TMT
China

September 22, 2016
Company Update

Vipshop Holdings Ltd. ADR (VIPS US)

Fool's Gold

Little has changed

VIPS continues to report deteriorating gross and net profit margins. Nothing has fundamentally changed, but the company is less able to push costs off balance sheet to affiliates.

More tricks

VIPS has reported negative free cash flow for four of the past five quarters. The most recent quarter's positive numbers were juiced by withholding payments to suppliers—a trick familiar to investors in VIPS.

Capex a continuing concern

Capex continues to be a concern for us. The capex account is probably a channel for VIPS to port funds out of the business. Property, plant & equipment utilization is at historically low levels yet VIPS announced plans to add 500,000 square meters of warehouse space in the current year.

High customer financing

Much of the recent uplift in revenue is generated by customer financing. As of June 30, 2016, the company reported RMB 1.2 bln in customer financing outstanding but it did not report what percentage of the quarter's sales resulted from this program. Furthermore, there was no information on the average balance in the quarter, and that omission probably masks significantly higher financing.

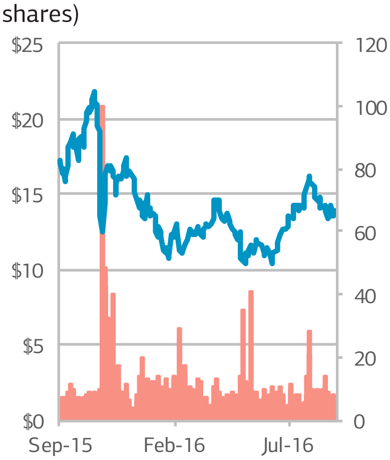
Financing still unprofitable

It should be noted that the financing program is still not profitable despite launching in 2013.

Vipshop (VIPS US)

Price	USD 13.96
Rating	**SELL**
Price Target	**USD 0**
Difference	100%
Market Cap	USD 8.18 bln
Avg. Volume (3m)	9.5 mln shares
P/E	39.70X

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



Source: Bloomberg

Responsible for this report:
Anne Stevenson-Yang anne@jcapitalresearch.com +1 917 929 7142

Anyone venturing into the VIPS gold rush will be sitting on a pile of dross.

The Fraud Continues

■ **Melvin Glapion**

VipShop continues to play the equity markets for fools. Given the company's nearly 60% drop after our initial SELL call, a number of investors have homed in on VIPS as a stock on a possible rebound. In the past few months, the stock jumped back to around USD 16, still a 43% decline, before losing steam and settling to current levels of USD 13.46. For those bemused and titillated by VIPS' Q2 2016 financials, a closer inspection of the numbers reveals that our thesis is sound and anyone venturing into the recent VIPS gold rush will be sitting on a pile of dross.

The recent rebound in VipShop's financial performance and dramatic uplift in new customer growth prompted a number of investors to reach out to us inquiring about the soundness of our thesis that VIPS is a fraud. Despite VIPS' return to mouth-watering growth, our view is confirmed by recent results. Now is not the time to jump back into VIPS. The fraud continues and the figures are consistent with our previous findings.

Go with the Flow

VIPS has reported negative free cash flow for four of the last five quarters. In Q2 2016, the company reported a seemingly healthy figure of FCF of USD 97 mln.

Table 1. Free Cash Flow Trends

(USD mln)	2015				2016	
	Q1	Q2	Q3	Q4	Q1	Q2
Cash Flow from Operations	79.6	(75.4)	45.0	233.0	24	185
Capex	54.6	70.1	132.0	355.0	102	88
Free Cash Flow	25.0	(145.5)	(87.0)	(122.0)	(78.0)	97.0

Unfortunately for those looking for glimmers of hope from a fading VIPS, those numbers were manipulated. After several quarters of getting its payables and accrued expenses in line—or, as Eric Shen called it, taking care of the 'ecosystem'—VIPS reversed course again and extended days payable outstanding and days accrued outstanding. Had the company maintained the levels recorded in Q1 2016, it would have reported USD 73 mln less in FCF or a meager USD 24 mln FCF.

Table 2. Impact of Deferring Payables and Accrued Expenses

(days in units; USD mln)	2015				2016	
	Q1	Q2	Q3	Q4	Q1	Q2
Days Payable Outstanding	56.8	47.5	46.3	43.1	39.0	41.6
Days Accrued Expenses Outstanding	26.2	23.1	22.8	20.1	19.0	19.6
Impact if DPO Held at Q1 2016 Figure						59.24
Impact if DAEO Held at Q1 2016 Figure						13.51
Total Impact of Deferring Payments						72.75

The FCF was further aided by lowering the level of capex spent in Q2 2016. After several quarters of mind-blowing capex spend, VIPS reported modest capex of only USD 88 mln. In our view, this is not a signal that future capex will be similarly modest but simply an attempt to dress up the company's poor FCF performance. In fact, on the Q2 2016 earnings call, VIPS announced that it intended to add 500,000 square meters of warehouse space in the current year.

Land Ho!

A significant portion of recent land acquisitions have been in Tier 2 cities, yet, based upon the amounts paid for deposits and land use, one would think VIPS is securing space in Midtown Manhattan. The figures at VIPS suggest that money is either being expropriated or shoveled off the balance sheet. While revenues in Q2 2016 increased over the prior year quarter at the rate of 39%, PPE increased at a modest 35%. However, deposits jumped 305% and land use rights soared an astonishing 1,138%.

The growth in expenses runs counter to what we would expect at investee companies like Ovation. Many of them are co-locating with VIPS. Most should experience synergies of scale, particularly with respect to sales and marketing and general & administrative expenses. These have not materialized.

However, having heralded the success of these investments and not wanting to show sustained losses that might prompt calls for a write-down of these assets, VIPS needs to show improvements. So while it continues to push lots of expenses onto the affiliates, it becomes more difficult over time. Hence, increasing levels of expense will now come onto the listed company's books and, in line with recent results, gross and net profit margins will continue to decline.

Doubters might reply that the company needs the land for its rapid growth in revenue. However, upon further observation of funds spent for total PPE, including deposits and land use rights, the level of turnover to total PPE is declining precipitously, suggesting that the company's spending is excessive and in keeping with our view that the funds accounted for in this line item are part of VIPS' misappropriation.

Whereas the turnover ratio in Q2 2015 was 3.03x, the figure for the Q2 2016 had dropped to 1.93x, continuing a trend in ever-lower PPE turnover ratios.

Table 3. PPE Turnover Ratio

(USD mln)	2015				2016	
	Q1	Q2	Q3	Q4	Q1	Q2
PPE & Deposits & Land	409.30	479.40	507.12	629.00	695.00	1050.00
Revenues to PPE & Deposits & Land	3.39	3.03	2.69	3.41	2.66	1.93

Give Us Some Credit

A few doubters may point to the fact that VIPS had a stellar quarter in revenues. I would agree. But the source of that revenue growth is to be found in one of the oldest revenue-acceleration techniques around: bring revenue forward by getting customers to purchase goods on credit at very favorable terms.

> "...As you know, we have recently launched a customer financing program in addition to our supplier financing program. As of June 30, 2016, the total balance of credit outstanding to customers was approximately RMB 1.2 billion, and the total balance of credit outstanding to suppliers was RMB 390 million.
>
> "At the end of the day, these programs are here to support the growth of our core business. Our plan is to expand the scale of these programs over time through balancing core growth opportunities with risk controls. This is demonstrated by our recent move to hire a chief risk officer for our internet finance unit, who has over

20 years of international and domestic financial risk experiences..."
Donghao Yang, Q2 2016 Earnings Call

There are some interesting components to what is said here, but the more important pieces are what is not said. The company claims that RMB 1.2 bln is related to credit to customers, which in relation to total sales for Q2 accounts for less than 10% of sales. However, what we do not know is how much revenue is related to customer credit. The figure provided is the balance at the end of the quarter. What was the maximum balance? What was the average during the quarter? Only then can we evaluate the impact of the credit program. Our view is that the company has continued to ramp up this program as a way of keeping up the growth façade.

VIPS has not accessed the capital markets in over a year, and that has hampered its ability to use cash and related-party transactions to beef up its revenue figures. The customer credit program allows them grow revenues in the absence of huge Cash and Held-to-Maturity balances the company enjoyed 12 to 18 months ago.

VIPS further states that the credit business is still not profitable. Curious, since it has been operational since 2013. Moreover, the company states that default rates are incredibly low. We have doubt about this, given that information provided by VIPS on the earnings call suggests that new customers in the Q2 2016 period, were younger and purchasing at lower price points. This suggests greater default risk. We do not buy the argument that defaults are low. Neither does VIPS, which is why it states that it is looking to hire a credit manager with 20+ years of experience to manage the business. He will not be able to help VIPS: experience is no match for deteriorating credit quality.

Running Out of Hiding Places

We believe that deterioration in gross and net profit margins at VIPS is partly due to the fact that it is becoming more difficult to push expenses to affiliates off balance sheet and still claim them as successful investments.

Table 4. Gross and Net Profit Margin Declines

(USD thousands)	2015				2016	
	Q1	Q2	Q3	Q4	Q1	Q2
Gross Margin	24.9%	25.0%	24.9%	24.1%	24.8%	24.1%
Net Profit Margin	4.0%	4.3%	3.4%	2.3%	3.2%	3.4%

In fact, both gross and net profit margin in Q2 2015 were 90 bps below the figures reported in the prior year's quarter.

We think VIPS has relied upon affiliate accounting to achieve historical profit, but a slowdown in the acquisition of affiliates means that fewer expenses can be pushed off balance sheet.

One of the largest affiliate investments involved Ovation, in which VIPS took a 23% stake in 2014. We suspected that one of the reasons for taking minority stakes in affiliates was to enable VIPS to move phantom assets off balance sheet.

Had VIPS purchased Ovation outright, it would have been forced to report consolidated figures for both companies: every USD 1 of revenue and every USD 1 of expense would have been included in VIPS's financial reports. But as an affiliate, only 23% of Ovation's profit/(loss) appears on VIPS's income statement. Since Ovation's revenue contribution is relatively small, the real benefit of Ovation is the opportunity to push expenses of the listed company onto Ovation. This is true of the growing list of affiliated companies that form the affiliates line item.

A review of the "Share of Affiliates" in conjunction with the amount VIPS attributes to non-controlling interests in Lefeng provides an idea of how losses on these investments have evolved.

Table 5. Investments in Affiliates vs. Acquisition

(USD thousands)	2015				2016	
	Q1	Q2	Q3	Q4	Q1	Q2
Share of Loss of Affiliates	(3.7)	(3.2)	(5.3)	(1.0)	(3.0)	(2.0)
Loss Attributable	(4.0)	(2.5)	(4.0)	(2.0)	(4.0)	(2.0)
Implied Losses at Investments	(17.4)	(10.9)	(17.4)	(8.7)	(17.4)	(8.7)

Losses attributable to Lefeng, the consolidated entity, have followed a pattern of between -USD 4 mln to -USD 2 mln per quarter. But share of losses at affiliates has been more volatile and accounted for -USD 13 mln in 2015 vs. USD 10 mln in 2014. The first two quarters of 2016 show a USD 1.9 mln improvement over 2015. But the benefits to VIPS of pushing expenses off balance sheet are much larger than USD 2 mln. We know from VIPS that the cosmetics business, of which Ovation is a part, has been growing rapidly:

> "So in the second quarter, cosmetics total GMV exceeding USD 400 million and Eric mentioned earlier saying that this is actually a historic new number for us."
>
> Eric Shen, Q2 2016 Earnings Call

For Ovation and the affiliates to show slight improvement in the level of reported "share of loss" expenses at the affiliates must have expanded significantly as well, though not as fast as revenue.

To what extent has this benefitted VIPS? Based upon what we know, the off-balance sheet expenses could be significant. Let's assume that the company's revenue is 25% of GMV. Further assume that GMV in 2013 (pre-investment) was USD 200 mln; we do not have the exact figure as management has not revealed this. These figures allow us to compute an assumed Ovation revenue figure. Furthermore, by adding the reported loss of share of affiliates, we can derive the level of expenses that must have been recorded. VIPS could have pushed tens of millions of dollars in expenses onto the income statements of its affiliates.

Table 6. Magnitude of Off-Balance Sheet Expenses

(USD mln)	2013	2014
GMV at Ovation	1,000.0	1,600.0
Cosmetics Revenue @25% of GMV	250.0	400.0
Ovation Revenue from Selling to Vipshop, Assume 40% of revs	100.0	160.0
Reported Loss of Affiliates	-10.0	-13.2
Implied Expenses	110.0	173.2
Increased Level of Expenses		63.2
% Increase		57.5%

Based on earnings calls, what we know about the percentage of revenue generated from GMV, and the GMV in the cosmetics division, we can extrapolate that over USD 60 mln in expenses could have been diverted to the P&L of Ovation. Had USD 60 mln in additional expenses had been included in Vipshop's expenses, the company would have reported a much lower net profit than the 3.6% recorded for FY 2014.

The implications of moving expenses off balance sheet further impact results for 2015 and 2016.

Catalysts

Potential catalysts include:

- Lack of cash: We think that VIPS' funnels cash to related parties to generate fake revenues. Tighter cash resources will mean lower revenues.
- Enforcement: We continue to believe that VIPS' responses to the SEC Division of Corporate Finance contained too many "we said this but really meant that" statements and will lead to an SEC investigation.
- Deteriorating macro: Financial conditions in China will impact VIPS' ability to report stellar results when all of its competitors report headwinds.

Risks to our thesis:

- VIPS has announced that it is seeking to offer securitized instruments; this may allow the company to generate additional cash to continue showing fake revenues via round-robin transactions with related parties;
- SEC decides to take no action.

Valuation

We believe that VIPS is worth USD 0.00 per share, which represents a downside of 100.0%. Our work leads us to believe that VIPS manipulates its account. Even if there is some value in the business, the cost of fines, class-action suits, and investigations will eat up resources before investors see a dime.

Melvin Glapion +852 2534 7405 melvin@jcapitalresearch.com
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