



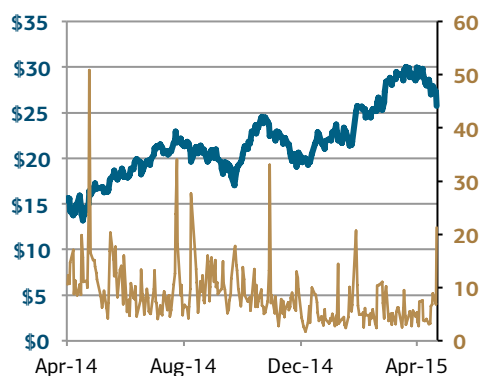
May 13, 2015

China | TMT

# VIPShop Holdings (VIPS US)

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VIPShop Holdings (VIPS US) one-year share price in USD (blue) and volume (gold, in mln shares)



Source: Bloomberg May 13, 2015

## VIPShop Holdings (VIPS US)

Price	USD 25.78
<b>Rating</b>	<b>SELL</b>
Market Cap	USD 16.52 bln
Simple Moving Avg.	6.23 mln
P/E	111.7x

Source: Bloomberg May 13, 2015



## Fraud

### + One-tenth the revenue claimed, losses

We believe that VIPShop has massively overstated its revenue and profit. Our research indicates that the company actually operates a smallish marketplace with less than one-tenth the reported turnover, gross margins of about 14%, and net losses. VIPS' statutory financial reports in China support our point of view.

### + Where are the assets?

When companies overstate profit, they often also overstate the value of assets on their balance sheets. The "assets" act as a bottomless pit into which fake profits can be tossed. VIPShop appears to be a classic example of this type. Reports to the SEC claim USD 308 mln in PPE, USD 670 mln in securities, and USD 578 mln in inventories, among other assets. The Chinese filings show far, far less. PPE is only USD 5.7 mln and inventories are USD 28.37 mln.

### + Everything rented

VIPS discloses that it owns about 500,000 sq m of warehouse space in Tianjin, but we believe this to be untrue. We have interviewed managers of the logistics park where VIPS operates facilities, confirmed ownership by the Australian company Goodman, and we have searched city records and found that VIPS does not own the space it claims to own. We learned that rental expenses per square meter in the park are lower than VIPS reports, and we suspect that the company distorts this figure in order to make it appear that VIPS pays rent on a smaller amount of space.

### + Undisclosed lending activities

Chinese press reports indicate that VIPShop has extended at least RMB 300 mln outstanding in loans that it has not disclosed. The company operates at least three subsidiaries that lend to suppliers and factor company receivables.

### + Reiterate Strong SELL: New TP of 0

VIPShop presents a reality far different from perception. While we formerly covered the company as a short on its excess valuation, we now believe that it actually has no earnings at all. Yet it is trading at more than 100x the inflated earnings. We believe that VIPShop will be forced to delist and we value it at zero.

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## Fraud

Our investigation of VIPShop indicates that **the company had USD 354 mln in gross revenue in 2014, not even one-tenth of the USD 3.7 bln reported.**

**Chinese financials present a picture of a company that is losing money on less than USD 300 mln in sales.**

**Instead of USD 122 mln in profit, VIPShop shows USD 2.86 mln in losses in its China reports. Instead of 25% gross margins, we calculate a GM of 14%.**

**Instead of half a billion in inventories and USD 308 mln in property, plant, and equipment, the company has about USD 34 mln in combined inventories and PPE.**

**We suspect that the USD 1.4 bln in cash and securities the company reports is mostly gone.** While VIPS may be holding a chunk of cash offshore, the line item called “held-to-maturity securities,” USD 607 mln, is likely a fiction or else represents risky securities such as outstanding loans the company has in three financing companies it has not disclosed.

## The Big Picture

VIPShop claims a degree of success rarely found in commerce. According to company disclosures, VIPS operates a discount website at only the cost of delivering products to customers. “Brand partners” provide their products to VIPShop and wait for the products to be sold before asking for payment. Suppliers take back unsold product and bear the cost of returns. There are no competitors, even though barriers to entry are extremely low. There is not even a search tool on the website, and yet sales are surging. VIPShop offers only middling site traffic, and brand recognition is low, but even so, the company can grow at 122% per year, distribute nationwide via only four logistic centers, and garner a 25% gross margin.

Indeed, VIPShop seems to live in a whole different universe from the companies that battle in China’s intense competitive environment.

**Table 1. VIPS Growth as Reported to the SEC**

in USD	2011	2012	2013	2014
Net Revenues	227,142,876	692,112,964	1,696,672,735	3,773,657,545
Gross Profit	43,341,542	154,475,104	407,772,279	938,346,953
Gross Margin	19%	22%	24%	25%

Source: Company SEC reports

The company commands massive cash flows from working capital, far higher than any domestic competitor and twice Amazon’s as a portion of revenue.

VIPShop reports all this surfeit of success despite being in an industry with low barriers to entry. Most of the majors, including Taobao and Dangdang, have gone into flash sales but without the stunning success of VIPShop.

### The Numbers

Unfortunately, none of this appears to be true. We accessed VIPShop's statutory financial filings in China. They paint a picture of a USD 350 mln company that loses money.

**Table 2. Consolidated AIC Reports vs. SEC Financials 2014**

in USD	Consolidated SAIC Financials*	SEC Financials	Difference
<b>Balance Sheet</b>			
Current Assets:			
Cash	\$107,966,894	\$2,130,750,546	\$2,022,783,652
Receivables	\$24,655,014	\$1,379,539,324	\$1,354,884,310
Other Receivables	\$28,370,243	\$29,992,278	\$1,622,035
Inventories	\$40,645,515	\$88,663,626	\$48,018,111
Other Current Assets	\$225,546,697	\$578,329,704	\$352,783,007
Long Term Investments		\$54,225,614	\$54,225,614
Fixed Assets	\$5,778,519	\$308,070,304	\$302,291,785
Other Assets	\$1,828,232	\$293,191,099	\$291,362,867
Total Assets	\$434,791,114	\$2,732,011,949	\$2,297,220,835
Short Term Liabilities		\$1,675,851,258	\$1,675,851,258
Short Term Loans	\$4,080,875		\$4,080,875
Payables	\$115,410,410		\$115,410,410
Other Payables	\$77,277,081	\$986,567,345	\$909,290,264
Other Short Term Liabilities	\$56,663,766	\$689,283,913	\$632,620,147
Long term Liabilities		\$0	
Long term borrowings			
Long term payables			
Investors Equity (Retained Earnings)			
Paid-In Capital	\$199,197,303	\$431,558,727	\$232,361,424
Total Debt & Equity	\$434,791,114	\$2,732,011,949	\$2,297,220,835

in USD	Consolidated SAIC Financials*	SEC Financials	Difference
<b>Income Statement</b>			
Revenue	\$354,077,936	\$3,773,657,545	\$3,419,579,609
COGS	-\$305,304,950	\$2,835,310,592	\$2,530,005,642
Implied GM	14%	25%	
Business Tax & Surcharges (Fulfillment)	-\$1,253,645	-\$370,189,860	\$368,936,215
Marketing Expense	-\$23,244,664	-\$189,936,406	\$166,691,742
G&A	-\$26,447,335	-\$157,846,115	\$131,398,780
Finance Costs	-\$1,145,910	-\$109,476,531	\$108,330,621
Investment Income		\$37,118,930	\$37,118,930
<b>Other business profit</b>			
Other income	\$716,602	\$25,122,023	\$24,405,421
Other expenses (losses on dispositions, fines, gifts, unusual expenses) including income tax	-\$257,911	-\$50,210,637	\$49,952,726
Net Profit	-\$2,859,877	\$122,789,192	\$125,649,069

Source: Company SEC filings and Chinese AICs, J Capital consolidation

\*At median USD exchange rate

**The SAIC reports are damning. Companies often show some discrepancy between Chinese and SEC reports, but not such a huge difference.**

Discrepancies of similar magnitude are observed in the 2012 and 2013 filings.

VIPShop's financials indicate a degree of fraud that is frankly staggering.

First, let us look at the income statement. The following statements consolidate all VIPShop subsidiaries in China that reported their numbers to the tax bureau in 2012-2014. These reports may overstate revenue, because we have not tried to eliminate inter-company transactions. They may also understate revenue if some of the sales have not been accompanied by legal receipts, which incur a tax obligation.

**Table 3. VIPShop Chinese and SEC Income Statements 2014: Margin Comparison**

	SAIC Consolidation	SEC Report	Difference
2013 GM	14%	24%	-10%
2013 Profit	-\$2.27 mln	\$52.3 mln	-\$54.6 mln
2014 GM	14%	25%	-11%
2014 Profit	-\$2.86 mln	\$122 mln	-125.9 mln

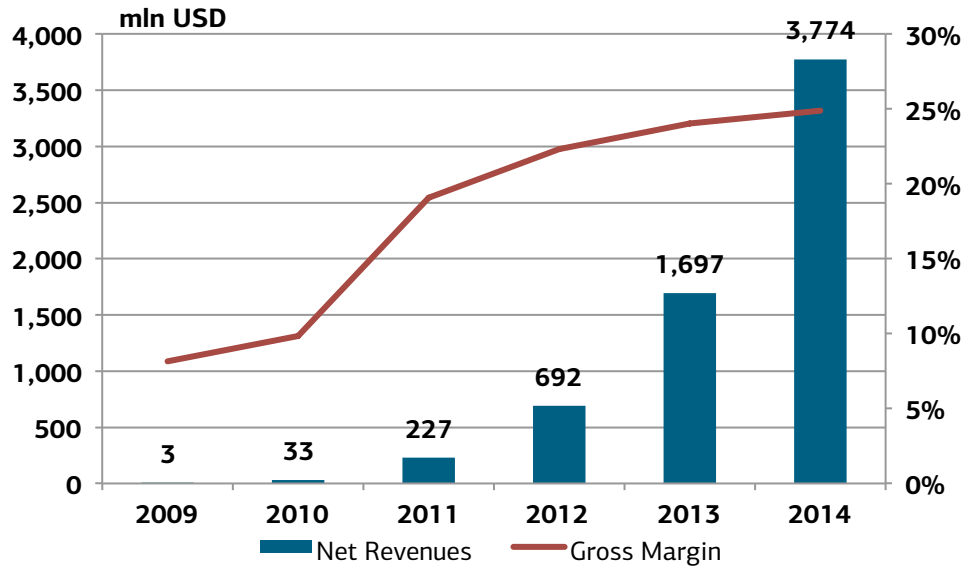
Source: Local AICs and SEC reports

In the SAIC financials, VIPShop reports gross margins of 14%, compared with

margins of 25% reported to the SEC. Given that the company has no revenue outside of China, one or the other reports must be false.

To the SEC, VIPShop reports very strong margins and healthy profitability.

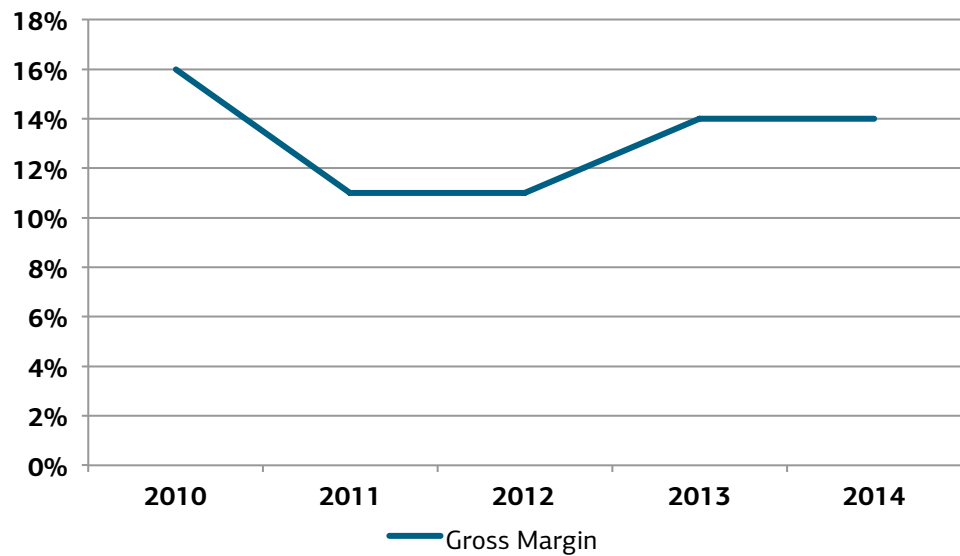
**Chart 1. VIPS SEC-Reported Revenue and Margin**



Source: Company reports

Here is the chart showing the Chinese financials:<sup>1</sup>

**Chart 2. VIPS SAIC-Reported Margin**



Source: SAIC filings

<sup>1</sup> Note: In 2013, two of the subsidiaries had no costs and appear to be engaged in inter-company transactions. To derive the gross margin for 2013, we added those companies' revenue to "other revenue" and did not use the revenue to calculate the GM.

## The Balance Sheet

More damning yet, because Chinese balance sheets tend to be reasonably accurate, is the consolidated balance sheet for VIPShop.

**There is no evidence that the large land and plant assets or the huge inventories actually exist.**

in USD	Consolidated SAIC Financials*	SEC Financials	Difference
<b>Balance Sheet 2014</b>			
Current Assets:			
Cash	\$107,966,894	\$2,130,750,546	\$2,022,783,652
Receivables	\$24,655,014	\$1,379,539,324	\$1,354,884,310
Other Receivables	\$28,370,243	\$29,992,278	\$1,622,035
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<b>Total Debt &amp; Equity</b>	<b>\$434,791,114</b>	<b>\$2,732,011,949</b>	<b>\$2,297,220,835</b>

Source: Local AICs

\*At median USD exchange rate

- PPE is only USD 5.78 mln. For a company this size, VIPShop owns almost nothing. Where did all the investment capital go?
- The company has a USD 4 mln loan that it has not reported to U.S. shareholders.
- Inventories are a mere shadow of what has been reported.
- Where is all the cash?

## Do the Chinese financials tell the whole story?

The filings we accessed are the annual financial reports from 11 VIPS subsidiaries in China, of which eight reported income to tax authorities in 2014. Those eight are the following:

1. VIPS (China) Company Ltd.
2. Guangzhou VIPS Software Co. Ltd.
3. Guangzhou VIPS Information Technology Co. Ltd.
4. VIPS (Jianyang) E-Commerce Co. Ltd.
5. VIPS (Kunshan) E-Commerce Co. Ltd.
6. VIPS (Tianjin) E-Commerce Co. Ltd.
7. VIPS (Hubei) E-Commerce Co. Ltd.
8. VIPS (Foshan) E-Commerce Co. Ltd.

For the filing year 2012, we additionally accessed VIPS (Beijing) E-Commerce Co. Ltd. Chinese legal records indicate that that company was dissolved in December 2013 and accordingly it did not file a financial report in 2014. VIPS (Foshan) E-Commerce Co. Ltd. was formed in April 2013 and VIPS (Hubei) E-Commerce Co. Ltd., formed in July 2013 and did not submit 2013 financial reports to tax authorities although it is possible they had income.

**We have seen discrepancies between SAIC and SEC financials but never anything as big as this.**

VIPS also operates offices in several cities but those offices do not record income and so are not required to submit the same sorts of reports. The reports are accessible to the public via registered agents.

These are all the subsidiaries that VIPS reports in its SEC filings. The company reports that it formerly operated out of Dongguan, Guangdong, before moving to the Foshan facility, but we could find no record of a company registered in Dongguan, including among de-registration records.

When we suspect companies of misreporting, we routinely access this type of filing. Often, the information is confusing and does not cast light on the company's operations, but we have never encountered a situation in which there was a good explanation for a set of financials in China that so radically diverged from the SEC financials.

In some cases, the evidence of SAIC reports has not been convincing to investors. In 2011, Muddy Waters published an [80-page expose](#) of Focus Media, then listed on NASDAQ as FMCN. That report relied in part on SAIC files on 160 operating subsidiaries and affiliates of Focus Media and

demonstrated dramatically lower revenue and margins than the company reported. In the end, however, a private equity consortium successfully bid to take Focus private at USD 3.5 bln, representing a 17% premium over the closing price of the stock.

Focus Media in some ways was similar to VIPShop: the company had a real business but that business was smaller and less profitable than claimed. Focus was apparently using overstated acquisitions and the accumulation of goodwill to whisk away the fake profits before they had to submit to an awkward audit. However, the business of Focus Media was far larger and more sprawling than VIPShop's, and the inter-company transactions associated with 160 companies would defeat any forensic researcher, particularly in an area like media, where no physical assets are required. VIPShop is much simpler and more clear cut than Focus.

We remain convinced that the Muddy Waters report was correct and its evidence of fraudulent results reported by Focus Media was accurate. We believe that, had the company remained public, its value would have sunk.

Chinese financial filings can be inaccurate in many ways. For example, companies often under report revenue in order to evade taxes. They very often fail to consolidate companies with shared ownership, which can make revenue look higher than it really is.

However, Chinese auditors care a lot about assets, and the reports tend to represent cash and PPE with a high degree of accuracy.

### Asset-Light

VIPShop management has repeatedly said and implied that the company has been aggressively raising money in order to build out an owned logistics infrastructure. On the Q4 conference call, Eric Shen said the following:

We are going to continue to invest into our infrastructure. In particular, our warehouse capacity is anticipated to reach around 100 million square meters [sic] by the end of 2015. And last-mile is another area that we're focusing. And we are expecting that by the end of this year, we would have more than 75% of the orders to be covered by our in-house delivery teams or through the companies that we have equity investments.

Here is a statement from page 73 of the 2014 20-F:

As of December 31, 2014, we have branches in Beijing, Shanghai, Tianjin, Jianyang, Ezhou, Foshan, Kunshan and Zhaoqing, ***and own close to 500,000 square meters of logistics centers and office space in Tianjin.*** [emphasis ours]

**As far as we can tell, the claim that the company owns 500,000 sq m of warehouses in Tianjin is a flat out lie.**

In late 2013, VIPS moved its northern China logistics operations from an office park owned by Global Logistics Properties in Beijing to a new park in the Wuqing District of Tianjin. The company has four large warehouses in Phase 1 there, two warehouses that are complete in Phase 2, and land where a third phase is planned.

We visited the park and interviewed the management office that operates the park. The interviewees said that Goodman owns the Phase 1 and Phase 2 land in the park, constructed all VIPS warehouses, and rents them to VIPS under a 10-year agreement. The park management told us that normal rental arrangements are RMB 15 per square meter per month, or USD 29 per year per square meter. The VIPShop Phase 1 facility is a little more than 100,000 sq m and therefore probably costs about USD 2.89 mln per year to rent.

**It even says on the gate that the logistics park is owned and managed by Goodman.**

Subsequently to renting the Phase 1 and Phase 2 facility from Goodman, VIPShop purchased a parcel of land from the Wuqing government, which reports that VIPS will erect an owned warehouse on that plot. We accessed land records for the city of Tianjin. On December 26, 2014, VIPS did indeed purchase a plot of land in Wuqing, paying RMB 36.5 mln or USD 5.87 mln.

The Tianjin facilities are clearly marked as owned not by VIPS but by Goodman, the listed Australian company, which discloses its relationship with VIPS in public reports.



A sign at the entrance to the VIPS Tianjin Logistics Center shows that Goodman owns and operates the facility. | Photo by J Capital May 2015.

In addition to the plot of land in Tianjin, VIPShop purchased land in Zhaoqing, Guangdong, where the company's logistics center is located. That price, according to public records, was RMB 24.4 mln or USD 3.86 mln. Apart from those two plots of land, we did not find any VIPS assets in China.

In Chinese financials, pre-payments for land do not go into the balance sheet line for assets, because before the certificate conveying use rights has been conveyed, the payment is simply a deposit. The pre-payments may appear in the line called "other assets" in the Chinese statements, amounting to a little more than USD 1 mln; it seems likely that VIPS did not actually make the pre-payment until 2015, since the land transactions were at the end of December in 2014.

**The company announced investments in Hubei but we can't find any.**

The numbers accord roughly with the assets and amount of pre-payments reported on VIPS' Chinese balance sheets.

The government of Ezhou, Hubei has announced that VIPShop committed to invest RMB 1.8 bln in logistics facilities there but no investment has yet been made. VIPShop reports that it has a warehouse in Wuhan but not in Ezhou, which is about two hours away overland. In January, we visited the Wuhan site, in the Xinzhou suburb of the city, and representatives of the town government said that VIPShop had not made an investment.

### **Sucking In Capital**

VIPShop has engaged in three rounds of capital-raising in the U.S. market, with the most recent convertible senior notes raising USD 621 mln, at 1.5% due in 2019. Yet the company's coffers are stuffed with cash, if the reports are to be believed, and free cash flow is robust. Why does the company need so much cash?

**If it's really so profitable, why does VIPShop keep raising money?**

We suspect that the reason is simple: VIPShop is actually not making money. We find the most suspicious portion of the balance sheet to be the "held-to-maturity securities." The full disclosure on such securities is as follows:

As of December 31, 2013 and 2014, the Group's held-to-maturity securities consist of debt securities carried at amortized cost of \$385,841,626 and \$607,345,904 respectively, which approximate the aggregate fair value. All of these securities mature within one year and are classified as current asset. The amount of unrealized holding gain as of December 31, 2013 and 2014 was \$4,256,810 and \$8,193,662 respectively.

Investors are not given information on what the investments might be. Some of the securities must be in China in order to offer the blended yield of 3.4% described in VIPS' financial statements. If so, there is both exchange risk and recovery risk associated with the securities. Yet the company reports that it

has not entered into any hedging arrangements.

In the 2014 financials, VIPS reported USD 809 mln in proceeds from held-to-maturity securities. But net cash used in investing in that year was USD -664 mln. The money went into investment in affiliates and goodwill (USD 79 mln), a USD 162 mln increase in intangible assets, a USD 283 mln increase in property, plant, and equipment, and other items that we believe are ephemeral or fictional.

In China, it is reasonably easy to obtain certification from a fund manager of assets, whether or not they truly exist. We question whether the USD 607 mln reported in held-to-maturity securities exists.

### **Sales Speak Volumes**

Our physical checks of VIPShop's logistics facilities have consistently found quiet warehouses visited by 20-40 trucks in a 24-hour period and with at least half the loading bays idle and apparently permanently unused.

**Our physical checks of warehouses suggest that they are under-utilized and generally quiet.**

In one interview in Tianjin, a person familiar with the logistics park operations estimated that 200 trucks enter and leave the facility in a 24-hour period and that a peak day saw as many as 500 trucks. But physical observation on three different occasions found more support for the count offered by a man who lives in his van outside the VIPS gate—fewer than 20 trucks on an average day and a peak count of 40.

Staff at the logistics parks in Tianjin, including the parks where VIPS and JD.com Tianjin facilities are located, told J Capital that total volume growth for the parks in 2014 over 2013 was 17%.

We have visited each of the logistics parks. At Jianyang in Sichuan, we estimate that as many as 200 trucks might enter and leave in a day. At the other facilities, a few dozen were more likely. But none of the warehouses appeared to be fully utilized, even as VIPS is building out more warehouse space.

At Zhaoqing there were about a dozen small trucks delivering products and a couple of container trucks leaving the facility. We were told the container trucks typically travel to ports.

**We find it puzzling that VIPS keeps moving and keeps building out new space when the old warehouses are not fully utilized. The company claims it will rent space to brand partners.**



Above: VIPShop logistics center in Zhaoqing, Guangdong. Note the trademark pink trim. Below, a side view showing the VIPS logo | Photos by J Capital January 2015.



**When asked about the small number of trucks at the old Foshan facility, the caretaker said that the location is very hard to find.**



Trucks entering the logistics center at Zhaoqing | Photo by J Capital January 2015.

Until mid 2014, VIPShop operated its southern logistics out of a facility in Foshan, Guangdong. We visited that facility, which is next door to a JD.com logistics facility. On two occasions, gate guards and the caretaker told us that VIPShop had moved all its operations to Zhaoqing in mid-2014 but had left a few administrative staff behind. Park staff said that VIPS business was very good in Foshan but estimated that only a handful of trucks entered and left the facility each day when VIPS was operating there. The Foshan facility sits near a road with poor highway and rail access in a highly congested area. Staff said that truckers had a difficult time finding the facility.



Aeon operates the local logistics park. It seems the company wanted to emulate the VIPS logo | Photo by J Capital January 2015.

We later interviewed 14 truckers at the Zhaoqing logistics center about their work moving VIPS packages around. Of those 14, two trucks were from Foshan and reported making runs between Foshan and Zhaoqing but also from Zhaoqing to Beijing, Wuhan, and Chengdu.

Gatekeepers and guards all gave glowing accounts of VIPS, but we could not detect much activity. At the Kunshan facility, in a quiet industrial neighborhood outside Shanghai, a loudspeaker was playing information about the listed company's revenue and margins on a loop.



Above: Foshan warehouse facility | Photo by J Capital January 2015. Below: The old VIPS warehouse in Kunshan outside Shanghai | Photo by J Capital May 2015.



In Kunshan, the old VIPS facility, still in use, is shared with a handful of other companies. The old Beijing and Shanghai facilities were rented from GLP.



Above: The new Kunshan warehouse, a few kilometers down the road. Below: Bays at the Phase 1 warehouse in Tianjin's Wuqing District | Photos by J Capital May 2015.





**Above: Bays at the Phase 2 warehouse in Tianjin. Below: One of the six warehouses in Tianjin showed significant activity, mostly of smaller trucks delivering goods | Photos by J Capital May 2015.**



Because large trucks generally load and travel at night in China, we visited the Tianjin facility after 10 pm to see whether volumes might be higher then. Still, most of the warehouse bays were idle.



A nighttime view of the Tianjin warehouse taken in May. | Photo by J Capital

**Our surveys and our experience in China indicate that VIPShop is a relatively small site.**

Given that VIPS has 7,110 current brand partners and each brand at a bare minimum must make two runs per year to at least one VIPS warehouse (to deliver products and pick up unsold products), the suppliers alone would need to make at least 10 trips a day to each of the four logistics centers. The returns, which the company claims are 20% of volume, would amount to nearly 14,000 orders per day per warehouse and would come from diverse locations. Truckers say that VIPS does not have substations where products are aggregated. The returns, therefore, would require a bare minimum of 10 trucks per day. If each warehouse averages 40 trucks a day, that would leave only 20 per warehouse, or 80 nationwide, for delivery of all products. That average is possible, given how small the packages are, but it is unlikely.

### **Imported Product?**

We understand that China is filled with excess inventories and that there is a business to be done in selling off inventories at a discount. However, many of the products we ordered from VIPShop were manufactured outside of China, and employees in the stores selling the items said that those particular SKUs were not available in China.

For example, this Puma t-shirt was manufactured in Turkey:

**We found that about half the products we bought had been manufactured overseas.**



We purchased it from [VIPShop](#) on March 18 for RMB 147, an advertised discount of 70% off the reported full price of RMB 490. We found the same shirt on other websites in China for RMB 239 against a posted “full price” of RMB 308.

The North Face pants we purchased from VIPShop on March 20 for RMB 399 were available also from JD.com at RMB 349. The pants were verified as real by a North Face store but were labeled as manufactured in Vietnam.



This pair of shoes was made in Cambodia.

**Import records from September 2013 showed \$650,000 worth of imported luxury items in a month.**



This is peculiar, because the VIPShop value proposition is that it sells products that are in oversupply in China. Furthermore, the brand owners deliver all their products to VIPShop and await sale before being paid. This is very unlikely for a product owner based in Cambodia.

We sorted for imports by VIPShop in China using custom records for September 2013. In that month alone, VIPShop imported 2,590 items, spending USD 644,157, for a run rate of USD 7.7 mln that year. The items included Cartier watches, Boss men’s suits, Versace wallets, belts by Ferragamo, Versace, and Bally, Dolce & Gabbana bags, and much more. Most of the imports were from Hong Kong, the United States, and special zones within China.

**Brand owners we met said they had no relationship with VIPShop.**

When visiting the logistics centers, we have viewed several VIPShop-branded container trucks. Local truckers told us that those trucks most likely come from or go to ports, because the cost for a container truck is too high to be used for domestic shipping of boxed consumer goods.

### Consumer Awareness

We have conducted three consumer surveys to understand purchasing preferences, and VIPS scored low in consumer recognition and use in every survey. In the most recent survey, focused on Tier 3 cities, VIP’s score improved somewhat, reflecting the high quantity of advertising the company has done since 2013. Nevertheless, 47 of the 60 respondents had not visited the VIPShop website. Given that VIPS claims 20 mln active users, we believe that about 10x that number, or 200 mln people, should visit the site to generate 20 million buyers. 200 million people would be equivalent to just under one-third of China’s Internet population.

## The Products

### Fakes

Several of the people surveyed who were familiar with VIPShop said that they believed the site sold fake merchandise. This feedback is common for virtually all websites in China. Consumers in our surveys have tended to be less critical of JD.com, and TMall versus Taobao.

We have made 21 purchases from VIPShop and brought the purchased items to stores to verify that the products were genuine. Of the products we purchased, one was verified as genuine by The North Face and one was verified as fake by Gucci, but sales clerks could not identify the other products as either real or fake—they said those SKUs were not available in China.

The fake Gucci bag, purchased at [this link](#), cost us RMB 4,600 (we returned it for a full refund).



Screenshot of the Gucci bag we purchased.

VIPShop does not represent that it does business with brand owners but only with distributors. We verified with several brands owners whose products appear on the site that they do not do business with VIPShop. The brands we contacted that said they do not work with VIPShop include Coach, Ferragamo,

Gucci, and Bottega Veneta.

### Lower shipping expenses

VIPShop consistently reduces its fulfillment expenses as a percentage of revenue even as it acquires more facilities. In 2014, revenue was 20x shipping and handling costs, up from 14x in 2013 and 13x in 2012.

**Table 4. VIPShop per-order metrics**

	2010	2011	2012	2013	2014
Revenue per order	\$35.15	\$31.25	\$31.58	\$34.51	\$35.17
Gross Profit per order	\$3.46	\$5.96	\$7.05	\$8.29	\$8.75
Gross Profit per order	\$4.64	\$4.04	\$2.46	\$2.39	\$1.79
Fulfillment (ex. S&H, Depreciation, & Options Expense) in mln USD	-\$1.51	-\$15.43	-\$40.06	-\$76.42	-\$172.15
Fulfillment cost per order	\$1.63	\$2.12	\$1.83	\$1.55	\$1.60

Source: Company filings

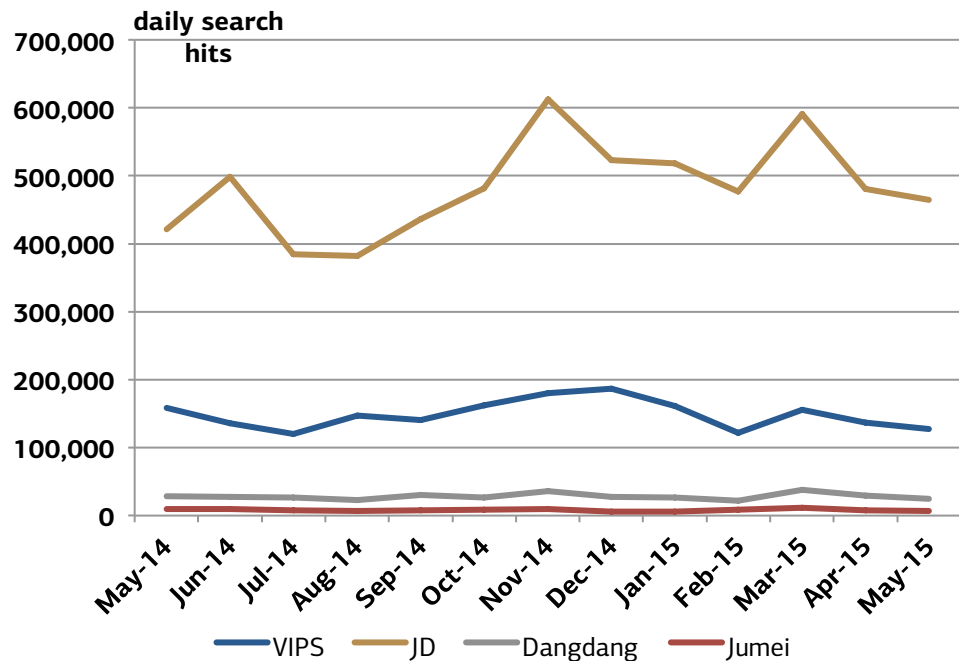
In Q2 2014, shipping and handling expenses declined from USD 2.27 to USD 1.52 per order, or by 75 cents in a single quarter. The company failed to explain how shipping expenses can contract so dramatically in a limited time period.

The revenue per order is significantly higher than the same number for comparable companies such as Dangdang, with an average order size of USD 25.80.

### Web and Mobile Traffic

VIPShop's Alexa score is relatively low, at No. 153 in China. In Baidu search statistics, however, VIPShop scores much higher than Dangdang and Jumei, and at about one-tenth the level of Taobao, which supports VIP's traffic claims. Average search traffic for VIPShop, according to Baidu, has declined by 30% year on year and 8% month on month. There were similar traffic declines reported for Taobao, Dangdang, Jumei, and Yihaodian; JD.com shows 6% growth. A decline can in part reflect a higher proportion of customers typing the URL directly into their browsers rather than searching on Baidu.

**Chart 3. Average Daily Search Hits on Baidu**



Source: index.baidu.com

## The Lending Business

VIPS is reported in extensive Chinese press accounts to offer receivable factoring and short-term supplier loans. The company has not reported such activities to U.S. investors.

**VIPShop operates at least three finance companies in China that extend small loans and factor company receivables. These activities have not been reported to investors but are widely reported in the Chinese press.**

### Shanghai VIPS Small Loans

Chinese press reports say that VIPShop opened loan companies in Guangzhou and Shanghai in 2014. A report from the Shanghai Association of Micro-Credit says that the Shanghai finance company is jointly owned by the Tianjin and Ezhou, Hubei subsidiaries of VIPShop. That would make it a wholly Chinese-owned company and therefore eligible for a finance license. The company has RMB 200 mln in registered capital. In summer 2014, the company was reported to have received a license to engage in online money-raising. Excited press reports announced that VIPShop was the newest entrant into the business of raising money and extending loans online.

Press reports also say that VIPShop operates a finance subsidiary engaged in the business of factoring receivables. We did not find such a company with the name VIPShop, but according to Chinese news reports like [this one](#), the factoring company has extended at least RMB 300 mln in loans to more than 100 companies.

The small loan companies, according to Chinese reports, offer loans at 7-8% and earn a 2% spread.

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These companies have not been disclosed by VIPShop.

### The Physical Stores

Having failed to disclose that it owns physical stores until we pointed out this fact, VIPShop now reveals that it has nine stores. Interestingly, seven of the nine operate in Guangzhou. VIPS says that the stores are an outlet through which they can dispose of the small portion of inventory for which the company lacks the right of return. But it does not make sense that Guangzhou would have 90% of the company's excess inventory or that warehouses in other parts of the country would ship to Guangzhou. The store discounts are as much as 90%, and the revenue would not justify the shipping costs.

The VIPS stores imitate the TJ Maxx logo and evoke VIPS' frequent reference to TJ Maxx as its key comparable. We believe that VIPS is trying to build a physical retail business.

### Returns

VIPShop discloses a very high return rate of 20%. That would mean that more than 20 million orders were returned in 2014.

### Insider sales

We have not detected any insider selling of VIPS stock. Insider stock pledged for loans is reported only in annual proxy statements, which, as a foreign issuer, VIPS is exempt from filing. Insiders could theoretically have margin loans against stock.

### SEC Correspondence

On December 30, 2013, the SEC sent a letter to VIPShop requesting further information on the company's cost of goods sold and inventory write-downs as a percentage of total inventory. The letter notes that inventory write-downs rose from 2.4% to 8.5% of inventory in a single year. The company's response is blacked out in public filings.

### Undisclosed Related Parties

We have found several companies owned by Eric Shen or Xiaobo Hong that appear to do business with VIPShop but have not been disclosed.

### Yurtowne

Eric Shen is registered owner of [Xinjiang Yurtowne](#), which sells jade, diamonds, and other semi-precious stones in China and in the export market. Yurtowne [sells products](#) on VIPShop.



## Luxlead

This Guangzhou-based company is owned, according to public documents, by Xiaobo Hong, COO and Vice Chairman of VIPS. The company [conducts flash sales](#) on VIP's site.



## And a disclosed one... Guangzhou NEM Import Export

Eric Shen regularly discloses his ownership in this company, which he has reported is a trader of machinery. Oddly enough, the company does not seem to exist anymore. The legal registration was canceled in May 2012 and it has not filed tax reports in China for three years. Our office spoke with two people whose resumes included stints working for Guangzhou NEM but they refused to discuss the business of the company or to confirm that it exists.

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## Valuation

Once the cover is pulled off the VIPS China business, a struggling and unprofitable company is revealed. Given the extent to which the company has misrepresented its business, we are at a loss to offer a fact-based valuation and believe that this company is most likely a go-to-zero.

## Risks

VIPShop management will likely respond to these allegations by claiming that it conducts un-receipted business and has much higher revenues and profits than its statutory reports represent. It is very possible that investors will believe the representations and that the company's share price will continue to rise.

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