JCAP

China Primary Insight

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Commentary

Cave Reflections

The Strange Symmetry Between E-Commerce and Payments Growth

- **Total eclipse of common sense:** A wealth of statistics indicate that reports by Alibaba, VIPShop, and JD cannot accurately represent e-commerce in China. They probably represent cash flow from new Alipay and WeChat customers.
- **Online shopping in decline?** Government statistics actually show sharp declines in online shopping. Sales of clothing overall have fallen slightly this year, and online prices of clothing are down.
- **Churn, baby, churn:** The only number that seems to track with Alibaba growth is growth in online payments. Unfortunately, this number is reported well after the e-commerce companies report.

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In the absence of reliable data, many investors have developed a childlike view of China's economy. It is different from the West. Growth comes without effort. If only a company be private, it can tap into that growth. The West is hidebound, mired in pesky political controversies, stuck with entrenched interests. China can set aside petty fights and do what's best for the economy.

For the most part, share prices have rewarded this attitude of credulous marveling. No class of companies has grown rich themselves and enriched their investors better than the e-commerce companies and their ecosystem. For crabbed and embittered analysts like myself, the only question is how long the companies will be able to live in the paracosm. The simple answer, for Alibaba, JD.com, Vipshop, the logistics providers, the payments companies and, yes, Tencent, is, as long as they have access to cash flows.

An executive of a large company involved in e-commerce said to me not long ago that his company had over-reported revenue growth by a factor of 10. "How can you do that?" I asked. "We have cash flow, so we can report whatever we like." This was considered so self-evident that saying it to a stock analyst was not even sensitive. The value AliPay gets from channeling your utility payments, mortgaqe payments, mobility expenses, entertainment expenses, and investments is the ability to report that cash flowing through their ecosystem.

All this means that a longer life in the paracosm belongs to those with payments tools. And the bigger payment platforms gate directly into all of the most popular services, mobility, entertainment, and banking/transfer services. No wonder that payments licenses trade in the market for USD 100 mln, and no wonder that both Alipay and Tenpay are insatiable about building out the market even as Alipay crosses the 900 mln mark in active users. Only hundreds of billions a day in turnover? Why can't it be trillions?

Just So Huge

Right now, e-commerce more than any other sector seems to have lofted free of the rest of the economy, and indeed from all economies if not the actual rules of economics, sailing into an untroubled sky of growth and profit without limits. Alibaba now does significantly more business volume than does Walmart, with its 40 years of operating history. BABA's business volume, scope, and growth (although not its revenue) dwarf Amazon's. Walmart did USD 123.4 bln in revenue in the most recent quarter; Alibaba saw gross merchandise value (GMV) of about USD 176 bln. The company claims nearly 15% of all consumer spending in China, even as Chinese leaders themselves have commented that the consumer spending numbers are inflated. The company is on track to post GMV of USD 700 bln in the current fiscal year, but there is still 85% of consumption Alibaba has not captured, and then there is the rest of the world's consumption for Ali to eat up.

Alibaba is not alone in reporting huge volume growth. In the most recent quarter, JD reported 46% growth in GMV. Also-ran Vipshop had a respectable 23% growth in reported orders.

In the meantime, a curious development failed to get as much attention as it deserved. The data landscape is like a palace garden maze. Even with its 56% top-line growth, Alibaba is 20% more profitable than it was a year ago. BABA now gets 4.2% of GMV in revenue instead of the 3.5% the company had prior to 2016. Cynics might say that it is becoming very hard to report GMV growth quite at the same level as formerly, since Alibaba is in danger of growing larger than the Korean economy; by the end of 2020, it should be larger than the African continent. In any case, net income in the most recent quarter rose by 67%, and the company somehow trimmed over USD 2 bln in cost growth.

It seems that active customers are spending more: while revenue rose 56%, the number of customers rose only 7%. In 2016, the average customer spent RMB 8,000 on the platforms and placed 85 orders, so presumably this year that person will spend RMB 12,000, which is a little more than two months of gross income for the average internet user, according to government statistics. Given that Alibaba has 466 mln active users, about 68% of all internet users in China, its users by definition are average internet users.

On the Q1 2018 earnings call, Joe Tsai fed the general perception of effortlessness: "I want you to know that these exceptional results did not come from anything specific we did during the quarter." Of course the share price rose to historical highs.

All of this has occurred as China's economy, everyone agrees, is downshifting. Companies more earthbound, like the manufacturers, the retailers, and even the property developers, are generally struggling with thinner and thinner margins. Whether it's KFC stores, Gome electronics outlets, or big fashion chains like Heilan Home, profit is tougher to come by for those in brick-and-mortar, or, shall we say, visible businesses where not only their merchandise but the traffic is visible.

A few contradictions

There is not even a remote possibility that e-commerce GMV represents sales of goods. Every public statistic, every interview, and every bit of common sense contradict that. Just a few curious statistics:

- Alibaba's implied order volume (39.6 bln orders in 2016) is 27% higher than the number of packages that the postal system says were delivered in China in 2016. The benign interpretation is that more than one-third of Alibaba's orders are virtual, for coupons, gift cards, insurance, investment products, and so forth.

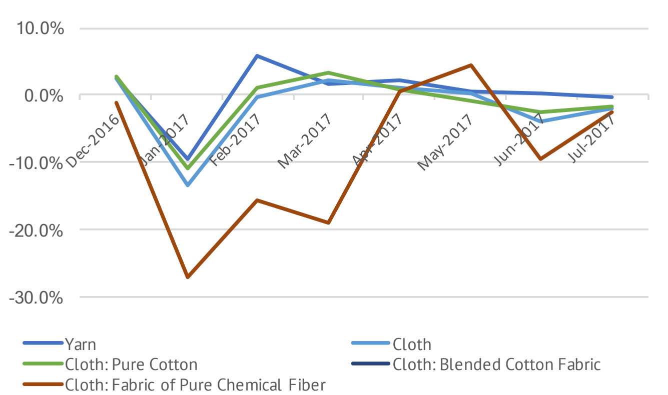
- The China Internet Network Information

Center (CNNIC), a government agency that conducts a wide-gauge survey of internet users twice yearly, reports that the number of people using China's internet each week actually declined, by 5%, in 2016 and then rose by 6% YoY in the first half of 2017. CNNIC also reports that online shoppers declined in 2016 and fell again by June of 2017. (CNNIC reports on online traffic and buyers weekly, and these are monthly averages to smooth out seasonal volatility.) In June 2017, an average of 132.16 mln people shopped online in China, according to the CNNIC, down 8% from the 142.95 mln who shopped in June 2016. The CNNIC's page view and visit tracking data provide consistent numbers for Taobao, TMall, and JD. Vipshop is not covered.

- NBS says the sale of physical goods online grew 28% in Q2. Alibaba has a share of about 85% of online shopping, so either the NBS is wrong or Alibaba is not selling mostly physical goods.

- Clothing is the core offering of Alibaba and Vipshop. But China's sale of yarn and cloth for manufacturing is down year to date through July.

Chart 1. Sales of Yarn and Fabric Through July YoY



Source: Wind Information

- The NBS reported that retail sales of garments for China's top 100 retailers through March were down by 1.3%. Sales of garments were down last year as well.

- Wind Information maintains a price index for Alibaba products. Overall, in 2016 the price index was flat. For clothing, Wind reports that prices were down by 2.38%.

- E-commerce package volume growth for all the listed logistics companies in 2016 (except for STO, which was slightly behind national growth) exceeded industry growth. All have exceeded industry CAGR since 2013. JD's and Vipshop also report industry-beating growth for their captive logistics companies. Altogether, these companies represent around 65% of the total express delivery market. And yet the industry has not seen consolidation. All the delivery companies are seeing flat or declining prices. Most desperately need cash. ZTO, for example, which recently listed on the New York Stock Exchange, is seeing fast growth, with 75% of parcel volume from Alibaba, but cash is decreasing.

The other companies

Like Alibaba, JD had a great second quarter. Company GMV grew 46% YoY. Orders were up 41%, to 591.2 mln in the quarter. Like Alibaba, JD reported a higher value per order. JD has acknowledged that its "marketplace," where third parties sell goods, is more profitable than its direct, B2C platform and it is offering merchants attractive incentives to join the platform. This puts JD more directly into competition with Alibaba and should gradually drive down advertising prices for merchants as well as mean better profit for JD.

JD.com has its own payment tool, called JD Payment, but it more commonly takes payment via WeChat Payment, the Tencent tool. Tencent is an investor in JD.

Poor Vipshop is losing out. It reported the lowest revenue growth of the triumvirate, at 30% in the second quarter. Unlike Alibaba's, VIPS profitability is declining. In the most recent quarter, gross profit rose by 19%, compared with revenue growth of 30%. Orders grew by 23%, to 84.8 mln. Merchants pretty uniformly say that VIPShop is no longer part of their marketing plan—the site just doesn't have enough traction.

Who even knows what they really do? The company says that, as of the end of H1, they employed 27,000 delivery people, and yet logistics companies all over China say that VIPS bids out delivery jobs to them.

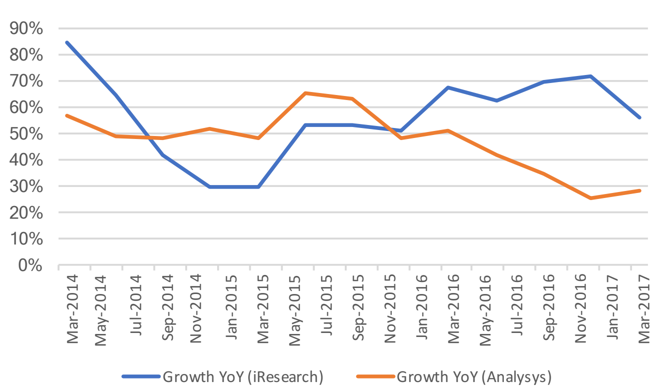
Watch the cash. In the most recent quarter, Vipshop reported negative operating and free cash flow. For the 12 months to June 30, the cash flows were positive—but only after internet financing. Without the internet financing, free cash flow for the year would have been USD -130.9 mln.

Paying for Payments

There is an interesting and mostly ignored statistic from the listed express delivery companies: roughly 80% of volume comes from the eastern seaboard. Since Alibaba's 466 million customers live across China's regions, that concentration suggests that, if the numbers are accurate, then a small proportion of buyers are buying the great majority of goods.

It is no secret that China's concentration of wealth is even more severe than that of the United States, and the Chinese bourgeoisie live along the east coast, mostly in the top four cities. Those people are buying all the gear. But more importantly, those people are making all the investments.

Chart 2. Online Payments Growth (as measured by iResearch and Analysys)



Source: iResearch and Analysis

Of all the plethora of statistics about China's economy, only one correlates with the volume triumphs of the e-commerce companies: third-party payments.

China's payments market, although it has more than 250 participants, is a duopoly between WeChat Pay and Alipay, and these two companies are competing at breakneck pace to sign up all of China's merchants, including—especially—all the soda stands and watermelon vendors who turn over RMB 100,000 per year. Ubiquity creates more incentive for new companies to sign up to accept these payment methods. But the companies claim that they want Mom-and-Pop China because they can effectively bring technology penetration and data management to small establishments that now operate in the paper-and-cash world, creating new efficiencies in supply chains, logistics, and customer relations management as well, of course, more trackability

So far, the payments business almost certainly loses money, and both Ant Financial and Tencent provide subsidies to the stores and sometimes to the independent agents who are charged with signing up new merchants. The "red packet" craze is highly encouraged and marketed by both companies, which boast a billion or more transactions on days like November 11 or the start of Spring Festival.

But at this point, each payment tool has 100% penetration of the Chinese adult population (more, actually). Why would Alipay and WeChat Pay not begin to raise the price of a transaction by a few bps and monetize that vast universe of payers?

Investors say that the acquisition of customer data will be more valuable than the payments business itself. I submit that the real value of payments is more earthbound. They do not have as much cash as they claim. Meanwhile, all three companies show signs of significant overstatement of balance sheet assets.

Innovation and financial "new product development"

If I had access to a billion dollars in someone else's bank account. I could create a billion dollars in turnover tomorrow. Say my revenue is 4% of turnover and profit is 60% of revenue. I need to show USD 24 mln in profit. Easy. Maybe your son has a business mowing lawns. I write a contract with him to pay him USD 24 mln for the business. The strategic explanation to investors is that urbanites will be getting more suburban, and a billion new homeowners will need their lawns mowed. Yet another benefit is that I can bill them through my sprawling payments system. I actually am not paying much attention to any previously known methodologies to measure actual market valuation, because the more value I can credibly claim, the more it helps my balance sheet absorb revenue claims. I give your son only USD 100,000 in cash, but he signs the contract—why not, for USD 100,000? Presto, USD 1 bln in turnover, USD 40 mln in revenue, and the vaporization of USD 24 mln in claimed profit from my balance sheet, which now, instead of cash, has a subsidiary worth USD 24 mln.

It is not a story of effortless growth. It is rather a case of where the effort has been focused.

It's worth reflecting on the one generation during which the Chinese Communist Party evolved from an ideology that was based on denying the taking of profit from control of capital to the most investment-driven wealth machine the world has ever known. This bespeaks a level of financial innovation that has established new benchmarks of mastery for engineering investment extraction and pumping up a capital gains-driven economy, and it calls attention to the political system and economic policy that are highly supportive of it.

The timing of risk in both the large enterprises and the system overall is related to an indeterminate level of ballast in the system supporting its forward-leaning growth. And it is related to an indeterminate level of hysteresis in investors' confidence in the big numbers, which get bigger and better to the point of being genuinely incredible, in the fundamental sense of that word. When investors conquer their awe at China's easy and miraculous growth, that itself will bat away one pillar of the torrid investment edifice.

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