“We envision that our customers will meet, work and live at Alibaba, and that we will be a company that lasts at least 102 years.”

Unless you live under a rock deep in a cave somewhere on Pitcairn Island you probably know Alibaba Group Holding just filed its F-1 Registration Statement with the SEC last week for a much hyped and much anticipated IPO. Coming late summer, the deal will be underwritten by CS, DB, GS, JPM, MS and Citi. Having read the full registration statement of 345 pages (twice), I have come to the conclusion Alibaba is a powerful story and the IPO will be in much demand.

The deal, however, is not without hair as on the other side of almost every transaction investors will find founder and Executive Chairman Jack Ma. We will examine these concerns closely.

Not JD.com

We wrote extensively on JD.com a few weeks ago (Emerging Markets Illustrated: Three Kingdoms) and view that company very positively. JD lists next week on Nasdaq and the book was already covered after just the second day of marketing in the US. JD.com is a much different story than much bigger Alibaba and is being pitched to investors as “China’s Amazon.” Much like Amazon (AMZN) in the early days, JD is a long way from turning a profit. This makes JD very different from Alibaba which earned $2.8 bn in net income in the nine months ended December 31, 2013. Even with no earnings in sight, JD is still being priced at the high end of its range, using a price to sales ratio of close to 1 times. Amazon trades at 1.9 times.
I like JD.com long term and its $1.9 bn IPO should do well. By investing now in a solid delivery system, the company will control the entire customer experience from soup to nuts. Alibaba, run by its quirky founder, has a very different strategy.

**The Company**

Alibaba is the largest online and mobile commerce company in the world in terms of GMV (gross merchandise volume) and is growing at virtually an unprecedented rate: we are still riding the J-curve here. GMV for 2013 was US$248 bn, derived from 231 mn active buyers and 8 mn active sellers. Revenue from the China retail business (the heart of the story) jumped 101% FY 2013 over FY 2012 to US$4.3 bn. This was due to a 62% increase in GMV over the same period.

Alibaba is also more and more a mobile e-commerce story as 19.7% of GMV last year came from buyers using smartphones, almost triple the 7.4% level of 2012.

This makes Alibaba the leader in mobile commerce in China. Using GMV, mobile transactions on Alibaba sites accounted for 76% of total mobile retail GMV (excluding virtual items) for the entire country.

“Our business model enables us to avoid the costs, risks and capital requirements associated with sourcing merchandise or holding inventory.”

Alibaba is an “asset light” business model as, unlike Amazon and JD.com, the company does not carry inventory. This means Alibaba does not compete with their customers – a characteristic of Amazon that irritates all who sell goods on that platform. By enjoying zero inventory risk, the company requires less working capital to sustain and grow the business. Alibaba is, however, investing more and more in logistics via an affiliate which may be a concern down the road.

Alibaba’s main attractive assets are Taobao Marketplace, “China’s largest online shopping destination,” and Tmall, China’s largest third-party platform for brands and retailers with over 100,000 brands represented.
(“Taobao” in Chinese means, by the way, to “pan for treasure” as a gold miner would pan for gold with the character “tao,” representing “to wash” and “bao,” meaning “treasure.” In another aside, traditional Chinese ages ago used to employ family terms of endearment for their children that were somewhat disparaging, like “cat puke,” or “dog widdle.” Nowadays family nicknames for children often employ a somewhat softer approach using words such as “bao,” much to the relief of younger citizens).

**It’s the ecosystem**

In analyzing Alibaba it probably helps to recognize this is not just one corporate entity but what management takes great pains to call “the ecosystem.” Management is 28 partners and the partnership (which we will comment more on in a moment) sees itself as “stewards of the ecosystem.” The ecosystem can be divided into two parts: retail, accounting for 83% of revenue (important, very important) and wholesale (no growth, not important). The main silicon-based life forms inhabiting this ecosystem are:
Intriguingly, Taobao also operates a “model marketplace” that lists 40,000 different fashion models; some hot, some lukewarm. The idea is to “consolidate search in the fragmented modeling industry” and one can kill a few minutes looking through them [here](#).

**Secular Tailwinds**

It is well known that China has the world’s largest internet “population” with over 600 mn users and, according to the [China Internet Network Information Center](http://cnnic.cn), only half of those, or 302 mn, are online consumers. This is a much lower portion than in developed countries. In the US the ratio is 74% and in Japan it stands at 56%. China also has the world’s largest mobile internet user base which now encompasses over 500 mn people. These two factors are combining creating a powerful new market which Alibaba is successfully addressing.
Shopping in China is a nightmare, to which I can attest from personal experience (although I find shopping tedious even on rare occasions when in a good mood). The impossibility of an enjoyable retail experience in China has, as ever, to do with severely underdeveloped physical infrastructure, poor product selection, lousy service and worse quality. Added to that, much of what is on display clamoring for that dirty wad of wrinkled, virus-laden Renminbi in your pocket are just “fugazi,” as the Godfather would say. Fakes. It is no surprise that online shopping with customer review-driven accountability is striking a chord with local consumers.

In 2013, real consumption in China was only 36.5% of GDP vs. 67% for the US and 59.4% for Japan, according to Euromonitor International. Consumption as a percentage of GDP will grow as China modernizes. Online shopping represented just 8% of total China consumption in 2013 and local internet research firm iResearch estimates that number will enjoy a 27% CAGR from 2013 – 2016.

Alibaba’s 231 mn active buyers seem to agree: in 2013 the average active buyer on Alibaba’s China retail marketplaces made 49 purchases, up 25% from 39 orders in 2012. Those active buyers are clearly telling their friends as the number of active consumers shopping on Alibaba’s marketplaces grew 44% last year from the year before. The secular tailwinds are blowing pretty strong.

The Partnership and Nine Million Nerds

Legend has it Alibaba.com was formed in Jack Ma’s Hangzhou apartment in 1999 when China’s internet population was just 9 million nerds. The company is still governed by some of the original founders, all of whom belong to the Alibaba Partnership. The partnership currently has 28 members, comprised of 22 members from management and 6 from related companies and affiliates. Collectively they hold approximately 14% of the ordinary shares with Jack Ma, the largest individual owner, personally holding 8.9%. (Softbank [9984 JP] and Yahoo [YHOO US] hold 34.4% and 22.6% respectively, pre-IPO).

Interestingly, this is not a staid group as membership to the partnership “rejuvenates itself” each year as
new partners are elected. A new partner must receive 75% of all votes from existing partners and have been a loyal employee for at least five years.

Why should we care? The Alibaba Partnership will have, post-IPO, the exclusive right to nominate for shareholder approval a simple majority of the members of the board of directors. Major shareholder, Softbank, will have the right to nominate one director to the board and will agree to grant the voting power of any portion of its shareholdings that exceed 30% to a voting trust at the direction of Jack Ma and Joe Tsai.

Oy VIE...

Due to regulatory hurdles in China that must be leaped via devious paperwork schemes, Alibaba operates via Variable Interest Entities. As a shareholder in most VIEs – but not this one - you do not “own” the economic assets but rather the Wholly-foreign Owned Enterprise which contractually receives economic benefit from those assets.

“Alibaba sets the gold standard for best VIE.” – Professor Paul Gillis

Interestingly, most of the assets of the Alibaba ‘ecosystem’ are in the WOFEs, not the VIEs. It is the WOFEs that are the parts of the business which are listing so this provides greater protection for shareholders. I calculate 11% of revenue and 17% of assets are in the Alibaba VIEs with no net income derived from them. (JD.com, for comparison purposes has comparatively more assets in its VIEs, but only 2.9% of net revenue is derived from these structures).

Under PRC law, VIEs are required to annually appropriate 10% of their net income to a statutory reserve until such reserves reach 50% of registered capital. Those assets are prohibited from being transferred to Alibaba in the form of dividends and now total in excess of $3 bn: a sizeable sum.

The necessary licenses to operate the entire business are majority-owned by Jack Ma and minority-owned by Simon Xie, a founder and existing partner. While it may be viewed by some as a related party transaction, this arrangement is common to all Chinese VIEs.

The final problem concerning Chinese VIE structures remains the fact the SEC has filed suit to prohibit Chinese subsidiaries of the large accounting firms from conducting audits. No approved audit means no US trading and eventual delisting. This issue is contentious and remains unresolved.

As a Cayman-registered entity and a foreign private issuer, Alibaba is not required to have a majority of the board be independent. Check. No plans to do that anyway. This means there are no independent directors whatsoever to sit on the compensation committee or the audit committee. Alibaba is also not
required to hold annual general shareholders meetings but promise that, unlike Baidu (BIDU US) for example, they will do so.

**Strong Operating Metrics**

Alibaba’s year end is March 31. The latest financial data we have (unaudited but prepared in accordance with US GAAP) is for the nine month period ending December 31, 2013. Revenue for that period was US$6.5 bn, of which China commerce was $5.6 bn, or 87%. The rest came from international commerce, cloud computing and “others.”

Net income for the period reached $2.6 bn, giving Alibaba net income margins of 44% - *forty thieves indeed*. Amazon, with its capex-heavy business model, eked out net margins of 0.4% and JD.com currently loses money.

The asset-light model means Alibaba does not spend much on capex and so generated $4.8 bn in free cash flow over the nine month period ending December 31, 2013. For comparison, Amazon generated $2 bn of free cash flow for calendar year 2013, and cash flow per share (their preferred metric) is falling. Amazon also spent $3.4 bn in capex last year and $3.8 bn in 2012. Investors have punished the stock, which is down 26% ytd, as surging operating costs (up 20%) caused the company to miss Q4 estimates. With a completely different business model, Alibaba has not yet needed to invest as heavily.
Significant operating leverage

Aside from building an unassailable moat and deriving monopolistic market share in the world’s largest internet community, Alibaba has demonstrated incredible operating leverage.

Cost of revenue for the year ended March 31, 2013 increased 48% y-y to US$1.5 bn - yet operating income more than doubled to US$1.7 bn over the same period of 2012. For the nine months ending December 31, 2013, operating income almost doubled AGAIN to US$3.1 bn while cost of revenue increased slightly to US$1.6 bn. In other words, the company is growing its income faster than expenses as margins expand.
Indeed, cost of revenue as a percentage of revenue continues to fall from 33% in FY 2012, to 28% in FY 2013 and again lower to 24.5% in the nine months ended December 31, 2013. Sales and marketing expenses have almost halved as a percentage of revenue over the same period. Net income has surged from 23% of revenue to 43.8%. It is no exaggeration to say Alibaba has a license to print money.

Their highly scalable business model meant that net income increased 85% to US$1.4 bn in FY 2013. This number would be even higher if it were not for the one-time Yahoo TIPLA payoff (Technology and IP Licensing Agreement) of US$550 mn.
Searches for purchases - a threat to Baidu

Alibaba primarily generates revenue from online marketing services. These services include sellers paying marketing fees to acquire user traffic as well as commissions based on GMV for transactions settled through Alipay. Much like Google, the pricing for marketing services is based on a bidding system with merchants competing against each other for favorable placement and search links. Sellers utilize what the company calls “P4P,” or “pay-for-performance” and bid for keywords that match product or service listings based on a cost-per-click model. In N. America and Europe if you type in “bunny slippers” the link to Amazon is likely at the top of the Google page, with Alibaba’s system buyers do not have to use Baidu for search at all. Given Alibaba is almost a monopoly in online commerce in China and a great deal of searches are for purchases, this poses a definite threat to Baidu’s revenue model.

Online merchants also bid for display positions on the relevant marketplaces. The company furthermore earns placement fees for promotional slots on the group buying site Juhuasuan for specified periods. Storefront fees are also received which include software tools that assist sellers in upgrading and managing their storefronts.

The wholesale part of the ecosystem is much less exciting, accounting for just 4.2% of total revenue. Recently privatized Alibaba.com saw flat “growth” over the year and along with 1688.com earns revenue primarily through membership fees, value-added services and online marketing services.

Tmall GMV is a profitability metric

While Taobao hogs the spotlight and garners over 100 mn visitors every day, Tmall is more profitable. Merchants on Tmall pay marketing service fees in addition to commissions based on GMV which makes per unit GMV more profitable on Tmall than Taobao. The monetization metric to watch going forward will be the ratio of Tmall GMV to Taobao GMV: if it increases profitability will rise as well.
While it would be nice to have more information, or granularity, on ratios and just which services the majority of profit comes from, we aren’t going to get it. This is it. Analysts may complain about such egregious lack of detail but Amazon demonstrates similar behavior in its results as well.

My concerns

As we wrote a few weeks ago about China’s current internet “land grab,” the team at Alibaba are in deal frenzy mode and have been spending money like drunken sailors. According to BBG, Chinese internet companies, led by Alibaba and Tencent (700 HK), have announced 61 acquisitions and investments with a value of $24.5 bn since 2012. Below are some of the acquisitions Alibaba has been spending cash on this year alone – notice the compressed time period for the nine different deals and US$5.7 bn committed:

**February 2014**
- Submitted bid to acquire AutoNavi (AMAP US) for US$1.1 bn

**March 2014**
- $200 mn invested in TangoMe
- $692 mn for 26% equity stake in Intime Retail (1833 HK)
- $806 mn for 60% equity stake in ChinaVision Media (1060 HK)
- $364 mn investment in Haier Electronics (1169 HK)

**April 2014**
- $449 mn to increase equity stake in Weibo (WB US) to 30%
- $1 bn to acquire equity stake of 16.5% in Youku Tudou (YOKU US)
- $120 mn to acquire 38% equity stake in CITIC 21 (241 HK)
Loan $1 bn to partner Simon Xie to invest in Wasu Media Holding (000156 CH)

With operating income in the nine months ended December 31, 2012 of $3.1 bn, the $5.7 bn spent in just three months’ time on wild, unrestrained deals is something potential shareholders will want to better understand. This huge sum is in addition to $1.9 bn spent in the nine months ended December 31, 2013 for “strategic purposes” (AutoNavi, Weibo and UCWeb). The company had US$6.7 bn in cash and cash equivalents and another $1.1 bn in short-term investments December 31, 2013. The last $3 bn of an $8bn credit facility was drawn down in April. This seemingly impulsive shopping spree, needless to say, is another area of concern.

Alipay: the circle of trust

In 2010 I was astonished when Jack Ma ripped Alipay away from shareholders Softbank and Yahoo without their prior knowledge or approval for “restructuring.” I was told by my then internet analyst this was in fact a “good move.” I wholeheartedly agreed with him; it was a good move for Jack Ma. Having seen this investors need to ask themselves the big question that I believe hangs over Alibaba: will Jack Ma suddenly make another “good move” that may or may not be in the best interest of shareholders? He has plenty of freedom to do so and very few restrictions.

Alipay is a related company in which Alibaba holds no direct equity stake. Alipay provides payment processing and escrow services “that are critical to our platform” and has become the largest online third-party payment services provider in China. One of the problems in China and a huge impediment to the development of online commerce is the lack of trust: nobody trusts anyone. Jack Ma was able to cleverly overcome this by offering an escrow service to buyers and sellers in China whereby funds are held by Alipay until products are confirmed by the buyer to have been received in good order.

Furthermore, due to the recent explosion of online commerce and online financial products the PBOC is in the process of revising and updating regulations concerning the sector. Some of the new measures being discussed may restrict the amount individuals can spend in a single transaction online with third-party payment providers – such as Alipay – to purchases less than Rmb 5,000. Even more ridiculous is the provision that prohibits more than Rmb 10,000 in aggregate purchases per month per consumer. If Beijing is interested in keeping China “poor and blank,” to use a favorite phrase of Chairman Mao, this is a good way to do that. Promulgated as drafted, such measures would be a direct threat to Alibaba and
to the explosive growth witnessed so far in the online industry. More likely, the goal of regulators here is to limit online commerce financial transactions to credit cards and banks – which the government conveniently controls.

Under the “Alipay Commercial Agreement,” Alibaba pays fees for payment processing services. These fees amounted to $265 mn FY 2012 and $305 mn in the nine months ended December 31, 2013. Alipay, on the other hand, pays Alibaba royalties every year for various software technology services of $45 mn in FY 2012 and $102 mn for the nine months ended December 2013, which are found under “Other Income.” Almost 79% of GMV for Alibaba was settled through Alipay. This is a weakness given Alibaba has no longer has direct control or a stake in the company, Jack Ma does.

There are plans to list Alipay before 2017. When this happens, Alibaba will receive a payment between $2 bn and $6 bn depending on listing valuation. The agreement caps any shareholder upside for what may prove to be a very popular listing. Jack Ma has no upside cap.

**Micro lender too?**

Another thing that worries me is the micro lending business Alibaba is involved in. The company makes short-term loans to their merchants of seven to 360 days and recorded $1.3 bn in loan receivables from this SME business. Funds are borrowed from third-party financial institutions and some of these loans appear to be sold back to such institutions. As Alibaba is still required to absorb an unspecified portion of the losses in the event of a default, these loan receivables do not meet the requirements for asset derecognition.

Micro lending is a grey area for potential shareholders who will want to know: just how much exposure the company has to this financing risk and how much capital do they intend to employ here? Licensing for the loan activity is granted at the provincial government level meaning rule changes recently mooted by regulators in Beijing may have little impact.
Cainiao threat

Alibaba also has a 48% owned affiliate, Zhejiang Cainiao Supply Chain Management Co., Ltd., or China Smart Logistics. The affiliate is a joint venture formed in 2013 “with five major express delivery companies in China...as well as firms specializing in real estate development” (Intime Retail). Jack Ma has been quoted as saying he wants to make Cainiao into the logistics and delivery backbone across the country so a package can be delivered anywhere in China in 24 hours. To achieve this Jack intends to invest $16 bn over the next 5-8 years. Will Alibaba shareholders be required to pony up the $2 to $3 bn each year to make this happen? This certainly moves Alibaba far away from its current and attractive asset-light business model. We want to know more.

In short, Jack and team have built a fantastic monopoly business in the right place at the right time. The Alibaba IPO, I believe, will be red hot. Before chasing the stock in the after-market however, investors should take a cold shower and remember the corporate governance issues that come with the house that Jack built.

The Last Page
An equity salesperson is said to be someone who knows very little about a great deal and keeps knowing less and less about more and more until he knows practically nothing about everything, whereas an equity analyst is a person who knows a great deal about very little and who goes along knowing more and more about less and less until finally he knows practically everything about nothing.

Cheers.

Derek Hillen, CAIA

Mirae Asset Securities