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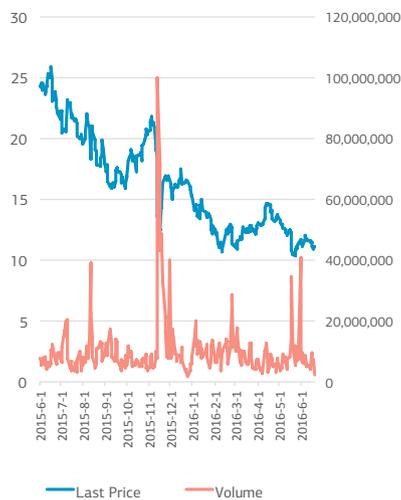
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VIPShop Holdings (VIPS US)

Price	USD 11.43
Rating	SELL
Price Target	0
Difference	100%
Market cap	USD 6.54 bln
Avg. Volume	USD 111 mln/day
P/E	26.7x

Source: Bloomberg June 22, 2016

VIPShop (VIPS US) last share price in USD (blue) and volume (pink, in mln shares)



Source: Bloomberg

VIPShop Holdings (VIPS US) More Nails in the Coffin

- ▶ **VIPShop continues to report** negative free cash flow and poor operating cash flow conversion
- ▶ **Despite large cash and securities balances,** the company has recently received cash injections from founder Eric Shen of nearly USD 130 mln
- ▶ **Related-party transactions** continue to account for an increasing proportion of key financial accounts
- ▶ **Company insiders sold** a significant quantity of shares in the month before reporting disappointing Q1 2016 results

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VIPS Cash

Now You See It . . .

■ Melvin Glapion and Anne Stevenson-Yang

I have heard from folks who have seen ghosts--mostly my two nephews--that the ghosts can seem believably real, even indiscernible from real people.

If ghosts exist in the financial world, surely VIPShop should be counted among them. The company recently reported 41% growth in first quarter revenue and 51% growth in net income as compared to the prior year period. VIPShop still displays an ability to effect economies of scale, as its operating income eked out an 80 basis point improvement over the same period last year. Remarkably, there has been no impact from the macro environment on the company's stellar results. Investors looking for a good story would find it hard to resist such ghostly/ghastly achievements. But VIPShop is a phantom, and its cash, in our opinion, disappears at will while other results are an optical illusion.

Even some ghouls, the vampire type, cease to haunt the living when their coffins are nailed shut. In this case, the company itself has provided the spikes in the form of information in the Q1 2016 earnings announcement and other information in the public domain. Here are a few nails worth mentioning.

Nail #1: VIPShop continues its history of poor cash flow conversion and negative free cash flow

For the period ended March 31, 2016, VIPS celebrated its "income from operations" of USD 92.4 mln, approximately 4.9% of total revenues, an increase over the 4.6% of total revenues reported in the prior year period. The problem with VIPS' impressive increases in income from operations, net income, and net income attributable to VIPShop's shareholders is that less and less of this money is making its way into cash flow from operations. In fact, only USD 23.76 mln was reported in Q1 2016, a cash conversion rate of 25.7%. This suggests that VIPS is using accounting estimates and accruals to report impressive income while, in fact, the actual cash impact on operations has been small. Most analysts expect the ratio of cash flow from operations to net income to exceed 100% at companies that are beyond start-up and early growth phases.

In the first and only year when VIPS has not accessed the capital markets, the company has benefitted from large cash injections from CEO Eric Shen.

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We find it very telling when management teams start to get testy and defensive on calls.

In our report of April 27, 2016, we pointed out that VIPS had reported negative free cash flow for the first time in its history. Well, now it's the second time. VIPS reported for Q1 2016 that cash flows from operations were USD 23.76 mln and that capex was USD 102.45 mln, meaning that free cash flow for the quarter was an abysmal USD -78.69 mln.

VIPS tries to argue that it should add the impact of its customer and supplier financing activities to its cash flow from operations. We view these cash flows as "Investing Activities." But even with the benefit of the financing activities, VIPS still reports negative free cash flow for the first quarter, an indication that the company's core business is not self-sustaining.

VIPS could have moderated its spend on capex, but we regard the capex spend as the means by which VIPS takes cash out of the business. This could be faked capex, for circular revenue transactions with related parties, or it could be real money diverted to the owners as misappropriation. Either way, why would VIPS cut back on capex?

Free Cash Flows with and without Financing

USD in 000	Q1 2016 w/o Financing	Q1 2016 w/ Financing
Cash Flow from Operations	USD 23,761	USD 23,761
Add: Impact of Financing		USD 47,954
CAPEX	(USD 102,449)	(USD 102,449)
Free Cash Flow	(USD 78,688)	(USD 30,734)

Source: Company results, 6-K reported May 17, 2016

We find it very telling when management teams start to get testy and defensive on calls. Here is VIPS' awkward and tense response to a legitimate question about its free cash flow, as reported in the Seeking Alpha transcript from May 18, 2016. Note that Eric Shen is so irritable that he does not even answer the question. CFO Yang answers the capex component but ignores the cash flow from operations component until pressed further by the analyst.

Operator

All right. Your next question comes from the line of Eileen Deng of Deutsche Bank. Please ask your question.

Eileen Deng

Hi, Donghao, hi Millicent. This is Eileen. Forgive me if this question

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When equity markets were getting excited about a potential share price comeback, a host of key executives and affiliated parties were busily unloading shares.

has been answered before. For management just I have to quantify each of the components of the active free cash flow of this quarter? And also what is the -- this quarters CapEx related too? Thank you.

Eric Shen

Well, what do you mean by specifying the each item of the cash flow. Well I'm sorry I don't quite get that question, go ahead.

Eileen Deng

What's the reason of an active free cash flow and can you quantify each of the impact?

Eric Shen

Well, the thing is clearly listed in the table as part of our earnings release starting from net cash from operating activities, we have some cash outflow.

Eileen Deng

Yes I understand.

Eric Shen

I'm sorry, I don't quite follow you.

Eileen Deng

Can I just make my question more cleared? May be first of all for management just comment on why the -- our operating cash flow level is so low compared to historical levels. And second one is that our CapEx is relatively actually is higher than what we see from the operating cash flow. So what is this CapEx related to?

Donghao Yang

All right. So the majority of the CapEx was related to warehouse expansion programs and we spent like close to RMB400 million on our -- on the construction of our warehouses and about RMB90 million on land and about RMB140 million roughly on the equipment related to our warehouse expansion.

Eileen Deng

And why do you see the operating cash flow is more than historical?

Donghao Yang

Yes we just talked about that. In Q4 we were on big promotions. So we saw significant increase in our top-line growth -- in our top-line

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in Q4. But our account payable days are usually 30 to 40 days. So we paid a lot of cash for the account payables that we had accumulated in Q4. So that's another reason why our operating cash flow was not as good as Q1 and in 2015

Nail #2: VIPS which reports cash and held-to-maturity (HTM) securities balances in excess of USD 663 mln, has sought multiple capital injections from Eric Shen in the last several months. The cash and HTM are down from about USD 700 mln the prior year.

The company represents that it is holding a large portion of its assets in cash. We have previously questioned whether these balances are, in fact real. The reported interest on HTM balances, for example, seems too low, and the cash and HTM are mostly in VIPShop's contractually related but not owned Chinese affiliate, meaning that balances are harder to audit and tough for foreign shareholders to access.

It is interesting to note that in the first and only year when VIPS has not accessed the capital markets, the company has benefitted from large cash injections from its Chairman and CEO Eric Shen. This is despite the large reported cash and HTM balances on its financial statements.

In August 2015, the Company effected transfer of 22.0% of equity interest from two of the former shareholders of VIPShop Information to Mr. Shen and a concurrent capital increase of VIPShop Information from RMB24.5 million to RMB274.5 million as contributed by Mr. Eric Ya Shen, and further amended the contractual arrangements the relevant entities had as explained above with Mr. Shen and Mr. Arthur Xiaobo Hong to reflect this transfer. In December 2015, the Company effected a concurrent capital increase of VIPShop Information to RMB824.5 million as contributed by Mr. Eric Ya Shen, and further amended the contractual arrangements the relevant entities had as explained above with Mr. Shen and Mr. Arthur Xiaobo Hong to reflect this transfer. As of December 31, 2015, shareholders of VIPShop Information include Mr. Shen and Mr. Arthur Xiaobo Hong, holding 99.23% and 0.77% of the total equity interests in VIPShop Information, respectively. (Source: Company reports, VIPShop 20-F, page F-18, April 22, 2016)

In fact, in the last five months of 2015, VIPS received nearly USD 130 mln in cash from Eric Shen. Was the company in dire need of cash? If so, given the huge sums of cash reported in the company's corporate filings, why?

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Nail #3: In the month before the Q1 2016 announcement, investors were getting excited about a potential VIPS comeback, and management was unloading USD 52 mln worth of shares.

While sales by insiders are perfectly legitimate, it is interesting to note that at a time when equity markets were getting excited about a potential VIPS share price comeback, a host of key executives and affiliated parties were busily unloading shares.

All of this just one month prior to reporting yet another disappointing quarter.

Insider Sales in March 2016

Name	Title	Date	Type	Shares	Av Price	Value (,000 USD)
Fan Liping	VP	3/31/16	144 Sale	10,000	\$12.59	\$125.90
Wei Yanxiang	VP	3/31/16	144 Sale	60,000	\$12.59	\$755.40
Meijuan Hong	VP	3/29/16	144 Sale	30,000	\$12.13	\$363.90
Cai Xianfeng	VP	3/28/16	144 Sale	100,000	\$12.58	\$1,300
Fan Liping	VP	3/28/16	144 Sale	30,000	\$12.58	\$377.40
Kao Daniel Tsun	Officer	3/28/16	144 Sale	140,000	\$12.58	\$1,800
Wei Yanxiang	VP	3/23/16	144 Sale	5,000	\$12.78	\$63.90
Fan Liping	VP	3/21/16	144 Sale	30,000	\$12.29	\$368.70
Cai Xianfeng	VP	3/17/16	144 Sale	100,000	\$12.56	\$1,300
Feng Jia Lu	VP	3/17/16	144 Sale	70,000	\$12.55	\$878.20
Meijuan Hong	VP	3/17/16	144 Sale	30,000	\$12.56	\$376.80
Fan Liping	VP	3/15/16	144 Sale	40,000	\$12.49	\$499.60
Kao Daniel Tsun	Officer	3/15/16	144 Sale	60,000	\$12.49	\$749.40
Wei Yanxiang	VP	3/15/16	144 Sale	20,000	\$12.49	\$249.80
DCM Affiliates Fund...	Affil Person	3/14/16	144 Sale	8,305	\$12.66	\$105.10
DCM Hybrid RMB Fund...	Affil Person	3/14/16	144 Sale	1,516,930	\$12.66	\$19,200
DCM V LP	Affil Person	3/14/16	144 Sale	1,474,765	\$12.66	\$18,700
Meijuan Hong	VP	3/14/16	144 Sale	160,000	\$12.66	\$2,000

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Wei Yanxiang	VP	3/14/16	144 Sale	10,000	\$12.66	\$126.60
Meijuan Hong	VP	3/10/16-3/11/16	144 Sale	120,000	\$11.79	\$1,400
Meijuan Hong	VP	2003-9-16	144 Sale	55,000	\$11.92	\$655.60
Meijuan Hong	VP	2003-7-16	144 Sale	45,000	\$11.54	\$519.30
Meijuan Hong	VP	2003-3-16	144 Sale	40,000	\$11.00	\$440.00
Meijuan Hong	VP	2003-2-16	144 Sale	40,000	\$11.32	\$452.80

Source: Washington Insider

If key investors were cashing out pre-announcement, other investors should be viewing this as a vote of no confidence now and following suit.

Nail #4: Related-party transactions are growing in size and importance to the VIPS growth story.

We have highlighted in previous reports that the company's investment in affiliate logistics companies and its supplier and customer financing programs provide unique opportunities to engage in a complex and vicious circle of round-robin transactions. Our view is that the Accounts Receivable, which have historically been debts owed from investee logistics companies, and Other Receivables, which are largely debts owed by customers and suppliers on in VIPS' financing program, are both predominantly transactions with related parties. In our view, the financial statements continue to show evidence of a growing reliance on related parties to achieve financial results.

VIPS Account Growth

Account	YoY growth
Revenue	41%
Accounts Receivable	129%
Other Receivables	136%

Source: Company accounts

The company reported revenue growth of 41% in Q1 2016 over the same quarter a year ago. However, growth in revenue was accompanied by 129% growth in accounts receivable, which, according to VIPS' 20-F, are primarily with investee logistics companies. Additionally, the 41% growth in revenue was accompanied by 136% growth in other receivables, which again, are a result of financing arrangements between VIPS and its suppliers and customers.

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These figures suggest that VIPS growth in the most recent quarter is highly reliant upon interactions between VIPS and its 'ecosystem' of suppliers, customers, and investees, and less upon arms-length transactions between VIPS and truly independent and unrelated customers.

Equity analysts on the most recent call attempted to get more clarity on the impact of these transactions on various accounts, but, as the below exchange highlights, they had limited success. CFO Yang does not even provide context (percentage of total) or clarity (is this Accounts Receivable or Other Receivables) in his answer to the question posed:

Operator

Your next question comes from the line of Natalie Wu from CICC. Please ask your question.

Chu Hua

Hi this is Chu Hua on behalf of Natalie Wu. Thanks for taking my question. Actually I have three questions...My third question is that we noted that accounts receivable has increased significantly. I was wondering to how much extent is this related to your consumer finance? Thank you.

...

Donghao Yang

Your last question the ending balance of our consumer finance as of end of March quarter was RMB570 million.

Valuation

We have assigned a go-to-zero valuation to VIPShop because of what we believe is very significant fraud in the company's operations and financial statements, making it likely that VIPShop could be required to delist.

Risks

- ▶ VIPShop could be acquired at some meaningful valuation.
- ▶ Companies like Dangdang and Jumei have become so relatively cheap that VIPS could acquire them for shares, and that would likely raise VIPS valuation.
- ▶ The company could do an equity of debt raise for its logistics affiliate, Pinjun, and in doing so, improve its own results.

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