JCAP

E-Commerce
China

December 15, 2016
Company Update

Vipshop Holdings (VIPS US)

Christmas Coal

Jig's Up End Q2

We expect VIPShop to run out of cash in Q2 2017. Our analysis suggests that nearly all VIPShop's cash has been depleted.

Sucking Sound

Vipshop exhibits all the elements of a "propping and tunneling" fraud. Management has successfully raised significant amounts of capital and has generated a nearly cult-like following among analysts and investors as a result of consistently outperforming estimates. Indicators make it appear that that same management team is now siphoning as much cash as possible out of VIPS.

Ever-Growing Capex

Capital expenditures continue to run above even management's estimates and continue to result in lowered property, plant, and equipment turnover figures. This suggests that VIPS has over-invested and over-capitalized expenses.

Equity Impairments

Cash could have been siphoned out via equity investments. Impairments to the investment in Ovation are one such channel.

Long-Delayed Cash Needs

Once VIPS pays down its bloated payables and accrued expenses, it will have USD 377 mln available to operate the business or tunnel out. Historically, the company has consumed cash at an average rate of USD 132 mln per quarter. Barring a reprieve from the capital markets, VIPS will likely run out of cash by the end of Q2 2017.

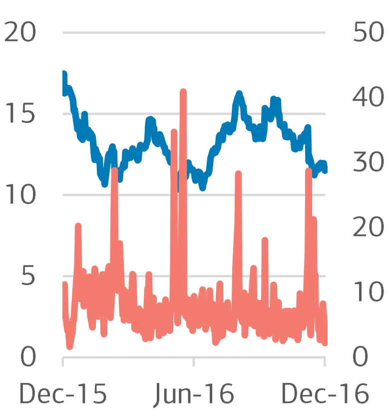
Big Zero

We maintain our view that the equity in this company will ultimately be worth nothing.

Vipshop Holdings (VIPS US)

Price	USD 11.48
Rating	**SELL**
Price Target	**USD 0.00**
Difference	100%
Market Cap	USD 6.61 bln
Avg. vol (3 mth)	7.99 mln
P/E	27.32x

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



Source: Bloomberg December 15, 2016

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We believe that Vipshop is a classic propping and tunneling-type fraud.

This Grinch Will Not Return Your Gifts

For those of you still longing Vipshop, I can't help but wonder if your faith is a result of too much Dr. Seuss as a child. He was the one who put that awful idea into our heads that if we get robbed, all we have to do is sing Christmas carols, and the perpetrator will return our presents. Like Cindy Lou Who, we too could boohoo and then sing, certain to recover every single thing.

Great story; awful investment advice. If you lose money to VIPS, you won't be getting it back. This Grinch does not return gifts.

As we have highlighted in previous reports, we believe that Vipshop is a classic propping and tunneling-type fraud. In these asset-misappropriation frauds, the founders/management engage in two distinct phases of manipulation. The first phase involves propping up or enhancing the look of the company's financial statement to gain access to capital markets. As part of the propping phase, the company will engage in revenue-acceleration tricks, conduct round-robin transactions with related parties, and defer or hide expenses to present a consistently profitable and growing business.

After several years of propping, the founder/management team will then start to find ways to take cash out of the business. Two of the easiest ways to take large sums of cash without much pushback is to overpay for capex and investee companies.

Seen through this framework, Vipshop has completed its propping phase and has nearly completed its tunneling phase. While there are many figures that could be examined to prove this point, it is best to focus on only one: cash. A depleted cash balance is the metric by which to evaluate a successful tunneling phase. Vipshop's founder and managers have done well in executing both elements.

Stuffing Its Stockings With Cash

Since going public in 2013, Vipshop has raised nearly USD 800 mln from the capital markets, much of it in 2015 through the issuance of convertible debt.

Table 1. Capital Raises (USD mlns)

	2013	2014	2015	2016	Total
Capital Contributions	—	—	1.9	1.5	3.4
Proceeds from Issuance of Stock Options	0.2	2.0	1.8	—	4.0
Issuance of Convertible Debt	—	—	618.3	—	618.3
Issuance of Shares	62.7	90.3	—	1.0	154.0
Balance of unpaid ST debt	—	—	—	14.0	14.0
Total	62.9	92.3	622.0	16.5	793.7

Source: Company filings

Typically, propping and tunneling companies return to the capital markets annually to secure further cash for use in the scheme. It should be noted that VIPS did not secure capital market funds in 2015, likely since our allegations of fraud and manipulation made investors more cautious. At the same time as it was unable to raise cash, VIPS began to experience dramatic declines in revenue growth.

A Lump of Coal Disguised as Cash Flow

VIPS claims that it needs the cash infusions from the capital markets to invest in its rapidly growing and sustainable ecosystem of a business. The best gauge of a sustainable business is free cash flow growth that tracks revenue growth.

For 2016, VIPS expects to report 35% revenue growth. But its free cash flow is poor and deteriorating.

VIPS has recently decided to include a non-GAAP metric it refers to as adjusted free cash flow. This takes the standard calculation of operating cash flow less capital expenditures and adds to it the impact of VIPS' financing program offered to customers and suppliers. In our opinion, this metric is misleading, as the financing program is not part of VIPS' core operations and should instead be treated as investing cash flows.

We analyzed Vipshop's free cash flow and determined that the company has been free cash flow-positive for only four of the last seven quarters.

Table 2. Free Cash Flows

	Three months ending		
	Sep-15 (RMB thnds)	Sep-16 (RMB thnds)	Sep-16 (USD thnds)
Net Cash from Operating activities	284,918	649,556	97,407
Add: Impact from Internet Financing activities	65,417	450,106	67,497
Less: Capital expenditures	-1,567,414	830,470	124,536
Free cash flow (out)/ in	-1,217,079	269,192	40,368

Source: Company filings

Moreover, on a year-to-date cumulative basis, the company had positive free cash flow in only two of the last seven quarters. But VIPS' figures require further adjusting. In recent years, the company has resorted to extending payables and accrued expenses to report higher cash flow figures. This was very evident in Q2 and Q3 2016, in which both days payable and days accrued expenses jumped markedly after having been in decline for each of the previous five quarters.

Table 3. Days Payable and Days of Accrued Expenses

	2015				2016		
	1Q	2Q	3Q	4Q	1Q	2Q	3Q
DSO	9.2	10.9	14.8	15.7	16.0	18.9	25.5
DIO	42.6	36.3	38.6	43.0	27.7	25.5	35.1
DPO	56.8	47.5	46.3	46.3	38.2	41.6	53.4
DAEO	26.2	23.1	22.8	21.6	18.7	19.6	22.9

Source: Company filings

We adjusted the reported cash flows by reversing the impact of the extension of payables and accruals, assuming that the days payable and days accrued metrics were the same as those reported in Q1 2016. Our adjusted free cash flow figures reveal that Vipshop has been free cash flow negative for the past 21 months. As of the nine months ended Q3 2016, VIPS had accumulated negative free cash flow of USD -373 mln compared to negative free cash flow of USD -208 million in the nine months ended Q3 2015.

In fact, had VIPS paid its accounts payable and accrued expenses in line with metrics reported in Q1 2016, the company would have recorded USD

Vipshop has been free cash flow negative for the past 21 months.

Table 4. Adjusted FCF (USD mlns)

	2015				2016		
	1Q	2Q	3Q	4Q	1Q	2Q	3Q
Cash Flow from Operations	79.6	-75.4	45	183.8	24	185	97.4
Capex	54.6	70.1	132	98.33	102	88	124.5
FCF	25	-145.5	-87	85.47	-78	97	9.4
Cumulative FCF	25	-120.47	-207.47	-122	-78	19	-8.1
Impact if DPO held at 1Q 2016 figure	—	—	—	—	—	-59.24	-287.92
Impact if DAEO held at 1Q 2016 figure	—	—	—	—	—	-13.51	-76.66
Adjusted Cumulative FCF	25	-120.47	-207.47	-122	-78	-53.75	-372.67

Source: Company filings, J Capital calculations

365 mln less in cash on its balance sheet. The current cash and held-to-maturity balance would have been USD 377 mln as opposed to the reported USD 742 mln.

Table 5. Reported Cash Balances (USD mlns)

	2015				2016		
	1Q	2Q	3Q	4Q	1Q	2Q	3Q
Cash balance	1,066.6	716.2	557.5	513.0	554	492	731.3
HTM balance	293.8	462.2	406.3	279.0	109	263	10.7
Cash + HTM	1,360.4	1,178.4	963.8	792.0	663.0	755.0	742.0

Source: Company filings

As VIPS generates negative free cash flow and has no access to capital markets, its cash balance continues to dwindle. In fact, the reported cash and HTM balance at the end of Q3 2016 was 30% lower than at the same time last year.

Lots of Space to Store Stolen Presents

Some of you might protest that Vipshop could resolve these free cash flow issues by simply moderating its capex. Moderating cash flow spend might

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buy VIPS more time, but this argument misses the point of what we believe is the fraud. To complete the cycle, there must be tunneling, and capex has proven an effective tunneling tool for VIPS.

The company focuses on numbers that might suggest that it is closely aligning growth in warehouse space to growth in orders. If you examine the company's projections for revenues and warehouse capacity, you will note that VIPS intends to grow revenues by 36% and grow warehouse capacity by 31%. That all seems reasonable.

Table 6. Revenues versus Warehouse Spend

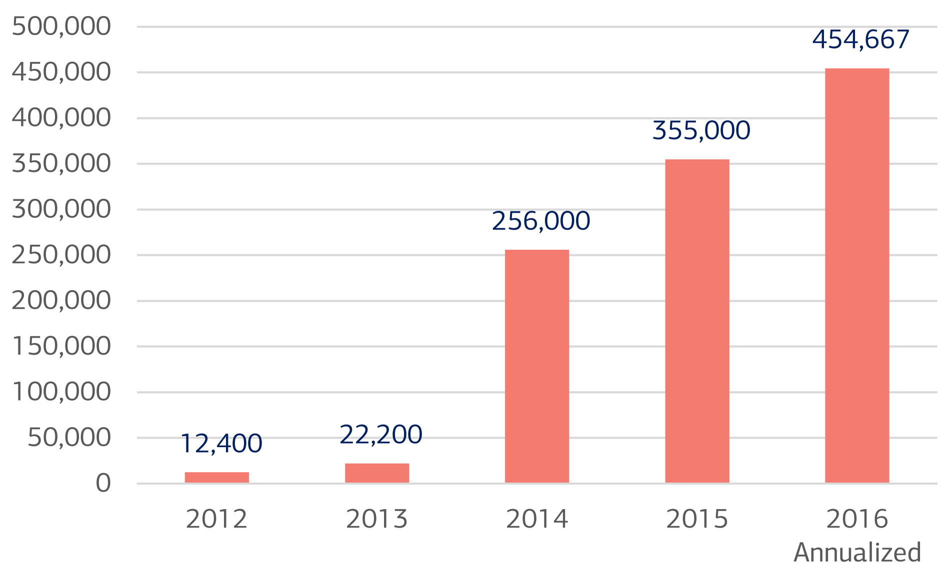
	2015	2016E	% change
Annual Revenues ($ millions)	6,206	8,408	35.5%
Warehouse space (square meters)	1,600,000	2,100,000	31.3%

Source: Company filings

But that analysis overlooks some pretty glaring indications that VIPS' spend on capex is beyond excessive. Moreover, the company has maintained its aggressive capex buildout despite several periods of unexpected declines in its revenue growth rate.

First, VIPS is spending beyond even its own estimates. In separate earnings calls in 2015 and in response to questions posed by the SEC in a comment letter, VIPS indicated that its investment in capex would be in line

Chart 1. Capex Spend by Year (USD thnds)



Source: Company filings

with that spend in 2014. The 2014 spend was USD 256 mln. In 2015 and year-to-date 2016, Vipshop has spent well in excess of the 2014 figure.

In addition, the sums spent on capex has been concentrated on those less tangible PP&E elements—deposits and land. In fact, while tangible PP&E grew 52% in the last years, deposits and land grew 111% and 1007% respectively.

The aggressive capex spend has resulted in a rapid decline in the net PP&E turnover ratio—a metric used to determine revenue generated against investment in PP&E. The ratio declines from a high 10.3x to 5.9x, or USD 5.90 of revenue for USD 1 of PP&E.

Aggressive capex spend has resulted in a rapid decline in the net PP&E turnover ratio from a high of 10.3x to 5.9x.

Table 7. 2015 PP&E Breakdown

	1Q	2Q	3Q	4Q
PPE	358.2	414.6	406.7	455.0
Deposits	38.0	37.5	69.3	144.0
Land	13.1	27.3	31.2	30.0
PPE + Deposits + Land	409.3	479.4	507.1	629.0
PV of Minimum Lease Pmts	144.5	144.5	144.5	144.5
PPE + Deposits + Land+ PV of Op Leases	553.8	623.9	651.6	773.5
Annualized Revenue to (PPE+Deposits+Land+PV of Op Leases)	10.0	9.3	8.4	10.3

Table 8. 2016 PP&E Breakdown

	1Q	2Q	3Q	3Q15–3Q16
PPE	513.0	560.0	616.2	52%
Deposits	152.0	152.0	146.4	111%
Land	30.0	338.0	345.2	1007%
PPE + Deposits + Land	695.0	1,050.0	1,107.8	118%
PV of Minimum Lease Pmts	115.5	115.5	115.5	-20%
PPE + Deposits + Land+ PV of Op Leases	810.5	1,165.5	1,223.3	88%
Annualized Revenue to (PPE+ Deposits+Land+PV of Op Leases)	9.3	6.9	5.9	

Source: Company filings

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The decline in the turnover ratio suggests an overinvestment in capex or an overcapitalization of expenses to the balance sheet or both.

We believe that this has been due to VIPS inflating capex spend as a means of siphoning cash out of the business via capex.

There is no indication that VIPS intends to discontinue or moderate its capex spend. In fact, in the most recent earnings call, the company reiterated its intent to achieve 2,100,000 square meters of warehouse space. We view this as management's intent to continue tunneling cash out of the business. On average, VIPS spends USD 96 mln in capex per quarter. This would be a significant source of cash outflow from the cash balance, particularly if payables and accruals are paid up in Q4 2016.

Empty Boxes Under the Tree—Ovation & Lefeng

The other method VIPS could plausibly have used to misappropriate assets is to acquire companies from related parties. We raised this concern in our May 2015 report. We thought the prices paid were too high, the assets purchased too biased toward intangibles, the long-term profitability of the companies suspect, and the potential for undisclosed related-party transactions high. Vipshop proceeded to invest USD 55.7 mln in Ovation for a 23% share and USD 132.5 mln in Lefeng for a 75% stake.

The most recent quarter's results were impacted by recording a significant impairment to the company's investment in Ovation. The cumulative amount of impairment taken since 2014 amounts to nearly 60% of the value of the original investment. This highlights either how poorly VIPS has invested or how clever it has been at tunneling cash out, take your pick.

VIPS' response to an SEC comment letter provided detail on Ovation revenues and net income.

Ovation reported USD 44 mln in losses in 2014. The company continued to report significant losses in 2015 and 2016. In both 2015 and 2016, VIPS recorded impairment charges against its investment in Ovation. In fact, the total impairment charges of USD 32.6 mln represent nearly 60% of the original cost of the investment.

As Ovation continues to bleed cash, we expect that VIPS will continue to record impairment charges against this investment. Our view is that this was not just a poor investment, but a route to taking additional cash out of the listed entity.

Table 9. Impairment in Ovation

	2015	2016 to date	Total	Ovation Investment	Impaired as % of Total
Loss of Affiliates	-15.4	-17.2	-32.6	55.7	-58.5%

Source: Company filings

Also detailed in the letter was the Lefeng acquisition. Lefeng continues to report negative, though somewhat improved earnings more than two years after the acquisition. The challenge however is that management, when pressed on earnings calls for details about the Lefeng integration, claim that they do not track Lefeng separately because it accounts for less than 5% of the company's revenues. We would challenge that assertion given the fact that the company could report the information to the SEC as recently as January 2016.

We suspect, without being certain, that the capex spend is overstated in financial reports in order to work phantom profits.

The reason VIPS may be hesitant to provide further detail on Lefeng is that it too likely requires or will soon require significant impairment charges. Lefeng continues to report negative earnings. The financials include a line item that accounts for the portion of the loss related to 25% non-controlling interests. These amounts have continued in the USD -10 mln range, suggesting total losses of about USD -40 mln. However, VIPS reported growth in revenues of 75% and 35% in the years 2015 and 2016 respectively.

In the immediate aftermath, VIPS management stated that cosmetics revenues were strong. If Lefeng revenues have grown at anywhere near the rates of the rest of VIPS, why then does the company continue to report nearly the same amount of losses each year? We expect that VIPS currently or will soon need to take an impairment against its Lefeng investment as well.

The End Is Nigh

To be clear, we suspect, without being certain, that the capex spend is overstated in financial reports in order to work phantom profits off published statements and that management—which has sold a lot of shares—has made itself wealthy on the back of a share price that is not actually supported by the fundamentals.

Our analysis suggests that the true picture of VIPS' cash flow indicates that only USD 377 mln is currently available. VIPS does not generate positive free cash flow to replenish its cash reserves. The company is likely unable to access capital markets given concerns about its financial statements. Yet VIPS has not indicated an intention to pare back its aggressive capex spend. The company, on average, reports outflows of USD 132 mln per quarter. Barring a significant cash infusion from the capital markets, we believe that the VIPS founders will drain the company of its remaining cash over the next three quarters. When the cash has been depleted, VIPS not be able to generate cash and the company will fall into insolvency.

Catalysts

Potential catalysts include:

- VIPS' cash balance and cash flow situation are deteriorating rapidly.
- Continued tunneling could prompt action from US regulators.

Risks

- VIPS accesses the capital markets and replenishes its cash balances
- VIPS is acquired by a larger player.

Valuation

- We believe that the magnitude and complexity of the fraud is such that the resulting sanction, shareholder litigation and reputational costs will result in value of the company's share being worthless.

Disclaimer