# JCAP

E-Commerce
**China**

June 16, 2015

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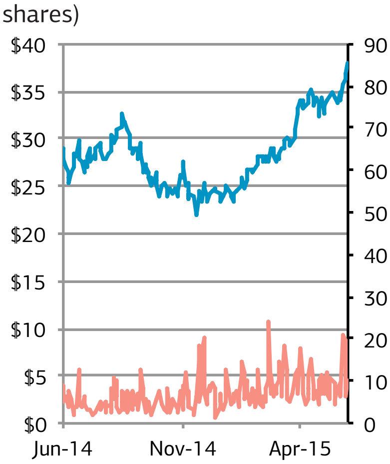
**JD.com (JD US)**

| | |
|---|---|
| Price | USD 36.63 |
| **Rating** | **SELL** |
| **Price Target** | **USD 23.36** |
| Market Cap | 501.bln |
| Avg. Volume | 9.1 mln |

JD.com (JD US) last share price in USD (blue) and volume (pink, in mln shares)




Source: Bloomberg June 16, 2015

# JD.com (JD US)

# Wholesaler

## Broker

30-50% of the business of JD.com derives from brokering sales between distributors, and we believe much of this business occurs at a loss.

## Subsidizing volumes

JD sometimes buys from distributors and sells substantially the same products back to them at a 3% discount. We believe the company may use accounting tricks to move subsidies onto its balance sheet as assets.

## Faking GMV

A portion of revenue comes from buy-backs the suppliers are required to make if products do not sell. We believe that JD books these returns as revenue.

## Nowhere to grow

JD's procurement volumes are already higher than the biggest retailer but margins are significantly lower, and the company faces structural obstacles to expanding its scale. We do not think that JD will grow its way into profit—at least not through direct sales.

## Overpriced assets

Land records indicate that JD has overpaid for its assets. JD has paid 20% more for 46% less land than Suning, buying in the same time frame.

## Valuation

1.5x sales: We see JD primarily as a wholesaler in an unattractive category, electronics, saddled with price deflation and expensive logistics. As such, we value the company at 1.5x sales, assigning JD the same valuation as Suning, China's largest physical retailer of consumer electronics, which also has a very robust online B2C marketplace. We believe this 30% discount to current value is generous, because JD has clearly misled investors as to the true nature of its business.

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# A New Breed of Wholesaler

## Our Summary View

JD offers an excellent value proposition to consumers. Its end-to-end logistics system consistently garners high ratings from buyers, and JD is the go-to platform for consumer electronics. But our work suggests that the company is pretending to be far larger than it really is and is in effect paying people to run transactions through the online system in order to present the appearance of a growing e-commerce business.

While JD.com claims to be the world's largest online B2C company, we have learned that **30-50% of products are sold to offline distributors rather than to end customers**. The website adds no value to those offline transactions, which are booked online just to goose the numbers. The offline business has negative margins and exists to create the mirage of high GMV, because investors in Chinese e-commerce companies are most concerned with GMV growth.

While JD claims to be the world's largest online B2C company, up to half of products are sold to distributers rather than end customers.

### Obstructions to Growth

The market position of a distributor in China is very fragile: distributors simply lack the scale or the capital to hold a secure market position. That is because wholesaling and distribution are traditionally owned by local governments, which, as the regulatory environment changed, created obstructions to inter-regional scale. No player in wholesaling and distribution has managed to achieve the efficiencies that would support profitability over the long term. This is doubly true of consumer electronics, which in China as elsewhere is a deflationary category.

Intermediaries traditionally belong to either makers or buyers. In the old days of scarcity, intermediaries functioned to negotiate and facilitate supply to buyers on behalf of sellers who could not meet demand and had leverage. In the current oversupply situation, intermediaries tend to be controlled by and represent buyers (as in hospital buying) and "earn" facilitation margins on behalf of buyers. In other words, distribution is about circumventing price controls and collecting rent in collusion with whoever has leverage in the transaction. So the independent and commercial distribution function, as known in other economies, is weak. Value chain analysis consistently shows distribution margins for things like electronics are very small. Mall operators in traditional wholesaling often distribute products to concession operators, and so the same model has evolved online.

For the portion of JD's business that is essentially wholesaling and distribution, we question whether the company offers any sustainable value even at scale. Instead, we see JD frantically using sales management and price promotions to drive volume at unsustainable prices. JD offers sales management and fulfillment at no extra cost, making it attractive to suppliers who can achieve high turnover volumes. But it is precisely the cost of providing these services that makes us negative on JD's long-term growth and margins. Naturally, big distributors are going to take advantage of the service, but it is provided because JD lacks the market power to go directly to the brand owner and get the best price. In fact, if the subsidies were removed, we believe JD would lose at least one-third of its sales.

Much of the bull argument on JD reasons that companies like this one lose money until they reach commanding scale and then become very profitable. But there is little added value for the B2B distributors in transacting on JD's platform, and there seems to be no good reason for JD to capture share of this business. Even China's largest electronics retailer, Suning, has procurement volumes that are tiny compared with concentrated U.S. retail chains. We suspect that China's fragmented regulatory and logistics systems make scale very difficult, and if it were to happen, it would take many years as well as political change. In other words, it is not happening.

So JD's business model is not what the company pretends.

Making matters worse, for the portion of the business directed at real consumers, the company appears to inflate revenues. For products sold on its own account, **JD requires suppliers to buy back unsold items, and then it records as revenue what are in actuality returns**. Suppliers are asked to execute the buybacks online, as if they were consumers, and they pay associated commissions, getting reimbursed in services from JD.

For third-party sales, JD requires that marketplace participants achieve a certain volume of transactions even when the company knows those transactions are faked. **Our primary checks indicate that as much as 50% of transactions for third-party goods are faked.**

We have two other gripes with JD: the way its loan business leaches company data without apparent benefit to shareholders, and the shady balance sheet transactions with Tencent.

In the loan business, we cannot identify where interest gains come into JD's books. JD's calculated interest yield seems too low, and if the proceeds are recorded as "other revenue," then they suggest a lower-than-reported volume of transactions. Around 50 people employed by these two companies manage RMB 1.8 bln in assets.

Regarding the relationship with Tencent, **JD has done a series of deals with Tencent whose principal value appears to be to inflate JD's valuation.** The deals are not accretive to either JD or Tencent, and we find that associated valuations have been overstated.

## Company Background

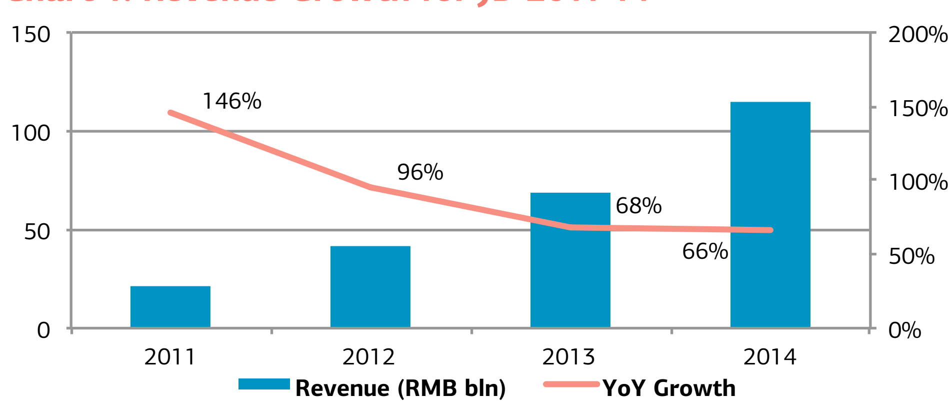
JD, formerly known as 360Buy.com, is the largest online direct sales company in China in terms of transaction value, with a market share of 49% in 2014 according to iResearch. The company achieved 75% CAGR in its direct sales GMV from 2011-14. Founded by Richard Liu in 2004, JD.com listed on Nasdaq on May 22, 2014.

JD started with a focus on direct sales of electronics and later diversified into media, infant and maternity products, cosmetics, and more.

JD started with a focus on direct sales of electronics products and later diversified into books/media, infant and maternity products, cosmetics, and other general merchandise categories. The company launched a third-party marketplace for general merchandise in 2010. JD describes its business model as both online direct sales and an online marketplace, with 94% of net revenue derived from the direct sales in 2014. The B2C portion, as defined by JD, involves procuring and managing its own inventories, selling products online directly to consumers, and providing delivery and after-sales service. Revenue is defined as the sale of products minus the cost of procurement.

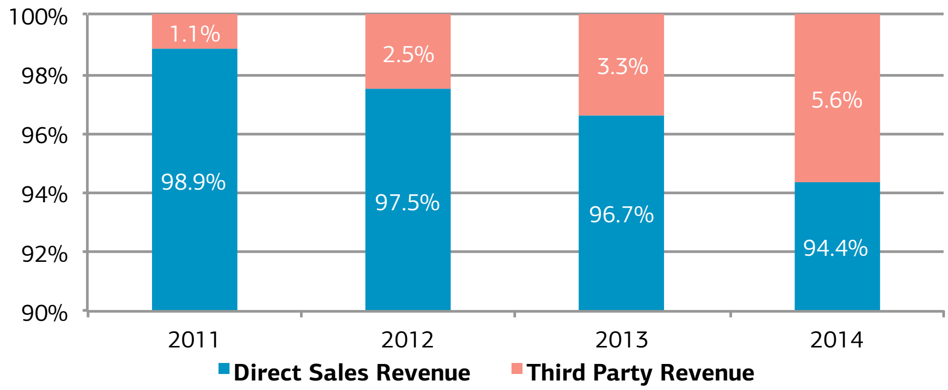
As of Q3 2014, JD operated 118 warehouses with an aggregate gross floor area of 2.3 mln sq m in 39 cities. The company had 2,045 delivery stations and 1,045 pickup stations in 1,855 counties and districts across China.

### Chart 1. Revenue Growth for JD 2011-14




Source: Company data

Chart 2. Revenue Breakdown




Source: Company data

## Go-Between Model

Our checks on JD find that a significant portion of the company's business is conducted offline and at low or negative margins, providing no apparent value other than the ability to display rising GMV to investors. We estimate that at least two-thirds of the offline business receives a subsidy from JD. Once delivery costs are included, the portion of the business concerned with wholesaling and distribution has negative gross margins of around 3.5%. This estimate is based on logistics costs of about 7% of revenue and a B2B margin of 3.5%.

To effect sales of products to distributors and retailers, JD has to offer prices lower than the distributors can get from the manufacturer.

Procurement managers at JD have contractual targets for sales volume, gross margin, and turnover, and some of the volume targets are met through JD's offline business. In order to meet the targets, procurement managers work closely with suppliers and their lower-tier distributors.

Our view that 30-50% of sales represent wholesale transactions is based primarily on our interviews with 21 suppliers who collectively represent roughly 5% of JD's gross revenue. The suppliers we interviewed include large, well-known brands selling over RMB 750 mln annually on the platform and include electronics brands, clothing, and infant products (which account for 8-10% of JD's revenue). Collectively, they were transacting about half of their JD sales volume through offline channels.

Of particular note in the interviews are distributors who say they receive 3-4% off the manufacturers' wholesale prices when they purchase from JD

## Table 1. Selected Interview Summaries

| City | Company | Interviewee Position | Comments |
|---|---|---|---|
| **East China** | JD | Formerly in procurement, left company in September 2014 | Fake transactions are very common. Some suppliers fake transaction in order to win free adverting space from JD. |
| **North China** | JD | Formerly in procurement, left in November 2014 | The supplier buybacks are standard. |
| **North China** | JD | Former management employee, left in October 2014 | If JD needs to offload inventory, the company will ask suppliers to buy back products, transacting the buybacks online. They sometimes resell the products on other websites at a discount. |
| **North China** | JD | Former employee, left in December 2014 | JD sometimes sells product at a 10% discount to the procurement price. |
| **North China** | Tier 1 computer brand | Key account manager | About 3% of our gross sales on JD are actually buy-backs. |
| **North China** | A Tier 2 computer brand | Sales manager | JD asks suppliers to buy back products when the sales are weak or the product quality is low. The contract with JD varies for different companies. |
| **North China** | Maker of cell phone components | Senior sales manager | Products that suppliers purchase back are usually less popular goods. Suppliers can only purchase online, not on the back end. |
| **North China** | A large distributor of white goods | Marketing manager | I have not done any buybacks, but it is very common in the industry. |
| **North China** | A manufacturer of set-top boxes and provider of entertain-ment products | Sales manager | If JD does not meet its sales target, they ask suppliers to repurchase online. |

| | | | |
|---|---|---|---|
| **Southeastern China** | A large shoe company | Manager of the e-commerce business of the company | We are a third-party vendor. JD takes a 10% commission on each transaction. Fake transactions are very common, and JD requires marketplace participants to fake a certain amount of transactions. I think 20-30% of the transactions on JD are fake. |
| **Southeastern China** | A soft drinks company | Marketing manager | Fake transactions are common. JD charges a 10% logistics service fee even on faked transactions. |
| **Central China** | A mid-size company making electronics products | Manager of e-commerce department | If sales targets are not met, suppliers will try to find offline customers to purchase the excess inventory. The buyback procedure is the same as normal transactions. Sometimes we ask lower tier distributors to make the purchases, and we make up the price difference to distributors later on. Sometimes we do not need to purchase online but just have the products transported back to our own warehouse. |
| **North China** | A large international electronics brand | Ex-employee of JD in procurement who now sells to JD | Procurement managers at JD are given specific targets for sales volumes, gross margins, and other metrics. If some products do not sell well, JD will lower the price to promote the products. If sales are still not good, JD will ask suppliers to purchase back at a lower price. Of course, JD will make it up to suppliers later with advertising and other discounts. |
| **Central Eastern China** | An e-commerce company | Marketing manager | It is very common to fake transactions. Probably 5-10% of transactions are fake. |
| **North China** | A large baby products brand | Head of the e-commerce division | We set targets with procurement managers each month and work with JD to meet our target. I know many foreign brands sell products offline through JD. JD prefers to work with foreign brands. Infant products account for 8-10% of JD's revenue and one-third are sold offline. The portion of 3c products sold offline is much higher: about half is sold to offline distributors. Those offline distributors get products at prices 5-6% lower than they would get from higher-tier suppliers. Buybacks are also common but not as big as the offline business. Procurement managers at JD have the right to set buy-back prices. |

| | | | |
|---|---|---|---|
| **Central Region** | A Tier 1 Apple distributor | Marketing manager with 18 years' experience in with two foreign electronics brands | We repurchase one-third of the products we sell to JD, because the price we get from JD is 3-4% lower than we can get directly from the company. JD holds significant deposits from us so we are under pressure to be cooperative. |
| **North China** | A financial services company | Supply chain financial manager | Around 25% of products are sold to offline distributors. If JD sales exceed the monthly target then JD gets a rebate payment of 2-5% of the excess sales. |
| **North China** | A large electronics retailer | Procurement manager | I used to supply books to JD. I estimate that about 10% of the books are sold to offline distributors. In electronics, the portion sold offline is definitely above 30%. |

Source: J Capital Research

in bulk.

One infant product supplier with a shop on JD's marketplace said that his company meets with JD monthly to set that month's sales targets. The targets in most cases are unrealistically high, and his company needs to make sales offline and book them online, so that the sales volumes are nominally transiting JD. The company is willing to do this, and pay the associated commission, because JD assists them in meeting their sales targets. If necessary to meet sales targets, JD absorbs losses by selling under cost to distributors, but this is rare.

JD procurement managers maintain special off-balance-sheet accounts to transact these sales, according to our interviewees.

One JD ex-employee told us that he estimated that around 25% of all products are sold to offline distributors.

## Inflated Revenue

In addition to deriving about half of its revenue from brokering wholesale transactions, JD artificially inflates its GMV through buybacks and circular transactions.

### Supplier Buybacks

JD sales agreements contain buyback agreements under which suppliers must repurchase products that are not sold if agreed sales targets are not met at the agreed-to prices.

Suppliers told us in interviews that the buybacks are executed online at JD's behest. We think these buybacks are likely recorded as revenue and that they contribute to GMV. The buyback agreements are sometimes signed beforehand and sometimes negotiated when there is a need. The buy-backs are mostly loss-making for the suppliers but indicate JD's strong bargaining power conveyed by the volume of its sales.

## Faked Marketplace Transactions

JD's agreements with third-party vendors on its marketplace platform contain volume targets. Vendors we spoke with universally used transaction-faking services to inflate their volumes in order to meet the targets, paying a 10% commission to JD on the faked as well as the real sales. Given that Taobao charges 5% in transaction fees and at least 10% in advertising fees for sales, 10% on unsold product is competitive in China's e-commerce world. To partially compensate for the costs associated with this process, JD offers free advertising to all vendors with high sales targets, generally RMB 10 mln per year.

A seller of shoes on the JD marketplace described to us how it hired an agent to create circular transactions in order to meet the volume target.

A seller of shoes on the JD marketplace described to us how it hired an agent to create circular transactions in order to meet the volume target. This supplier estimated that 20-30% of its transactions were faked. A beverage supplier corroborated this information, as did a former employee of JD subsidiary Yixun.

Additionally, we found an article describing how JD procurement managers asked a third-party supplier to fake RMB 500,000 in transactions. Some shops reported being required to fake RMB 1 mln.


Source here

The screenshot on the left represents a conversation between a JD procurement agent and a third-party vendor. In the online chat, a procurement manager is trying persuade the vendor to fake RMB 500,000 in transactions in return for advertising.

By the end of 2014, JD had more than 500,000 third-party vendors on its platform. News reports indicate an average of RMB 1 mln in faked transactions each year per vendor. Using a lower estimate of RMB 750,000 per vendor would yield a total of RMB 36.5 bln in faked transactions, or 37.5% of the total GMV on the third-party platform.

Unlike the buybacks, these faked transactions do not incur fees, and we believe that JD's reported revenue from the marketplace reveals the actual transaction level. According to JD's 2014 annual report, the transaction volume of the third-party platform was RMB 100.9 bln. Given that JD collects a 10% fee on third-party transactions, revenue from the platform should be RMB 10.09 bln, and yet JD recorded only RMB 6.45 bln revenue from services. We believe this indicates a RMB 35.5 bln overstatement in GMV.

### Structurally Low Margins

We estimate that the gross margin for JD's B2B business is 3.5% and fulfillment cost is reported as 7%. If fulfillment cost were calculated as part of the COGS, the gross margin on the B2B business would be negative 3.5%.

### Table 2. Margin Growth

| | 2012 | 2013 | 2014 |
|---|---|---|---|
| **Gross margin** | 8.40% | 9.90% | 11.60% |
| **Online direct sales** | 6.40% | 7.20% | 7.10% |
| **Services and others** | 80.00% | 80.00% | 80.00% |
| **Fulfillment expense as % of direct sales** | 7.60% | 6.10% | 7.40% |

Source: Company data and J Capital estimates

# Comparables

We question JD's cost structure. We find the marketing and technology expenses abnormally low, and we suspect that some costs are tucked away as assets.

### Marketing

Marketing costs as a proportion of net revenue are relatively low for JD compared with other e-commerce companies.

We suspect that some expenses may be recorded as assets. The rapid rise in short-term investments, for example, from RMB 1.9 bln pre-IPO to RMB 12.1 bln in 2014, could be one place where expenses may be capitalized.

Technology and content expenses for JD are lowest among its peers.

## Table 3. Marketing Expenses as % of Net Revenue

| Company | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|
| **JD** | 2.27% | 2.65% | 2.29% | 3.49% |
| **Amazon** | 3.39% | 3.94% | 4.09% | 4.21% |
| **VIPShop** | 6.61% | 4.62% | 4.31% | 5.00% |
| **Dangdang** | 4.14% | 3.77% | 4.09% | 4.70% |

Source: Company data

Additionally, general and administrative expenses rose from RMB 760 mln in 2013 to RMB 5.16 bln in 2014.

### R&D

JD claims in its prospectus that it is a technology-driven company and invests heavily in R&D, yet technology and content expenses for JD are lowest among its peers. The prospectus reads:

> "We are a technology-driven company and have invested heavily in developing our own highly scalable proprietary technology platform that supports our rapid growth and enables us to provide value-added technology services. In addition, our sophisticated business intelligence system enables us to refine our merchandise sourcing strategy to manage our inventory turnover and control costs and to leverage our large customer database to create customized product recommendations and cost-effective and targeted advertising."

## Table 4. Technology and Content Expenses as % of Net Revenue

| Company | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|
| **JD** | 1.14% | 1.54% | 1.39% | 1.60% |
| **Amazon** | 6.05% | 7.47% | 9.62% | 8.82% |
| **VIPShop** | 2.64% | 2.17% | 2.59% | 2.90% |
| **Dangdang** | 2.49% | 2.95% | 3.24% | 2.62% |

Source: Company data

# Weaker than the Retailers

The attractiveness of JD as an investment rests upon having higher efficiencies than physical retailers and ultimately more bargaining power. However, JD has already surpassed the revenue of the chief offline competitors and yet has less attractive metrics.

### Table 5. Net Revenue Comparison (RMB bln)

| Company | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|
| **JD** | 21 | 41 | 69 | 115 |
| **Suning** | 94 | 98 | 105 | 109 |
| **Gome** | 60 | 48 | 56 | 60 |

Source: Company data

Accounts payable for JD are better than at Gome but significantly worse than Suning.

### Table 6. Accounts Payable Turnover (Days)

| Company | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|
| **JD** | 66 | 78 | 64 | 59 |
| **Suning** | 14 | 16 | 15 | 12 |
| **Gome** | 120 | 149 | 138 | 148 |

Source: Company data

JD's gross margin is lower than those of more asset-heavy companies such as Suning and Gome, even though JD's revenue has surpassed Suning and Gome. Higher prepayment ratios by JD and lower accounts payable days indicate that JD has greater bargaining power than Gome. But Suning's accounts payable days are lower than JD's. Suning and Gome have more than 20 years of industry relationships, and even though it has a higher sales volume, JD appears less efficient in working with suppliers.

The lower margin, we believe, is because of where JD sits in the value chain, facilitating wholesale transactions rather than selling on to end-users. Wholesaling in China is a very low-margin business, since no player has the scale and capital resources to provide an indispensable service.

We believe that JD is unlikely to make a profit in the next three years. Fulfillment costs account for around 7% of direct sales, twice our estimated gross margin for the B2B portion of the business. Given that JD procures inventory, fulfillment costs should be classified as part of the COGS. If the fulfillment were added into COGS, margins would be badly negative.

JD may have more bargaining power than Gome and less than Suning.

## Where's the Leverage?

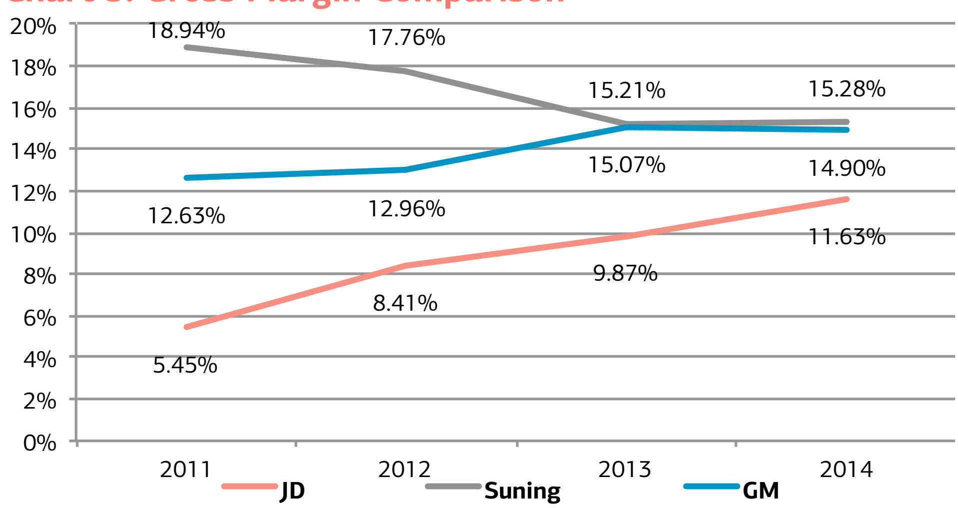
The proportion of procurement costs that has to be pre-paid is an indicator of bargaining power with suppliers—the higher the pre-payment, the lower the bargaining leverage. According to this metric, JD is in between Suning and the much smaller electronics retail chain, suggesting that JD has more bargaining power than Gome and less than Suning.

### Table 7. % of Procurement Prepayments (Prepayment as % of COGS)

| Company | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|
| **JD** | 0.80% | 0.27% | 1.11% | 0.81% |
| **Suning** | 0.48% | 0.38% | 0.46% | 0.42% |
| **Gome** | 1.10% | 1.30% | 1.35% | 1.44% |

Source: Company data

### Chart 3. Gross Margin Comparison




Source: Company data

## Logistics

The apparent logistical efficiency of offline retailers Suning and Gome is much higher than that of JD. JD books more than Suning in warehouse assets and yet has only half the space Suning has. JD also operates 3,210 delivery stations and yet covers less geographical territory than Suning, with 1,777 delivery stations. Suning makes it easy to break out the costs of its online purchasing and delivery system because these services and assets are lodged in a separate company from the one that manages logistics for the old-line retailer.

Among the red flags in JD's logistics network is its high cost compared with online and offline facilities for a traditional retailer such as Suning. JD acquired its warehousing and delivery assets somewhat earlier than Suning and yet it has spent 20% more money to get a bit more than half the space. Land acquisition records for JD show a company that is paying 3-4 times as much as it needs to for land.

## Table 8. JD Land Purchase Records

| Date | City | $M^2$ | Price (RMB mln) | $RMB/m^2$ |
|---|---|---|---|---|
| **April 3, 2015** | Chengdu | 255,708 | 44.1 | 172.5 |
| **Dec. 31, 2014** | Nanjing | 46,854 | 55.7 | 1,188.80 |
| **July 19, 2014** | Wuhan | 40,235 | 87 | 2,162.30 |
| **Nov. 7, 2011** | Beijing | 45,012 | 295 | 6,553.81 |
| **June 13, 2011** | Wuhan | 96,053 | 36.1 | 375.83 |
| **Total** | | 483,862 | 517.9 | 1,070.37 |

Source: Wind

## Table 9. Suning Land Purchase Records

| Date | City | $M^2$ | Price (RMB mln) | $RMB/m^2$ |
|---|---|---|---|---|
| **April 24, 2015** | Foshan | 279,364 | 111.0 | 397.3 |
| **Sep. 26, 2014** | Changzhou | 99,877 | 47.9 | 480.0 |
| **Jan. 13, 2014** | Zhengzhou | 27,104 | 13.7 | 505.1 |
| **Jan. 13, 2014** | Zhengzhou | 28,531 | 14.4 | 503.0 |
| **Jan. 13, 2014** | Zhengzhou | 23,113 | 11.6 | 502.7 |
| **Jan. 13, 2014** | Zhengzhou | 23,486 | 11.9 | 505.0 |
| **Aug. 26 2013** | Suzhou | 39,783 | 13.4 | 336.1 |
| **Aug. 26 2013** | Suzhou | 69,304 | 23.3 | 336.5 |
| **Aug. 21 2013** | Nanjing | 10,710 | 50.2 | 4,687.2 |
| **April 12, 2013** | Baotou | 25,104 | 299.6 | 11,935.9 |
| **June 7, 2012** | Kunming | 136,172 | 58.6 | 430.5 |
| **Total** | | 762,548 | 655.6 | 859.8 |

Source: Wind

## Table 10. Warehouse Assets for JD vs. Gome and Suning

| (As of End of 2014) | Warehouse | Related Asset Value |
|---|---|---|
| **JD** | 2.20 mln $m^2$ | RMB 5.40 bln |
| **Suning** | 4.30 mln $m^2$ | RMB 5.31 bln |
| **Gome** | 1.95 mln $m^2$ | RMB 4.47 bln |

Source: J Capital estimates and company data

Suning recorded similar revenue with higher margins and more investment in logistics and yet has a lower valuation than JD's. We think JD's main selling point, its owned logistics, has been overvalued.

## Table 11. Revenue per Warehouse Space per Employee

| (As of Dec. 31, 2014) | JD | Suning | Gome |
|---|---|---|---|
| **Warehouse (mln $m^2$)** | 2.2 | 4.3 | 1.95 |
| **Revenue 2014 (RMB mln)** | 115,024 | 109,000 | 60,360 |
| **Revenue/$m^2$** | 52,284 | 25,349 | 30,954 |
| **Employees** | 62,051 | 13,391 | 42,839 |
| **Revenue per Employee (RMB mln)** | 1.85 | 8.14 | 1.41 |

Source: Company filings

# Financial Services

JD offers financial services through two affiliates.

JD.com offers financial services through two affiliates: a company that does commercial factoring and one that offers small loans. Together, the two companies have only about 50 employees. The companies are a factoring business carried out by Shanghai Banghui Commercial Factoring Limited Company and a small loan business conducted by Jinghui Small Loan Limited Company.

To establish the factoring business, JD.com invested RMB 1.5 bln as disclosed by the State Administration of Industry and Commerce on its website, but we are not clear where the gains of the financial services are recorded. If recorded in interest income, then the effective interest income seems too low: it's around 3.7%. If the gains are recorded as "services and others," then the calculated commission on transactions suggests that either the commission is extraordinarily low or the transaction volume overstated.

CEO Liu states that JD is aiming to derive 70% of net profit from financial services within 10 years.

## Table 12. Finance Companies Records of Establishment

| Company Name | Legal Person | Formation | Date | Registered Capital |
|---|---|---|---|---|
| **Shanghai Banghui Commercial Factoring Limited Company** | Richard Liu | Sole Ownership Limited Company | June 5, 2013 | RMB 1.5 bln |
| **Jinghui Small Loan Limited Company** | Richard Liu | Joint-Venture Limited Company | Dec. 31, 2013 | RMB 300 mln |

Source: SAIC

Here is the Chinese-language record from the AIC's website:

上海邦汇商业保理有限公司　注册号：310115002127534

工商公示信息

登记信息 | 备案信息 | 动产抵押登记信息 | 股权出质登记信息 | 行政处罚信息 | 经营异常信息 | 严重违法信息 | 抽查检查信息

| 基本信息 | | | |
|---|---|---|---|
| **注册号** | 310115002127534 | **名称** | 上海邦汇商业保理有限公司 |
| **类型** | 有限责任公司(外商投资企业法人独资) | **法定代表人** | 刘强东 |
| **注册资本** | 150000.0万人民币 | **成立日期** | 2013年6月5日 |
| **住所** | 上海市嘉定工业区叶城路925号A区4幢205室 | | |
| **营业期限自** | 2013年6月5日 | **营业期限至** | 2043年6月4日 |
| **经营范围** | 出口保理，国内保理，与商业保理相关的咨询服务，信用风险管理平台开发。【依法须经批准的项目，经相关部门批准后方可开展经营活动】 | | |

Source: Shanghai AIC

The company has received loans totaling about RMB 5 bln, former employees said, from Bank of China, Construction Bank of China and China Merchants Bank. The financing companies use data from JD on turnover, trading volume, and cash cycle to determine the creditworthiness of potential borrowers. The senior deputy of the JD Financial Group, Liu Changhong, stated that JD's financial services business is independent from JD and that the only connection the two companies' share is that 80% of the customers are from JD.

Yet this is contrary to what we have found through our checks. The two companies can access JD's CRM/ERP system to evaluate borrowers' credibility. In our interviews, we also learned that JD's loan companies are expanding services to provide loans to individuals who own businesses selling on JD's platform.

## Factoring

The high growth of the factoring business in China has attracted many companies to the sector. Outstanding receivables in the industry are reported to be RMB 20 trn. According to one industry insider, the average growth rate in factoring in China was 96% annually from 2005 to 2011, the trial period when licenses were issued in a few cities. China's commercial factoring business formally began in 2012. By 2014, factoring reached RMB 3.5 trn by volume, meaning the amount of lending against receivables. Volume is expected to reach RMB 5.39 trn in 2018.

JD's factoring company provides services to suppliers in the direct sales business. Our interviews show that the business has access to JD's CRM/ERP data. Suppliers that sell more than RMB 100,000 in products to JD qualify for loans. The loans are made against JD's payables to the suppliers at an 80% loan-to-value ratio. Loans are extended at 0.025% per day, or about 9% annually but may be repaid early.

Our research indicates that by the end of 2014, outstanding loans to 600 suppliers totaled RMB 12 bln. Based on these loans outstanding, JD's factoring company has leverage of eight times its RMB 1.5 bln in registered capital.

## Small Loan Business

JD's financial services are currently not very successful.

The JD small loan company offers three types of loans at slightly different rates, to suppliers, vendors on the third-party platform, and the individual owners of businesses selling on the third-party platform. Loans to the third-party platform operators are provided for 90 days with a ceiling value of 40% of the supplier's turnover on JD's platform and a rate of 12% annually or 0.035% daily. Former employees said that the service began last September and that the company lends about RMB 100 mln per month.

**We believe the low ceiling of 40% of turnover is a red flag for sales volumes.** Normal loan-to-value in the commercial factoring business is 80%. Either JD marketplace participants have far lower credit ratings than other small businesses or JD knows that their sales volumes are overstated by a factor.

JD's financial services are currently not very successful. Interest rates are only half of Alibaba's, but few suppliers seem to be applying the loans, partly because the approval process is comparatively slow and partly because the loan values, at about RMB 100,000, are small relative to the size of the JD suppliers. Alibaba suppliers tend to be much smaller and so Alibaba can charge higher interest and yet issue more loans. Loan processing time for JD takes normally up to two weeks, and the interest rate is half that of Alibaba—10% versus 20%.

JD's effective interest income rate is relatively low compared with the returns on financial products one can get from the market. One possible reason is that the cash is being used for lending through the small loan company.

### Table 13. Interest Income

| RMB '000 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|
| **Cash and Cash Equivalents** | 6,288,777 | 7,177,294 | 10,812,339 | 16,914,651 |
| **Interest Income** | 56,098 | 175,751 | 343,770 | 637,641 |
| **Interest Rate** | 0.90% | 2.40% | 3.20% | 3.80% |

Source: Company data

## Does the CEO Know What's Happening at JD?

We find it puzzling that Richard Liu frequently makes statements to the press that do not line up well with JD's financial statements. Some examples:

| What Liu Said | The Facts |
|---|---|
| In October 2011, Liu told CCTV that revenue would reach RMB 28 bln that year. (See here and here.) | 2011 revenue was RMB 21 bln. |
| In June 2012, Liu stated that JD's GMV was RMB 1 bln and that the platform had 1.5 mln orders with an ASP of RMB 677. (See here.) | At the same time, the media reported RMB 200 mln in GMV, 800,000 orders and an ASP of RMB 300. (See here.) |

| | |
|---|---|
| At the 2014 annual meeting, Liu stated that JD now had more than 70,000 employees. (See here.) | Company filings indicated 62,000. (See the 2014 annual report.) |
| At the 2014 annual meeting, Liu stated that JD had more than RMB 30 bln cash. (See here.) | Company filings disclose RMB 16.2 bln. (See the 2014 annual report.) |
| In December 2013, Liu said JD would not go public before 2015. (See here.) | JD filed an IPO prospectus on January 30, 2014. |

Source: J Capital

# Monkeying with the Balance Sheet

JD entered into a strategic partnership with Tencent in March 2014. Through the partnership, JD acquired Tencent's QQ Wanggou and Paipai marketplaces and was able to capture traffic from Tencent's platforms. As part of the deal, Tencent inserted direct access points to JD.com from WeChat and mobile QQ, Tencent's most popular products. Tencent became a strategic investor in JD.com, with a 17.78% stake.

JD's deal with Tencent appears to have been designed to elevate JD's valuation before IPO, thus also inflating Tencent's e-commerce assets.

## Deal Overview

**What did JD get?**

- USD 214.7 mln in cash
- The Tencent e-commerce businesses QQ Wanggou and Paipai as well as a minority stake of 9.9% in Yixun
- Level 1 access point on Tencent's WeChat app (which is valued at USD 1 bln)
- The right to purchase the remaining assets of Yixun by March 10, 2017 at the higher of the then fair value of Yixun or RMB 800 mln. Yixun operates a B2C e-commerce platform in China

**What did JD give?**

- A 15.5% share in its equity
- The right for Tencent to purchase another 5% in JD post IPO

Both Wechat and JD raised their valuations in the deal: the JD valuation rose by 97% and Wechat's increased by nearly 100%. This may have made it easier for JD to achieve a higher IPO valuation.

But an unintentional consequence of the deal and its related disclosures was information about the booked value of Tencent e-commerce subsidiary Yixun. Tencent bought 100% of Yixun in 2012. According to JD's filings, 9.9% of Yixun's equity was valued at RMB 253 mln, which implies a total value of RMB 2.55 bln (USD 404 mln). At that time, Yixun recorded GMV of RMB 30 bln and net revenue of RMB 10 bln. Dangdang at the time had only RMB 10 bln in GMV and RMB 7 bln in net revenue yet was valued at USD 1.5 bln. If Yixun's reports were true, then its valuation should have been at least USD 2.2 bln.

We think the likelier explanation is that Tencent was over-reporting Yixun's GMV and revenue. Tencent's 2013 annual report indicated revenue from e-commerce of RMB 9.79 bln, including both Yixun and PaiPai. This number is even less than the reported Yixun figure of RMB 10 bln.

We estimate that actual net revenue for Yixun was only about RMB 3 bln. This view is supported by reported losses of RMB 437 mln, against Yixun's previous net income loss rate of 9%.  If Yixun's income had actually reached RMB10 bln in 2013, the loss would have been RMB 900 mln.

We believe that JD bought the loss-making Yixun, which iResearch said had only a 2.1% share in the B2C market, to inflate its IPO valuation.

We believe that JD bought the loss-making Yixun to inflate its IPO valuation.

## Table 14. Tencent Assets Acquired by JD Before IPO

| | |
|---|---|
| **Paipai & QQ E-Commerce** | USD 461 mln |
| **9.9% Equity in 51Buy** | USD 41.8 mln |
| **Personnel** | USD 2.3 mln |
| **Land Use Rights** | USD 12.2 mln |
| **Net Cash Acquired** | USD 0.2 mln |
| **Subtotal** | **USD 517.4 mln** |
| **Goodwill** | USD 1,409.5 mln |
| **Total Valuation** | **USD 1,926.9 mln** |

Source: JD prospectus

### Table 15. Valuation Before and After Acquisitions

| Before (Dec. 20, 2013) | After (March 11, 2014) |
|---|---|
| USD 8.0 bln | USD 15.7 bln |

Source here

### Table 16. JD vs. Tencent Share Price

| Date | JD'S Share Price | Tencent's Share Price | Events |
|---|---|---|---|
| **Jan. 30, 2014** | USD 3.96 | HKD 108.00 | First IPO filings |
| **Mar. 10, 2014** | USD 6.30 | HKD 123.00 | Tencent's investment |
| **May 22, 2014** | USD 20.90 | HKD 112.00 | IPO |
| **Dec. 4, 2014** | USD 23.80 | HKD 118.00 | Secondary offer (Tencent acquired USD 150 mln) |

Source: J Capital

## Over-Valuing WeChat Access


**Screenshot of the "Level 1 Access Points"**

On February 19, 2014, Tencent acquired 20% of Dazhong Dianping, a restaurant review site, and granted it a “Level 1 Access Point” to WeChat. The access was valued at USD 690 mln.

One month later, in the deal with JD, the same Level 1 access point was assigned a valuation twice as high.

According to JD’s Q4 report, the Tencent access point helped JD gain more users and non-3c product customers. Yet the deal also was the main contributor to JD’s RMB 5 bln loss (2013: RMB 50 mln). The conversion rate of customers from WeChat and QQ mobile was lower than that of JD’s own app. We believe the acquisition of the WeChat access point was of very limited value.

# Valuation

We initiate on JD with a SELL at a price target of USD 23.36 based on 1.5x 2015 revenue vs 2x for Amazon and 13.1x for Alibaba. Given that half of JD's revenue is derived from the B2B business, which has a structurally low margin, we take a discount of 25% to Amazon's valuation of 2x revenue.

| Companies | P/S FY15 |
|---|---|
| **Alibaba** | 13.1[1] |
| **Amazon** | 2[2] |
| **eBay** | 3.8[3] |
| **Suning** | 1.41[4] |
| **Gome** | 0.55[5] |
| **Valuation P/S for JD** | 1.5 |
| **Company value (RMB '000)** | 200,290,385 |
| **Market Cap (RMB '000)** | 286,254,000 |
| **Downside** | -30% |
| **PT** | 23.36 |

We see growth coming from JD's third-party platform rather than its direct-sales business.

Given that JD is heavily reliant on a money-losing B2B business, we see positive growth coming from its third-party platform rather than from the direct-sales business. As JD accumulates more warehouses and delivery stations, third parties will likely rent more space to merchants and logistics. Currently, one-third of the third-party vendors are using JD's logistics, and JD is planning to open its warehouse to third parties in the current quarter. This means that, going forward, JD's business will look more like third-party logistics and less like e-commerce.

For the moment, direct sales to consumers make up more than 90% of revenue, and gross margin post fulfillment cost is negative. After taking out other operating costs, JD has a long way to go before it can turn a profit.

[1] According to JP Morgan estimates

[2] According to JP Morgan estimates

[3] According to JP Morgan estimates

[4] According to COB International estimates

[5] According to BOCOM estimates

The business of arranging transactions for wholesalers is a low-margin one but provides volume and is not easy to change. We forecast widening but negative gross margins for the coming three years.

# Risks

**Upside risks:**

1. JD may improve margins by raising the proportion of B2C business.
2. JD may grow faster than we expect.
3. JD may win significant government subsidies.
4. JD could make gains from other new businesses.

**Downside risks:**

1. Aggressive penetration in lower tier cities may lead to shortages of capital and pressure on margins.
2. Aggressive M&A activities may drain resources.
3. The government could sanction companies for permitting fake transactions and JD's GMV could consequently drop.

# Disclaimer



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