dominant market position, wide economic moat, fantastic operating leverage and a long runway for growth.

## Key Metrics

The key metrics for ATHM are revenue, gross profit, owner earnings, net income margin, and the balance sheet. The business drivers that influence these key metrics are described in greater detail below.

### Revenue

Revenue is currently derived from two primary sources – advertising revenue and subscription services. The advertising revenue is generated by selling digital advertisement space on *autohome.com.cn*. The total advertising spend on ATHM websites continues to rise as automakers shift their advertising dollars from traditional platforms, such as newspapers and television, to online platforms. *Autohome.com.cn* is extremely well positioned to further gain share in this advertising space due to the higher ROI on ad dollars spent on their site. The higher ROI is driven by the strong consumer intent for individuals that visit the site. The demographic of users surfing

*autohome.com.cn* is superior to that of a general television broadcast or newspaper placement – after all; the website visitors are looking for cars. Pricing continues to increase for ad space on ATHM’s sites as ROI from this channel begins to slowly align with other traditional advertising spending. Advertising revenue is approximately 66% of overall revenue.

The remaining 33% of ATHM’s revenue is derived by charging ~20,000 auto dealerships an annual fee for leads provided by ATHM. These dealer subscriptions are priced at roughly \$7,000 per year and generate approximately 100 – 200 closed deals for dealerships that subscribe. Each car sold has a gross profit of roughly \$1,000 dollars (3.5% of \$25,000 ASP) – meaning the dealer subscriptions are generating between \$100,000 and \$200,000 in gross profits annually for dealerships. ATHM is aware that their subscription service is currently underpriced and the company is in a strong competitive position to raise prices. In the last twelve months ATHM increased prices 35% and the number of dealers subscribed continued to climb from ~17,000 to ~20,000. Subscription revenue has substantial room for growth.

In the next decade we believe that the total addressable market for ATHM’s services will continue to expand as the company shifts its efforts from advertising for new car purchases to other aspects of the automobile ownership life cycle. The majority of a customer’s lifetime value for a dealership is in aftermarket services over the course of a cars life – not the initial purchase of the vehicle. ATHM is just beginning to target the aftermarket services and used car verticals – which will triple the size of the total addressable market. We anticipate both of these avenues to generate substantial revenue for ATHM in the years to come. Monetization possibilities include advertising for mechanics, subscription services for leads for auto repair shops, and transaction fees for used car sales. Each of these represent a meaningful opportunity.

#### Gross Profit

Gross profit is the total revenue minus the cost of revenues. The cost of revenues includes content-related costs, such as independent reviews of automobiles written by their professional staff, and bandwidth and internet data center costs. As the industry leader the gross profit margin for ATHM continues to expand as each content-piece and review is paid for once, but then leveraged across more end users. This gives ATHM a scale advantage that increases gross profit at a faster rate than revenue. The cost of revenue does not include traffic acquisitions costs for users as they visit the site (a very important variable).

#### Owner Earnings

Owner earnings represents the profits that could be distributed to the owners of the business without impacting ATHM’s competitive position in the market place. The company generates strong cash flow from operations and requires almost no capital expenditures to maintain its competitive position. The primary spending required to maintain ATHM’s competitive position is R&D for the web platform, advertising for traffic acquisition, and content for independent reviews. These are all expensed annually.

#### Net Income Margin

The net income margin is calculated by dividing owner earnings by revenue. This metric factors in all expenses for ATHM – including a critical variable – traffic acquisition costs. In order to attract users ATHM pays search engines, such as Baidu, for superior placement in search rankings. This is known as ‘traffic acquisition costs’. As the leader in the industry and the number one brand name in China for auto information, ATHM has lower traffic acquisition costs than its peers due to a very high volume of direct traffic (people that go straight to the site). We anticipate this trend to continue as many individuals directly visit the site, or type in ‘Autohome’ directly into Baidu, or are repeat buyers.

## Balance Sheet

The balance sheet for ATHM is relatively straight forward. The company operates with no debt and a substantial amount of cash. Legally, Autohome Inc. is a Cayman Island company and operates through its wholly owned subsidiaries in the People’s Republic of China and as such a portion of the cash is ‘restricted’ to mainland China and not available for dividends without meeting certain requirements. We view this restricted cash as cash and cash equivalents.

## **Historical Performance of Key Metrics**

Year	'10	'11	'12	'13	'14
Total Revenue	\$38,383,000	\$68,826,000	\$117,574,000	\$200,953,000	\$343,802,000
<i>Gross Profit</i>	\$25,652,000	\$48,081,000	\$88,965,000	\$159,288,000	\$282,310,000
Expenses	\$24,489,512	\$42,616,488	\$71,189,704	\$112,014,304	\$199,726,320
Income	\$13,893,488	\$26,209,512	\$46,384,296	\$88,938,696	\$144,075,680
Net Income Margin	36%	38%	39%	44%	42%
Cash	\$35,865,000	\$33,954,000	\$67,505,000	\$228,549,000	\$446,839,000
Debt	\$0	\$0	\$0	\$37,889,000	\$0

## Revenue

In the last 5 years Revenue has compounded at a rate of 73% per year. We anticipate this growth rate to decelerate tremendously over the next 5 years, but maintain a healthy pace in excess of 15% per year over the next decade. The explosive growth of the last 5 years was achieved by ‘unleashing’ the earning power of the incredible user traffic generated by the site. This monetizing process is still in the early innings with many additional avenues for continued growth. We expect pricing to increase on advertising (it currently is priced per location and not per number of impressions). Performance based advertising will increase the revenue generated per ad location for ATHM substantially. We also expect price increases for dealer subscriptions, additional dealers to subscribe to the lead generation service, new subscription revenue from repair shops, and transaction fees on new and used car sales. Each potential area for revenue growth benefits from a rising middle class in China, a rapidly growing auto market, and increasing internet penetration rates. Currently more than 90% of Autohome’s visitor are between the ages of 18 and 45. As this age cohort gets older their buying power will increase further creating value for ATHM’s web properties. Our expectation is for Revenue growth to fluctuate between -15% to +50% with a long-term growth rate averaging 15% over the next 10 years.

## Gross Profit

In the last 5 years Gross Profit has compounded faster than Revenue at 82% per year due to the strong operating leverage inherent in the business. ATHM has an in-house staff of 1,771 individuals with roughly 700 of those dedicated to creating professional content and developing the website. This professionally curated content lends itself to wonderful operating leverage. With more than 4.5 million daily visitors a single article created by ATHM’s professional staff receives considerably more advertising revenue due to the high volumes of traffic. The content-creation costs have been relatively fixed while revenue has been increasing rapidly. We expect this operating leverage to continue as ATHM expands its business and services into other verticals. We anticipate gross profit to grow at a rate between -18% to +60% with a long-term growth rate averaging roughly 17% over the next 10 years.

### Owner Earnings

Owner earnings have grown at a rate of 79% per annum for the last 5 years – faster than revenue but slower than gross profit. In the next 5 years we anticipate owner earnings to be much more difficult to predict than revenue and gross profit due to the wide array of initiatives ATHM can undertake to expand their business. For example, as ATHM builds out a platform for used cars to be listed and sold through their site it will require heavy R&D spending. This new platform would be a future channel for growth, but depress owner earnings in the short-term. Due to the wide number of growth initiatives available to ATHM we anticipate owner earnings to grow at a slower pace than revenue and gross profit in the upcoming years as the company invests in these new initiatives. We view these investments as prudent and with a high probability of payoff for shareholders. Additionally, if these investments do not bring a fruitful ROI we believe there is a sufficient margin of safety in our purchase price that ATHM will be much larger based strictly on the company's core business – ad sales and subscriptions to dealerships. We anticipate owner earnings growth ranging from -25% to +35% with a 10-year annual average of roughly 15%. However, we expect the next few years to exhibit slower growth and later years more rapid growth as new initiatives eventually become profitable.

### Net Income Margin

The net income margin for ATHM has expanded in the last 5 years from 36% to 42%. This expansion is extremely important as it demonstrates some of the competitive advantages ATHM has over competitors with less brand recognition and inferior content on their website. The net income margin has expanded due to strong operating leverage (described in the section on gross profit) and an advantage in traffic acquisition costs. As ATHM has strengthened its position in the market users are accessing the site directly (circumventing search engines), are repeat users, or search the key phrase 'Autohome' (which has lower costs for ATHM than competitors). The advantage in organic traffic allows ATHM to outbid competitors for new users while maintaining extremely attractive overall traffic acquisition costs. The dominant market position is allowing ATHM to put more resources into content creation, platform development, and traffic acquisition while simultaneously expanding net income margin. We intend to monitor the net income margin carefully over the next few years to ensure traffic acquisition costs does not rise substantially relative to revenues. To perform this calculation we will estimate expenditures on new growth initiatives, such as platform development for a used car platform, and add that back in our net income margin calculation. Excluding these expenses we anticipate net income margin to be relatively flat for the next few years.

### Balance Sheet

In the last 5 years cash has increased from \$35 million to \$537 million. This increase in cash was entirely from operating profits demonstrating the high quality earnings of the business. We expect ATHM to maintain a debt free balance sheet and are agnostic about how the \$537 million in cash will be allocated. We view all of the following as reasonable uses of this capital at current prices: share repurchases, dividends, acquisitions (at appropriate prices), or new initiatives (such as platform development for used car sales).

Summary of Key Metrics

Metric	Expectations
Revenue (Primary measure of Intrinsic Value)	Growth ranging from -15% to 50% per year Average of 15% over 10 years
Gross Profit	Growth ranging from -18% to 60% per year Average of 17% over 10 years
Owner Earnings	Growth ranging from -25% to 35% per year Average of 15% over 10 years
Net Income Margin	Relatively flat (excluding growth initiatives)
Balance Sheet	Debt Free

**The Moat Around The Metrics**

The economic moat surrounding ATHM’s competitive position is comprised of a strong brand name, a user/payer disconnect, operating leverage, operational excellence, and a slight network effect. These factors working in tandem position ATHM uniquely in the value chain for automobile purchases, repairs, and resales. Here is how each of the factors contribute to the moat.

Strong Brand Name

ATHM is the leading brand name in China when it comes to independent information on all makes and models of automobiles. The flagship site, *autohome.com.cn*, is well known for the highest quality content and most accurate information on all makes and models of cars released in China since 2005. This brand name drives substantial organic traffic to the site which lowers overall traffic acquisition costs. This cost advantage can then be used to increase the quality of the platform making it more user friendly, increase the accuracy and quality of the content, and decrease load times for site information (improve performance).

User / Payer Disconnect

ATHM is ultimately a media property. Similar to newspapers or televisions from 30 years ago – ATHM provides content that individuals are interested in. In this case the content is independent information on the quality, pricing, and reliability of automobiles. This content ultimately attracts users the same way newspapers attract subscribers. Having the attention of a large user base is an extremely valuable resource because advertising can be sold to companies that want to distribute their products to users. This type of business model creates a disconnect between the individuals that utilize the service (people looking for independent information on cars) and the individuals who pay the company (namely advertisers; and in this case automakers and dealerships). A user / payer disconnect makes it impossible for competitors to undercut ATHM on price – users access content for free. As long as ATHM can maintain a large user base advertisers will always pay at a level that provides them a reasonable ROI. This disconnect gives ATHM a competitive edge because it is impossible to lure users away based on price. This type of disconnect has traditionally made many media properties some of the most attractive businesses in the world.

Operating Leverage

The economics for ATHM are extremely attractive. The professionally curated content and the website platform has a fixed cost, but once it is paid for each additional user can use it at almost no cost. This creates substantial operating leverage in the business model. Each new user that ATHM is able to attract almost no additional cost to the company. As the largest automobile website in China ATHM is able to pour more resources into the quality of their platform and content while still maintaining industry leading profitability. This operating

leverage serves as a barrier to entry for competitors. It doesn't make sense for the market to create more than a handful of auto platforms to serve customer's needs – a highly fractured industry would create redundancy in the content and platform creation and consolidation would inevitably occur. It is very rare that an industry with such strong operating leverage would move in the direction of 'more fractured' and ATHM is already the biggest winner.

### Operational Excellence

There are a few other major competitors that compete against ATHM in providing content about automobiles. The largest competitors include Bitauto, PC Auto, and internet portals such as Sina and Sohu. In this particular industry there is sufficient room for a few large providers to be extremely profitable – and most of the players are. Despite the strong competition ATHM is the industry leader in terms of profitability, daily average users, time spent on the site, and customer reviews. Users, automakers, and dealerships agree that ATHM provides that most reliable and accurate information about automobiles in China. The commitment to excellence has helped ATHM establish the company's strong brand name and significant operating leverage will allow ATHM to maintain this commitment to excellence without sacrificing profitability.

### Network Effect

ATHM also benefits from a slight network effect. There are more than 1,800 forums with 12.4 million registered users posting valuable content on automobiles for car owners. These users post information ranging from reviews to repair information to auto facts. As the number of forums increases the volume of content on the site increases – meaning more questions can be answered using ATHM's website. More answered questions drive more users, and more users drive more answered questions. This network effect would likely be considerably more valuable for aftermarket services, such as repair questions, than for new cars.

These five elements working in tandem have positioned ATHM as the clear leader in the industry. The company is in a powerful position with automakers and dealerships – if dealerships or automakers decide not to advertise or subscribe with ATHM the sales decline is substantial. ATHM is becoming a 'must use' vertical for industry players due to how close *autohome.com.cn* is to purchasers. We also believe that being an auto review site is substantially more valuable than your typical third party review. Buyers tend to increase the level of work and research that goes into a purchase as the size of the purchase increases. Very little research is done when considering what paper towels to purchase, slightly more for a washer or dryer, and even more for a car. We believe as a major ticket item for buyers independent reviews are more valuable in this space than most other verticals. All-in-all we view ATHM as having a wide economic moat that will last long into the future.

### **Risks**

ATHM is a dominant company with a leading market position, zero debt, and substantial cash. We view the company as a low risk investment, but with no tangible assets we have assumed some risks as owners of the business. We believe the risks ATHM faces are the loss of a major advertiser, poor capital allocation decisions, increased traffic acquisition costs, a buyout from the largest shareholder, and currency fluctuations.

In China advertising is sold to advertising agencies rather than directly to clients. For example, a large auto manufacturer would contract an ad agency to purchase all of its advertising slots and manage the return on investment. The advertising agencies often pool several clients and then lobby with media properties for the best rates on ad placements. As such, ATHM had some concentration in revenue from the largest ad agencies that represent auto manufactures in China with 38.7% of all revenues coming from the ten largest ad agencies and 5.9% of revenue from the largest. In the event that ATHM were to lose a relationship with one of these ad agencies it would have a material impact on earnings in the short-term. We view this scenario as unlikely due to the high ROI customers receive when advertising on *autohome.com.cn*. This high ROI stems from the high purchase intent of

customers that browse the site. We don't believe it is possible for a billboard, newspaper, or TV broadcast to compete effectively against ATHM's user base of prospective buyers.

The large cash balance, \$537 million dollars, is a valuable asset to ATHM shareholders if it is allocated skillfully. We have assumed that the company would create at least \$1 of value for each dollar retained, but the relatively young history of the company has not provided sufficient insight into how management intends to allocate these profits. We believe the retained earnings will be reinvested into either dividends, stock repurchases, organic projects, or an acquisition. We view the only potential for poor allocation of capital to be a high priced acquisition and view this as unlikely due to management's repeated emphasis on growing the company's core business.

As competition in China heats up between auto sites, such as Bitauto and PCauto, it is possible that these companies will increase their spending on key words to attract more user traffic. The increasing prices for key words would in turn elevate the traffic acquisition costs for all players involved. We view this risk as unavoidable and believe that traffic acquisition costs for new users will rise, but ATHM has an advantage with the largest volume of direct traffic and repeat users. We believe this competitive advantage will allow ATHM to outbid their competitors for new traffic while maintaining strong profitability. This is the highest risk factor we face as owners of ATHM and one we will monitor closely.

The largest shareholder of ATHM stock is Telstra – an Australian based media company. Telstra currently owns just over 55% of the outstanding shares and it is possible that the company may attempt to acquire the remaining 45% of ATHM not currently held. Telstra would be required to pay a premium over the current market price to purchase our stake in ATHM, but we believe that even a 20% to 30% premium to the current market price would undervalue ATHM as a business. Our intention is to hold ATHM for a longer duration and participate in the meaningful growth of the company in the upcoming years and an acquisition by Telstra, while profitable for us, would limit our long-term gains.

The earnings of ATHM are denominated in Chinese Yuan and the exchange rate between the USD and RMB will have a meaningful impact on our investment performance. At our time of purchase the USD was historically strong versus the RMB and other major world currencies. If the USD were to return to more normalized levels it would increase the value of our ATHM position – however – if the USD were to continue to strengthen against the RMB it would hinder our investment results. We view this risk as low due to China's long-term fiscal policy of pegging the value of the RMB to the USD and expect this continue. As a firm our position size is not sufficiently large to participate in currencies hedges to mitigate this risk.

## **Conclusion**

ATHM owns the leading online destination for automobile shoppers in China. The company's flagship site, *autohome.com.cn*, has more than 4.5 million daily visitors. In the last 5 years the company has grown revenue at a rate of more than 70% per year by selling advertising to auto manufactures and subscriptions to dealerships for lead generation. The key metrics for the business are revenue, gross profit, owner earnings, net income margin, and the balance sheet. In the upcoming years we will measure the intrinsic value of the business primarily on revenue due to the increased spending on new initiatives. These new initiatives should greatly increase the value of the company's for shareholders in the long-term, but will depress short-term earnings. We anticipate revenue growth in excess of 15% per year over a 10 year period with the primary drivers being increased pricing on ad spaces and subscriptions, new dealership subscribers, and expanding into new verticals such as used car transactions and aftermarket services. The company has a wide economic moat that stems from a strong brand name (lower traffic acquisition costs), a user/payer disconnect, operating leverage, operational excellence, and a slight network effect. ATHM is a Selective Company with a bright future.

**Works Cited**

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