Alibaba and the new banking paradigm

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Points of focus

The landscape:

- What is behind the growth in e-commerce?
- The nature of financial transactions in e-commerce
- Other types of online finance
- What does it mean for banking?

Alibaba and Tencent:

- What makes them so big?
- How do product companies interact with them?
- What might Chinese e-commerce look like in five years?

Sizing e-commerce

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The e-commerce puzzle

- Weak consumption trends at mid-2014
- Some conundrums
- The conversion theory
- A lot of faking

What is happening with consumption?

- ***Consumption is probably falling in absolute terms:*** Most categories seem to be declining despite NBS data that shows 11-13% consumption growth.

- ***Salespeople and distributors are very pessimistic:*** Interviews suggest little hope for an upturn in the foreseeable future.

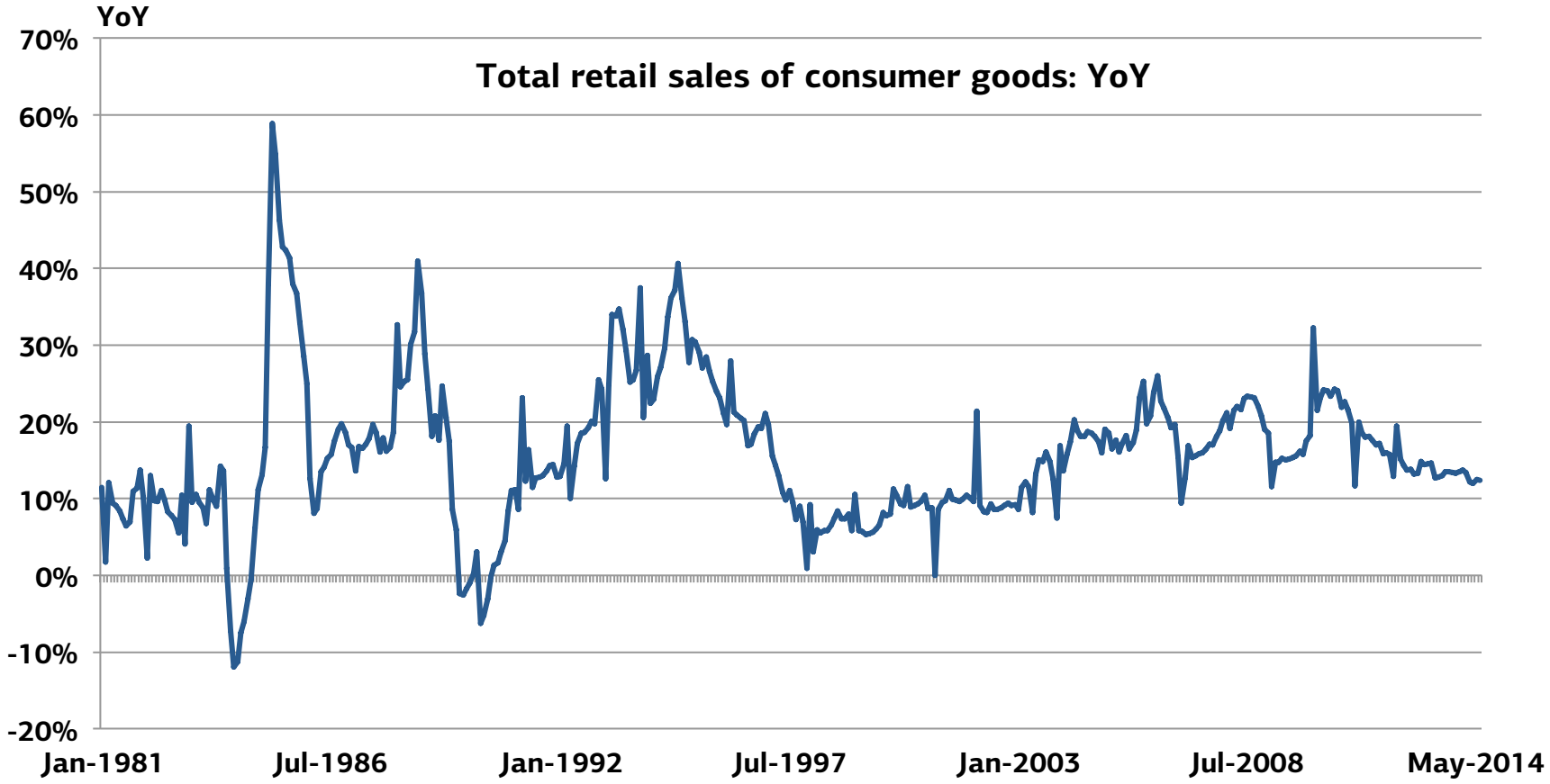
- ***Growth is declining fast in the categories that are still positive:*** Autos seem likely to flatten in H2 and then decline

- ***Worst-off regions:*** Companies are struggling most in the Northeast, especially Heilongjiang and Liaoning, the coal-mining regions of Shanxi and Inner Mongolia, and the Yangtze River Delta areas in Zhejiang and Jiangsu.

- ***Bright spots:*** Share gain by strong brands, international competitors in consumer staples

The difficulties with data

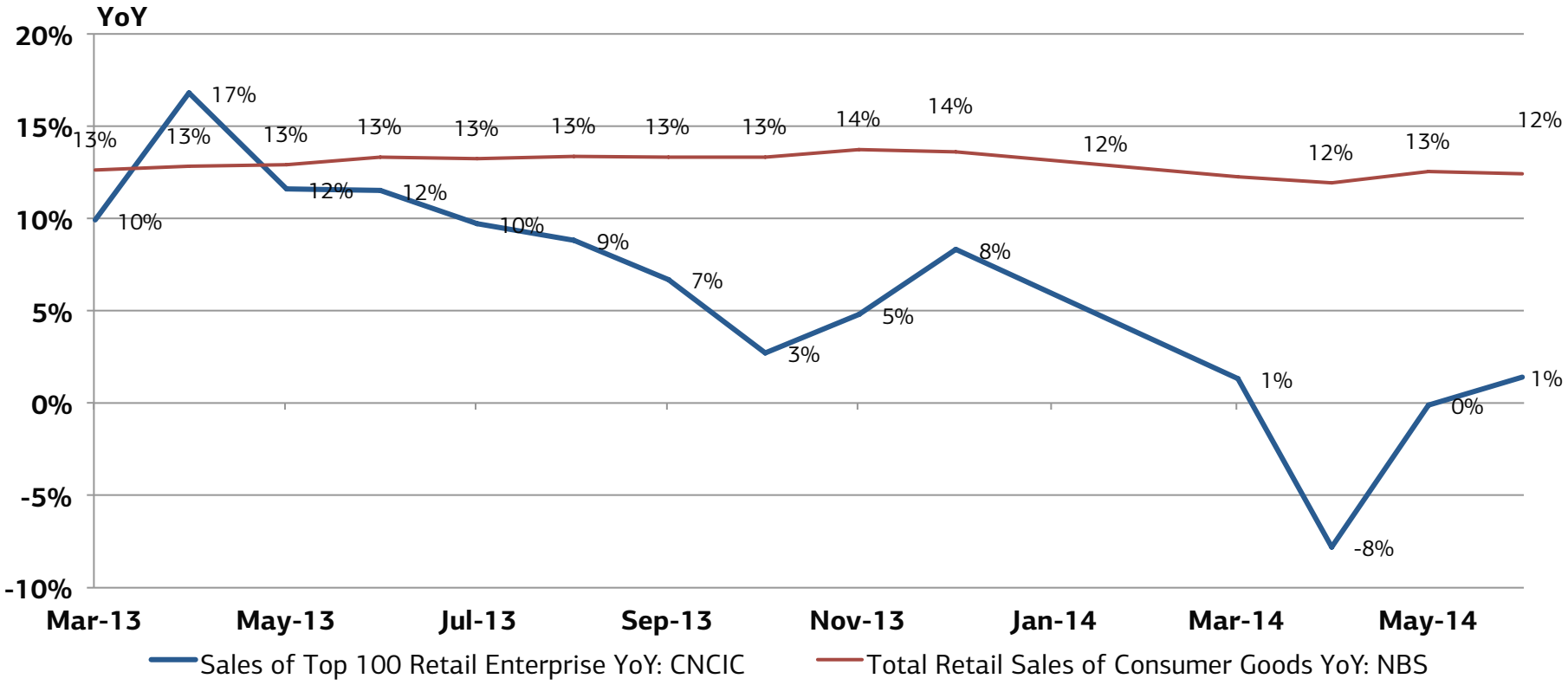
- The National Bureau of Statistics consistently shows growth of 11-13% YoY in retail sales. But those numbers are not supported by other evidence.



Source: NBS

The NBS data differ significantly from other government sources.

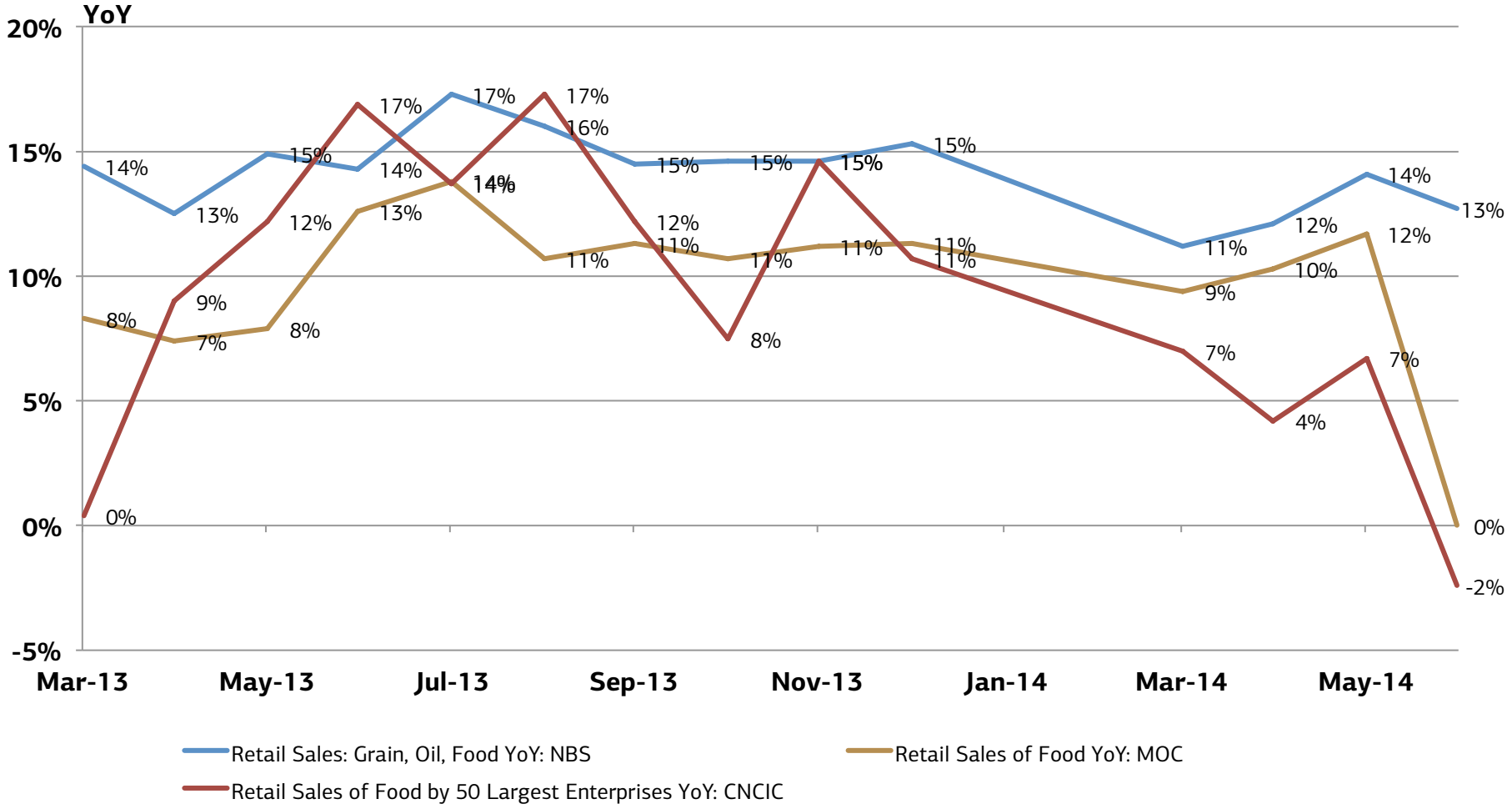
NBS vs. CNCIC data on retail 2013-June 2014



Source: NBS, CNCIC

The China National Commercial Information Center (CNCIC) was formerly the statistics department of the Ministry of Internal Trade and continues to gather statistics on the retail sector, which comes under this agency's governance.

Other government data series on food retailing show lower growth and more volatility than the NBS.



Note: we have eliminated January data from the CNCIC series because the month is not consistently broken out of the series and has no comparable number in the other data sets. That month showed 27% growth in 2014 and negative 15% growth in 2013,

Sources: Ministry of Commerce, NBS, and CNCIC

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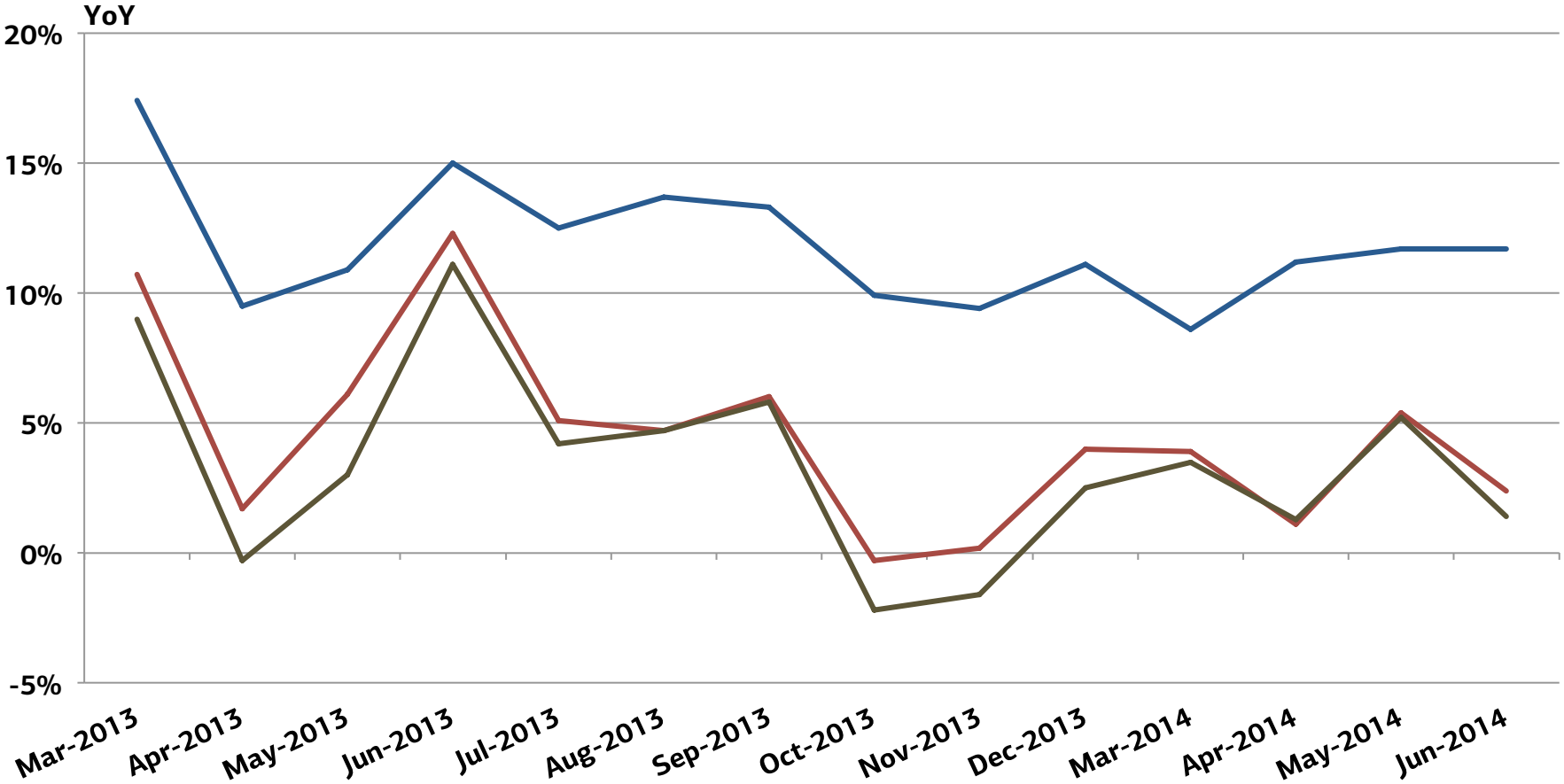
NBS also shows high sales of garments than do the data sets from MOC or CNCIC.



Sources: Ministry of Commerce, NBS, and CNCIC

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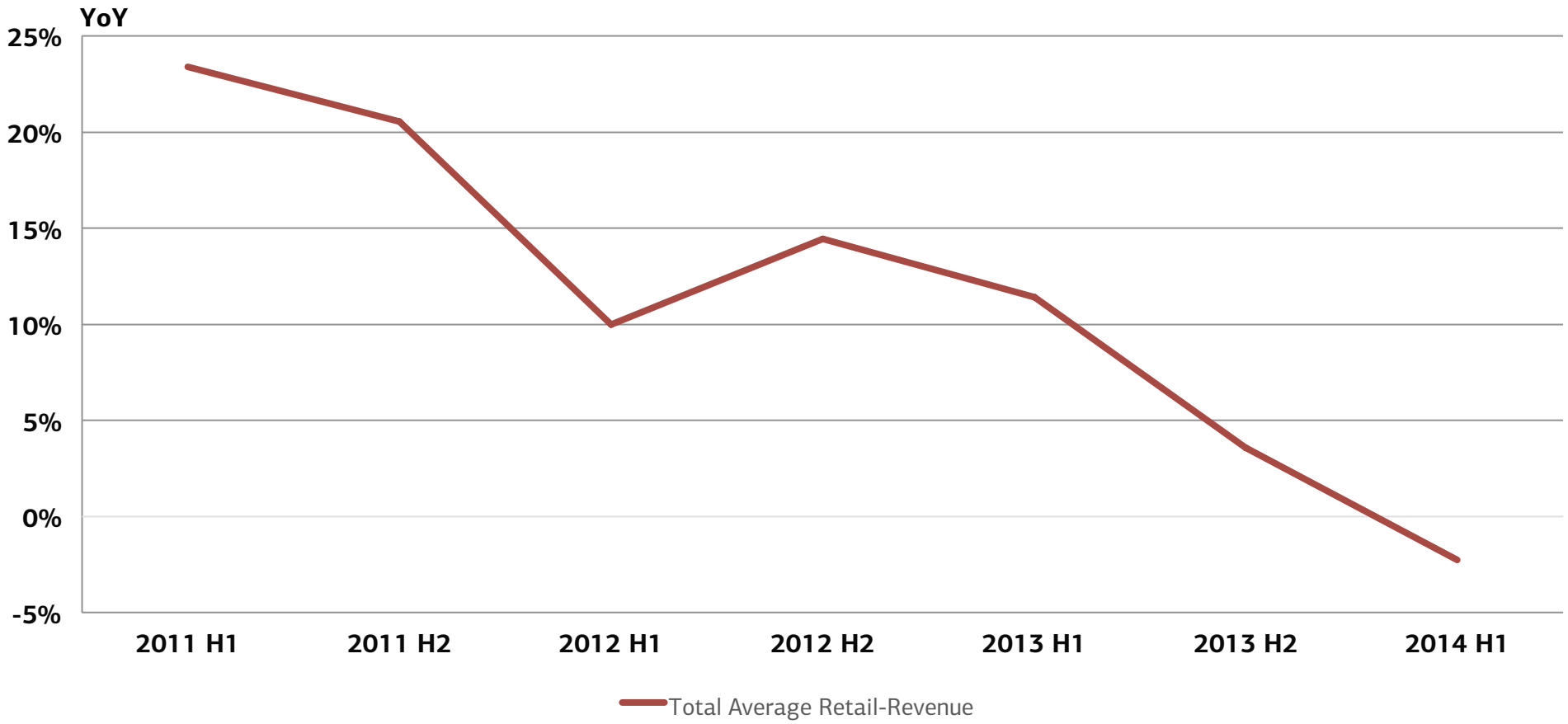
For consumer firms listed in China and Hong Kong, revenue has decelerated since 2011 and now is negative YoY.

Industry	2011 H1	2011 H2	2012 H1	2012 H2	2013 H1	2013 H2	2014 H1
Apparel Retail	20%	23%	2%	-3%	4%	-4%	-4%
Computers & Electronics Retail	16%	16%	-11%	-9%	14%	4%	2%
Department Stores Retail	23%	23%	12%	23%	14%	4%	-4%
Drug Retail Retail	14%	11%	10%	6%	2%	6%	11%
Food Retail	16%	15%	5%	5%	4%	1%	0%
General Merchandise Stores Retail	24%	16%	10%	15%	11%	2%	-5%
Hypermarkets & Super Centers Retail	28%	14%	15%	12%	11%	9%	6%
Specialty Stores Retail	43%	30%	17%	13%	17%	6%	-5%
Total Average Retail Revenue	**23%**	**21%**	**10%**	**14%**	**11%**	**4%**	**-2%**

Source: Bloomberg, J Capital analysis

2014: gross revenue down 2% YoY

The results do not correct for acquisitions, investment income, new-store revenue, asset injections from the parent companies, income from unrelated businesses. Like-on-like, revenues could be down 10% overall.



Source: Bloomberg, J Capital analysis

And yet, Chinese ecommerce is said to be growing extremely fast.

- Online shopping in China is now 17% of retail value, with a CAGR of 120% 2003-11 amid sluggish growth in retail overall.
- For China, e-commerce was measured at USD 295 bln in 2013. U.S. e-commerce was USD 227 bln in 2012.
- That means that, in the U.S., e-commerce is 5.2% of retail. In China, the value is 9%. And yet Internet use in China is lower per capita than in the U.S.

Sources: NBS, U.S. Bureau of Census, MIIT

Could it be conversion from offline to online?

- Rents have risen much faster than inflation, challenging brick-and-mortar retailers to stay competitive. Goods are cheaper online.

- Mobile conversion has been occurring very quickly, making e-commerce accessible to a new population of buyers.

- But there are some problems with attributing the growth in e-commerce to conversion:
  - Retailers with popular and successful e-commerce channels, like Suning, are seeing more growth offline than online despite online discounts.
  - Manufacturers of popular products sold online are not seeing volume growth anywhere near the levels reported by the sites.
  - For example, JD.com is the exclusive online reseller of Lenovo products and derives 80% of its revenue from electronics and home appliances. JD.com grew revenues by more than 60% in 2013, while Lenovo reported growth of 14% on the top line.

Could it be conversion from offline to online?

- The retailing loss in growth is insufficient to account for the growth in ecommerce. If you assume that ALL the reduction in retail sales, from the peak of 24% growth in 2011 to the nadir of 2% reduction, was due to e-commerce, the cumulative value of that drop, based on gross revenues of the companies, is about USD 11.5 bln. That's only 5% of China's reported e-commerce value in 2013.

- Another way to look at it: if you assume that retail would have continued growing by 24% annually since 2011 without e-commerce, and you assume that brick and mortar stores actually declined 2% since 2011, that would suggest that online channels grew at about 26% since 2011. But claimed CAGR is 120%.

- Direct interviews with companies selling on Taobao, although a very small sample and not representative, consistently find losses. These companies generally report declining revenue through Taobao.

Fraud: cannot be dismissed as a source of volume

- Marketing budgets: “100-120”
  - To demonstrate growth, many companies essentially purchase their own products in the run-up to IPO, using their marketing or acquisition budgets.
- Empty packages
  - A recent FT report quoted a delivery company as saying that up to 50% of packages delivered are empty, sent by e-commerce companies to affiliates in order to prove “growth.”
- Acquiring future revenue
  - Companies sometimes use their capital resources to make overstated acquisitions: the acquired company earmarks a portion of the “purchase price” for future purchases from the acquirer.
- Fraud
  - Cases like Longtop Financial, Focus Media, China Media Express, and many more show that fraudulent overstatement of revenue and profit is, unfortunately, common.

Unpacking the Financial Component

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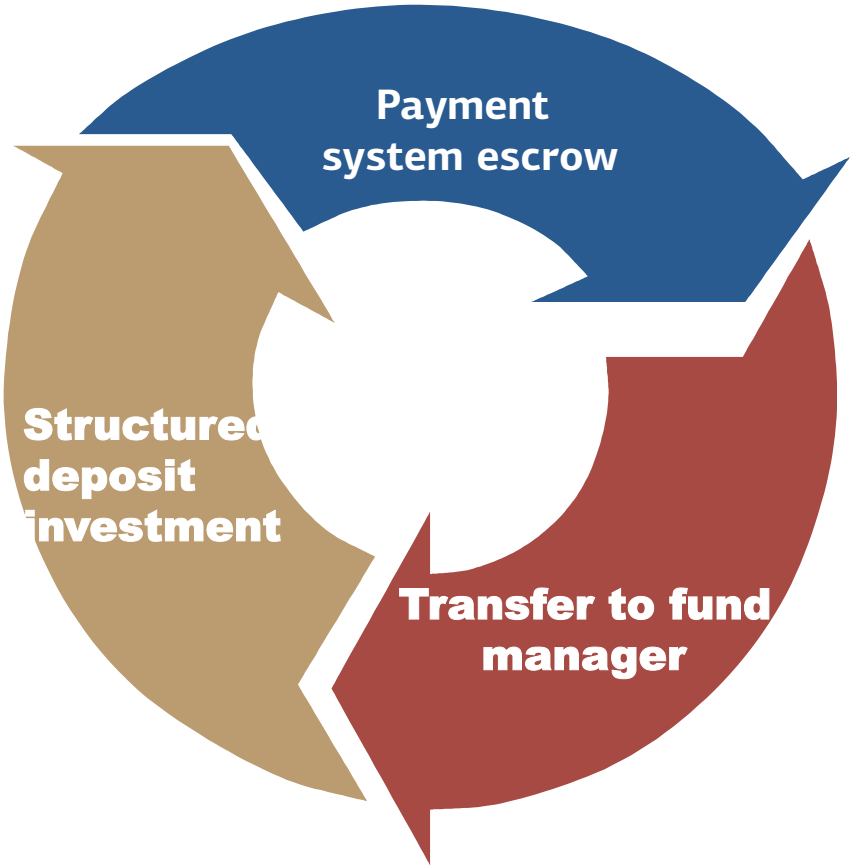
Online finance

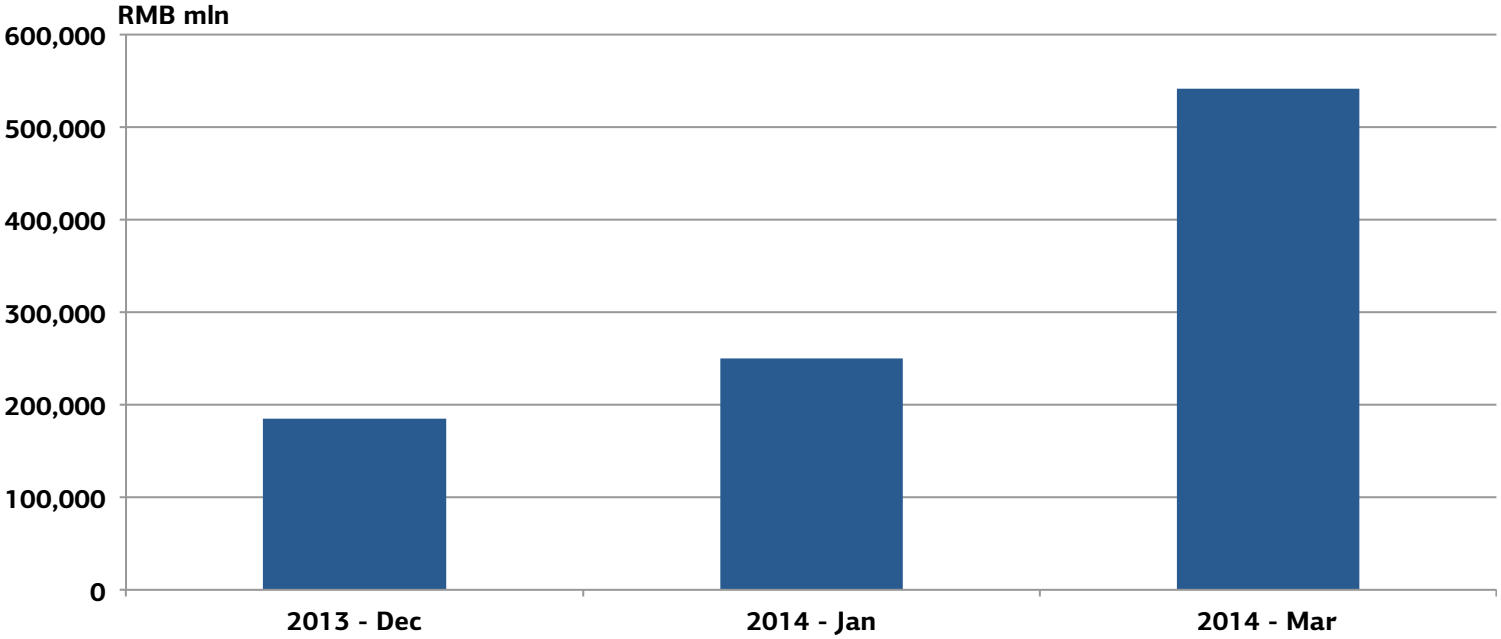
- The nature of financial transactions in e-commerce
- Other types of online finance
- What does it mean for banking?

Money Market Funds

- Represent the majority of online financial products by volume.
- When you pay for a product with Alipay or Tenpay, the money is held for average three days before being disbursed. During this period, the balances may be transferred to a licensed fund-management company, such as Alibaba's Tianhong, associated with Yuebao.
- Account owners may also choose to put their unspent balances into money market funds via services like Yuebao. Yuebao conceptually markets the funds to retail investors and Tianhong holds and invests them.
- Tianhong has agreements with a number of banks to invest in "structured desposits." These are bank accounts with fixed terms and negotiated interest rates. Structured deposits are routinely available to corporate but not individual clients.
- Because of the volume of cash and reliable growth, Alibaba and others can be reasonably certain of enough cash on balance to be able to negotiate a favorable, long-term rate.
- Banks, which have to struggle for deposits, like the funds. Regulators like them because they are more liquid than loans. Individuals like them, because they get higher rates than in traditional checking accounts. Win-win.



Off balance sheet: Yuebao Money Market Fund



Source: Alibaba corporate materials

- AUM of about RMB 600 bln make Yuebao the world's fourth-largest money market fund
- Yuebao invests mainly in structured deposits, ie, money-market funds, but also in sovereign debt, Bank Acceptance Notes, finance bonds, and interbank assets
  - These "interbank" deposits can help banks meet RRR requirements, but do not count toward LDR or deposit quotas
- Yields at ~ 4.9% vs. bank WMP of ~6%

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Small and micro lending

- Alibaba, Tencent, and many other online companies have small lending companies licensed locally. These companies technically may only refer lenders to borrowers.
- The lending capital is held by registered fund managers that are usually off-balance-sheet partners to the e-commerce companies, which choose borrowers and take the default risk.
- Because small lending companies may charge much higher interest than banks, and place money more quickly, banks often partner with them.
- Sometimes, loans are genuinely “small and micro.” But often, funds are aggregated and directed to bigger borrowers with more collateral, such as property developers.
- The companies then may securitize the loan pools and sell them to retail investors.

P2P

Notionally matching lenders and borrowers, these platforms sometimes raise retail deposits and can morph into Ponzis.

Funders

Success brings in the banks

The platforms begin by raising funds from individuals and small companies, but over time, if they are successful, they attract institutional money.

Assets

1. **Short-term SME loans**
2. **Collateralized bridge loans**
3. **ABS, securitized mortgage pools, OTC private equity funds, WMPs**

Challenges

- These tend to be too expensive to qualify and bear too high a risk to be the focus for long
- High-yield and, if the fund has a good working relationship with banks, fairly low-risk
- Usually guaranteed and considered low risk

P2P is an expansion of a very old Chinese gray market model and brings the Internet's reach to the task of raising funds from the retail market.

The assets naturally migrate to high-yield areas.

Marketing investments online

Companies like HowBuy, Noah Finance, and Alibaba's "Zhaocai Bao" market wealth-management products online. One popular product is the "Bank Acceptance Note" derivative, in which individuals and companies can buy bundles of BANs.

What does it mean for finance?

- Banks just got a lot more boring. With payment aggregators online, they do not have to work so hard to recruit retail deposits.
- They have proven they need shadow partners to make loans outside SOEs. Once loan demand returns, instruments like private equities, trusts, AMPs, etc. will likely make a comeback.

Small lending company in Fujian | Photo by J Capital

What the regulators want

- Better aggregated players with clear loyalty to one regulator
- Highly liquid investments to avoid runs and hide defaults
- A degree of licensing ambiguity in order to pull back on the players if they grow too powerful.

New challenges

- Financial repression as the engine of wealth accumulation has given way to land sales as the essential aggregation mechanism. This may have been the net effect of Hu Jintao's "populism": more power for local governments relative to SOEs as borrowers and managers of capital.
- Where does that leave the banks? At the moment, they may not like Yuebao and Tenpay, but they need the deposits and need partners to make commercial loans.

How this affects the Internet titans

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A whole different universe

The Alibaba and JD.com prospectuses indicate phenomenal scale and profitability

From the Alibaba materials:

- GMV USD 270 bln (eBay = USDb 76.5 bln, Amazon = ~USD 100 bln, JD.com = USD 20 bln)
- Average annual spend per active user: USD 1,075 (eBay = USD 597, JD.com = USD 241)
- 6 bln packages delivered in 12 months to June (JD = 323 mln orders)
- 231 mln active buyers (eBay = 128 mln, JD.com = 47.4 mln)
- Average 49 orders per year per active user (JD.com = 16.6).
- Average value per order: USD 21.95
- 19.7% of GMV is via mobile sites. GMV from mobile in 18 months from June 2013 to December 2014 went from USD 6.12 bln to USD 45.5 bln.

Sources: company filings

How big is China's e-commerce? Some puzzles:

- China's retail industry was measured at between USD 3.4-3.7 tln in 2013. US retail was about USD 4.3 tln in 2012. Yet US consumption is more than double Chinese as a proportion of GDP, and the U.S. GDP is almost 50% larger than China's.

- China's reported online retail penetration is higher than anywhere else in the world, including Germany, Japan, and the US.

- U.S. broadband penetration is 70-80%, while China's is 40%, and yet Chinese adoption of ecommerce has been occurring at roughly three times the pace of adoption/conversion in the United States.

- China's warehouse space per internet user is only about one-sixth as much as that in the United States, and yet products are cheaper and should require more, not less space.

Sources: Alibaba, NBS, U.S. Bureau of Census, MIIT, Financial Times

Too good to be true?

- Margins for ecommerce at Alibaba/Taobao appear higher than what can be expected in the United States. Average operating margins claimed across Alibaba properties are about 46%. Group OP margins for Ebay, which reports revenues on a net basis and includes Ebay and Paypal, were 21% in 2012.

- Despite Alibaba's enormous turnover and market share, the company is still able to drive 65% annual growth.

- The average spend per active buyer reported by Alibaba represents 32% of average urban disposable income in China as reported by the NBS. This suggests that active buyers must include large, corporate buyers. But companies purchase on U.S. sites as well, so Alibaba's number seems high.

- And yet, prices are lower online than off, logistics costs are higher than in the U.S., and vendors have lower margins.

- Despite claiming greater efficiencies by being asset-light, all the ecommerce companies are investing in warehouses and logistics companies. This suggests at a minimum that the cost model is unsustainable.

An alternative explanation

- Our surveys indicate that 60-75% of the transaction volume through Alipay consists of:
  - Balance transfers
  - Credit card payments
  - WMP and other investments
  - Utility bill payments

- The agreements between Alibaba, Tencent, and other e-commerce companies with their vendors consist partly of payments for ranking and partly of commissions, but the commission rates are subject to a wide and undisclosed range.

- It seems likely that Alibaba and others have more modest product volumes than it might appear. But the huge volume of online payments and investments creates a commission and interest-revenue stream that can easily feed into e-commerce companies.

- Right now, the only industry showing strong growth in China other than e-commerce is finance. It is logical to think that the growth in ecommerce is related to the companies' financial activities.

Why the huge size?

- ***Affiliations, not integrated corporations:*** There is probably no company of scale in China that operates in the fully integrated fashion of Western companies. To grow, Chinese companies must permit local accounting autonomy and control of bank accounts, independent investment in branches and subsidiaries, fragmented ownership of assets, and fragmented managerial control.

- ***Big like the post office is big:*** Chinese IPOs of the past have borrowed the grammar of Western corporations to create bundled entities more like a confederation of local post offices than offices of a corporation.

- ***Flexibility but also risk:*** The system permits fast growth through flexibility. But it also means that companies must constantly offer value to maintain their local affiliations, which are unstable.

- ***Goal: to aggregate capital***: The principal value that local operator might gain from affiliation with an Alibaba or Tencent is access to capital. Once access becomes constrained, the companies tend to lose market power.

What does it all mean for the future?
Questions to ask

- Once Alibaba has raised capital, who will be the important challengers?
  - UnionPay? Other payments systems?
  - Brokerages or online investment platforms?
  - If credit cards become more effective or well-managed mobile carrier payment grows dominant, will escrow be needed?

Once the payments system is successfully challenged, Alibaba is unlikely to compete effectively in e-commerce.

- What tools do vendors need to bypass Taobao?
  - Impediments to reaching the buying public are largely regulatory rather than logistic or due to cost

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