



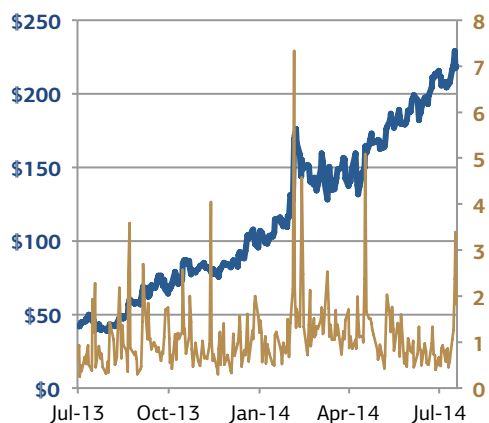
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China | TMT

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 August 18, 2014

VIPShop Holdings (VIPS US)

Price	USD 218
Rating	SELL
Price target	USD 110
Difference	50%
Market Cap	USD 12.4 bln
Simple Moving Avg.	1.1 mln
P/E	135x

Source: Bloomberg August 18, 2014

+ Shift in business strategy

We believe investors are ignoring the fact that VIPShop's gargantuan capex spend marks a shift in strategy toward growing into new business ventures as a provider of warehousing and logistics services.

+ Mobile transactions over 50% of sales?

VIPShop has grown mobile revenue from 8% of sales in 2013 Q1 to over 50% of sales in July, 2014. In our experience, discounts are usually used in China to incentivize customers to purchase on mobile. We question how VIPShop has grown mobile to over 50% sales without impacting margins.

+ Questionable shipping expenses

In spite of order volumes increasing 30% from 20.2 mln in Q1 to 26.3 mln in Q2, shipping expenses declined on an absolute basis from 45.8 mln to 39.9 mln, or 13% QoQ. We question how shipping expenses can fall when order volumes grew 30% QoQ.

+ Missing related party transactions?

Sequoia Capital is a significant shareholder of both Mecox Lane and VIPShop. In its 20-F document, Mecox Lane details USD 11 mln of sales through VIPShop's platform as a related party transaction. However, no such disclosure appears on VIPShop's filings. We emphasize that VIPShop discloses smaller related party transactions as little as USD 3 mln in its financials.

+ Reiterate SELL; PT USD 110

On our estimates, VIPShop would have to attain sales volumes of USD 15 bln to justify its current valuation. We maintain our valuation methodology of using 40x 2014 consensus earnings. As consensus has lifted to USD 2.74 per share, we adjust our target price from USD 100 to USD 110.

Strategic shift?

VIPS has acquired 1,000 acres of land for the purpose of warehouse construction.

In Chinese press VIPShop's VP of Logistics Tang Yizhi has again been quoted describing VIPShop's build-out of new warehouse facilities. Specifically, VIPShop has acquired roughly 1,000 acres of land for purposes of warehouse construction.¹ According to our understanding, roughly 4-5 warehouses will be built on this newly acquired land.

VIPShop appears to be pursuing a strategy of vertical integration with these new facilities. Within these warehouses, VIPShop will rent out some 40% of the total space to brands which sell goods on its website. This strategy will save VIPShop some freight expense, but more importantly, allow VIPShop access to greater amounts of inventory. (Here we point out that VIPShop only achieves a 50% sell through on inventory currently stored in its warehouses.) In addition, VIPShop intends to become a logistics provider for the brands—facilitating shipping between the warehouses and the physical stores of the brands.

We believe investors have not been appropriately informed on the scale of VIPShop's land acquisitions, or on its intention to enter the logistics business and lease land/warehousing space to brands and distribution companies. We question a) whether developing logistics capabilities for brands makes strategic sense for an e-commerce business; b) whether VIPShop can profit from renting space to brands; particularly as it intends to offer discounts up to 20% below market, and c) whether these aggressive investments are indicative of VIPShop attempting to move cash off its balance sheet to deceive auditors.

The photographs below pertain to VIPS' new Tianjin warehouse, which, according to the sign, will require investment of USD 75 mln. Interestingly, we do not see any indication of construction in progress on VIPShop's Q2 balance sheet, though admittedly this could remain buried in the PPE figures.

¹ <http://www.chinairm.com/news/20140707/105415985.shtml>



J Capital Research: Tianjin Warehouse Details; Aug 2014



J Capital Research: New Tianjin Warehouse under construction; Aug. 2014

Mobile revenue over 50% of sales in July?

In our experience in China, e-commerce sites frequently provide discounts to customers to incentivize them to purchase on mobile devices. For instance, as Dangdang reported on its recent 2014 Q2 call:

“...We also encourage customers to transit to mobile Dangdang from PC by providing discounts for first time mobile purchases. Mobile orders were 17% of total orders in the second quarter 2014 and this rose to 22% in June...”²

Table 1. VIPShop mobile revenue

USD Mns	2013 Q1	2013 Q2	2013 Q3	2013 Q4	2014 Q1	2014 Q2
% Mobile	8%	12%	15%	23%	36%	46%
Mobile revenue	24.9	42.2	57.6	149.7	252.7	381.5
Desktop revenue	285.8	309.1	326.2	501.3	449.2	447.9

Source: Company transcripts

How has VIPS been able to grow mobile revenues to more than 50% without impacting margins?

We are surprised that VIPShop has been able to grow mobile revenues to more than 50% of sales without impacting margins or average ticket size. Furthermore, we note that desktop revenue for the business has actually decreased in absolute terms between Q4 2013 and Q2 2014. We question how VIPShop has been able to achieve such success in mobile conversion seemingly without reduced margins.

Furthermore, VIPShop attributed the increase in marketing expenditure in Q2 (USD 30 mln in Q1 to USD 44 mln in Q2) to increased spend on mobile marketing—the first time the company has done so, in spite of having already crossed the 40% conversion barrier in early Q2:

“...On the marketing expenses I think Eric has already explained our strategy. We are going to spend dollars to acquire more mobile traffic because it’s the right time for us to do that. And then we’re going to spend money to build greater brand awareness which will benefit our long-term growth...”³

With mobile revenue already constituting over 50% of sales, we question VIPShop’s need to increase marketing spend on converting customers to mobile traffic—and more importantly, how VIPShop has been able to convert such a large percentage of its customer base without prior spend.

Contracting shipping expenses?

VIPShop consistently reduces its fulfillment expenses as a % of

² DangDang 2014 Q2 Conference Call

³ Donghao Yang, 2014 Q2 Conference Call

revenue on account of reduced shipping and handling expenses. However, we note that in this quarter, VIPShop was able to cut shipping and handling expenses in absolute terms, despite the number of orders increasing by 6 mln, or 30% QoQ.

Table 2. VIPShop shipping and handling expense

	2013 Q1	2013 Q2	2013 Q3	2013 Q4	2014 Q1	2014 Q2
S&H Expense (USD mln)	24.0	23.5	26.6	42.9	45.8	39.9
Orders (Mns)	8.8	11	11.7	17.7	20.2	26.3
S&H per order (USD)	2.72	2.14	2.27	2.42	2.27	1.52

Source: Company filings

We are suspicious of how VIPS shipping and handling expenses diminished by 75 cents in a single quarter.

As a result of this change, shipping and handling expenses declined from USD 2.27 to USD 1.52 per order, or by 75 cents in a single quarter! We are perplexed as to how shipping expenses can contract so dramatically in a limited time period.

We look to DangDang (Table 3) for comparison. DangDang only discloses its shipping expenses independent of fulfillment costs on an annual basis. Additionally, DangDang’s figures are in RMB, while VIPShop’s are in USD. Depending on the exchange rate used, DangDang’s shipping cost for 2012 and 2013 has been around USD 1.10 to USD 1.20 per order. While lower than VIPShop’s USD 1.50 per order, investors should consider that VIPShop also returns a full 50% of the inventory it absorbs to brands. In addition, DangDang’s return rate is in the low single digits, while VIPShop’s return rate is approximately 20%.

Table 3. DangDang shipping expense

	2011	2012	2013
Orders (mln)	40.7	54.2	63.6
Shipping expense (RMB 000's)	284,146	405,951	416,924
RMB/order	6.98	7.49	6.56

Source: Company Filings

Declining sell through?

Recent interviews with brands suggests that sell through may be declining due to a rapid proliferation in the number of sales events. As a result, each brand gets less traffic:

“...From 2012 to 2013, we typically sold RMB 50,000 in each sales event, but in 2014 this has declined to less than RMB

30,000 per event. The frequency of sales events has increased, but each event has lower sales. With only RMB 30,000 of sales for each event, we don't have profit, but we aren't losing money either...⁴

If VIPS sell through is declining for each sales event, shipping costs per order should be increasing rather than decreasing.

The implication for us is the following: if sell through is declining for each sales event, shipping costs per order should be *increasing* rather than decreasing, as VIPShop spends incrementally more on return shipping to brands for each event.

Drawing firm conclusions based on a handful of brand interviews is challenging when VIPShop contracts with some 10,000 brand vendors, but we are not surprised to hear that sales per event for many brands has declined given the recent proliferation of events on VIPShop's website. Our checks indicate that daily sales events have increased from roughly 40-50 events per day in Q1 to roughly 60-80 per day in Q2.

Missing related party transactions?

Sequoia Capital is a significant shareholder of both Mecox Lane and VIPShop. In its 20-F document, Mecox Lane details USD 11 mln of sales through VIPShop's platform as a related-party transaction. However, no such disclosure appears on VIPShop's filings.

In its 2013 20-F, Mecox Lane discloses:

"...For the year ended December 31, 2011, 2012 and 2013, we recorded sales of goods of \$356,090, \$2,818,196 and \$11,109,843 to VIPShop Holdings Limited or VIPShop, with which a company in which Sequoia Capital, one of our shareholders, also has significant shareholding. Pursuant to the framework agreement with VIPShop, we sell our products to VIPShop on a consignment basis, at arm's length. The receivables from VIPShop are due 5 days after the issuance of invoices by us. The amount due from VIPShop was nil as of December 31, 2013. The amount due to VIPShop was \$459,623 as of December 31, 2013, which represents advanced payments from VIPShop...⁵

In Note 15 on VIPShop's 20-F, however VIPShop only discloses USD 3.7 mln worth of related party transactions.

⁴ Sales Manager, Apparel Company

⁵ Mecox Lane 20-F

Table 4. VIPS related party transactions

USD	2011	2012	2013
Purchase of goods	6,310,308	6,663,431	3,688,492

Source: VIPShop 20-F

We suspect VIPShop and investors may dismiss the USD 11 mln based on immateriality, but if this is the case, we question why VIPS makes disclosure on smaller transactions of USD 3.7 mln in 2013.

Valuation

We struggle to understand the markets enthusiasm on VIPS, but anticipate street estimates to rising upgrades. Since initiation, the forward 2014 earnings multiple for VIPShop has expanded from 65x to approx. 80x on account of revenue growth running ahead of market expectations.

We maintain our valuation methodology of using 40x 2014 consensus earnings. As consensus has lifted to USD 2.74 per share, we adjust our target price from USD 100 to USD 110.

Market expecting VIPS to achieve annual sales of USD 15 bln?

On our estimates, we believe the market is pricing in expectations for VIPS to achieve sales of USD 15 bln in annual sales, up from USD 3.5 bln of goods in 2014. We arrive at this conclusion based on our comparison with TJX in Table 5:

Table 5. TJX and VIPS valuation

USD bln	Market cap	GMV (2014)	Pre-tax margin
TJX	40	30	12%
VIPS	12	3.5	5%

Source: Bloomberg, Company filings

To begin, we do not believe VIPShop can increase PBT margins much beyond 5% as gross margin expansion in the core business has stalled in recent quarters, and market place sales remain small. Fundamentally, the margins between TJX and VIPShop should not converge as TJX buys inventory outright (without the right to return products), while VIPShop operates on a commission model. As such, we cut TJX's pre-tax margins in half to align them with VIPShop, and in doing so, arrive at a TJX adjusted market cap of approx. USD 20 bln. Figures which have been adjusted are

highlighted in pink in Table 6:

Table 6. TJX and VIPS valuation adjusted

USD bln	Market cap	GMV (2014)	Pre-tax margin
TJX	20 (Adj.)	30	6% (Adj.)
VIPS	12	3.5	5%

Source: Bloomberg, Company filings, J Capital Analysis

Following this margin adjustment, we note that the market capitalization of TJX remains twice that of VIPShop, while the amount of merchandise TJX sells is nearly 10x that of VIPS. For a more linear comparison, we note that GMV sold through TJX in half, and accordingly adjust its market capitalization. The results of these adjustments are shown in Table 7:

Table 7. TJX and VIPS valuation adjusted

USD bln	Market Cap	GMV (2014)	Pre-tax Margin
TJX	10 (Adj.)	15 (Adj.)	6% (Adj.)
VIPS	12	3.5	5%

Source: Bloomberg, Company filings, J Capital Analysis

We remain skeptical that VIPS can achieve the level of revenues expected by the market.

On this back-of-the-envelope math, we believe the market is pricing in expectations for VIPShop to ultimately sell approximately USD 15 bln of inventory each year, against USD 3.5 bln in 2014. We remain skeptical that VIPShop can achieve revenues of this magnitude given its purely on-line sales model. Furthermore, even if the market believes USD 15 bln in annual sales is achievable, with revenues increasing at the rate of USD 1.5 bln per year, we believe it might take 7-8 years for VIPShop to achieve sales of this magnitude.

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 Q3 financials and Q4 guidance.

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