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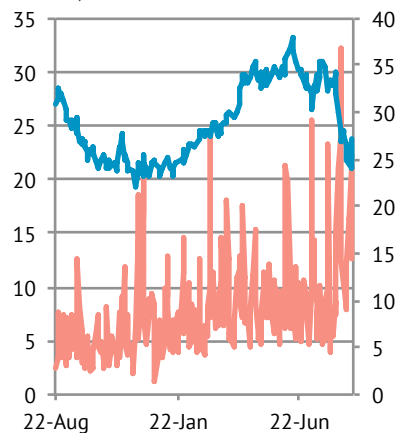
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JD.com (JD US)

Price	USD 24.75
Rating	SELL; Closing Coverage
Price Target	USD 23.36
Difference	5.6%
Market Cap	USD 35.40 bln
Moving Avg.	11.85 mln
Free Float	69.01 mln

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



Source: Yahoo

JD.com (JD US) JD in Freefall

- ▶ **Large suppliers to JD.com** interviewed in July said that their sales had fallen this year, with only one vendor—who was selling at a loss—claiming growth and all others seeing decline, sometimes as much as one-third. As surprising as these results are, the drop seems to be accelerating.
- ▶ **We strengthened our confidence** in our estimate that direct sales to consumers represent only about 40% of the GMV reported for the direct sales platform. The 60% balance of GMV derives from wholesale transactions plus a small proportion of faked¹ or circular transactions.
- ▶ **Faked or circular transactions** account for about 40% of the transaction value on the marketplace platform, which represents a small portion of revenue but 40% of GMV. We think the faked proportion has come down, from about 50% in 2014, due to better supervision by JD.com management.
- ▶ **We think JD is buying and selling** land to eke out a profit and not disclosing the transactions.
- ▶ **We are closing coverage** on JD, which is now trading close to our target price. JD is down 32% since our initiation vs a 24% fall for China ADRs (Bloomberg: INDEXCME:BKCN).

¹ Note: A "fake transaction" refers to three types of transactions: 1) "brushing" on the third-party marketplace, whereby vendors buy their own products through elaborate circular transactions in order to boost visible sales results 2) possible manipulation of statistics on the direct sales platform from the backend and 3) the practice of JD.com suppliers buying back unsold inventory via the JD.com and BJD.com sites as if the returns were retail sales. JD.com requires suppliers to do this to increase JD.com total sales.

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Pretending

JD.com has built a solid distribution system and strong consumer reputation. But the company chose to boost stock valuation by using any means at its disposal to pump up GMV. In the race to generate volume, JD became a wholesale channel, and not necessarily a very efficient one. Wholesale is a miserable business in China with perpetually low margins, and JD brings no special expertise to the table. The wholesale transactions from JD's direct-to-consumer platform are really part of an elaborate pantomime designed to capture capital investment. The business model is to pay for the appearance of rising GMV and capture heady share valuations.

The company has been working with some success to develop its Marketplace, a third-party platform, but that platform offers no more value than TMall or Taobao and has far less volume.

Should JD decide at some point to end the channel sales, take a hit on GMV, and go back to building a direct-to-consumer business, we may be positive on the company's mid- to long-term growth prospects and ability to become profitable. But the current business of the company is only half retail and half wholesale, and we view wholesaling in China as one of the worst games in town. Consequently, we value JD.com at a wholesaler's valuation of 1.5x sales and close coverage.

This Year's Stunning Decline

In 16 recent supplier interviews, 15 of the JD suppliers in Shanghai, Wuhan, Chengdu, Guangzhou, and Shenzhen said their sales on the platform this year were down compared to last year. The 16th was seeing sales growth due to a strategic decision to sell well below cost. Most suppliers interviewed did not disclose their annual sales value on JD, but we estimate that as a group, the suppliers interviewed in this round represent around 8% of JD's total USD 17.9 bln in reported annual sales. We tried to choose suppliers that are generally representative of JD's product mix, with consumer electronics most heavily represented and other categories, such as baby products, close behind. Some examples:

- ▶ A supplier of European safety seats in Beijing that we estimate does about RMB 40 mln in sales on JD said his company's sales on the platform had fallen by 50% this year.
- ▶ The sales manager of a large domestic IT products brand said sales were down by 30% on JD.
- ▶ The sales manager of a European white goods and home electronics

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brand estimated that sales were down by 20%.

- ▶ The manager of a digital camera company's sales estimated a decline of 10%.
- ▶ A company in Wuhan that sells personal technology products had flat sales.
- ▶ One large supplier told us that 60% of its products sold to JD are actually sold to lower-tier distributors and at prices that this OEM cannot match

Some reasons the vendors offered for this decrease:

- ▶ Saturated markets in Tier 1-2 cities
- ▶ More competition from specialized e-commerce platforms
- ▶ Lower demand and lower consumer spending this year due to a weak economy.

The interviews do not account for sales by new vendors recruited onto the platform; we were focusing on speaking with vendors who have been selling on JD for many years, so that we could gauge growth. JD may legitimately get GMV growth from adding new vendors and brands.

JD Offline

Soon after our last report revealed that 30% of JD's direct-to-consumer business is actually arranged offline among distributors, JD disclosed that it had derived nearly 10% of net revenue in 2014 from its "B2B business." Why hadn't they ever said so?

Song Chunzheng, general manager of JD's B2B business, [told the press](#) that JD started its B2B business on a trial basis in 2010 and launched it formally in March 2015—that's why they never announced it to investors. JD is positioning itself as a wholesaler, he said, providing storage and fulfillment services for large corporate and government clients.

But in China, selling to government and big corporations is a murky business requiring facilitation payments that eat into the margins. The simplest reason is that customers are a scarce resource and product abundant: buyers can set the terms of trade. One good comparable is Yiyatong (002183), which has enabled B2B transactions since 1999. For the financial year 2014, its gross margin was 5.5% and revenue was RMB 20.2 bln.²

² See [here](#).

Those numbers are probably optimal for this segment.

That is to say that we do not believe that an online wholesale business can grow into profitability under the current Chinese economic structure. But JD.com is not even really trying. The company’s stated goal is to provide superior IT management and database integration so that companies can place orders online, but JD’s current IT system falls far short of this goal. In large part, *JD is simply using various persuasions to get existing, of-line distributors to book existing transactions through JD for cosmetic purposes, even though the process loses money.* The losses are sometimes funded by JD and sometimes by the OEM, but the transactions as a rule are loss-making. Brand owners say that JD sells their products into channels at prices below those they themselves can offer, so there is a loss on each sale. Second, much more of the transaction volume occurs between businesses than JD claims is the case.

This means that marginally profitable distribution businesses have been turned into loss makers simply because the valuations that foreign investors are willing to assign to an “e-commerce company” are so attractive.

Table 1. JD Supplier Interviews July 2015

Region	Product Type	Interviewee Position	Comments
North China	Producer of dietary supplements	Director of e-commerce department	About 20-30% of transactions on JD’s third-party Marketplace platform are faked. In clothing categories, the fake transaction volume is higher.
North China	Automobile tires	Sales Director	At least 40% of transactions on JD’s marketplace are faked, but the faking also occurs on the direct platform. On the direct-sales site, suppliers buy back products they cannot not sell and transact those buybacks on JD and B.JD.COM, adding to GMV.
North China	First tier distributor of consumer electronics	Operations manager	Across the direct and third-party platforms the average proportion of faked transactions is about 20%.
South China	Jewelry company	General manager	Buybacks generate some fake GMV, and JD sells the company’s products offline to wholesale channels.

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North China	Large home appliance brand	Sales Director	More than 40% of transactions in consumer electronics and clothing are faked. In other categories the proportion is about 30%. Payable days to suppliers are around 30-45, sometimes 35-50 if sales are weak. JD sets targets for their own gross margins, but the targets are hard to achieve: they are 5% for consumer electronics, 15% for small consumer products and 10% in the less-popular brands, 15% for major appliances. When our company fails to meet the sales target, we ask distributors to purchase on JD.com and we compensate them later through various discounts. Our proportion of buybacks from JD is around 5%. The proportion of sales to offline distributors is around 25%.
South China	Sanitary ware	Sales Director of the e-commerce department	The volume of fake transactions is around 40%. Some of the products are sold offline, but the proportion is not very significant.
South China	Sanitary ware	Sales Director	We ourselves purchase on JD.com and we ask some of our clients to purchase through b.jd.com. Additionally, the volume of fake transactions is around 40%. We normally do not buy back, but I know that, for small brands, buybacks amount to 10% and for JD overall, The buyback ratio is 3-5%.
North China	Large PC brand	Manager of e-commerce	Management in JD is very weak. Buybacks amount to less than 10% of total volume.
North China	Sportswear	Marketing Director	Our fake transaction volume is 15-20%. Each year, JD closes down the worst-performing shops on the third-party platform.
West China	Toys	Manager of e-commerce	30-40% in fake transactions
Central China	A top PC brand	Manager of e-commerce	60% of our transactions on both the direct and third-party platforms are false. Because PC sales are very bad this year, we are keeping a blind eye to the practice of dumping low-priced product into irregular channels, like city wholesale markets and other e-commerce companies.

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South China	Japanese electronics brand	Regional manager	40-60% of our third-party platform sales are fake and 20-30% of the direct sales platform, maybe more for other companies. Because JD can control the apparent sales on its backend, they can create the appearance of high sales by simply adjusting the counter, but they have a different set of accounts they share with suppliers. Of the direct sales, 20-30% of reported sales are totally faked and another 20-30% of product is actually sold into distribution channels offline.
North China	Former JD employee	Supply Chain department	Some of JD's products are sourced from VIPShop.
South China	Supplier to VIPShop		Some of the sales on the VIPShop platform are actually sales to JD.com.
South China	Electronics	Sales manager	We supply products to the direct sales platform on JD. About 20% of our sales are booked by our distributors on b.jd.com and another 40% are fake transactions. In this industry it you have to fake 80% of transactions to get 20% of actual sales. I would estimate that 30% of JD's overall direct sales are to offline distributors.

Source: J Capital

Marketplace

JD's growth is now being driven by its third-party platform, the marketplace. But we find that this platform invites an unusual degree of transactions faked by the vendors as a form of marketing, in order to drive up their sales results. GMV on this platform in Q2 2015 was RMB 114.5 bln (USD 18.5 billion), up 82% from Q2 2014. GMV from the online direct sales and online marketplace businesses totaled RMB64.7 bln and RMB49.8 bln in Q2 2015, an increase of 65% and 110%, respectively, over the second quarter of 2014. The contribution of the third-party platform to total GMV rose from 38% in Q2 2014 to 43% in Q2 2015. The growth of GMV is mainly driven by high growth in third-party transactions.

Table 2. JD's Reported Growth Q2 2015

RMB bln	Q2 2014	Q2 2015	YoY
# of orders (bln)	0.16	0.31	87%
Average price/order	384	375	-3%

Mobile orders	22%	47%	
Total GMV	62.91	114.5	82%
Direct sales	39.21	64.7	65%
Third party	23.71	49.8	110%
Net revenue	28.51	45.9	61%
Direct sales	26.92	42.6	58%
Service and other	1.59	3.3	108%

Source: Company data

JD's O2O strategy, we believe, will lead to widening losses.

Online-to-Offline

JD's O2O strategy, we believe, will increase operating expenses and lead to widening losses. JD announced that it had established an O2O department early this year and acquired a 10% share in Yonghui Superstore on August 7 for RMB 4.3 bln as part of the strategy to deliver fresh fruit to customers. Over the last year, JD [invested](#) RMB 434 mln in other companies providing O2O services such as Elema, Daojia, and Beijing Guomao Car Parts.

The Land Party

We think JD may be taking advantage of local promotional policies for e-commerce parks to acquire land inexpensively and resell it at a profit. That would explain why the listed company has a pattern of recording less land at lower value than it purchased. JD may be using its status as a listed e-commerce company to access preferential prices offered by government e-commerce parks, after which it resells land parcels to logistics companies. This may all be well and good, but if the transactions are not properly accounted for in the public books, it leaves open the possibility that JD could use land sales profit to eke out some of the "revenue" that is missing from the core business. For example, in 2011 land-use rights were recorded at RMB 200 mln less than the total price JD had paid for land purchased in Beijing, Wuhan, and Shanghai, according to public records (see table).

In 2011, JD.com bought three pieces of land, in Beijing, Shanghai, and Wuhan, spending RMB 365 mln in total, according to public land records, but the balance sheet reflected only RMB 97 mln. Where did the remaining RMB 260 mln go? We suspect resale. We found such an example in Wuhan, where the company appears to have sold land to a logistics company

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and to be renting back the parcel.

On the cash flow statement, spending on land-use rights for 2011 was RMB168.8 mln, still RMB 192 mln less than the purchase price of the land. Why the difference? Chinese rules [do not permit](#) installment payments for land. We suspect that the difference may derive from resale.

Table 3. Land Purchases (in RMB mln)

Price of land bought in Beijing in 2011	295
Price of land bought in Wuhan in 2011	36.1
Price of land bought in Shanghai in 2011	33.6
Total	364.7
Land use rights (2011 cash flow statement)	169
Land use rights (2011 balance sheet)	97

Source: JD prospectus and Wind



The JD Wuhan warehouse | Photo: J Capital, July 2015

JD is building a central China headquarters in Yanglou outside of Wuhan, which construction workers onsite told us is costing RMB 300 mln. That number accords roughly with standard estimates of warehouse construction costs per square meter in China. But JD [has announced](#) RMB 7 bln in investment in Yangluo.

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JD Avenue, on the way to the warehouse | Photo: J Capital, July 27, 2015



JD's Beijing headquarters | Photo: source [here](#)

Meanwhile, there is evidence of land disposals. Gross floor area decreased from 2.3 mln sqm (Prospectus Page 3) to 2.2 mln sqm (2014 Annual report

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page 62) over the last quarter of 2014, but there is no information on the disposal of warehouses disclosed in the 2014 annual report. What they do disclose is land holdings to build warehouses: “As of September 30, 2014, we had land use rights in six cities, including Beijing, Shanghai, Guangzhou, Wuhan, Shenyang and Kunshan, to build our own warehouses.”

The following table summarizes JD’s land acquisition.

Table 4. Logistics and Warehouse Summary

City [Source]	Date of Purchase	Land Purchase Price	Investment	Area	Project Started	Project Finished	Function	Note
Beijing [1] [2] [3]	11-Nov	RMB 295 mln	NA	300,000 sqm	NA	2010: warehouse 2015: head quarter	Warehouse/ headquarters	
Beijing	13-Jul	NA	NA	NA	NA	NA	Warehouse	It will take an estimated 2-3 years to finish the project
Shanghai [1] [2] [3] [4] [5] [6] [7]	11-Sep	RMB 33.6 mln	NA	230,000 sqm	2012 Apr: Phase one (warehouse) 100,000 sqm	2013 Jun: Phase one	Warehouse/ headquarters for Eastern China	Daily processing capacity 100,000 orders.
Guangzhou [1] [2]	NA	NA	Planned to invest RMB 800 mln for its e-commerce park	172,000 sqm	2010 Dec: Logistics center/ warehouses/ headquarter of South China	2012 March: Logistics center/ warehouses/ headquarter of South China	Logistics center/ warehouses/ headquarters for South China	This is said to be the largest cloud computing center for internet of things nationally.
Wuhan [1] [2] [3] [4]	11-Jul	RMB 36 mln	Plans to invest RMB 5 mln in its China e-commerce “harbor”	197,000 sqm	NA	2014: Logistics center/ warehouse	Warehouse/ logistics center/ e-commerce platform	It is said to be a platform also used by other e-commerce companies.
Wuhan	14-Aug	RMB 87 mln	Planned to invest RMB 7 bln for its e-commerce park	154,501 sqm	In 2013, JD signed investment memo with local government.	In the investment memo	Logistics center/ warehouses/ headquarters for Central China/ e-commerce park	It is said that investment for phase one is RMB 2 bln and RMB 5 bln for phase two. Phase one is for the headquarters for Central China. Phase two is an e-commerce park.
Shenyang [1]	NA	NA	NA	174,000 sqm	NA	2014 Aug: logistic center/ warehouse	Warehouse/ Logistic Center	

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Kunshan [1]	NA	NA	Planned to invest RMB 700 mln for the warehouse and logistics center	400,000 sqm	2013 May: JD sign agreement with local government and start construction in 2014 Oct.	Expected to complete the project in 2016	Warehouse/ Logistic Center/ Headquarters of South Suzhou	Even the project is still under construction yet sale revenue for JD Kunshan since last June reached RMB 4 bln and for the first 5 months of this year is RMB 1.3 bln. Currently they are renting warehouses in Kunshan
Guiyang [1]	14-Aug	NA	Planned to invest RMB 1 bln for the E-commerce park	306,000 sqm	2014 Sep: e-commerce park	2015 Aug: for phase one	Logistic center/ E-commerce park	
Suqian [1] [2] [3] [4] [5] [6]	9-Nov	NA	Planned to invest RMB 4.5 bln for the whole JD Technology park	The total park is 250,000 sqm Call center is 60,000 sqm	Phase one (call center): 2011 Sep	Phase one (call center): 2013 Nov	Call center/ Logistics management/ Clearance Center/IT R&D	The call center is able to support 10 mln orders per day. There are 5000 employees in the center. There is also a residential property project in the park. No detailed info on the second phase of the park.
Chengdu [1]	NA	NA	NA	64,000 sqm	NA	2010 Mar: logistic center/ warehouse	Warehouse/ logistic center	It is said that the area for the warehouse was going to expand to 260,000 sqm. Yet no further news on that.
Xi'an [1] [2] [3]	NA	NA	NA	NA	NA	NA	Logistic center	The logistic center is first embark operation in 2010 Nov. JD said to finish another advanced warehouse there in 2-3 years

Source: J Capital Research

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Valuation

We reiterate JD with a SELL at a price target of USD 23.36. We base our valuation on 1.5x 2015 revenue, a bit higher than Global Sources (NASDAQ:GSOL), a B2B media company that provides information and integrated marketing services, with a focus on the Greater China market and is valued at 1.24 times sales. Our price-to-sales ratio is between the Suning and Amazon valuations. Suning's price to sales is now 0.97, and Amazon is valued at 2.63 times sales as of August 28.

Risks

Upside risks:

1. JD may improve margins by raising the proportion of its B2C business.
2. The government stimulus efforts could be effective at least in the short term and JD's price could rise.

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.

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