Research on Best Inc.- 4/2/19

Description: BEST Inc. operates as a smart supply chain service provider in the People's Republic of China. Its proprietary technology platform enables its ecosystem participants to operate their businesses through various SaaS-based applications. The company applies its technologies to a range of applications, such as network and route optimization, swap bodies, sorting line automation, smart warehouses, and store management. It offers integrated services and solutions across the supply chain, including warehouse management, order fulfillment, express delivery, freight, and other services for multinational and corporate customers, as well as small and medium enterprises. The company also provides express delivery services; and door-to-door integrated cross-border supply chain services to and from China, including international express, less-than-truckload, fulfillment, reverse logistics, and freight forwarding through its network, and transportation and warehouse partners. In addition, it operates real-time bidding platform to source truckload capacity from independent transportation service providers and agents; and offers online merchandise sourcing and store management services for convenience stores, as well as last-mile B2C services, such as parcel pick-up and drop-off, and bill payment services. Further, BEST Inc. provides various value-added services, including customized financial services, including fleet and equipment finance leases; and centralized sourcing of products and services, such as bulk procurement of trucks and accessories. The company was founded in 2007 and is headquartered in Hangzhou, the People's Republic of China.

Ticker: BEST
Price: $5.04
Market Cap: $1.95B
Performance: +22.4% YTD

Analysis

While YTD it may look like BEST has been killing it, it couldn't be further from the actual story. The Chinese supply chain manager has been struggling mightily for a multitude of reasons.

Take a look below at the 1yr chart:

Shares are down from over $12.50 to $5 after bottoming out in the upper $3s. This chart leads us to our main question: Why have shares been performing so bad? Two main reasons:

1. Like most China companies, the U.S. China tariffs have put a huge dent in Chinese companies' stock prices and BEST is even more susceptible to these political risks as they are a shipping/supply chain management company whose business is entirely dependent on the health of the economy
2. Little room for error – BEST resides in one of the tightest industries with regard to profit margins as the cost of goods sold make up such a larger portion of revenues

When we examine BEST there are a ton of things we like and a ton of things we don't like. Let's begin with the latter. For one, and we already hinted at it a bit. BEST is in the business of razor sharp margins. Not only that, they are in a space that is becoming extremely crowded which means they will have to deal with continued pricing pressure and relentless customer satisfaction standards as the slightest mispackage can have a customer run toward the next guy with such little barriers to transition.

If we look at the chart below, BEST's gross margins, not net income, gross margins for the year ended at 5.2% vs. 2.4% in 2017. Moving further down, we see that earnings before interest, taxes, depreciation & amortization comes out to be -0.1% vs. -2.9% in 2017 while net losses amount to -1.8% vs. -6.1% in 2017.

RMBmm (Except for %)	FY 2017	FY 2018	%Change YoY
Revenue	19,990	27,961	39.9%
Express	12,786	17,703	38.5%
Freight	3,178	4,103	29.1%
Supply Chain Management	1,601	2,074	29.6%
Store[+]	2,226	2,845	27.8%
Others[1]	199	1,236	523.5%
Gross Profit	486	1,441	196.8%
Gross Profit Margin	*2.4%*	*5.2%*	*+2.9ppts*
Express	*2.7%*	*4.4%*	*+1.7ppts*
Freight	*(5.8%)*	*3.8%*	*+9.6ppts*
Supply Chain Management	*6.1%*	*5.0%*	*-1.1ppts*
Store[+]	*6.9%*	*9.0%*	*+2.1ppts*
Others[1]	*34.3%*	*11.2%*	*-23.1ppts*
Net Loss	(1,228)	(508)	(58.6%)
Net Loss Margin	*(6.1%)*	*(1.8%)*	*+4.3ppts*
Non-GAAP Net (Loss)/Profit[3,4]	(923)	(452)	(51.0%)
Non-GAAP Net (Loss)/Profit Margin	*(4.6%)*	*(1.6%)*	*+3.0ppts*
Adjusted EBITDA[2,3]	(583)	(18)	(96.9%)
Adjusted EBITDA Margin	*(2.9%)*	*(0.1%)*	*+2.7ppts*

Yes, make no mistake these numbers are getting better and the company is still young in its days on an industry that is poised to grow for the foreseeable future but these margins are tough for investors because not only do they indicate that the company will have to stay insanely disciplined to watch every single dollar, these companies also don't fetch the craziest multiples when it comes to valuation. All that I kept seeing when performing my due diligence is people saying that BEST trades at 0.5x sales and has revenue growth near 40% and that it should get a higher multiple and that shares should be over $20. We've got bad news for you, that's simply not going to happen unless BEST can multiply their gross margins. If gross margins remain in the low-to-mid single digits it's going to be extremely difficult for this company to fetch higher multiples. Think about it, for every $1 that BEST brings in they have nearly $0.95 cents in costs of goods sold. This industry is not like the tech industry that has 85% gross margins and is insanely scalable with low variable costs. In fact, it's quite the opposite. Are we happy margins are growing in the right direction at

BEST? Of course, but they are still alarmingly low especially when compared to a competitor in ZTO Express.

ZTO is only a parcel express delivery service while BEST is more diversified with its service offerings (we'll touch on this more as it is a pro). ZTO has gross margins of 30.5% and net income margins of 24.9%. Just to reiterate, BEST has gross margins of 5.2% and net income margins of -1.8%.

This comparison isn't 100% fair though because margins at BEST are comprised of their multiple business segments. The best thing we can do to truly gauge BEST's success is to compare and single out their Express business to ZTO's Express business. Unfortunately for BEST, this works against them. BEST's Express business has gross margins lower than their total gross margins at 4.4% and is responsible for 65.8% of BEST's total revenue.

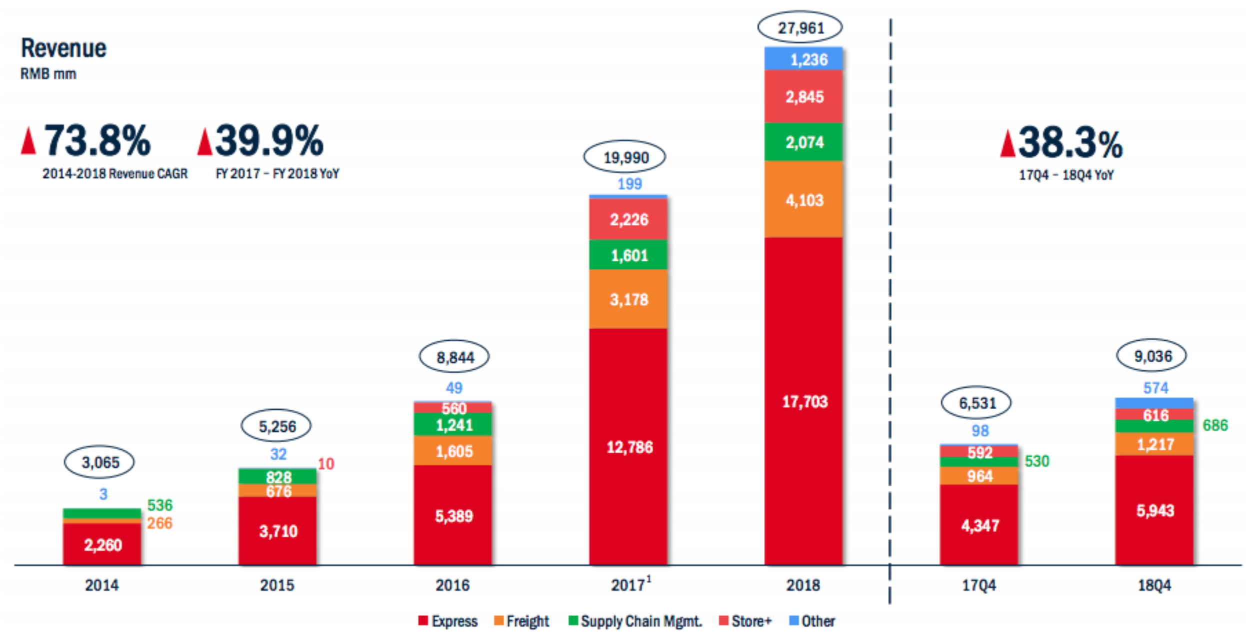
On a fundamental basis, this is why ZTO has such a premium valuation in comparison to BEST. View the table below:

	BEST	ZTO
P/S	0.5x	5.7x
Forward P/S	0.36x	4.4x
P/E	N/A (recorded -0.17 EPS in 2018)	21.8x
Forward P/E	N/A (EPS Guidance not given)	19.2x
Net Profit Margins	-1.8%	24.9%
Rev Growth ('18/'17)	39.9%	34.8%

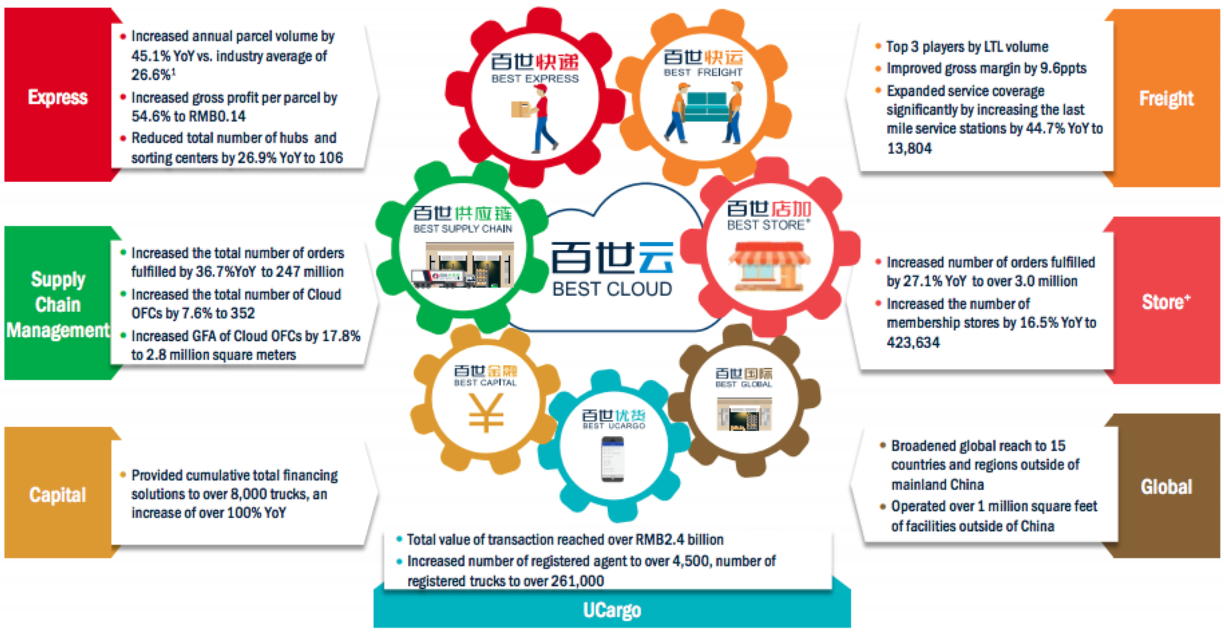
Let's talk about some bright spots at BEST.

1. Company is growing total revs at a solid pace as 2018 saw revenue growth of 39.9% and is also guiding for revenue growth of 32%. This growth is company from each and every one of their segments
    a. Express Service Revenue increased by 36.7% YoY to $864.4M primarily due to 47.1% YoY increase in parcel volume.
    b. Freight Service Revenue increased by 26.2% YoY to $176.9M primarily due to 29.7% YoY increase in freight volume.

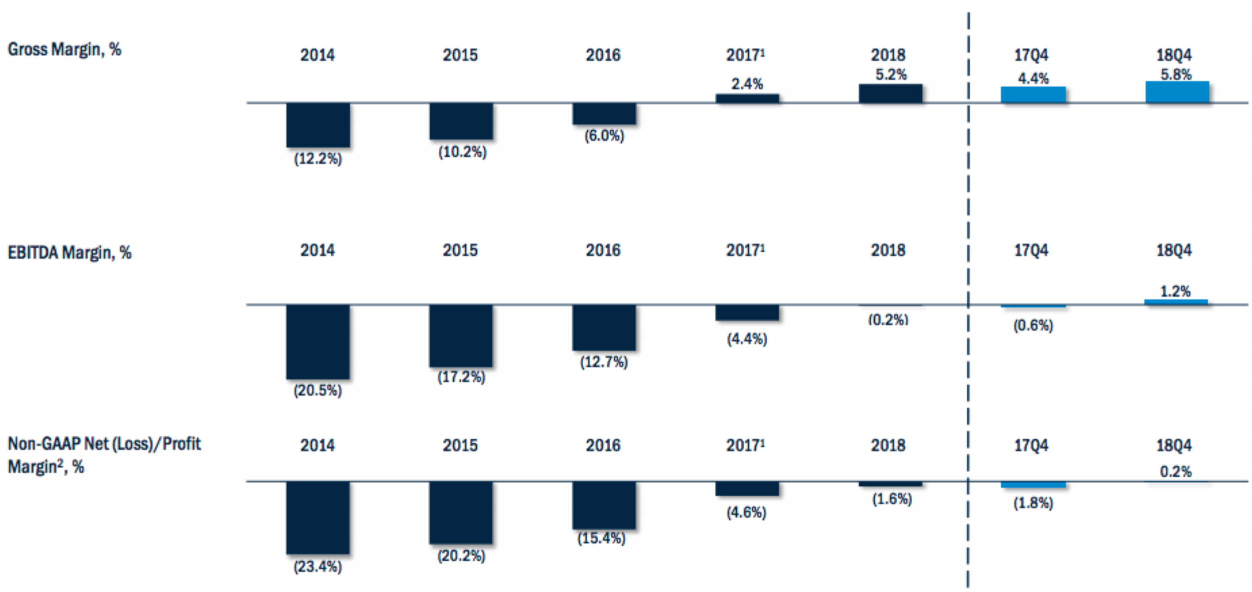
c. Supply Chain Management Service Revenue increased by 29.5% YoY to $99.7M primarily due to an increase in fulfillment and transportation revenue from both existing and new customers.
d. BEST Store+ Service Revenue increased by 4.0% YoY to $89.5M primarily due to an increase in merchandise sales to branded and membership stores.
e. Others Service Revenues increased by 482.5% YoY to $83.5M primarily due to increased revenue generated from BEST UCargo's external customers, BEST Global's expanded operations and BEST Capital's financing solutions to ecosystem participants.

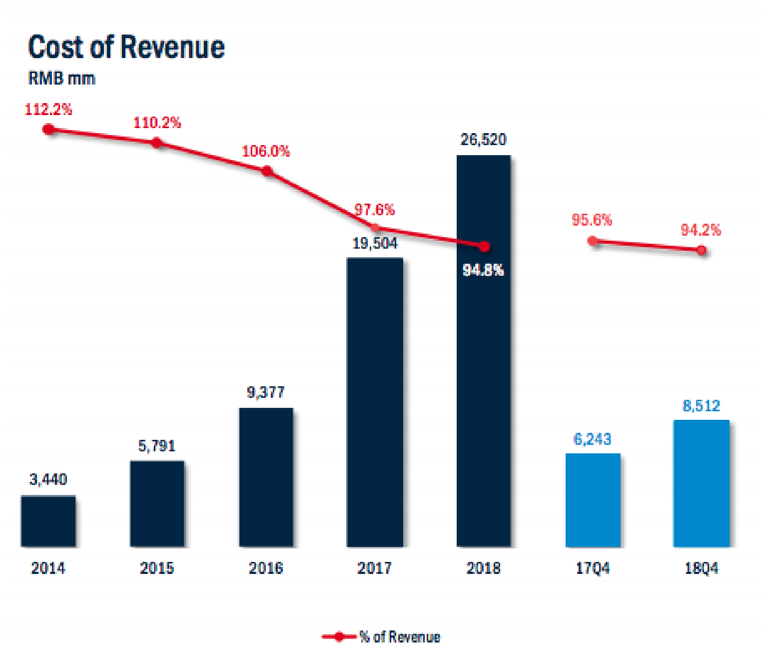


2. Company is well diversified
    a. Unlike ZTO who only takes care of parcel delivery BEST has their hands in many different business segments (as you saw and above and view image below) and is a more full-service provider.

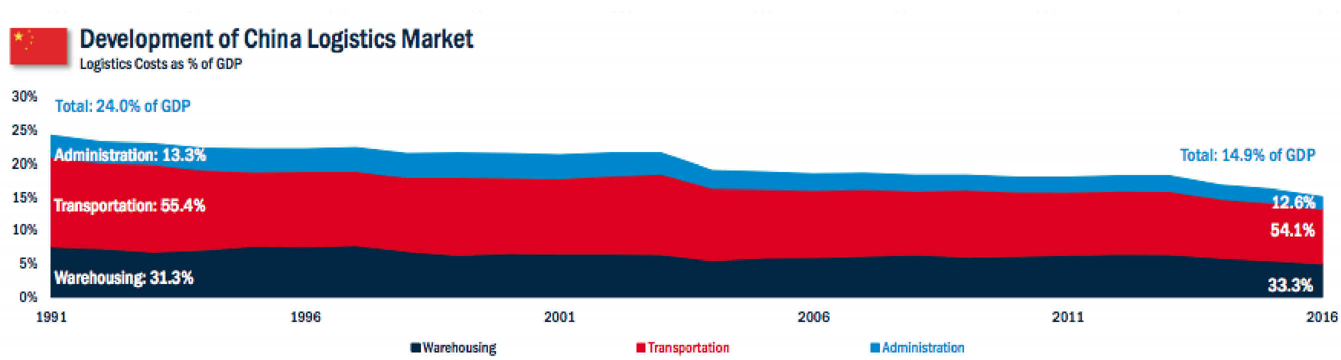


3. Margins may be low but are growing and moving in the right direction





4. U.S./China trade deal should be huge industry tailwind and industry itself is growing at an impressive pace.



China's logistics market makes up nearly 24% GDP in comparison to the United States which is at 16.1%.

Addressable Market and Growth

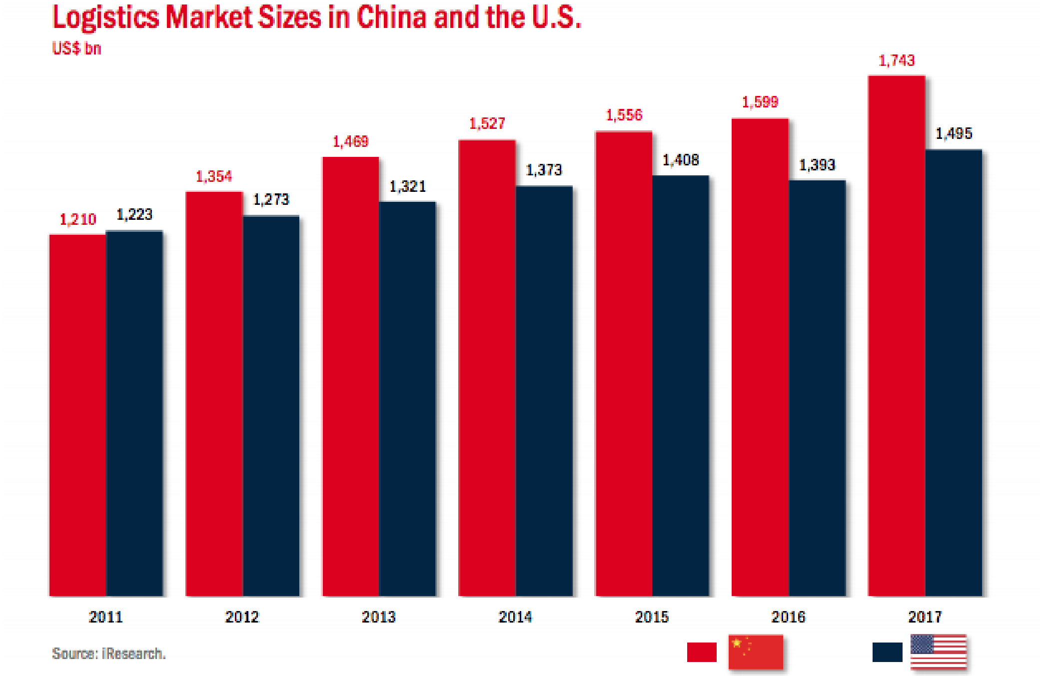
Major Sub-Segments

	Market Size[1]	2016-2021E Revenue CAGR
Express	US$ 98bn	18.5%
LTL[2]	US$ 208bn	13.8%
Supply Chain Management	US$ 729bn	23.9%
Cross-Border E-commerce Supply Chain[3]	US$ 203bn	14.4%

As we can also see from the image above, there is still a ton of potential over the next several years for BEST to capitalize on a growing industry especially with growth spanning across multiple segments and not just one area. We believe this is a huge advantage for the company and will help them with their business “moat”. They are not a single-play on the logistics market like ZTO is.

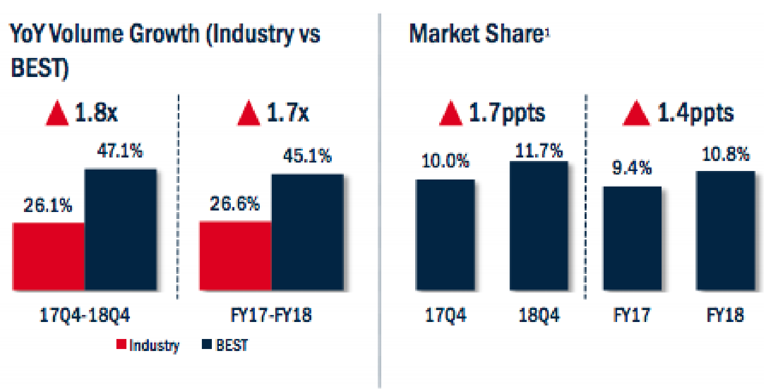
Below is another image to help display how big of a market this is when compared to the United States.

With ecommerce just getting warmed up and China consumption booming, this serves as a very strong tailwind for BEST to capitalize on.



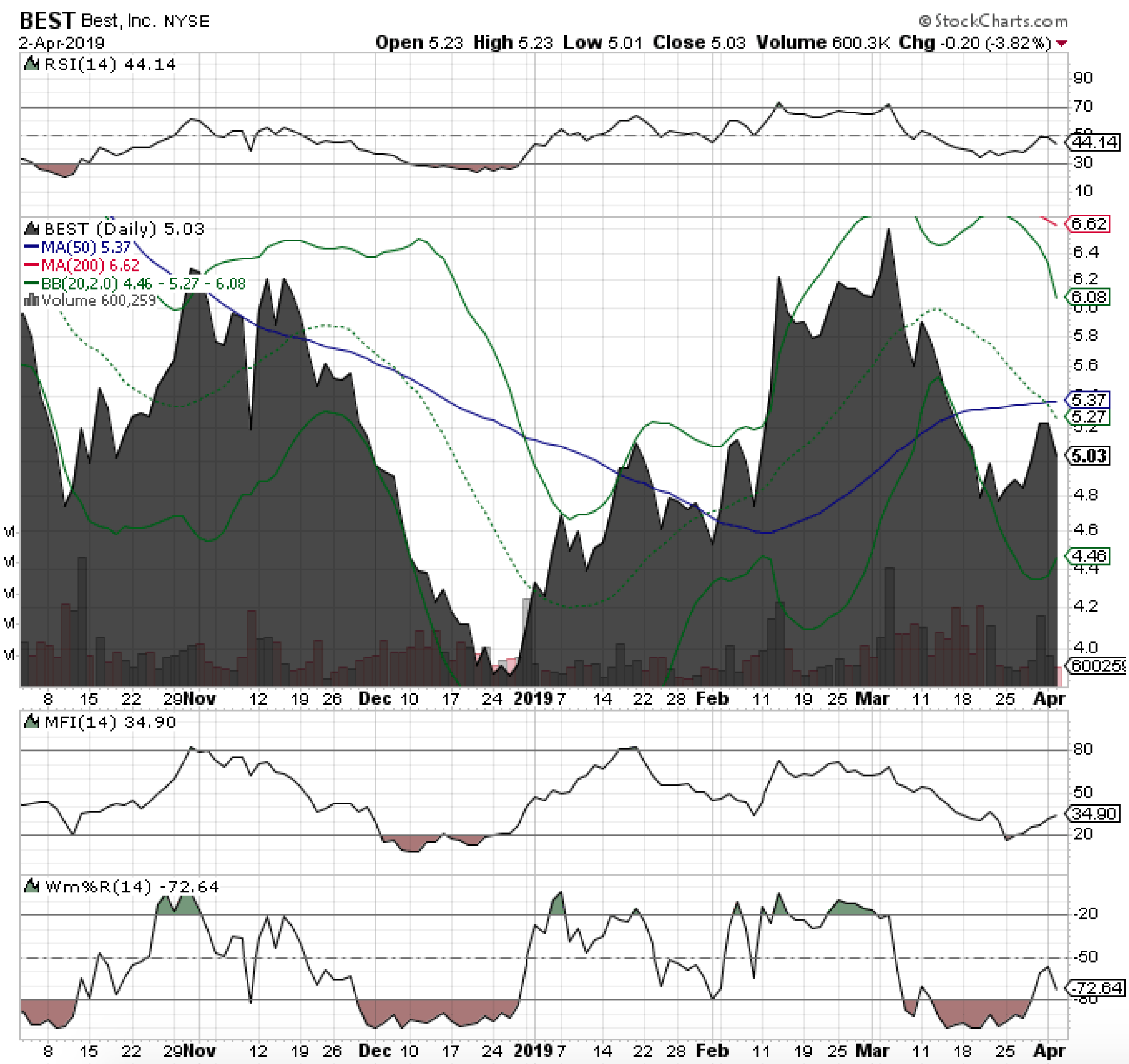
5. Growing market share
    a. The company increased its express market share to 11.7% in the fourth quarter of 2018, compared to 10.0% in the same period of 2017. In the fourth quarter of 2018, parcel volume increased by 47.1% YoY, compared to an industry-wide YoY growth rate of 26.1%. In fiscal year 2018, parcel volume increased by 45.1% YoY, compared to an industry-wide YoY growth rate of 26.6%.

Below is an image displaying how BEST is growing at a faster pace than the overall logistics market and is also grabbing more market share at the same time. In fact, BEST is growing at nearly double the pace.



Wrapping up the fundamentals of the company, we think we have a case where ZTO has gotten a little overpriced and BEST has become a bit oversold. We believe they've pretty much both went a little extreme in the opposite directions and have caused a pretty large gap between the two. We definitely believe ZTO deserves a premium multiple as the company is without a doubt operating in a much leaner fashion but they're also growing at a slightly slower pace and are only in the parcel express industry while BEST is playing a much more diversified strategy by going as far as having a financing unit.

We believe long-term both will be capitalizing greatly on this market and both can earn a spot in one's portfolio but let's examine BEST's charts first to see if now is the right time at $5 per share.



As we examine these charts, we think $5 is a good price but we'd look to see if it holds here first. The shares are not bashful entering into oversold territory and staying there for a while. The next line of support looks to be $4.75 and then the lower channel of the Bollinger Band at $4.46. We'd stay patient here before entering just to see if it holds $5 but if this is going to be a long-term hold than a few pennies should make too much of a difference to you and you can always just add more to your position in the $4s. We'd like to say there isn't any rush to enter here but any announcement of a trade deal and we can see a pretty large upswing in the share price.

Overall, this is a long-play. Aside from the trade deal, the only catalyst that's going to get shares truly moving higher is if BEST continues to get their margins up. They have to get their gross margins at least into the double digits and get into the green on net income. We don't expect them to fetch a valuation like ZTO but at least somewhere in between the likes of FedEx and UPS valuations.

We believe long-term this is a good play as the industry is still in a super growth phase and we can see companies like BEST and ZTO both utilizing artificial intelligence and blockchain over the next 2-3 years to truly enhance their margins by cutting out a lot of unnecessary costs, thus propelling shares higher.