Alibaba getting thieved?

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Key benefits:

- The recently announced IPO of Alibaba Group Holding Ltd. may make the company one of the 100 largest public companies in the world.

- Due to its complex corporate structure, Alibaba is likely to be left out of some popular global benchmarks. Other companies like Alibaba are also being left out of global benchmarks, and this creates a lost opportunity gap the size of Mexico.

- The Russell Indexes home country assignment methodology retains these companies as important pieces of the global equity opportunity set.

China’s Alibaba Group Holding Ltd. is the world’s largest e-commerce company. According to Economist magazine, it sells more “stuff” than eBay and Amazon combined. The company recently announced plans for an initial public offering that values Alibaba at an estimated $110 billion, although some have said its value may be as high as $200 billion. The $110 billion valuation would make Alibaba the 64th-largest company in the world; $200 billion, the 20th largest, behind such well-known companies as IBM and Nestlé. With Alibaba’s 80% market share in China and plans for more growth and diversification, global equity investors might naturally be excited see the company added to global equity benchmarks.

Not so fast. You see, while Alibaba is generally regarded as a Chinese company, it is incorporated in the Cayman Islands, headquartered in Hong Kong, and to be listed on the New York Stock Exchange (NYSE). This complex corporate structure means that Alibaba likely won’t be included in many widely used equity indexes that sidestep companies with such complex corporate structures.

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3. Based on Russell Indexes unadjusted market capitalizations as of April 28, 2014.

4. The non-Russell index holdings projections made in this paper are based on a survey of home country assignment treatment across 2014 global index methodologies published by FTSE, NASDAQ, MSCI, and S&P Dow Jones, as applied to the membership of the Russell Global Index at Reconstitution 2013. No direct index holdings comparisons could be conducted.
Non-Russell methodology leaves gaps in coverage

For observers learning this, perhaps a few obvious what, why and how questions will jump to mind. For starters: What would cause the world’s largest virtual marketplace to be excluded from some global and emerging markets benchmarks? The answer is simple, but the reason complex: index methodology. Index methodology governs, or should govern, which stocks are ultimately eligible or ineligible for index membership. But the rules around index construction and how those index rules are applied can differ, sometimes significantly, among global index providers.

In this case, index methodology is responsible for evaluating Alibaba and assigning it a home country. Russell Indexes uses an approach started in 2010 that looks at three primary home country indicators (HCIs): place of incorporation, place of headquarters and place of primary trading. If all three of these HCIs point to the same country, then our task is done, and the company is assigned a home country. However, in an increasingly globalized market, there are plenty of companies for which our HCI test does not yield a conclusive answer – more on that shortly.

Russell’s rules-based approach can accommodate companies with complex corporate structures

Other index providers use a variety of indicators to gauge where a company belongs, but none use an objective and rules-based process such as Russell Indexes follows. One might expect that index providers unencumbered by specific rules would have the flexibility to always get the “right” answer. But, perhaps surprisingly, that’s not the case when it comes to a company like Alibaba. When a company maintains a complex corporate structure, listing its stock in one region of the world but doing most of its business in another, some non-Russell index methodologies can’t make sense of where the company should belong; they short-circuit, like robots caught in the rain, and exclude companies with greater degrees of ambiguity from their indexes. When Russell gets an inconclusive result, we then go a step further, analyzing the geographic segmentation of a company’s assets or revenues. If we are able to tie a majority of a company’s assets to (let’s say, for example) China, then China becomes the home country.

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5 Based on a survey of home country assignment treatment across 2014 global index methodologies published by FTSE, NASDAQ, MSCI, and S&P Dow Jones.
Figure 1: Russell Indexes company-to-country determination process

Under a rules-based system like Russell’s, which is applied to over 10,000 stocks worldwide, we understandably end up with a small group of companies each year that, even after our assets or revenues test, do not give us a clear answer. In these instances, our ultimate default is to the country in which the company’s headquarters is located. While those outcomes can be debated, Russell’s approach provides a clearly articulated path that leads to a specific classification, and companies like Alibaba are not arbitrarily dropped from the Russell Global Indexes (RGI).

Lost opportunities from around the world add up to another country the size of Mexico

You might ask yourself: “But does this really matter? We’re talking about one company, right?” Wrong. Russell estimates that more than 180 companies worldwide have similar corporate structures. These companies are held in the RGI but may be left out of other popular benchmarks as a result of following their stated processes and methodologies. That’s a combined market capitalization of approximately $553 billion. To put that number into context: It’s roughly as large as the market capitalization of Mexico, one of the larger countries in the Russell Emerging Markets Index.

Other large companies from China, such as Baidu – the so-called “Google of China” – are being left out of standard benchmark offerings. As are other prominent companies, such as Italian luxury-goods maker Prada – which listed on the Hong Kong Stock Exchange (HKSE) in order to raise brand awareness in the region – and United Company Rusal, one of the world’s largest aluminum producers, which is headquartered in Russia but listed on the HKSE in order to escape the operational and geopolitical risks of its home country, which Russell Indexes designates as Russia. Also in the news recently: U.S. pharmaceutical giant Pfizer pursued a takeover of the UK’s AstraZeneca that would have seen Pfizer headquarters and incorporation shift to Britain – although the combined company’s listing would likely have remained in the U.S.

Sources: Russell Indexes

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7 Of the four non-Russell methodologies surveyed only the S&P Dow Jones methodology appears to allow for the inclusion of Chinese companies with corporate structures like Baidu.

Figure 2 shows, by Russell Indexes home country designation, the market cap associated with companies most likely to be left out of standard non-Russell benchmarks when their countries of incorporation and primary listing differ. Figure 2 also provides names of the 10 largest (by market cap) companies currently included in the RGI that have complex corporate structures.

**Conclusion**

As large public companies (particularly, large multinationals) increasingly make strategic decisions about where to incorporate, base their headquarters and list their stock – often on opposite sides of the world – Russell Indexes has a responsive methodology that includes, rather than excludes, these investment opportunities. As investors decide among global benchmarks, it’s important that they understand how companies with complex corporate structures are addressed by indexes’ underlying methodologies – or risk missing out on big opportunities like Alibaba.
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