JCAP

TMT
China

April 1, 2016

Melvin Glapion
melvin@jcapitalresearch.com

Anne Stevenson-Yang
anne@jcapitalresearch.com

+852 2534 7405

VIPShop Holdings (VIPS US)

VIPS Correspondence Casts Doubt Over Cash

Beginning of the End?

The recent correspondence between VIPShop and the SEC suggests that the company should restate its historical financials. At the very least, we expect the 2015 20-F could be delayed.

Bloated Balance Sheet

The biggest problems for VIPS appear to be its claims about gross vs net reporting and advances to suppliers. Correspondence makes it clear that the company should be reporting income on a net basis and therefore removing around USD 700 mln in inventory from the asset side of its balance sheet. Changing the accounting treatment to "net" could lower VIPS margins to 5.6%, the currently reported operating margin. The company also appears to be seeding partners with cash to buy products on the platform.

Where's the Cash?

VIPS reported that it has USD 648.6 mln in cash and held-to-maturity securities in its VIE company. This arrangement is very unusual even in the murky world of Chinese e-commerce. That cash is inaccessible to auditors and investors.

And Where's the Rest of the Value?

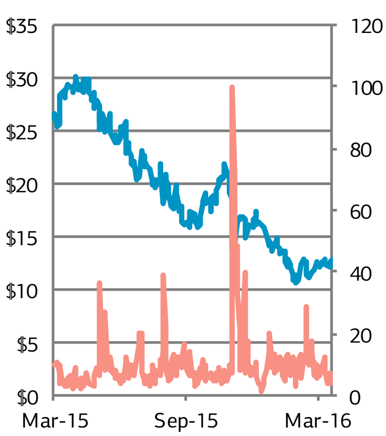
Unlike many of its e-commerce peers, VIPS holds large percentages of revenues, profits and assets in the VIE. It has been kind enough to leave all the debt in the consolidated entity. As such, 99% of net assets are held in the VIE. Comparable figures for other e-commerce firms show net assets in VIEs at less than 5%.

Reiterate SELL

VIPShop Holdings (VIPS US)

Price	USD 12.88
Rating	**SELL**
Price Target	**0**
Difference	100%
Market Cap	USD 7.49 bln
P/E	31.19x

VIPShop (VIPS US) last share price in USD (blue) and volume (pink, in mln shares)



Source: Bloomberg

Tangled Up in Red?

The SEC recently released a lengthy exchange with VIPShop on Edgar leveling a skeptical eye on the company's disclosures. VIPS was asked to explain:

- Why VIPS reports revenue on a gross basis when it appears not to take inventory risk
- Where it holds all that cash
- Whether reported "factoring" actually may consist of advances to suppliers
- Why reported capex is not reflected in PPE or cash flows
- How the company assesses the value of Lefeng and Ovation

An SEC investigation could be the next step.

The initial SEC letter was sent to VIPS in mid-December 2015, but the communications were only finalized and posted to the Edgar website in February 2016. The SEC has not announced a formal investigation but a review of SEC correspondence trends with other companies suggests that an investigation could be the next step. The SEC letter is here and the VIPS response letter can be downloaded here.

In February 2016, the SEC's Corporate Finance Office provided VIPS with the standard completion letter saying that the review is complete for now, but the specificity of correspondence and the clarification requests suggest to us that the SEC may push for restatements or possibly open an investigation.

Asset Alert

In its disclosures, VIPS reveals alarming detail about the cash it claims.

- 100% of the Held-to-Maturity securities are held with Chinese financial institutions. With interest earned of USD 19 mln and the average balance of Held-to-Maturity securities of USD 499 mln, the company earned a meager return of 3.87%, which is lower than the average rate that was offered online by money market funds managed by companies like Alibaba and Tencent last year.

- 70% of the USD 607 mln in HTM securities are held by the company's VIE, which, unlike most VIEs, contains layers of subsidiaries and affiliates with multiple branches, assets, and thousands of employees. The VIE company is subject to far blurrier audit standards, and its cash does not belong to U.S. investors. In fact, VIPS is unlikely under Chinese law to have the right to transfer those securities to its Chinese, Hong Kong, or U.S. companies.

- The response to Question 4 from the SEC erroneously states that the company has USD 948.5 mln of cash with "PRC subsidiaries." A VIE company is not a subsidiary, and that distinction is critical for understanding only 30% of the cash claimed by VIPS is actually in a subsidiary that could be secured by U.S. investors in any bankruptcy proceeding or lawsuit. So 70% of the cash claimed by VIPS is not available to secure obligations of VIPS in legal proceedings. Legally, the VIE has no connection to VIPS other than contracts that can be deemed invalid and would be superseded by any legal claim on VIE assets.

- If the VIEs are called "PRC subsidiaries," then we are concerned that the USD 430.5 mln of cash reported held by Hong Kong "subsidiaries" could be sitting in companies owned by Eric Shen and other managers and not by VIPS. We have identified 18 undisclosed companies registered in Hong Kong under Eric Shen's ownership and one called "VIP Shop Limited" whose owner is listed as Li Bin Hong, three characters that coincidentally represent a composite of names of top VIPShop executives. We are not aware of disclosures that have detailed cash in the VIPS Hong Kong subsidiary in the past.

- The imbalance in holdings does not stop with the cash and HTM. We analyzed the most recent filings of VIPS' e-commerce peers and found that VIPS keeps a much larger amount of revenues, profits, and assets in the VIE. It does leave the debt in the consolidated entity. Over 99% of net assets sit in the VIE. This compares to less than 5% at BABA, JD, and JMEI. If there are any problems with the company, the risk is that a large percentage of assets and revenues are out of the reach to investors.

Table 1. Comparison Table: VIE Assets at Chinese Internet Companies (in RMB ,000 except for VIPS, in USD ,000)

		Revenue	Net Income	Assets	Liabilities	Net Assets
VIPS	VIE	3,066,493	26,587	810,442	378,883	431,559
	Consolidated	3,773,657	137,260	2,732,011	2,297,162	434,849
	VIE as % of Cons.	81.3%	19.4%	29.7%	16.5%	99.2%

JMEI	VIE	108,150	(3,857)	34,669	28,017	6,652
	Consolidated	632,919	65,960	743,315	192,796	550,519
	VIE as % of Cons.	17.1%	-5.8%	4.7%	14.5%	1.2%
JD	VIE	3,431,134	(41,228)	3,784,170	4,180,518	(396,348)
	Consolidated	115,002,000	(4,996,000)	66,493,000	28,995,000	37,498,000
	VIE as % of Cons.	3.0%	0.8%	5.7%	14.4%	-1.1%
BABA	VIE	10,457,000	659,000	13,811,000	11,420,000	2,391,000
	Consolidated	76,204,000	24,149,000	255,434,000	97,363,000	158,071,000
	VIE as % of Cons.	13.7%	2.7%	5.4%	11.7%	1.5%

Source: Company filings, J Capital

Among the most startling aspects of VIPS' responses is their obfuscation of the difference between their VIEs and their wholly foreign-owned enterprises. For example, on page 4, the SEC has asked for a disclosure of the HTM held by the VIEs, yet VIPS proposes a table showing holdings by "Subsidiaries – PRC." Why is VIPS not responding to the SEC inquiry by, for example, including two columns, one for "Subsidiaries - PRC" and one for "VIEs - PRC"?

The obfuscation is particularly evident in their longer response to the next question, in which they propose an enhanced disclosure on their 20-F and discuss in greater detail how they would be able to remit funds out of the PRC from their wholly owned enterprise subsidiaries. Since this immediately follows their response to the SEC inquiry on VIEs, and their obfuscating response on "Subsidiaries – PRC," there is an implicit linkage that their method of remitting funds out of the PRC covers both WFOEs and VIEs, when in fact it avoids discussion of the VIEs completely.

Oops I've Done It Again

VIPS' responses to the SEC fall into three broad categories: "We did not mean what we said," "Yes, it is a mistake but it is not material," and "Yes, it might be a mistake and it might be material, but we are still not restating it."

We Did Not Mean What We Said

- **Gross vs. Net Revenue Recognition:** The SEC asked (Question #10) how the company decided to report revenues on a gross basis in light of the fact that it had largely mitigated its “General Inventory Risk.” General Inventory Risk is one of the more important determinants of whether a company is a consignment seller (and should report revenues net of costs) or actually taking possession of its inventory and reselling it. Largely mitigating inventory risk means the company should report net revenue. The SEC even pointed to VIPS’ statements on calls that it pays for only 10% of its Inventory and is not principal owner of the inventory.

VIPS says it does indeed take ownership title and that on the earnings call management was simply referring to the fact that 10% of goods are not returnable to suppliers. Both of these arguments are in direct opposition to what was discussed in the earnings call of Q4 2013, where management states:

> “...So meaning we don’t want to become the principal owner of the inventory unless we have to. For example, currently, about 10% of the inventory in a warehouse has to be purchased from the supplier. And understandably if those suppliers are big suppliers like Nike, but going forward as we become bigger with greater marketing power, we believe that more and more suppliers will allow us to take their inventory without having to purchase upfront.. ”

The implications of reporting on a net basis would be very significant:

- The company would have to restate historical financials, which in itself would massively impact the stock.
- The fact that the company is mixing owned inventory with consignment inventory suggests that the figures it is reporting for both inventory and costs of goods sold are incorrect. If the company is forced to report on a net basis, the net revenues will likely be lower than that the currently as gross profit.
- The company would delete some USD 700 mln in inventory from its balance sheet.
- We suspect that some of the reported receivables and held-to-maturity securities would be taken off the balance sheet. That’s because we think a portion of these categories could represent inventory that VIPS is selling on through other channels than its own website.

The company admits that these are just advances to customers.

- **Factoring vs. financing:** The SEC asks about the company's factoring program and the company says it isn't really factoring but actually making advances to suppliers. We believe this could be cash being fronted to related parties to buy unsold inventory from VIPS. At any rate, the company CEO Eric Shen and CFO Donghao Yang are very clear on the difference between the two terms and mentioned "factoring" five times between them on the Q2 2015 earnings call. Yet when pressed (SEC questions #6 and #7), they told the SEC that they had misstated:

  > "The Company further clarifies to the Staff that the use of the word "factoring" on page 81 was not consistent with the definition of factoring under ASC860-10- 05-14. The arrangements should be more accurately described as "financing activities" to suppliers."

  Essentially, the company is admitting that these are indeed just advances to customers—quite possibly cash to related-parties. These advances are distributed across multiple accounts, including Advances, Pre-payments, Other Receivables.

- **Not really capex:** In November 2015, on the Q3 2015 earnings call, the company called its investment in land in Puzhou "capital expenditure":

  > "We at least have incurred a capital expenditure of RMB 837 million in the third quarter of 2015."

  Capital expenditure implies a purchase of land or a capital lease, either of which would be reflected in the PPE section of the balance sheet. The SEC (question #5) tried to reconcile this investment by comparing changes in the PPE against Cash Flows. To justify that the two don't tie together, VIPS states that this investment is really an operating lease and does not impact PPE. It further states prepayments on the lease have been captured in the Operating Cash Flows.

  VIPS is saying that it incorrectly reported a rental agreement as capex.

Yes, It's a Mistake But It's Not Material

In a few instances where VIPS cannot explain a question away by changing the definition, it claims that the impact is not material. Two excellent examples of this strategy were observed in the discussion of Lefeng and Ovation and in the way the company claims it records income from financing receivables.

- **Lefeng and Ovation: do it yourself!** In question #3, the SEC asks why VIPS has failed to highlight the revenue and net income impact of Lefeng and Ovation in disclosure notes. The SEC states that the breakouts would be useful since the figures were not part of the company's operations in the prior year.

  VIPS admits that it probably should have included the information but that readers could have derived the figures from the financial statements. VIPS fails to acknowledge that the accounting guidance calls on them to present the data clearly. The mere fact that forensic accounting could have derived the information is moot.

  We think VIPS is attempting to obscure the size and trajectory of the losses from these businesses--which the company celebrated, to justify their robust valuations, as critical acquisitions.

- **Recording interest from financing receivables as income:** Not only was VIPS erroneously stating that it was operating a factoring business, but the interest earned on the financing of receivables was actually being recorded as 'Other Revenue.' The company admits its mistake: this should have been recorded as a reduction in Cost of Goods Sold. However, VIPS claims that, because the interest earned was only around USD 1 mln, the amount is immaterial to revenues. Also because the amount of receivables financed was USD 18 mln, representing only 0.9% of current assets, the figure is equally immaterial.

  We beg to differ. VIPS is applying an arbitrary numeric threshold to materiality. The SEC has stated over the years that materiality is best assessed by determining whether an item alters the view of a company or its prospects in the eyes of investors. We would argue that the USD 18 mln (and this is only the end-of-period figure; we suspect that the number was much higher during the interim reporting period), currently being classified as accounts receivable and which VIPS now claims should be in advances to suppliers, is material because "Advances to Suppliers" would then record a *MATERIAL* increase of 136%. Also, Advances to Suppliers as a total would account for 1.5% of Current Assets and 1.1% of Total Assets.

Yes, It Might Be a Mistake and It Might Be Material, But We Are Still Not Restating It

In an effort to avoid a restatement of its financial statements at all costs, VIPS makes a convoluted argument that includes the admission of a material error but still contends that it will not restate historical financial results. Instead, the company will change reporting prospectively.

- **Pre-payments incorrectly included in "operating cash flows":** The SEC in question #5 attempts to understand why the pre-paid rent relating to the operating lease has been classified within operating cash flows. VIPS makes a confused argument to justify its mistake and says it will change the accounting treatment in the future. The discussion is painful to read:

  The SEC points to Accounting Standards Codification 230 to show that the pre-payments should be accounted for as cash flows from investing. VIPS actually includes the relevant section then decides to reference a different rule, ASC 840, which deals with leases and is irrelevant to this discussion. VIPS tries to explain its mistake by stating that it has researched other companies and has not found any consistency in presentation. VIPS then says they are going to reflect these payments in "cash flows from investing" going forward, because they have had a change in strategy. They say either ASC 230 or ASC 840 should be permissible, so the accounting change should not result in a restatement of prior years. VIPS states that:

  > "...in light of change in the Company's business strategy starting early 2015, the Company has reconsidered its historical cash flow treatment for the payment of land use rights in 2015."

VIPS should be forced to restate prior statements for this accounting error.

Supplementary Disclosures Support View of VIPS as a Manipulator

The additional disclosures and supplementary quantitative information give us continued confidence in our view that VIPS is a manipulator:

- The disclosures regarding the "advances to suppliers" provide further support that the company may be seeding related parties with cash. That cash would then return to VIPS in the form of fake revenues. Interestingly, VIPS now discloses that it is providing advances to suppliers to which it does not have outstanding accounts payable.

Hence, the company is expanding the universe of potential companies it can seed.

- VIPS is grasping at straws when it tries to support its desire to report a gross basis. The company glosses over the fact that it has significantly mitigated risks around general inventory and credit. Its disclosures do not support reporting revenue on a gross basis and if it were forced to correctly account for its Inventory and COGS, the amounts are likely to be much less than what is currently reported as Gross Margin—the figure that would become revised Net Revenues.

- The Lefeng and Ovation entities are continuing to grow their losses. Furthermore, the disclosures reveal that Lefeng was grossly overpriced. With revenues in 2015 of USD 119.6 mln, the purchase price of USD 214 mln would suggest that VIPS paid more than 1.8 times revenues. The company also reported to the SEC that fair value is in excess of 18% over the company goodwill entry. Since the entities are losing money at a faster rate and continually since the acquisition, this 18% should probably be impaired.

- The company reports it has USD 430.5 mln held in Hong Kong, of which USD 327.5 mln is in Renminbi. The company should explain why it is holding RMB in Hong Kong, since that money would be subject to restrictions if VIPShop converted it to U.S dollars to repatriate.

- And how did the money get there? If the money was reported out of the China subsidiaries as dividends, a withholding tax should have been reported, and if so, why would the money be in RMB? It is more likely that the VIE company is moving RMB into stock trading accounts in Hong Kong. If the USD 430.5 mln in cash reported in Hong Kong represents profits that will be repatriated, then VIPShop should note the potential tax liability. If instead the money comes from equity or debt raises, then why is it mostly in RMB?

- We find it curious that all VIPShop's lending and underwriting institutions are international and yet only Chinese institutions hold its cash.

- Given the numerous risks raised, VIPS should also explain to investors why the vast majority of net equity is in the VIE.

While it is difficult for us to predict if the company will be forced to restate its financials or if the SEC will commence an investigation, it is clear from the SEC's questions, VIPS' responses, and the supplementary information that has been provided that VIPS' financial statements will continue to be challenged and monitored in the near term.

What Happens Next?

According to Sarbanes-Oxley rules, the SEC is required to evaluate the financial statements of each company listed on U.S. exchanges at least once every three years. Recent data from the SEC indicates that the regulator examined nearly 51% of all companies on U.S. exchanges in 2015.[1] However, not every firm that is examined receives an SEC comment letter. VIPS received a comment letter in 2014, relating to its 2013 annual filing. The focus of the SEC comment letter was on the company's inventory write-downs and expenditures for capex. The most recent SEC comment letter, then, is the second round in two years. The 2016 letter relating to the 2015 financial results is also far more thorough. The letter is five pages long and contains 16 categories of questions, with sub-questions, and each question relates to specifics of the company's accounting.

Nearly all the SEC's questions ask for additional information or suggest the need for more complete disclosure. A significant number ask for the company to explain its methodology.

Table 2. Questions from the SEC

		Quatitative	Explanation of Methodology	Request for Further Explation
1	Intangibles		X	X
2	Goodwill	X		
3	Change in Share in Loss of Affiliates, Non-Controlling Interests	X		X
4	Cash and Held-to-Maturity Securities	X		X
5	Acquisition of Land in Operating vs. Investing Cash Flows	X	X	
6	Advances to Suppliers in Cash Flows		X	X
7	Factoring offered to Suppliers		X	X
8	Reconciliation of PPE in Cash Flows	X	X	X
9	Cash and HTM held in VIE and Chinese entities	X		X

[1] SEC Agency Financial Report 2015, page 51.

10	Revenue Recognition--Gross vs. Net		X	X
11	Lefeng Revenue and net income disclosure	X		X
12	Significance test for Lefeng & Ovation as single business	X	X	X
13	Reconciliation of amounts reported in HTM	X		
14	HTM components			X
15	Calculation of Basic and Diluted EPS	X	X	X
16	Operating leases and related commitments			X

Source: SEC Edgar filings; Vipshop Holdings Correspondence and Uploads

A study by Haas Business School in September 2015 indicates that, of the 50% of firms reviewed by the SEC in each year, only 30% receive comment letters.[2] Of those that receive comment letters, the average number of questions is 6.5.[3] Typically, the SEC will issue a comment letter seeking supplemental information, requesting revisions or suggesting more detailed explanations. SEC comment letters often illuminate when a company's financial statements are deficient or in conflict with applicable accounting standards. Clearly, the SEC found VIPS' disclosures lacking or in conflict with a number of areas. It should also be noted, that of the 16 questions raised, all but three were questions that had been highlighted in the reports by J Capital and Mithra Forensic.

Valuation

Because of what we believe are significant misstatements that make published financials unrepresentative of the company's business, we have assigned a zero price target to VIPShop.

Risks

- China's private equity market is in a bubble, and there could be a bid to take VIPS private.
- More than 15% of listed companies receive comment letters each year from the SEC. This correspondence could be less significant than we believe.

[2] Textual Classification of SEC Comment Letters, James P. Ryans, Haas School of Business, September 2015

[3] Textual Classification of SEC Comment Letters, James P. Ryans, Haas School of Business, September 2015

Disclaimer

This publication is prepared by J Capital Research Limited ("J Capital"), a Hong Kong registered company. J Capital is regulated as a company advising on securities by the Hong Kong Securities and Futures Commission (CE# AYS956) and is registered as an investment adviser with the U.S. SEC (CRD# 165324). This publication is distributed solely to authorized recipients and clients of J Capital for their general use in accordance with the terms and conditions of a Services Agreement and the J Capital Authorized User Content Agreement available here. Unauthorized copying or distribution is prohibited. If you are reading this publication without having entered into a Services Agreement with J Capital, or having received written authorization to do so, you hereby agree to be bound by the J Capital Non-Authorized User Content Agreement that can be viewed here. J Capital does not do business with companies covered in its publications, and nothing in this publication should be construed as a solicitation to buy or sell any security or product. In preparing this document, J Capital did not take into account the investment objectives, financial situation and particular needs of the reader. This publication is intended by J Capital only to be used by investment professionals. Before making an investment decision, the reader needs to consider, with or without the assistance of an adviser, whether the contents are appropriate in light of their particular investment needs, objectives and financial circumstances. J Capital accepts no liability whatsoever for any direct, indirect, consequential or other loss arising from any use of this publication and/or further communication in relation to this document.