

June 21, 2016

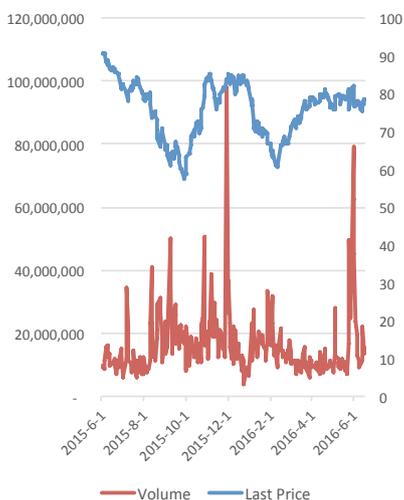
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Alibaba Holdings (BABA US)

Price	USD 78.27
Rating	SELL
Market Cap	USD 193.34 bln
Target Price	USD 36.58
Difference	53%
P/E	18.55

Source: Bloomberg June 17, 2016

Alibaba Group Holding (BABA US)
one-year share price in USD (blue)
and volume (red, in mln shares)



Alibaba Group Holding (BABA US) The Colony

- ▶ **Irregular cash flows between Alibaba and affiliates like Ant Financial, Tianhong, and Cainiao are becoming too big to ignore.** As Ant scampers toward an IPO, BABA investors should worry about the same bait-and-switch that torpedoed the Hong Kong-listed Alibaba and raised the then-unlisted Taobao to blue-chip status.
- ▶ **The forecast that 2017 would bring 48% growth in GMV drove up BABA's stock in daily trading by 3%,** even as Jack Ma, prompted by the SEC investigation of the company's GMV standards, said that GMV is irrelevant. Recent funding to Ant Financial, with which Alibaba has millions of daily, unauditable transactions, should make it easy for Alibaba to show impressive growth in turnover.
- ▶ **Ant Financial disclosures suggest as much as a 400% overstatement of GMV by Alibaba.** Our metrics support roughly that level of exaggeration.
- ▶ **Softbank and Yahoo:** BABA and its managing partnership recently agreed to buy USD 2.4 bln of Softbank shares at USD 74 per share, prompting Yahoo! shareholders to try to get in on the cash as well. Meanwhile, BABA management have sold about USD 258 mln in shares in June so far.
- ▶ **Reiterate SELL, TP USD 36.58.**

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Alibaba disclosed that Ant had made a loss in the last quarter due to marketing costs. But press reports said that Ant's RMB 2.6 bln in profit had grown by more than 60%. Did BABA need a loss for its own books?

An Infestation of Ants

■ Anne Stevenson-Yang

Jack Ma's recent forecast that Alibaba would see 48% revenue growth in FY 2017 (already under way) sent the stock up 3%. At the same time, BABA announced that it would no longer report Gross Merchandise Value (GMV), a turnover metric that has been questioned by the SEC. Just before pulling a curtain over GMV, though, Ma announced that GMV by 2020 would exceed the GDP of Japan. Growth like that would put Alibaba perfectly in sync with China's Five Year Plan, which targets a doubling of the economy from the 2010 level by 2020, surpassing the U.S. in economic size, and surpassing Japan in all ways.

At the recent Investor Day in Hangzhou, Ma called the company unstoppable. "You can't stop Alibaba for two hours otherwise it's going to be a disaster for China. You can stop Tencent for two days, you can stop Baidu for two weeks and everything will still be OK," he said.

We continue to believe that GMV is radically overstated, and the new Alipay disclosures provide more support for our view. The Ant reports (see, for example, [this presentation](#)) say that Alipay's average commission is 60 basis points. That is almost four times Alibaba's reported commission rate. The most likely explanation is that the denominator is bloated; it is unlikely that Alipay charges Alibaba less than it charges other clients; Ant Financial documents also demonstrate that Alibaba contributes only 20% of turnover but 33% of revenue.

Alibaba's FY 2015 report says that fees paid to Alipay were RMB 3,853 mln in the year ended March 31, 2015. GMV for the same period was RMB 2,444,000 mln, yielding a transaction fee of 15 bps. In FY 2016, the payment processing fee was RMB 4,898 mln (page F-80). GMV was RMB 3,092,385 mln, or 16 bps. The Alipay numbers suggest that GMV at Alibaba is overstated by a factor of four.

As far as we can tell, Cainiao doesn't do much of anything. It certainly does not warehouse and ship goods.

Alibaba's Transaction Fees to Alipay

	FY 2013	FY 2014	FY 2015	FY 2016
GMV (mln RMB)	1,077,000	1,678,000	2,444,000	3,092,000
Alipay payment processing fee (mln RMB)	1,646	2,349	3,853	4,898
Alipay fees (bps)	15.3	14.0	15.8	15.8

Source: Company filings

Since Alibaba paid to have its GMV “verified” by a third party, it may not be too surprising that Alibaba appears to have simply chosen a number. In its June 16, 2014 response to the SEC, BABA reported, “with respect to the “IDC GMV Report” referenced on the table of contents page and pages 1, 86 and 132, among others, IDC undertook an industry study of GMV upon the request of the Company. The Company paid a fee in connection with this report. IDC prepared the report independently. Because of the independent nature of the report, IDC does not view it as a commissioned report.” It may be hard to be independent when the client represents 85% of the metric you are studying.

In the most recent quarter, Alibaba reported GMV up 24% YoY.

The lingering suspension of disbelief on which such claims hang might be summed up in a direct quote from the transcript of a September 17, 2015 investor presentation by Alibaba at the Deutsche Bank Technology Brokers Conference. The unidentified attendee told the assembled group, as recorded in the Seeking Alpha transcript:

“And by the way, I love China. I mean, I love China. How can you not love China? I love China, China, China. China, China, China, and, you know, China, China, China. South China, China, China. People say, you don't like China, I like China. China, I love China, China, China all the time. And by the way, I love China. I mean, I love China. How can you...”

Amazing Ant

Recent disclosures around Ant Financial added to our conviction that Alibaba is using unconsolidated companies like Alipay and Cainiao to hide costs and create exciting turnover growth.

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How "related" is Alipay?

Ant Financial, the parent company of Alibaba's payment tool Alipay, recently raised USD 4.5 bln at a lofty valuation, generating many articles in the Chinese and foreign press claiming that Ant is a cash machine. "Soon 'BAT' will become 'ATM'," said one report, referring to the Baidu-Alibaba-Tencent triumvirate that currently rules China's Internet. But in its last quarterly report, Alibaba disclosed that Ant had made a loss in the quarter ended March 31, 2016.

Alibaba said the loss was due to marketing costs around Spring Festival. The disclosure from the FY 2016 report tells investors that the Ant loss resulted in a "charge of RMB 207 million (US\$32 million) in the quarter ended March 31, 2016, compared to income of RMB 266 million recognized in the same quarter of 2015 and income of RMB 502 million in the prior quarter."

[Articles published in China](#) indicate that Ant's 2014 revenue was RMB 10.2 bln with net profit of RMB 2.6 bln and that the company was expecting to see 64% growth in profit in each of 2015 and 2016. Even if Ant missed by a mile, it is hard to imagine that marketing costs could have been so huge: the implied loss is USD 85 mln, based on a 37.5% share in Ant's gains and losses. For one thing, with 450 mln active users, Alipay has more users than make purchases on the Internet in China, according to the government agency CNNIC. Consequently, there is no one left to market to.

In fact, our research in China suggests that Alipay marketing is mostly around subsidizing product sales to create incentives for consumers to buy with Alipay. Typically, Alipay will strike a deal with, say, a sports shoe brand that the shoes will sell at 10% off if the buyer uses Alipay, and Alipay will subsidize the discount. Given Alipay's slim margins, there would have to be huge transaction growth from a promotion like that to justify subsidies.

Instead, it seems more likely to us that Alipay's "marketing costs" are there to benefit Alibaba and not Alipay. By recording a charge, Alibaba may have been tucking away costs it could not otherwise explain.

That the relationship between Alipay and Alibaba should be chummy is not surprising. Alibaba discloses that one-third of its share-based compensation consists of shares granted to Ant Financial employees (see page 16 of the May 5 press release). These grants came to RMB 2.26 bln in 2015. Ant Financial reciprocally granted RMB 3.79 bln in shares to Alibaba employees. Following the recent round of financing, those grants must be very attractive.

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Alibaba's share-based compensation was 19% of revenue for the recent quarter and 16% for the year. That means an average of USD 70,000 in FY 2015 granted to every single employee at Alibaba.

Exoskeleton

The recent fundraise by Ant Financial led to circulation of a good deal more information about the company than has been seen publicly in the past. Reports say the company raised USD 4.5 bln at a USD 60 bln post-money valuation from an arm of the sovereign fund, CIC, and Construction Bank, among others. Ant solicited funds only from State-owned institutions.

Although we still do not know much about the company's financial situation, its volume and commission rate have now been widely reported.

The SEC called Alibaba on its claim that Alipay was not a related party. It said:

Please disclose the basis upon which you characterize Alipay as your "related company." In this regard, we note your statement on page 10 that you "do not have any ownership interest in, or control over" Alipay and your statement on page F-33 that you have not "consolidated or equity accounted for the entities engaging in Payment Services because [you have] no direct and indirect investment in and [do] not control or have significant influence over Alipay Holdco, Alipay and their subsidiaries." ¹

In its revised IPO prospectus, Alibaba said that Alipay was not related but was a sort of kissing cousin because it is responsible for the majority of Alibaba revenue.

That is only partly true. Alipay is a subsidiary of Ant. At the end of 2013, Ant Financial's owners were the Hangzhou Junhan and Hangzhou Junao partnerships. Junhan and Junao owned about 58% and 42% respectively before the last funding round. Jack Ma and Xie Shihuang were the limited partners of Junhan and Jack Ma, through a holding company, was the GP of Junao, which names several LPs. Jack Ma's percentage of ownership is not disclosed, but [online information in China](#) says that Jack Ma's ownership in Ant is not more than his share in Alibaba' before IPO, and that was 8.9%. Ma has told the press that 40% of Ant is owned by employees and 60% would gradually be sold to strategic investors.

¹ <https://www.sec.gov/Archives/edgar/data/1577552/000119312514237452/filename1.htm>

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The operating divisions of Ant Financial are as follows:

- ▶ [Antsdaq](#): a crowd-funding site for media and software projects. Press reports say the site has 18 million users.
- ▶ [Ant Check Later](#): Short-term lending for online purchases, similar to PayPal credit.
- ▶ [MyBank](#): Small loans to corporations. The site says that RMB 613.2 bln has been extended to 3 mln borrowers, so the average loan size is RMB 2,000. The company reports a 2% NPL rate.
- ▶ [Zhima \(“Sesame”\) Credit](#): Loans to individuals and “credit” scores for individuals
- ▶ [Ant Fortune](#): A mobile handset-based sales platform for investment products
- ▶ [Zhaocaibao](#): A web-based sales platform for investment products
- ▶ [Yuebao](#): A tool for transferring money to the Tianhong fund.
- ▶ [Alipay](#): Online and mobile wallet
- ▶ [Ant Financial Cloud](#): Cloud computing platform for financial institutions

Several of the divisions make small loans. Alibaba receives a “Small and Medium Enterprise Fee” from Ant that is calculated as 2.5% of the average balance of outstanding loans in the period. In the last quarter, this SME annual fee went from RMB 90 to RMB 708 mln. That means that SME loans ballooned by a factor of nearly eight in a single year, to USD 4.35 bln.

No bank could octuple its loans in a year without incurring high defaults. It also seems curious that Alibaba should have expanded this business so dramatically in the last year when the business has been around for a long time.

Wind, the financial data service based in Shanghai, reports that third-party Internet-based payments average a bit more than RMB 3 trn per quarter and that Alipay has a 45% market share. That indicates RMB 450 bln in turnover per month for Alipay. News reports on Alipay say that Alibaba represents 20% of Alipay’s turnover. That would mean RMB 90 bln per month rather than the RMB 153 bln reported by Alibaba in 2015 monthly average GMV resolved by Alipay.

Cainiao

Alibaba also disclosed that its logistics “platform,” Cainiao (which does not appear actually to deliver or store anything) raised another RMB 10 bln in the first calendar quarter this year and that Alibaba subscribed to the raise on a pro-rata basis, keeping its shareholding at 47%, the better to leave Cainiao unconsolidated. Cainiao lost USD 15 mln in the March quarter.

Alipay's
commission
rate reportedly
averages 60
bps, but BABA's
payment to
Alipay is just
over 15 bps on
GMV.

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Cainiao contributed to Alibaba's net cash used in investment activities of USD 1.147 bln in the quarter.

Alibaba does disclose that Cainiao is only a "platform." From the 2016 20-F:

Cainiao Network does not deliver packages itself. It operates a logistics data platform that leverages the capacity and capabilities of logistics partners to fulfill transactions between merchants and consumers at a large scale.

... In order to enhance consumer experience and improve efficiency in last-mile delivery in both rural and urban areas, Cainiao Network is also engaged in initiatives including arranging delivery from county-level Rural Taobao stations to villages, and setting up pick-up stations around urban communities.

During the twelve months ended March 31, 2016, Cainiao Network and its logistics partners enabled the delivery of 12.2 billion packages from our China retail marketplaces. Currently, Cainiao Network primarily derives its revenue from end-to-end logistics solutions and generates a significant portion of its revenue from providing these services to Tmall Supermarket.

Press articles seem to promote a general misunderstanding that Cainiao carries out physical delivery. For example, [this Chinese language article](#) in Caijing says that Cainiao **partners** own and operate 180,000 express delivery stations and 128 warehouses, but [foreign reports](#) often claim that Cainiao makes deliveries directly. Cainiao executives tend to add to the confusion. Speaking of last year's Singles Day, Cainiao Chief Technology Officer Ben Wang said, "The massive number of delivery orders generated from this great online shopping event really pushes us and our delivery partners to do our very best."

For us, Cainiao is among the more puzzling aspects of Alibaba's operations. It doesn't seem to do anything. Each vendor on Alibaba's platforms continues to handle its own logistics through its own preferred partners. Cainiao purports to be an IT platform that the logistics partners use to improve efficiency. We have met many last-mile logistics providers in China, and most of them "participate" in Cainiao in that they make the obligatory cash deposits, but we have not yet succeeded in identifying logistics companies that use the IT platform. That does not mean that they don't, but Cainiao is not a commonly used IT solution, at least now.

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If you can buy at \$74 and sell at \$78, who wouldn't do that deal?

Tianhong

Ant Financial says that 260 mln people have now invested cash with Tianhong, the fund manager partially owned by Alibaba, and Tianhong advertises that the money market fund into which Ant's Yuebao deposits funds now manages RMB 673.9 bln. Disclosures on the Yuebao website indicate that deposits made through Yuebao before they reach term may be used only for e-commerce purchases. Users are not restricted to purchases on Alibaba but they must use Alipay, which is not an option on competing JD.com.

Tianhong also [advertises](#) that investors in its funds can choose hard-currency investments. "Overseas assets are not just a special privilege of the rich," the website says. Tianhong is a full-fledged mutual fund, with several smaller hedge funds that trade onshore and offshore stocks, so investment in BABA shares would be one choice.

Insiders

According to public filings, BABA insiders have sold USD 258 mln in stock in the last two weeks.

Insider Sales in Jun

	Name	Relation	Date	Type	Shares	Avg. Price	Value (mln)	Form	Return	Shares	Mkt Val
BABA	Eagletron Management...	Affil Person	2006-7-16	144 Sale	2,000,000	\$78.06	\$156.10	144	-0.3% O	-2,000,000	\$156.1M
BABA	Dai Shan	Officer	2006-3-16	144 Sale	17,387	\$77.30	\$1.30	144	-1.3% O	-17,387	\$1.3M
BABA	Eagletron Management...	Affil Person	2006-3-16	144 Sale	1,000,000	\$77.24	\$77.20	144	-1.3% O	-1,000,000	\$77.2M
BABA	Hu Xiaoming	VP	2006-3-16	144 Sale	50,000	\$76.69	\$3.80	144	-2.1% O	-50,000	\$3.8M
BABA	Jiang Peng	Officer	2006-3-16	144 Sale	22,267	\$77.35	\$1.70	144	-1.2% O	-22,267	\$1.7M
BABA	Liu Zhenfei	Affil Person	2006-3-16	144 Sale	40,701	\$76.62	\$3.10	144	-2.2% O	-40,701	\$3.1M
BABA	Wu Minzhi (Sophie)	Officer	2006-3-16	144 Sale	65,279	\$77.30	\$5.00	144	-1.3% O	-65,279	\$5.0M
BABA	Yongfu Yu	Affil Person	2006-3-16	144 Sale	89,000	\$76.62	\$6.80	144	-2.2% O	-89,000	\$6.8M
BABA	Zheng Junfang	Officer	2006-3-16	144 Sale	50,000	\$77.30	\$3.90	144	-1.3% O	-50,000	\$3.9M
BABA	Jin Jianhang	Pres	2006-2-16	144 Sale	772	\$77.30	\$0.06	144	-1.3% O	-772	\$59.7K
							Total	\$258.96			

Source: Washington Insider

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Some of this may have to do with Alibaba's [agreement](#) on June 2 to purchase 27 mln shares from Softbank at USD 74 per share and the Alibaba partnership, meaning management insiders, to purchase 5.4 mln shares. Given sales by those same partners at up to USD 78 per share, that is not a bad deal. It seems likely that Yahoo! will follow suit with an agreement to sell shares back to Alibaba.

Investments

Alibaba has predictably backed off discussions to acquire Paramount Pictures, which is too visible and transparent a company to fit in the Alibaba group. Instead, the company is discussing licensing deals with Paramount and is looking at investing in Indian logistics firms and possibly raising its stake in the Indian payments company PayTM.

In addition to acquiring the English-language Hong Kong-based newspaper the South China Morning Post, in a less-public move, Alibaba in 2015 acquired 37% of First Financial, a respected economic magazine on the mainland with the stated goal of improving the image of Alibaba.

For the March quarter, nearly half of Alibaba's net income derived from a write-up of USD 471 mln on investments. Overall, by the time of the March quarter report, Alibaba's goodwill, intangibles, and investments in subsidiaries were up by USD 22.4 bln since the quarter prior to IPO, even though Alibaba's disclosures indicate that all minority investees are losing money. That is where all the IPO cash went.

Counterfeits

At the recent Investor Day, Ma riled some international companies by portraying Alibaba as a slayer of knock-offs and fakes. "We can solve the [fake] problem better than any government, any organization, any person in the world," he said.

The fact is, however, that Alibaba's e-commerce platforms exist because of their low price. Appropriately named, Alibaba is like an online souk, with a jumble of products of dubious origin all selling at rock-bottom prices. Should the fakes be eliminated, average prices would rise and that would deal Alibaba a blow that will ultimately be mortal.

Technology

The quarter call focused a good deal of attention on cloud computing and

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tweaks to the search tool to direct mobile users preferentially to TMall. What investors fail to appreciate about the Alibaba platforms is how little standardization there is of databases, inventory management, logistics, and payment systems and how much is done manually. In the Alibaba e-commerce universe, cloud computing is deeply irrelevant.

On the call, Daniel Zhang said, “[A]ctually our value add to our merchant is that to enable them to operate their software effectively. So today, what we are doing is to use the big data we have to help the merchant to tailor-made their storefront and -- to the right audience and in the right location.” In other words, Alibaba can target advertising. This is not related to the question, which was “how will GMV be affected by interface changes on the Taobao app?”

Valuation

Our view of Alibaba might be compared with a group of alligators underwater, all tethered to a lifesaver ring—the listed company—that floats on the surface. All the nice bait is put into the ring, as the alligators look for a choice swimmer to capture for lunch.

Under Alibaba’s audit line lurk a series of murky companies like Ant Financial and Cainiao, all hungry for cash and related to the bright-orange ring by lines no one can see. Swimmers beware.

We consider our USD 36.58 price target for Alibaba generous considering the undeniable degree of fraud in this company. The target is based on our lower estimate of turnover and profit against a P/E multiple of 23

Risks

- ▶ A robust recovery in the Chinese economy could lead to a positive view internationally of the consumer economy, and there are few companies left that are investable. Alibaba on a relative basis could look attractive.
- ▶ Alibaba could absorb JD.com, VIPShop, or another popular Chinese Internet site.
- ▶ Alibaba could begin issuing dividends, which would support the proposition that the company is genuinely producing cash.

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Note: Some Chinese-language news articles offering information on Ant Financial include the following:

[36KR on Ant's valuation and basic metrics](#)

[Xinhua on the active user count and valuation](#)

[Transaction volume and some revenue metrics](#)

[Techweb with more metrics](#)

[WeChat on turnover and other metrics](#)

[2014 revenue and profit](#)

[Ant's revenue](#)

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