Alibaba Group

June Quarter 2024 Results

Conference Call

Transcript

Thursday, 15 August 2024

Introduction

Rob Lin

Head of Investor Relations, Alibaba Group

(Original)

Good day everyone, and welcome to Alibaba Group's June Quarter 2024 Results conference call. With us are Joe Tsai, Chairman; Eddie Wu, Chief Executive Officer; Toby Xu, Chief Financial Officer. We have also invited Jiang Fan, Co-Chairman and CEO of Alibaba International Digital Commerce Group, to join the call. This call is also being webcast from the IR section of our corporate website. A replay of this call will be available on our website later today.

Now, let me quickly cover the safe harbor. Today's discussion may contain forward-looking statements, including without limitation statements about our strategies and business plans, as well as our beliefs, expectations and guidance about our business prospects, such as the future growth of our business, revenue, take rate, profitability and return on investment and share repurchases. Forward-looking statements involve inherent risks and uncertainties that may cause actual results to differ materially from our current expectations. For detailed discussions of these risks and uncertainties, please refer to our latest annual report on Form 20-F and other documents filed with the U.S. Securities and Exchange Commission or announced on the website of the Hong Kong Stock Exchange. Any forward-looking statements that we make on this call are based on assumptions as of today and we do not undertake any obligation to update these statements, except as required under applicable law.

Please note that certain financial measures that we use on this call, such as adjusted EBITDA, adjusted EBITDA margin, adjusted EBITA, adjusted EBITA margin, non-GAAP net income, non-GAAP diluted earnings per share or ADS and free cash flow, are expressed on a non-GAAP basis. Our GAAP results and reconciliations of GAAP to non-GAAP measures can be found in our earnings press release.

Unless otherwise stated, growth rate of all stated metrics mentioned during this call refers to year-over-year growth versus the same quarter last year.

With that, I will turn the call over to Eddie.

Group Business Update

Eddie Wu

CEO, Alibaba Group

(Translation)

In the new fiscal year, our strategies of "user-first" and "AI-driven" are starting to bear fruit. This quarter's results reflect continued steady growth momentum.

Taobao and Tmall Group achieved steady year-over-year growth in orders and in GMV. Alibaba International Digital Commerce's revenue maintained strong growth. Alibaba Cloud's revenue excluding Alibaba-consolidated subsidiaries returned to positive growth, notably driven by core public cloud and AI products. And across other segments, we achieved better operational efficiency and monetization capabilities to varying degrees. This drove significant improvement in loss-making businesses.

In line with our "user-first" strategy, Taobao and Tmall Group continued to invest in key capabilities aiming to deliver quality products and services at attractive prices across diverse shopping needs of consumers. This quarter saw steady growth in GMV and order volume, notably driven by increased purchase frequency. Internal and external data on e-commerce market share dynamics indicates a trend of gradual stabilization in our market share, further validating the effectiveness of our investments in user experience. 88VIP members reached 42 million by quarter-end. We will continue to explore and improve program benefits, product offerings, and service experiences for this expanding premium member base.

In TTG's operational strategy, we place great importance on Taobao's rich and diverse product offerings, while investing in consumer experience enhancement. We continuously improve the efficiency of matching user traffic with products to ensure stable and sustainable growth. As orders and GMV continue to grow, we are advancing monetization step by step, including with the roll-out of our new marketing tool, "Quanzhantui". Through algorithm improvements, we aim to optimize merchants' monetization efficiency while also enhancing platform traffic utilization and conversion of user traffic to purchases. We expect CMR growth to gradually align with GMV growth over the coming quarters.

In our cloud segment, we continue to pursue high-quality revenue and effectively execute our integrated "Cloud + AI" development strategy. This quarter, Alibaba Cloud's overall revenue from external customers grew 6%, with public cloud revenue maintaining double-digit growth. Notably, revenue from AI-related products sustained triple-digit growth, continuing to increase its share of public cloud revenue. We're seeing more and more major customers choosing Alibaba Cloud as their computing infrastructure for AI development. At the same time, Alibaba's proprietary large language model Qwen is gaining wider adoption.

This year, Alibaba Cloud served as a major technology service provider for the Olympic Games, providing cloud computing and AI services to Olympic Broadcasting Services, OBS. At the Paris

Olympics, cloud-based live broadcast powered by Alibaba Cloud overtook satellite signals as the primary means of broadcast for the first time in Olympic history. Two-thirds of broadcasters used live signals transmitted by Alibaba Cloud in real time around the world, reaching billions of viewers. Additionally, Alibaba Cloud's AI technology saw its first widespread application at the Paris Olympics, including 360-degree replays in real time, bringing pleasant surprises to the audience.

Our long-term strategy for integrated Cloud + AI development focuses on three key elements. First, we'll continue to optimize our cloud product portfolio, concentrating on public cloud products that are competitive, have sustainable gross margins, and generate replicable revenue. This forms the foundation for Alibaba Cloud's healthy, high-quality growth. Second, we'll strengthen synergies between cloud and AI products in the AI era, not only supporting existing customers in implementing new AI capabilities on Alibaba Cloud, but also enabling AI-native enterprises to succeed on our platform. We're committed to capitalizing on both opportunities. Third, to ensure the growth of our AI-driven cloud business, we'll continue to make ongoing investments in product R&D and AI CapEx.

Looking to the medium and long term, we are confident that Alibaba Cloud's overall revenue from external customers will return to double-digit growth in the second half of the fiscal year, with gradual acceleration thereafter. While maintaining intensive R&D investment, we aim to sustain profitable growth, establishing ourself as an AI and cloud service provider with healthy profitability and market share leadership.

In international e-commerce, AIDC achieved 32% revenue growth this quarter. Our international business segment comprises a diverse business matrix that integrates both cross-border and local operations, as well as B2B and B2C formats. This presents numerous opportunities, in terms of both operational models and market expansion potential. Jiang Fan will share more details with you shortly.

Beyond e-commerce and cloud, we've implemented strategic realignments across our key internet technology businesses following a thorough evaluation of their product capabilities and market competition dynamics. While maintaining product competitiveness, most of these businesses will now place higher priority on enhancing their monetization capabilities. These businesses have already shown significant improvement in their capabilities this quarter, and we expect this trend to continue in the coming quarters. We anticipate most of these businesses will achieve breakeven within one to two years and gradually begin to contribute profitability at scale.

This new fiscal year marks a critical stage for Alibaba as we solidify our strategic direction and realize the successes of our transformation. We are fully confident in Alibaba's sustained, healthy development into the future.

AIDC Business Update

Jiang Fan

Co-Chairman & CEO, AIDC Group

(Translation)

Hello everyone! I’m delighted to share with you the latest progress of AIDC.

Over the past quarter, AIDC maintained its rapid growth momentum, with overall revenue increasing by 32% year-over-year, primarily driven by our cross-border business.

In terms of the three drivers we consistently focus on：

First, the ongoing upgrading of our business model and supply chain services. AliExpress maintained rapid year-over-year order growth, with the percentage of AE *Choice* orders continuing to be high and gradually stabilizing, which enhanced the certainty and consistency of user experience. AliExpress and Cainiao continued to jointly optimize the logistics experience, significantly reducing our average delivery time quarter-over-quarter. We further optimized the balance between user experience, richness of merchandise assortment, and efficiency across our marketplace and consignment models. The unit economics of AE *Choice* improved significantly this quarter.

Second, product and technology innovation. We advanced our AI and intelligent technologies across scenarios like AI customer service, cross-platform product placement, product detail page optimization, multilingual search, and precise recommendations. These innovations enhanced efficiency and user experience. They have been deployed across our platforms, serving approximately 500,000 merchants and covering 100 million SKUs.

Third, sustained growth in key markets. Continuous improvement in user experience bolsters AE's confidence to step up its investments in key markets to expand our user base and maintain market leadership. As the exclusive e-commerce partner for UEFA Euro 2024, we effectively enhanced brand awareness for AE and Trendyol. In Türkiye, Trendyol improved its monetization rate and profitability, further consolidating its leading position in e-commerce. In the Gulf region, Trendyol also broadened its merchandise selection and improved operational efficiency, while continuing to invest in user growth. In Southeast Asia, Lazada achieved single-month adjusted EBITDA profitability for the first time in July. This milestone reinforces our confidence to continue investing efficiently in the Southeast Asia market to consolidate our market share.

In conclusion, our strategic focus is twofold: First, enhancing operational efficiency across all our business lines, while further enhancing profitability in certain businesses and regions, aiming to turn loss-making operations profitable as quickly as possible. Second, actively investing in key markets to drive quality growth, with the goal of attaining more scalable profitability in the future.

Thank you, everyone.

Financial Highlights

Toby Xu

CFO, Alibaba Group

(Original)

Thank you, Jiang Fan. This past quarter's financial performance continues to demonstrate our strategy to revitalize growth in our domestic commerce and cloud segments while reinforcing our leadership position. At the same time, we are improving the monetization and operating efficiency of our loss-making businesses, with the goal of achieving sustainable business growth and profitability.

Taobao and Tmall Group is winning the mindshare of our consumers. This past quarter, we achieved high single-digit online GMV growth and double-digit order growth. AIDC continues to achieve robust revenue growth, driven by rapid order growth in cross-border businesses, especially from AliExpress' *Choice*. Ali Cloud's revenue quality is improving and back to growth. Overall revenue, excluding Alibaba-consolidated subsidiaries, grew over 6%, driven by double-digit public cloud growth and increasing adoption of AI-related products. Our loss-making businesses are improving their monetization and operating efficiency significantly. For example, Local Service Group and Lazada significantly narrowed their losses during the quarter.

During this quarter, we repurchased a total of 613 million ordinary shares, or 77 million ADSs, for a total of US$5.8 billion. This includes the concurrent buyback of approximately 14.8 million ADSs for US$1.2 billion that was associated with our new CB issuance.

As of June 30, 2024, we had 19 billion ordinary shares or approximately 2.4 billion ADSs outstanding. Compared to March 31, 2024, there was a 2.3% net reduction in our outstanding shares after accounting for shares issued under our ESOP. As of June 30, 2024, we still have US$26.1 billion remaining in our share repurchase program.

Additionally, as part of our plan to minimize annual ESOP dilution and better utilize the cash generated by our domestic businesses, we have started to replace a portion of Alibaba Group's ESOP incentives with long-term cash incentives for our employees starting last quarter. These cash incentives will be reflected as costs in our adjusted financial metrics, including segment EBITA. While this change in compensation structure will lower adjusted EBITA, it will also result in less ESOP dilution in the future.

On a consolidated basis, total revenue was RMB243.2 billion, an increase of 4%. Adjusted EBITA decreased 1% year-over-year to RMB45 billion. Excluding the effects of long-term cash incentive, adjusted EBITA growth would have turned positive on a like-for-like basis.

Our non-GAAP net income was RMB40.7 billion, a decrease of RMB4.2 billion or 9%. Our GAAP net income was RMB24 billion, a decline of RMB9 billion or 27%, primarily due to a decrease in income from operations and increase in impairment of some investments, partly offset by the mark-to-market changes from our equity investments.

As of June 30, 2024, we continue to maintain a strong net cash position of RMB405.7 billion or US$55.8 billion. Free cash flow decreased by RMB21.7 billion to RMB17.4 billion. This year-over-year decrease mainly reflected the increase in expenditure related to our investments in Alibaba Cloud infrastructure and other working capital changes related to factors, including our planned reduction of direct sales businesses.

Now, let's look at cost trends as a percentage of revenue excluding SBC during this quarter. Cost of revenue ratio decreased 1.1 percentage points. Product development expenses ratio remained relatively stable. Sales and marketing expenses ratio increased 1.7 percentage points year-over-year, primarily due to our increased investments in e-commerce businesses. G&A expenses ratio increased 1.4 percentage points. Excluding the provision of RMB3.1 billion from a one-time shareholder class action lawsuit, our G&A expenses ratio would have remained relatively stable.

Now, let's look at the segment results, starting with Taobao and Tmall Group.

Revenue from Taobao and Tmall Group was RMB113.4 billion, a decrease of 1%. Revenue from our China commerce retail businesses was RMB107.4 billion, a decrease of 2% compared to RMB109.8 billion in the same quarter of 2023.

Customer management revenue increased by 1% year-over-year, primarily due to a high single-digit year-over-year growth in online GMV, partly offset by a decline in take rate. The year-over-year take rate decrease was primarily due to increasing proportion of GMV generated from new models that currently have lower monetization rates.

Direct sales and others revenue under China commerce retail business was RMB27.3 billion, a decrease of 9%. As mentioned, we are proactively scaling down certain direct sales businesses, including those in Taobao and Tmall Group.

China commerce wholesale business revenue increased 16% to RMB6 billion, primarily due to an increase in revenue from value-added services provided to paying members.

Taobao and Tmall Group adjusted EBITA decreased by 1% to RMB48.8 billion, primarily due to the increase in investments in user experience and technology infrastructure, partly offset by the narrowing losses in certain businesses. This increase in investment led to better consumer retention, increased purchase frequency, and positive feedback regarding the overall shopping experience.

Revenue from Cloud Intelligence Group was RMB26.5 billion, an increase of 6%. Overall revenue, excluding Alibaba-consolidated subsidiaries, grew over 6% year over year, driven by double-digit public cloud revenue growth and increasing adoption of AI-related products. AI-related product revenue continued to grow at triple digits year over year.

Cloud's adjusted EBITA increased by 155% to RMB2.3 billion. The increase was primarily due to improving product mix through our focus on public cloud adoption and operating efficiency, partly offset by the increasing investments in customers and technology.

We are observing strong and sustained demand for AI products and solutions from our customers and are making significant investment to address this demand effectively. We believe our investments in AI capabilities and infrastructure will help strengthen our market leadership. We are confident in our ability to balance these investments with steady profitability improvements, ensuring sustainable growth and value creation.

Revenue from International commerce retail business increased by 38% to RMB23.7 billion, primarily driven by order growth from AliExpress' *Choice*, as well as improvements in monetization. Revenue from our International commerce wholesale business increased by 12% to RMB5.6 billion, primarily due to an increase in revenue generated by cross-border-related value-added services.

AIDC's adjusted EBITA was a loss of RMB3.7 billion, an increase of RMB3.3 billion, compared to a loss of RMB420 million in the same quarter last year, primarily due to the increase in investments in AliExpress and Trendyol's cross-border businesses, partly offset by Lazada's significant reduction in operating loss from the improvements in its monetization and operating efficiency.

Revenue from Cainiao Smart Logistics Network Limited was RMB26.8 billion, an increase of 16%, primarily driven by the increase in revenue from cross-border fulfillment solutions. Cainiao's EBITA decreased by 30% to RMB618 million, primarily due to increased investments in cross-border fulfillment solutions, partly offset by improved operating efficiency.

Revenue from Local Service Group was RMB16.2 billion, an increase of 12%, driven by the order growth of both Amap and Ele.me, as well as revenue growth from marketing services. Adjusted EBITA was a loss of RMB386 million, compared to a loss of RMB2 billion in the same quarter last year, primarily due to improving operating efficiency and increasing scale.

Revenue from our Digital Media and Entertainment Group was RMB5.6 billion, an increase of 4%. Adjusted EBITA was a loss of RMB103 million compared to a profit of RMB63 million same quarter last year.

Revenue from All others segment increased 3% to RMB47 billion, primarily due to the increase in revenue from Freshippo, Alibaba Health, and Intelligent Information Platform, partly offset by the decrease in revenue from Lingxi Games and Sun Art. Adjusted EBITA from All others segment was a loss of RMB1.3 billion, compared to a loss of RMB1.7 billion in the same quarter of 2023, primarily due to improved operating results from Sun Art, Freshippo, Alibaba Health, and Lingxi Games, partly offset by the increased investment in technology businesses.

To wrap up, as Eddie and Jiang Fan mentioned:

For our Taobao and Tmall Group, as order and GMV grow, we are advancing monetization efforts step by step. We expect CMR growth to gradually align with GMV growth over the coming quarters.

For Alibaba Cloud, we are pursuing high-quality revenue and effectively executing our integrated cloud plus AI development strategy. We are confident that revenue from external customers will return to double-digit growth in the second half of the fiscal year, with gradual acceleration thereafter.

For AIDC, we focus on proactive investment to drive high-quality growth, enhancing operating efficiency across all business lines.

Our loss-making businesses are improving their monetization and operating efficiency. We expect most of these businesses to break even within one to two years, and gradually contribute to the profitability at scale.

Thank you. That's the end of our prepared remarks. We can open up for Q&A.

Q&A

Rob Lin:

(Original)

Hi, everyone. For today's call, you are welcome to ask questions in Chinese or English. A third-party translator will provide consecutive interpretation for the Q&A session. Please note that the translation is for convenience purpose only. In the case of any discrepancy, our management statement in the original language will prevail. If you are unable to hear the Chinese translation, bilingual transcripts of this call will be available on our website within one week after the meeting.

Ronald Keung (Goldman Sachs):

(Original)

Thank you, Joe, Eddie, Toby, Jiang Fan, and Rob. I want to ask a question about our take rate that with the high single-digit GMV growth and 1% CMR growth, it does imply a wider gap this quarter. But management, you just mentioned about the narrowing gap that should come.

So, how should we think about the take rate trajectory, the time needed for CMR to align with GMV? And could you talk a bit on what are the actual measures that we're doing? Is it software service fee or marketing tech upgrades? How would these new products translate to Taobao and Tmall respective take rates into the next few quarters?

Thank you.

Eddie Wu:

(Translation)

Currently, Taobao and Tmall’s priority is enhancing the user shopping experience to drive increased purchase frequency and GMV growth. With initial market share stabilization this quarter, we’re now accelerating efforts to increase take rate and monetization.

In this regard, there are several key factors to consider:

First, many of our new product formats, such as live streaming and the 10 billion yuan subsidy program, as well as the various new product formats that we’ve invested in heavily this year, have resulted in high user retention and repurchase rates. However, these new products and their monetization for merchants, as well as related revenue-generating features, need some time to be fully implemented. That's what we're looking to do over the coming few quarters.

Second, an important new development is that we are accelerating our new marketing tool, “Quanzhantui”. For this to achieve solid performance, you need more than just the product in place. You need three different things to come together effectively:

1. Effective integration with all user traffic channels within Taobao;
2. On the advertiser side, sufficient adoption across diverse sectors, with enough products supporting the system to generate adequate marketing volume;
3. Optimization of marketing algorithms and user data, which will take about six months or more.

We expect to see significant results and progress within 6-12 months from Quanzhantui’s April launch. However, it will likely take 12 months from that initial launch date for those three elements to gradually come together seamlessly into a fully optimized system.

Now, I'll hand over to Toby to say a few words about the technology service fee.

Toby Xu:

(Translation)

Let me briefly introduce the technology service fee. As you may have seen, we plan to implement a 0.6% technology/software service fee for merchants on Taobao and Xianyu (Idle Fish) starting in September. This fee will be calculated based on merchants' actually received GMV.

This fee level is based on our comprehensive assessment of standard industry practice and merchant feedback. We expect to implement this in September.

In rolling out this fee, we're fully considering the situation of small and medium-sized merchants. For those with annual GMV below a certain threshold, we'll fully refund their annual service fee, or give them a certain allowance, to help them expand their customer base and increase their GMV on the Taobao platform.

We anticipate that this service fee will gradually start contributing to our revenue over the remaining seven months of this fiscal year, following its September implementation.

That covers the introduction to the service fee.

Alicia Yap (Citigroup):

(Original)

Hi. Good evening, management. Thanks for taking my question. I have a question on your AIDC business.

How does management think about the overall competitive landscape now? And how will that evolve over time? What are the competitive advantages of AliExpress for both merchants and consumer that will help you defend your market position in some of the important countries?

And then, as a follow-up, with Lazada seems to be turning profitable starting in July. Is there a timeframe that you target to achieve profitability for AliExpress as well?

Thank you.

Jiang Fan:

(Translation)

In answer to your question, the first thing I would say is that AIDC comprises multiple business lines with different business models. That is different from many other companies that have a single business model. We have different brands in different markets, and we have many experienced, highly local teams operating these platforms. And our business is a combination of cross-border and local operations.

In that context, with local brands in different markets, operated by experienced local teams, we're working on sharpening our supply advantage by better integrating supply from the entire Alibaba Group, especially from China, including supply from Taobao and platforms like 1688.com.

On the consumer side, we have very strong consumer brands and widespread market recognition in many markets.

We're currently upgrading and transforming our business model. For example, AliExpress in the past may have been a relatively low-efficiency model with weaker user experience and service. We're now in the process of transforming this business model.

As for Lazada, yes, in July we achieved adjusted EBITDA profitability for the first time. Moving forward, we will continue to make adjustments based on market conditions, aiming to maintain market share while continuously optimizing our profitability level.

AliExpress is still at a relatively early stage, as it's still transitioning from a platform model to a consignment + platform model and is still in the investment stage. We're continuously optimizing its operations, as evidenced by the improvements in AE *Choice's* UE (Unit Economics) over the past quarter. In the coming quarters, we'll continue to optimize our efficiency while pursuing healthier growth.

Thomas Chong (Jefferies):

(Original)

Hi. Good evening. Thanks, management, for taking my question.

My first question is about Stock Connect. Can management comment on our thoughts about the status of a dual primary listing and the chance of going into Stock Connect?

And my second question is about our cloud business. Given that we are expecting the external cloud revenue back to double-digit growth in the second half of fiscal year and accelerate going forward, I just want to get some color with regard to our AI revenue contribution. What's the goal that we are looking for in the long run coming from AI?

Thank you.

Toby Xu:

(Original)

OK. Thomas, thank you for your question. I will take the first one, and then Eddie will answer the second question.

Regarding your question about the Stock Connect, I guess your question is about the primary conversion at our end.

Currently, we are actively pursuing Hong Kong primary listing. We will have an AGM on the 22nd of August. So we have proposals that are subject to shareholders' approval, and then we are aiming to complete the conversion process after we obtain approval from the shareholders and get it completed before the end of August.

Then join the Stock Connect, it will still be subject to different exchanges sort of like process. So that's, what we understand, is there is a procedure to go through.

So that's the update on the status.

Eddie Wu:

(Translation)

Let me take the second question about cloud.

We are indeed seeing very strong demand from our cloud customers for AI-related products. From our perspective on the customer pipeline, we're still far from meeting their demands. So, we expect that revenue from external customers will reach double-digit growth in the second half of the fiscal year. That's a pretty clear-cut projection.

Regarding the revenue contribution from AI-related products, from the data we're seeing, most of the growth - the larger part of the growth rate - is AI-related product growth. This is partly because, across the industry as a whole, the growth of the traditional cloud computing market centered on CPUs is now quite limited. The bulk of new IT demand from customers is primarily focused on GPU-based AI-related products.

So, more than half of our growth momentum is driven by the revenue growth of our AI-related products.

Ellie Jiang (Macquarie):

(Original)

Thank you so much, management, for taking my question.

Just first of all, a quick follow-up on the prior cloud question. Obviously, we are already showing some early indicators of the positive momentum, and the management shared about the strong demand on AI. Given the current macro conditions and softened enterprise demand into the second half, can you comment on kind of the mix impact, especially in the next several quarters?

And then also, the second question is on the Taobao and Tmall GMV reacceleration. So we're encouraged to see our overall GMV momentum catching up. And actually, for the second quarter, we already caught up to industry pace reported by NBS.

Wondering, can management comment on the key drivers behind the GMV reacceleration? And anything you can talk on the return rate that we've seen across the ecosystem?

Thank you.

Eddie Wu:

(Translation)

Let me first address the question about cloud.

Your question referred to a slowdown in enterprise demand under current macroeconomic conditions. However, what we're actually observing is that most enterprises, especially our cloud customers, have significantly increased their AI investment budgets this year compared to last year. For most digitally-driven enterprises, AI investment is crucial. This is because industries across the board are leveraging AI to enhance their product capabilities and improve operational efficiency.

We believe that, in our observation, industries and enterprises that rely heavily on digitalization are unlikely to reduce their investments in this area. The reason is simple: falling behind in AI investments could lead to a competitive disadvantage in terms of product capabilities within the industry. Consequently, we're seeing robust demand in this sector, with no signs of a downward trend. We believe this represents an important new industry trend.

Regarding your second question about the recovery in Taobao and Tmall's GMV growth rate, this fundamentally comes down to our business strategy for these platforms. As we've shared previously, our most crucial investments are in creating a user experience centered on "quality products and services, at attractive prices". These are the core elements of user experience in e-commerce.

What's unique about the Taobao and Tmall platform is our extremely rich and diverse product assortment, and our highly diverse consumer base. Consequently, our proposition of "quality products and services, at attractive prices" needs to be tailored to different tiers of consumer demand. So we segment consumer demand into various levels, catering to each with different product supplies, service experiences, and product formats or capabilities, ensuring all consumer segments are well served.

So, in essence, while it all fundamentally revolves around "quality goods and services, at attractive prices", Taobao and Tmall provide differentiated experiences across these three dimensions for different consumer segments. Underpinning these differentiated experiences is our continuous optimization of supply chains to enhance product quality, price competitiveness, and service levels.

Toby Xu:

(Translation)

Let me address your second question regarding return rates.

Firstly, return rates are increasing across the entire Chinese e-commerce industry, including for us and all other e-commerce platforms. Currently, our return rate is slightly lower than the industry average. That is our first observation.

Secondly, we believe that the return experience is a crucial part of the overall consumer experience and an important factor in retaining customers. Therefore, when we see improvements in consumer retention rates, purchase frequency, and shopping experience feedback alongside enhancements in the return experience, we consider this to be healthy.

In particular, we've observed continuous improvement this year in our Net Promoter Scores (NPS), especially among mid- to high-end users. This reflects increased satisfaction with after-sales service, including the convenience of returns.

Given that our return rate is slightly below the industry average, we're not particularly concerned that the increase in return rates will negatively affect merchants' willingness to do business on our platform.

Gary Yu (Morgan Stanley):

(Original)

Hi. Good evening. Thank you for the opportunity to ask questions.

My question is regarding management comment about some of these loss-making businesses aiming to reach breakeven in the next one to two years.

Could management share more detail in terms of individual segments including Local Services, AIDC, as well as most of the retail businesses under the All others segment? How should we look at the timing of kind of breakeven target in the next one to two years individually?

Thank you.

Toby Xu:

(Original)

Thank you, Gary. I'll take that question.

I think what Eddie and I was explaining is that, except for the core businesses we mentioned previously, including Taobao Tmall, Cloud and AIDC, all the other businesses, some of those businesses are still loss-making at this stage and they will be ramping up their efficiency and monetization and reduce their losses significantly in the next year or so, one or two years, and to reach breakeven. And then afterwards, they will sort of like start to deliver a scalable profitability going forward.

How we are going to achieve that, as I was explaining, what we want those businesses do, they need to, on one hand, care about the efficiency of the investment they are making, balance the scale and efficiency, which is very important. Secondly, on one hand that they are making investment, they also need to care more about monetization. So it's critical the enhanced monetization rate, using their business model.

So with both more income and higher efficiency in the spending, they are moving toward breakeven and profitability.

We can clearly see, during my prepared remarks, I used two examples. One is Local Services, and the other one is Lazada. I think Jiang Fan explained about Lazada.

For Local Services, I think it's all about, on one hand, you need to increase the scale, i.e., you need to increase the orders. On the other hand, you need to improve unit economics. For example, in Ele.me’s case, it's all about delivery business and improve the unit economics continuously. And then in Amap, I think it's all about, for example, the ride-hailing businesses, per order unit economics need to improve.

So with both scale and efficiency improve, we are able to reducing the losses very significantly and moving toward the profitability.

So I think this is pretty much how these businesses will execute and move towards profitability.

Jiong Shao (Barclays)

(Original)

Thank you very much for taking my question.

My question is about the gap between CMR and GMV. It's great you achieved high single-digit for GMV growth this quarter. The gap between the two appears to be high single digit as well.

Is that a high water mark going forward? Especially you recently launched the “Quanzhantui” and especially when you start to charge a technology service fee starting in September? Any comments would be great.

And related to that, I think Toby talked about 0.6% of GMV for the technology fees, but some of the smaller merchants, you are going to waive that. I was wondering, is that a net number in terms of percentage of GMV you think the technology service fees will bring to CMR? Any clarification would be great.

Thank you.

Toby Xu:

(Original)

Thank you for the question. I'll take that.

I think as previously said by Eddie, also in my prepared remarks, I think the gap between online GMV and CMR reflect the drop of the take rate.

Why the take rate dropped? Because currently, some of the new models with a very high growth in GMV currently still have relatively low monetization, which will be ramping up in the next few quarters. So that's why there's still a gap.

As we also said, in the next few quarters, CMR growth will be at the same pace with GMV, which means take rate will start to get relatively stabilized. So that's what we're expecting.

And Eddie explained why GMV was currently growing faster than the take rate. The reason is because by executing our strategy, we first need to invest in the consumers, get higher purchase frequency from the consumers, then get the GMV growth. And as soon as we start to observe the GMV back to growth and then the market share stabilizing, we will gradually ramp up the monetization pace.

A few things we're doing. Eddie explained "Quanzhantui", which is currently being rolled out. The penetration into traffic will take a number of quarters. So that will certainly improve the take rate, which means we will accelerate CMR growth. And secondly, with this software service fee charge will also help on the take rate. A few other measures as well.

So these are all the things currently we are doing. Why we started to do it? Because we see the growth back on the GMV, and we see the sign of stabilizing market share.

And then your question about how it is calculated for this 0.6% charge. So it's charged on the completed GMV. However, we will refund back to some of the small and medium merchants if their annual GMV is below certain threshold.

Kenneth Fong (UBS):

(Original)

Good evening, management. Thanks for taking my question.

I have one question maybe on the financial figures.

One is on the tax rate. I noticed that the taxrate is quite high for the current quarter. Can management explain what's the rationale behind, and how should we model the tax expense going forward?

And the other thing is about the decline in our free cash flow. I understand that it is related to our investment on AI / Cloud, as well as some one-off expenses with free cash flow on the planned reduction on direct sales business.

Should we expect that to gradually normalize in the next one or two quarters, especially for the direct sales business part?

Thank you.

Toby Xu:

(Original)

Thank you, Kenneth. I'll take this question.

Your first question is about tax rate. Because if you're using our P&L's tax divided by profit, you normally cannot reach the real effective tax rate because we do have a lot of permanent difference, one-off items, which does not have tax implication there.

We are monitoring on an adjusted basis on the tax rate, which is relatively stable in this quarter compared with last quarter.

So in terms of your model, I guess, probably our team can look into your model and communicate offline. So this is your first question.

Your second question is about free cash flow. As I explained, there is quite a big significant drop of free cash flow. One of the reason is the significant increase in expenditure on the AI infrastructure investments,. And the other reason, as I said, is because of the working capital changes in relation to some of the business scale drops.

For these business scale drops, a majority of them are from those planned scale down. As I was explaining why our direct sales business within Taobao and Tmall dropped quite significantly, the reason is we proactively scaled down some of these 1P businesses in Taobao and Tmall. The reason is that we believe in some of these business or categories, 1P format probably is not a more efficient format. So that's the practice.

But you will also have some of the businesses, scale drop was not because we proactively did that. Some of it was just the overall market situation. For example, as I said, the revenue dropped from, for example, like Sun Art, like Intime, all those businesses are in 1P. And the drop of their scale actually impacts the working capital.

Probably I can give a little bit more color. Because for doing 1P business, on one hand, you are buying inventory from vendor. On the other hand, you sell it and that the vendors normally give you a credit term like 60 days or 90 days. If you can make your inventory turnover, i.e., sell inventory within a short period of time, shorter than the credit term you've given, actually, you are generating cash flow.

Particularly if the size is going up, you are generating positive cash flow. So on the contrary, if you're reducing the scale, it will have outflow on the working capital. But is this a permanent impact? To me, I think that this is a relatively temporary impact. During the process of reducing the scale, we will see this outflow.

But when the business size became stable, we will no longer see these types of outflows.

James Lee (Mizuho):

(Original)

Great. Thanks for taking my question here.

My question is related to AI, more big-picture question for you guys. Can you talk about maybe implication of open-source large language model, how that impact the adoption of AI in China?

And also, how should we think about large language model as that transition into agents? And how do we think the use cases may change for your merchants and customers?

Thank you.

Eddie Wu:

(Translation)

That's an excellent question. Let me address it.

On your first point about open-source vs. closed-source in generative AI, different companies have been taking different approaches. At Alibaba Cloud, given our focus on providing cloud infrastructure, offering a world-class open-source model makes a lot of sense. It's highly beneficial for developers both in China and globally, as most of them want greater control over the model and more room for fine-tuning.

So to an extent, we believe that open-source models have a distinct advantage when it comes to widespread adoption by developers. This aligns well with our business model as an AI infrastructure provider. When developers use our open-source model, they're more likely to choose Alibaba Cloud's AI products when launching their applications. So this is in line with our business strategy.

We're seeing a clear trend of companies and developers prioritizing open-source models, especially in China where applications often require stronger controllability. While I can't provide hard data on how many developers have chosen our AI services because of our open-source model, we believe we're uniquely positioned in the Chinese market as the only vendor offering both open-source models and AI cloud services. These two strategies complement each other perfectly.

Your second question is more complex and forward-looking, given its broad scope.

Looking ahead, we expect large language models to become increasingly powerful. They'll use more diverse, multimodal data and grow in parameter scale, expanding their capabilities. However, for solving complex problems, we're seeing a trend towards using agents, particularly for intricate reasoning tasks. These agents might call upon different models to work through complex reasoning processes. This trend is quite evident.

While many developers are currently working on such agents, I personally believe that in the future, sufficiently advanced large models may be able to generate these agents more automatically.

Youssef Squali (Truist Securities):

(Original)

Thank you. It's Youssef Squali from Truist. So just on the follow-up on the AI question. One, if I look at your CapEx, it's more than doubled year on year in Q1.

Number one, is that a good run rate to work off for the rest of the year?

And number two, as you look at the return on those investments, can you help us just understand your framework of reference. One of the key questions we often get here, at least in the U.S., is the ROI associated with the AI and kind of the timeline or the time or framework around which you expect these investments to start bearing fruit, and maybe give us examples of where you're seeing early green shoots.

Thank you.

Toby Xu:

(Original)

I will take the first question, and Eddie will answer the second question.

I think with respect to the CapEx, just like as you have observed from our reporting, increased very significantly. I think the reason is because we see clearly very strong demand and the backlog. That's why we are investing.

We would expect in the next few quarters, we would expect a similar level of investments in CapEx going forward.

Eddie Wu:

(Translation)

Let me address the latter part of your question.

As Toby mentioned, we will maintain our current pace of AI CapEx investment over the next few quarters. This is because we're seeing very strong customer demand, and our customer pipeline is far from being satisfied. We're experiencing rapid growth in demand for our AI offerings, including training, inference, and API calls for Qwen.

What we are seeing internally is that once we deploy these CapEx investments in the form of new servers, they are almost immediately fully utilized by our customers. We expect very significant returns on these investments in the coming quarters. The amount of idle capacity is minimal. Most of our computing power starts generating revenue as soon as it's deployed and typically operates at near-full capacity.

Robert Lin:

(Original)

Thank you everyone for joining. We'll see you next quarter.

[END OF TRANSCRIPT]