

May 22, 2018
Company Update

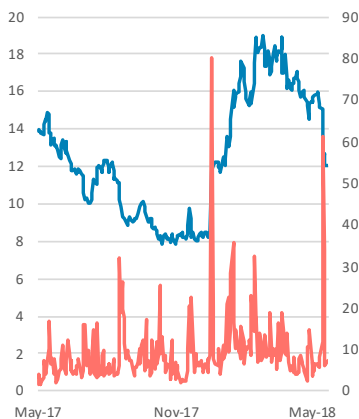
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Vipshop Holdings (VIPS US)

Price	\$12.03
Market Cap	\$7,928 mln
Price Target	\$0.00
S/I	14.9 mln shares
Days to cover	1.9
P/E	24.7

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



Source: Bloomberg May, 21, 2018

Vipshop Holdings (VIPS US) Is VIPS in Decline?

- ▶ **Is the revenue real?** Growth in payables and receivables in excess of revenue indicates to us that a lot of VIPS' revenue growth is manipulated. After all, this is an e-commerce company whose customers pay upon purchase. Why should receivables keep rising?
- ▶ **Still overstating logistics**
VIPS claims to handle delivery of 97% of its orders using its own company, but interviews indicate that simply isn't true. Instead, it looks like the logistics claims may be in place to support phantom capex.
- ▶ **Running out of cash?**
Vipshop faces a \$400 mln payment of convertible notes in February 2019, but the company now sees free cash flow at a trickle and cash-in-hand declining in Q1 by 30%, while the company took on short-term debt. Though it has \$1.1 bln in the bank, short-term liabilities are mounting. The company may be in trouble.

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Vipshop was roundly punished by the market after the company issued its Q1 2018 report on May 14 reporting a decline in net profit even as revenue rose 25%. Rightly so: the report painted a picture of a company that is mortgaging itself to create the appearance of top-line growth, neither paying suppliers nor being paid by customers. What happened to the company that boasted a market advantage in negative working capital?

But a look into Vipshop's China-reported financial statements for 2017 reveals an even more dire situation: a company whose financial health is eroding very quickly.

Desperate for cash

We looked at the 2016 and 2017 financial statements for Vipshop's wholly foreign-owned entity in China, Vipshop (China) Co. Ltd., as reported by Vipshop to China's tax authorities. Vipshop China, the 100% owner of VIPS' nine logistics centers, should consolidate all the company's revenues, costs, and assets.

- ▶ The company's cash fell from \$272.5 mln in 2016 to just \$21.3 mln at the end of 2017. Gearing was 88%.
- ▶ The company borrowed \$51 mln and owes the tax bureau \$55 mln. The latter is particularly curious, as Vipshop China reported a tax rate of 42.5%, higher than the 25% corporate rate charged in China. The 42.5% suggests that some of the listed expenses may not actually be tax-free expenses and could instead be expenses related to interest income or proceeds from investment.
- ▶ Receivables rose 40%, by ¥7 bln, and payables rose 58%, by ¥5.3 bln. Inventory declined.
- ▶ Somehow, fixed assets rose by 6.2x in a single year and are now booked at \$110 mln.
- ▶ Net profit margin was just 0.3%. And yet the WFOE should, if anything, have higher profitability than the logistics companies or the Variable Interest Entity (VIE). The subs should pay their net profit up to the WFOE and should record high costs in order to avoid being taxed locally.

We also decided to check Zhuhai and Chongqing companies. VIPS followers will recall that the company in Zhuhai is a paper fiction. There are no operations in Zhuhai, not even a phone number, and the local government

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admits that Vipshop is using the registered company there to run revenues from elsewhere in order to save on taxes. After we disclosed this in 2015, the company and its investors were silent, suggesting that Vipshop tacitly admits the strategy. We remind readers of how the operation looks:



Site of Vipshop's registered warehouse in Zhuhai, which reported nearly \$1 bln in revenue in 2014. | Source: J Capital, photo was taken in May 2015.

As of 2017, the Zhuhai company was still operating, but, like the WFOE, the company looks suspiciously like it may be manufacturing revenue. In 2017, receivables rose by 173%, to ¥1.3 bln, compared with revenue growth amounting to ¥657,519. Short-term debt rose by 90%.

We looked as well at the Chongqing company, which had a similar purpose to Zhuhai, at least a couple of years ago. In 2017, Chongqing reported revenues up by an impressive 38%, to ¥38.9 bln, but payables and receivables more than doubling and nearly matching each other: payables were ¥10.7 bln and receivables ¥10.9 bln. Additionally, the Chongqing company took on ¥200 mln in short-term debt and yet had only ¥1.2 mln in cash by the end of the year.

Reported results betray distress

The underlying Chinese companies will generally show a more dismal picture than the top-level, reported company, both as a tax-avoidance strategy

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and for lipstick-on-a-pig reasons. But VIPS' 2017 and Q1 public reports did not make the company look particularly healthy.

- ▶ In 2017, accounts payable rose by 120% and accounts receivable by 47%, against revenue growth of 37%.
- ▶ In Q1, the company reported a measly \$2 mln in free cash flow, and that only from a \$360 mln benefit realized from internet financing. The internet financing represents a positive change in the balance of outstanding loans to consumers, suppliers, and in “cooperative lending.” In other words, Vipshop is pushing out loans and calling them free cash flow. Capex conveniently eliminated all but \$2 mln from the operating cash flows.
- ▶ Net income attributable to shareholders fell by 4% YoY despite 24% revenue “growth.” We put “growth” in skeptical quotes because a full 40% of revenue is in receivables and 49% of revenues in payables. If volume were increasing faster than VIPS' ability to pay, inventory ought to be rising, but inventories fell by 27%. Granted, receivables and payables declined compared with the December quarter, but why such a high proportion of revenues? The whole point of Vipshop's model is that VIPS collects cash from customers and remits that cash to suppliers only when the sales event is over.
- ▶ Interestingly, the company did not report on the number of sales events in Q1. It did report that the active customer count was up a mere 1.9% QoQ, in spite of the celebrated partnership with Tencent and JD. The WeChat mini-program for VIPS started up only in April, but the partnership started in Q4 2017.

As usual, VIPS insiders have been major sellers of the shares in the last quarter. Director Jacky Xu sold \$86.7 mln in shares. CFO Yang Donghao earned \$8 mln. Vice President Tang Yizhi earned \$7.5 mln. Management is doing considerably better than are the public shareholders.

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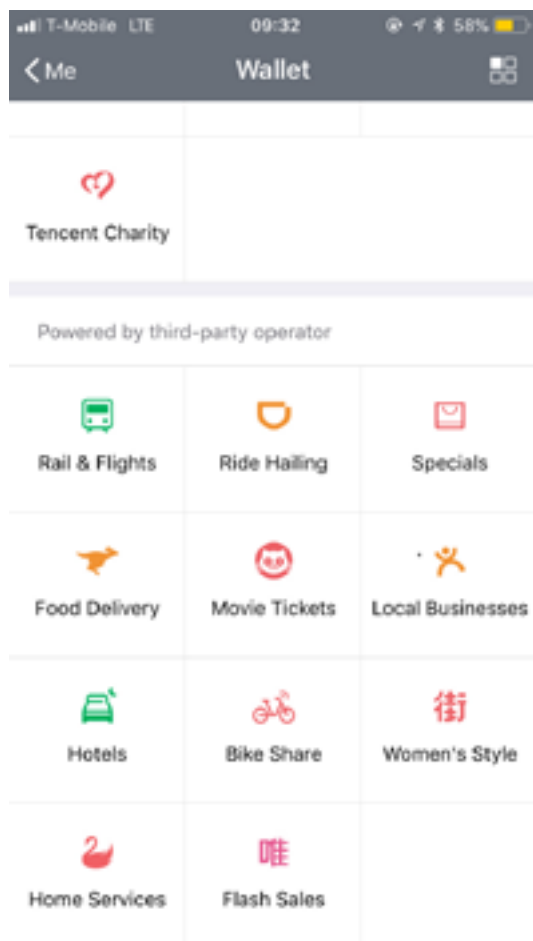
Table 1. Insider sales Q1 2018

								Insider Activity Summary	
Ticker		Transaction Detail			Sold			Net Traded	
Type	Insider	Beneficial Owner	Trading Date	Type	Shares	Price	Value	Shares	Market Value
VIPS	Advanced Sea International Ltd	Jacky Xu, Director	4/30/2018	144 Sale -PlannedP	1,086,800	\$15.37	\$16,704,116	(1,086,800)	\$16,704,116
VIPS	Advanced Sea International Ltd	Jacky Xu, Director	4/23/2018	144 Sale -PlannedP	4,200,000	\$16.19	\$68,000,000	(4,200,000)	\$68,000,000
VIPS	Fan Liping	VP	3/28/2018	144 Sale	253	\$16.83	\$4,257	(253)	\$4,257
VIPS	Huang Yan Lin (Bill)	Officer	3/27/2018	144 Sale	89,216	\$18.00	\$1,605,888	(89,216)	\$1,605,888
VIPS	Zheng Nanyan	Dir	3/27/2018	144 Sale	76,136	\$18.00	\$1,370,448	(76,136)	\$1,370,448
VIPS	Yang Donghao	CFO	3/26/2018	144 Sale	500,000	\$17.00	\$8,500,000	(500,000)	\$8,500,000
VIPS	Fan Liping	VP	3/22/2018	144 Sale	10,000	\$18.87	\$188,700	(10,000)	\$188,700
VIPS	Tang Yizhi	VP	3/20/2018	144 Sale	100,000	\$18.04	\$1,804,000	(100,000)	\$1,804,000
VIPS	Tang Yizhi	VP	3/15/2018	144 Sale	250,000	\$18.11	\$4,527,500	(250,000)	\$4,527,500
VIPS	Feng Jia Lu	VP	3/14/2018	144 Sale	11,419	\$17.65	\$201,545	(11,419)	\$201,545
VIPS	Fan Liping	VP	3/13/2018	144 Sale	30,000	\$18.46	\$553,800	(30,000)	\$553,800
VIPS	Li Yong	Officer	3/13/2018	144 Sale	2,308	\$18.46	\$42,605	(2,308)	\$42,605
VIPS	Tang Yizhi	VP	3/13/2018	144 Sale	200,000	\$18.46	\$3,692,000	(200,000)	\$3,692,000
VIPS	Tang Yizhi	VP	3/9/2018	144 Sale	222,899	\$17.36	\$3,869,839	(222,899)	\$3,869,839
VIPS	Huang Hong Ying	Officer	3/6/2018	144 Sale	49,576	\$17.70	\$877,495	(49,576)	\$877,495
VIPS	Shen Neil Nanpeng	Sequoia	2/28/2018	144 Sale	350,000	\$17.00	\$5,950,000	(350,000)	\$5,950,000
VIPS	Feng Jia Lu	VP	2/26/2018	144 Sale	100,000	\$18.95	\$1,895,000	(100,000)	\$1,895,000
VIPS	Li Yong	Officer	2/22/2018	144 Sale	70,999	\$18.39	\$1,305,671	(70,999)	\$1,305,671
VIPS	Tang Yizhi	VP	2/22/2018	144 Sale	288,848	\$18.39	\$5,311,914	(288,848)	\$5,311,914
VIPS	Liu Chun	Dir	2/21/2018	144 Sale	50,000	\$18.38	\$919,000	(50,000)	\$919,000
VIPS	Huang Yan Lin (Bill)	Officer	2/15/2018	144 Sale	211,529	\$18.92	\$4,002,128	(211,529)	\$4,002,128
VIPS	Sun Ge Fei	Officer	2/15/2018	144 Sale	12,137	\$18.92	\$229,632	(12,137)	\$229,632
VIPS	Elegant Motion Holdings Ltd	Eric Ya Shen, CEO	2/13/2018	Ben. Ownership (13D/G)	-	-	-	-	-
VIPS	High Vivacity Holdings Ltd	Arthur Xiaobo Hong, COO	2/13/2018	Ben. Ownership (13D/G)	-	-	-	-	-

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Ticker		Transaction Detail			Sold			Insider Activity Summary	
Type	Insider	Beneficial Owner	Trading Date	Type	Shares	Price	Value	Shares	Market Value
VIPS	Liu Xing	Dir	1/16/2018	144 Sale-PlannedP	150,000	\$14.51	\$2,176,500	(150,000)	\$2,176,500
VIPS	JD.com Inc	>5% Own	1/8/2018	Ben. Ownership (13D/G)	-	-	-	-	-
VIPS	Tencent Holdings Ltd	>5% Own	1/8/2018	Ben. Ownership (13D/G)	-	-	-	-	-

Source: Washington Insider



Screenshot from WeChat Wallet. VIPS is the “Flash Sales” button at the bottom. | Source: J Capital.

The deal with Tencent and JD

On December 18, 2017, JD and Tencent announced they would acquire 5.5% of newly issued Vipshop shares for \$863 mln. In return, VIPS gets a “mini-program” on Tencent’s WeChat Wallet app, which theoretically should give VIPS more traffic, and will get a link on the home page of JD.com’s mobile app and on JD’s “WeChat Discovery” page. JD has its own flash sales but, being a Tencent investee itself, helps WeChat by passing traffic over.

The biggest traffic boost should come in Q2 this year. However, partners to Tencent have complained to us in the past that the traffic boost did not convert to income.

Call us skeptics. We note two aspects of the cooperation:

- ▶ The connection is explicitly through the WeChat wallet and has the potential to raise cash flow without revenue to Vipshop by creating circular payments.
- ▶ On April 26, VIPS invested alongside Tencent and JD.com in a share subscription to Cosmo Lady (China) Holdings, listed in Hong Kong as 2298. The total subscription value was about \$140 mln. These transactions can easily enable passing money from one, in theory, borrower—let’s say VIPS for the sake of argument—to a lender—let’s just say Tencent.

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- ▶ In March, Vipshop invested in an unnamed private equity fund for \$250 mln. (6-K filed March 30, 2018).

These transactions suggest to us that the cooperation between Tencent (and JD.com as an extension of Tencent) is short-term and transactional rather than strategic.

Explain those logistics?

Try as I might to appreciate the successes of Vipshop, every time I look deeper, I find more misleading statements and general hype. I recently revisited the logistics issue. Vipshop shifted at a speed that is actually incredible, in the proper sense of the word, from using third-party logistics companies to handling logistics internally. In 2014, all of Vipshop's deliveries were made through third-party logistics companies. The logistics company Vipshop acquired, Pinjun, at the time was a mere shell with very little in the way of operations. The first mention of Pinjun was made in the 2015 20-F, and already, by that time, Vipshop reported Pinjun and other "invested and in-house last-mile delivery capabilities" handled 80% of total orders.

"We operate our national delivery and logistics network primarily through a subsidiary of Vipshop Information, namely Pinjun Holdings Co., Ltd., or Pinjun, and its subsidiaries and branches. Vipshop Tianjing and a number of subsidiaries of Pinjun currently hold courier service operation permits that allow us to operate an express delivery network across the county. Pinjun and a number of its subsidiaries are in the process of applying for additional courier service operation permits to further expand our delivery coverage. Furthermore, Vipshop China, Pinjun and a number of Pinjun's subsidiaries and branches hold road transportation operation permits that allow us to provide road freight transportation services. A number of subsidiaries of Pinjun are in the process of applying for additional road transportation operation permits to further enhance our logistics capacities." (2015 20-F page 65-66)

Now it is 97%.

The problem is that this is simply not true. We read through job ads posted by Vipshop and its in-house logistics company, Pinjun, around the country and interviewed logistics managers in 11 regions. Both employees of Pinjun and managers of other logistics companies familiar with Vipshop deliveries said that Pinjun principally manages a delivery-outsourcing process. This fits with our observations and interviews with logistics companies in

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China. In some regions, such as Chengdu, Pinjun employees were handling the last-mile delivery process and using third parties for long-haul “trunk” services. In many regions, Pinjun handles the last mile and third parties pick-up inventory from merchants and deliver the unsold portion back to them. Managers at the Baidu-invested last-mile company Baishi reported handling a lot of the Vipshop volume.

Vipshop furthermore claims that they deliver all their orders nationwide within two days, but this conflicts with reports from both customers and logistics companies. Other logistics companies said that Pinjun is unusually slow when it makes deliveries, and online reviews of Vipshop’s delivery service were mostly negative and complained of waits of up to two weeks.

None of this should matter all that much. The price of last-mile delivery in China has been falling for a decade, and companies are brutally competitive. Using external suppliers is actually more economical than building an internet network, as JD.com can attest. But claiming 50,000 delivery employees, not to mention trucks, sorting facilities, neighborhood delivery stations, and the other infrastructure associated with delivering 335 mln orders in 2017, enables Vipshop to pack up the company with capital costs while also claiming ever-greater efficiencies.

- ▶ Every year, Vipshop claims to add logistics and delivery employees well in excess of the number of additional orders that are delivered by owned companies. Consequently, the number of orders per logistics employee declines each year. And still, each year VIPS claims to have gained cost efficiencies by bringing delivery in-house.
- ▶ Presumably a big portion of its capex spend since 2015 has gone to the huge new headquarters being built in Pazhou, Guangzhou. That headquarters is scheduled to complete in 2019. As previously reported, we are very skeptical of the \$100 mln Vipshop says it spent on the land parcel alone. There are no public records on the land sale.
- ▶ Vipshop spent \$380 mln in 2017 on land and plant and now has 2.5 mln square meters of warehouse space. The company rents the space out to third-party logistics companies. But we are not aware of any lack of logistics facilities in China. If the company does not need to use the warehouse space itself, it should stop building.

Back in 2015, we reviewed Vipshop’s statutory filings from the previous year and, controversially, stated that we thought the company was overstating revenue by 10x. In that review, we gave VIPS every benefit of the

Table 2. Vipshop Warehouse Space, Orders, and Logistics Employees

	2013	2014	2015	2016	2017
Orders	49,159,000	107,300,000	193,079,000	269,800,000	335,000,000
Logistics and delivery employees	5,762	11,703	23,233	38,065	50,908
Orders per Logistics and delivery employee	8,532	9,169	8,311	7,088	6,580
Sales per employee	\$198,581	\$223,043	\$208,826	\$186,655	\$197,453
Revenue per m2	\$5,317	\$5,977	\$3,804	\$3,966	\$4,483
Orders per m2	154	170	118	131	129

Source: company filings

doubt by adding up revenue in all the companies (except for the Zhuhai tax vehicle) and not doing any inter-company consolidation. Still, the numbers did not add up.

Vipshop has been floated for several years now and has moved through several controversies surrounding its numbers. We are eager to find something to like in Vipshop. Unfortunately, the more we look, the less we see.

Catalyst

Vipshop looks very much like a company that is running out of money. Despite claimed profitable growth, the company’s cash resources are declining, and the balance sheet is becoming stretched. We expect that, in the coming quarter, Vipshop will show high active user growth due to the partnership with Tencent. That might bring some boost to the share price. But sales growth is increasingly costly to the company. Reported gross margin in Q1 declined by 300 bps and net margin, already meagre, shrunk by 80 bps. The falling cash resources, increasing dependence on consumer credit to drive free cash flow, and rising payables and receivables all suggest a company that is stretched. The company is in decline.

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Valuation

We appreciate that Vipshop is a real company providing real e-commerce services. Some ask, therefore, why we have assigned such a brutal, \$0 price target. That is because our research on the company has indicated very concerning variation between public reports and on-the-ground reality, from the actual cost of capital assets as opposed to their higher, reported cost, to the company margins, which we consider overstated, to asset ownership. We view VIPS as so troubled by misreporting and structures inaccessible to public-market investors that we cannot place trust in the reported cash and debt and believe there is a good chance that, in a distress situation, VIPS' reported assets might just melt away. Imagining we had a few millions of dollars to spend at discretion, we could not take on VIPS at any price.

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