



May 23, 2014

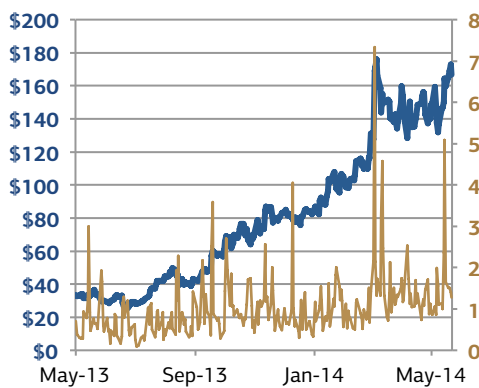
China | TMT

VIPShop Holdings (VIPS US)

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Not buying it

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



Source: Bloomberg May 23, 2014

VIPShop Holdings (VIPS US)

Price	USD 166.83
Rating	SELL
Price target	USD 100.00
Difference	40%
Market Cap	USD 9.40 bln
Simple Moving Avg.	1.62 mln
P/E	158.8x

Source: Bloomberg May 23, 2014

+ 2014 Q1 results

VIPS reported revenues of USD 702 mln, surprising to the upside against guidance of USD ~640-650 mln. Guidance for Q2, at USD 780-790 mln is exceptionally strong, and took the market by surprise. We continue to question the validity of VIPS financials.

+ Reporting oddities

Disclosures on sales events differed from previous disclosures and, we believe, may have been made to deflect investor concern about a decreasing number of sales events despite rising revenue. In VIPShop's Q1 conference call, the CFO cited 7,900 sales events from VIPShop's "main channel" and 6,300 events from VIPShop's "group buy" channel for the quarter. At the same time, VIPS' CFO disclosed that 39,300 total sales events were held in 2013. This figure differs from the 20,122 flash sales events reported in the 2013 20-F.

+ Loss making stores?

Our store checks indicate that VIPShop may be selling some items in physical stores at a loss. Management, however, maintains that inventory write-downs are not related to products sold at VIPShop's physical stores.

+ Contracting fulfillment expenses

VIPShop has long maintained that contracting fulfillment expenses (as a % of revenue) is related to its increasing use of local couriers, resulting in decreased shipping and handling charges. We note that ex. shipping and handling, fulfillment expenses have remained suspiciously flat relative to revenue, even as rents and logistics staff costs have escalated.

+ Reiterate SELL, PT USD 100

We maintain our valuation methodology of using 40x 2014 consensus earnings. As consensus has lifted to USD 2.50 per share, we adjust our target price from USD 90 to USD 100.

Reporting Oddities

VIPShop's CFO reported 7,900 sales events from VIPShop's "main channel" and 6,300 sales events from VIPShop's "group buy" channel for 2014 Q1:

VIPS has finally discussed publicly the company's group-buying channel, which surprisingly accounted for half of its 2014 Q1 sales.

"...I would like to highlight that our number of sales events, including 7,900 events from our main channel and 6,300 events from our group buy channel, exceeded 14,000 in the last quarter, up 63.4% from a year ago. This compares to the 39,300 total events we held during the full year 2013, which included 20,100 events from our main channel and 19,200 group buy events, indicating the fast growing output per event..."¹

The report marks two "firsts:" the first time that the company has announced the number of flash sales events in any quarterly report outside of direct questioning and the first time VIPS has publicly discussed its group-buying channel, which was previously undisclosed in any of its F-1, 20-F, and quarterly statements and transcripts.

Group buying channel

Although VIPShop has long displayed a group-buying platform called VIP Group² (<http://day.vip.com/>), we have assumed this platform is non-material in revenue contribution, given lack of disclosure. We are surprised to learn that nearly half of the sales events in 2014 Q1 are from its group-buying channel. Given the apparent scale of this business, we question why VIPShop has not historically disclosed information on this segment. If the group-buying channel is a substantial part of revenue (as it appears), we believe shareholders deserve further disclosure.

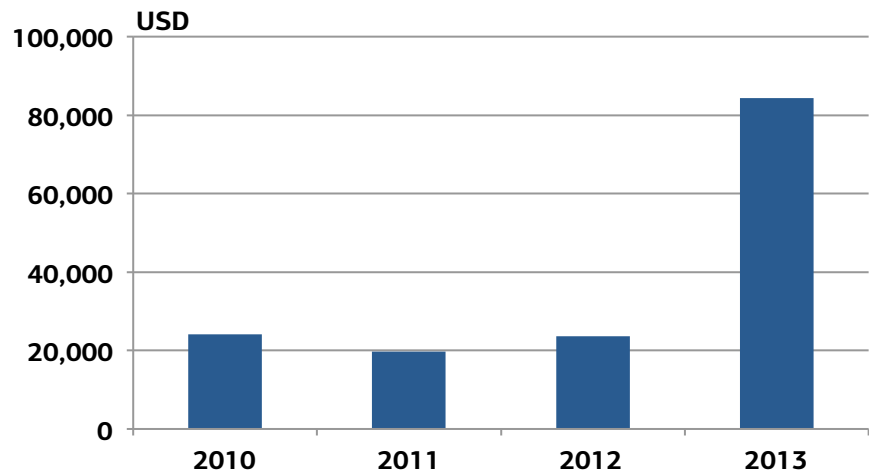
Flash sales events obfuscation

We consider the number of sales events to be a material disclosure for investors. We suspect that VIPShop's management disclosed the additional group sales events in Q1 to deflect investor concern on the mismatch between increased revenue in 2013, and decreasing flash sales events, which contributed toward a dramatic increase in revenues booked per sales event.

¹ CFO, 2014 Q1 Earnings Transcript

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Chart 1. Revenue per sales event (2010-2013)



Source: Company filings

We note that, historically, VIPShop has disclosed only the number of flash sales events in its annual reports. Hence, management’s sudden disclosure of 19,200 “group buy” sales events in 2014 Q1 does nothing to change our calculations as depicted in Chart 1.

To the extent that management has been booking material revenues from the group-buying channel for the last four years, we believe financials should be restated.

Other historical reporting anomalies

Upon reviewing some of VIPShop’s historical transcripts, we found several examples of inconsistencies communicated to investors:

VIPS historical transcripts show several inconsistencies communicated to investors.

“...Okay. So Gene our gross margin, obviously the pricing power will increase as our sales increase. To give you an example typically for one sales event last for five days, if we can help supply to monetize 1 million versus 8 million within five days, the take-rate that we negotiate or we can secure is quite different. Obviously the gross margin will benefit from the economy of scale. But going forward we do think that we’re going to keep our gross margin in a healthy ecosystem to be in a reasonable range. We expect that to be in the range of 26% to 28%. We say this because for T.J.Maxx as a reference their normalized gross margins between 27% to 28%. So we think our longer term gross margin will be in line with that figure...”³

³ Chairman and Chief Executive Officer, Q3 2012 Earnings Transcript

In contrast with the underlined above, our checks with suppliers indicate that take rates are NOT negotiated or based on sell through on a per event basis. Rather, contracts are entered on an annual basis. Pricing can be renegotiated annually, but does not fluctuate based on sell through for individual sales events.

Furthermore, we find the chairman's basis for long-term gross margins of 26-28% confusing. The comparison between VIPShop and TJX's business models is nonsensical. T.J. Maxx reports the cost of inventory AND store occupancy costs in COGS, whereas VIPShop books only cost of inventory. T.J. Maxx purchases inventory outright, and typically does not hold the right to return unsold inventory. VIPS sells on consignment. In reality, T.J. Maxx achieves a significantly higher take rate than VIPShop of about 35%—on account of this increased risk. The chairman's comparison between these two disparate business models leads us to question his grasp of understanding over his own business.

Further to this point:

Several of our channel checks conflict with the statements given by VIPS Chairman: does he understand his own business?

“...At Vipshop we are very dedicated in our business, which is into online discount fresh sales operation. And to the brand partners, we are their preferred channel, because we have the capability to monetize the inventories at a very rapid speed. And for customers, we offer them high-quality brands at very discounted price. And in this industry, we have already accumulated quite a lot of experience, which is very valuable to the company. And the other factor to add to is our IT, our content and warehouse capabilities are all designed to fit in our operational—into our operation. And another thing to point out is, because we provide very valuable data customer analysis feedback to the brand partners. And in this, all the once that Eric mentioned just now maybe very difficult for other players to duplicate or replicate our business model...”⁴

Our channel checks conflict with the underlined above. Our conversations with customers have unequivocally confirmed that brands are NOT provided with any sort of customer analysis feedback when transacting with VIPShop. Rather, after shipment to VIPShop no information is provided to brand owners with the exception of how many items were actually sold.

⁴ Chairman and Chief Executive Officer, Q1 2012

Loss-making store items

We believe VIPS is selling some items at a loss.

We note that our checks at stores suggest that for at least some items, sales are likely made at a loss. Below, the VIPS price on this Guess bag shows a sale price of RMB 350, or approximately USD 60. At the time, all items in the store were marked down 50% off, meaning that the bag was selling for RMB 175, or USD 30.



All photos by J Capital Research | April, 2014.

On the opposite side of the same bag, we found a U.S. price tag and bar code. The tag reads “MSR \$118. Our price \$74.99”



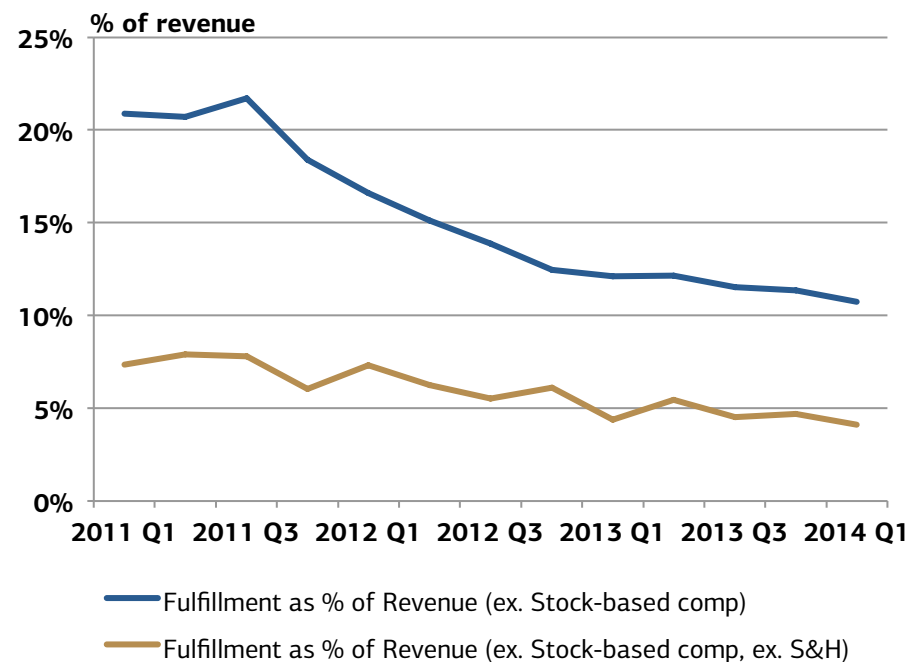
We suspect that this handbag was purchased in the U.S. at a discount retail store (similar to T.J. Maxx) and then shipped to China. What concerns us, however, is that it would appear that VIPShop purchased the bag for around USD 75, but is reselling it for USD 30. To our knowledge, management has maintained that inventory write-downs disclosed in the past are unrelated to inventory held at physical stores. If this is true, we question why some inventory at stores appears to be marked down below cost.

Shrinking fulfillment costs

We question how VIPS has been able to decrease steadily its fulfillment expenses—net of shipping and handling costs—as % of revenue despite rapid increases in warehouse capacity.

VIPShop consistently reduces its fulfillment expenses as a % of revenue on account of reduced shipping and handling expenses. VIPShop attributes this trend to increasing use of local couriers, which offer lower costs to their national counterparts. Below, we present fulfillment as a % of revenue (blue line) against fulfillment costs ex. shipping and handling expense per order (gold line):

Chart 2. Fulfillment expense as % of revenue



Source: Company filings

In Chart 2 above, we draw attention to the gold line, which represents fulfillment expense per order, net of shipping and handling costs. What surprises us here is that VIPShop has been able to decrease these costs steadily as a portion of revenue, despite rapid increases warehouse capacity. Recall that these expenses should include rent, packaging, and logistics staff costs.

According to VIPShop's 20-F, fulfillment costs consist of:

"...shipping and handling expenses, packaging expenses and logistics center rental expenses, as well as compensation and benefits of our logistics staff..."

However, we are skeptical if these costs are accurately reflected in the financials, given the rate of warehouse expansion and staffing increases at VIPShop:

Table 1. Fulfillment expense as % of revenue and warehouse expansion

	Fulfillment as % of revenue (ex. stock-based comp)	Fulfillment as % of revenue (ex. stock-based comp, ex. S&H)	Warehouse area (sqm)	Logistics & delivery staff
2011 Q1	21%	7%	-	-
2011 Q2	21%	8%	-	-
2011 Q3	22%	8%	-	-
2011 Q4	18%	6%	125,556	1,854
2012 Q1	17%	7%	-	-
2012 Q2	15%	6%	-	-
2012 Q3	14%	6%	-	-
2012 Q4	12%	6%	234,955	3,609
2013 Q1	12%	4%	-	-
2013 Q2	12%	5%	-	-
2013 Q3	12%	5%	-	-
2013 Q4	11%	5%	319,085	5,762
2014 Q1	11%	4%	-	-

Source: Company filings

To emphasize our point, we cite VIPShop's 20-F:

"...Historically, we primarily relied on our regional logistics center in Guangdong Province in Southern China for our fulfillment services. In September, November and December 2011, we started operating our new logistics centers in Jiangsu Province in Eastern China, Sichuan Province in Western China and Beijing in Northern China, respectively, to enhance our fulfillment capacity. Throughout 2012, we were able to fully utilize the regional logistics centers and warehouses..."

Note that in September, November, and December of 2011, VIPShop started expanding its warehouse network out of

We suspect VIPS is overstating its revenues and margins, and caution investors against strong Q2 financials.

Guangdong into three new regions: Jiangsu, Sichuan, and Beijing. Amazingly, fulfillment costs (ex. shipping and handling) as a percentage of revenue remained incredibly consistent quarter to quarter throughout 2011—in spite of VIPShop’s expansion into these new geographies. More troubling, the same pattern persisted in 2012, despite warehouse space/staff essentially doubling. To us, these results appear too good to be true. We caution investors that VIPShop’s financials appear to be too good to be true on a number of accounts, and we suspect revenues and margins to be overstated.

Risks

If we are correct in our supposition that VIPShop’s financials are largely exaggerated, there is no reason why VIPShop should not continue reporting attractive numbers. We caution against strong Q2 financials.

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