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VIPShop Holdings (VIPS US)

Behind the Numbers

- **The balance sheet and cash flow** statements contained in VIPShop's 20-F, released on Friday, indicate deterioration in key business metrics. A standout red flag is that free cash flow is negative for the first time.

- **VIE revenue fell by 60%** even as company revenue rose by 64%, and the VIEs now book just 18% of company revenue, down from 81%. And yet the VIE companies hold 70% of company cash. This is either highly risky for U.S. investors or it is simply not true. Neither scenario bodes well.

- **The company appears to be bloating** its balance sheet with undisclosed minority equity positions or stock investments while the cash position deteriorates. Cash fell by 34% and held-to-maturity securities fell by over half.

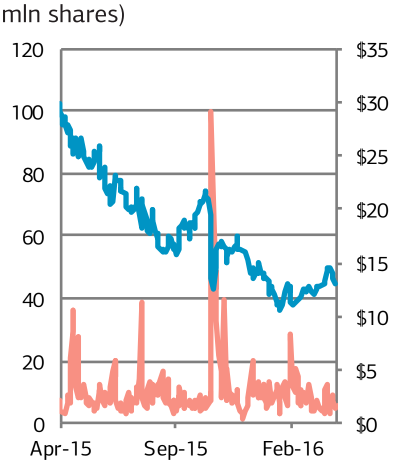
- **VIPShop may well be seeding** its partners with cash so they can buy inventory. Balance sheet growth all came from investments in affiliates and "other investments," defined as "a number of investments in private companies."

- **Reiterate SELL**

VIPShop Holdings (VIPS US)

Price	USD 13.33
Rating	**SELL**
Price Target	**0**
Difference	100%
Avg. Volume	USD 8.9 mln
P/E	32.56x

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



Source: Bloomberg

VIPS will continue to spend on capex.

More Red Flags

We have beaten the drum for two years now on VIPShop's financial manipulations. We believe that whether you look at the Chinese financial statements, the physical activity occurring at the warehouses, the distribution points, or at the financial statements, you find overstatement of activity. Now, the data provided in the company's recent 20-F raise new red flags: VIPS, for all of its astronomical growth, supposed efficiencies of scale, and superior business model, has negative Free Cash Flow. The company recorded operating cash flow of USD 296 mln. However, capital expenditures on PPE and land of USD 641 mln resulted in an abysmal free cash flow of negative USD 346 mln. When you add in M&A, which is now a habit, the cash flow plunges to negative USD 440.2 mln.

It will get worse. The company has highlighted two key priorities for the next two years—a greater reliance on company-owned warehouses and further investments in its logistics partners. This means that VIPS will continue to spend at least USD 200 mln in each of the next two years on capex and will continue to invest in logistics companies and suppliers. All of this argues for continued negative Free Cash Flow.

Over the next several quarters, if you are still holding on to VIPS shares, the Adjusted FCF will be the numbers you can look back over and kick yourself for not having paid attention. Adjusted FCF, which deducts the amounts spent on M&A and JV activities from FCF is a better way a looking at the ever-more acquisitive VIPS. Here are the numbers as they look now. Watch them deteriorate over the next two years.

Table 1. Free Cash Flow and Adjusted Free Cash Flow

(in USD)	2012	2013	2014	2015
Operating Cash Flow	111,569	437,082	505,660	295,638
CAPEX (PPE + Land Deposits)	(12,379)	(27,462)	(260,695)	(641,497)
Free Cash Flow	99,190	409,620	244,965	(345,859)
M&A Investments/ Affiliates	-	-	(193,800)	(94,298)
Adjusted Free Cash Flow	99,190	409,620	51,165	(440,157)

Source: Company 20-F

Honestly, we were already skeptical of VIPShop back in 2014. But back then, on the numbers, an asset-light VIPShop had enviable profitability. It could take possession of inventory without paying for up to two months. It

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could spend just 2% of revenue on capex compared with a more standard 5% for Amazon and yet achieve enviable efficiencies. Now VIPShop is spending 6% of much higher revenues on capex. If it wasn't broke, why is the company fixing it?

Because that's how you generate revenue in China. Given a commodious VIE structure with lots of subsidiaries and related parties, VIPShop could very easily plant cash with partners to enable them to purchase inventory from the company. Investment is also a key tool for winning assistance from local governments. In this 20-F, the company provided more disclosure on its capex, showing that it has received local-government subsidies, which generally come with an obligation to build facilities. Governments in China are all eager to sell their land and attract capital investment, and they generally offer all sorts of benefits to investors. In our primary research, we have been to VIPS locations where the local government said it gave e-commerce companies cheap land for commercial development and profitable sale, direct subsidies, access to cheap logistics, tax breaks, and other sweeteners to coax the companies to buy industrial land. These benefits could create income for VIPShop and its cluster of partners, but government sweeteners generally come with obligations to investment more and build more.

I'll Gladly Pay You Tuesday

Another grave concern is the company's growing reliance on IOUs to support its growth in revenue. Our view is that the aggressive use of supplier financing and prepayments is likely a means for the company to funnel cash to related parties in order to generate "revenue." But even if you did not subscribe to that argument, the growth in receivables, particularly related party and "Other Receivables," should raise some alarms if only from the perspective of sustainability. In this report, receivables soared and advances to suppliers rose by a factor of 10.

In addition, given negative FCF, one would think that VIPS would be in cash-conservation mode. Yet the company continues to expand its financing, pre-payments, and accounts receivable to various suppliers. In the last year, while revenue grew 64%, accounts receivable, including amounts due from related parties and other receivables, grew 194%.

Table 2. Hyper-Growth in Accounts Receivable

(in USD)	2014	2015	Growth YoY
Revenue	3,773,657	6,206,307	64%
Accounts Receivable	24,997	54,230	117%

(in USD)	2014	2015	Growth YoY
Amounts Due From Related Parties	4,994	4,918	-2%
Other Receivables	88,664	288,596	225%
Total Accounts Receivable	118,655	347,744	193%

Source: Company 20-F

Finally, if none of the above arguments sways you, consider what happens to investors if VIPS runs into serious problems. The lion's share of the company's cash sits in its VIEs, which are not owned by foreign investors. Indeed, in the event of legal claims on a VIE, Chinese law would assign a low priority to the that company's contractual promise to hand its revenue to VIPShop's direct subsidiaries. Yet if the 20-F is to be believed, the value in VIPShop sits comfortably in the VIEs, and that places the value out of reach of the company's equity investors.

All VIEs Not Created Equal

In 2014, VIPShop's revenue recognition arrangements baffled us. The company reported on page F-14 of its 20-F that its two VIE companies were responsible for USD 3.066 bln in revenue attributable to the Company after inter-company eliminations. Although there are two—Lefeng and Guangzhou Vipshop Information Technology Co. Ltd.—only Guangzhou really matters. The reported VIE revenue amounted to 81% of company revenue in 2014. And yet VIPShop reported in in its Chinese statutory financials that its Zhuhai subsidiary was responsible for over USD 900 mln or 25% of the year's reported revenue. This was especially confusing since we visited the Zhuhai company and found that there was nothing there except a mailbox—no warehouse, no people, no phone number, nothing.

We continue to find the VIE disclosures inscrutable.

In the 2015 20-F, we continue to find the VIE disclosures inscrutable. Revenue to the VIEs has plummeted by more than 60% and is now at USD 1.14 bln (page F-20 of the 20-F) even as company revenue overall rose by 63%. There is no word to investors about the Zhuhai company that was earning so much money in 2014.

We do not know of any regulatory change in China that has made VIEs obsolete. If it was not actually necessary to run most revenue through the VIE structure, then why was VIPShop doing this? Why did the portion of revenue in the VIE shift so radically in a single year? Could it be that audit standards for the local VIE company are actually more rigorous than Deloitte's audit standards for the other companies in the group?

Despite the radical shift, VIPShop shows a lot of consistency in the brand partners and repeat customers. The brand partners all would require legal receipts. Having operated commercial companies in China, we can attest that a shift in invoicing and issuance of receipts of this magnitude in one year would be a significant challenge.

With only 18% of company revenue in 2015 instead of the 81% reported in 2014, the two VIEs still have an outsized share of the company assets. Moreover, the vast majority (93%) of the company's cash and held-to-maturity securities are maintained in PRC accounts, and 70% are at the VIEs. If the VIEs are now responsible for only 18% of revenue, why do they have 70% of cash?

Table 3. VIPShop and Other Companies' VIE Financials

		Revenue	Net Income	Assets	Liabilities	Equity
VIPS-2015	VIE in RMB	7,388,637	226,986	4,673,422	2,237,622	2,435,800
	Consolidated in RMB	40,203,212	1,508,712	20,035,522	16,422,255	3,613,267
	VIE as % of Cons.	*18.4%*	*15.0%*	*23.3%*	*13.6%*	*67.4%*
VIPS-2014	VIE in USD	3,066,493	26,587	810,442	378,883	431,559
	Consolidated in USD	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%*
VIPS-2013	VIE in USD	1,694,782	(1,946)	631,849	254,911	376,938
	Consolidated in USD	1,696,672	52,299	1,072,059	828,804	243,255
	VIE as % of Cons.	*99.9%*	*-3.7%*	*58.9%*	*30.8%*	*155.0%*
JMEI	VIE in USD	108,150	(3,857)	34,669	28,017	6,652
	Consolidated in USD	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 in RMB	3,431,134	(41,228)	3,784,170	4,180,518	(396,348)
	Consolidated in RMB	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 in RMB	10,457,000	659,000	13,811,000	11,420,000	2,391,000
	Consolidated in RMB	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 20-Fs

The VIE structure featured prominently in the SEC's recent 16-question comment letter to VIPS. It should be something investors should be looking at more closely.

Valuation

We believe that misstatements in VIPShop's financials are so significant as to make valuation impossible. We have assigned a value of 0 to indicate that we believe there is a good chance VIPShop would be suspended or delisted if fully exposed.

Risks

- At the current valuation, investors could make a bid to take VIPShop private.
- We have only a very inexact understanding of the degree of VIPShop overstatement, and revenues and assets could be more robust than we believe.

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