ALIBABA
AND THE TWELVE DIGITS

BREAKINGVIEWS
REUTERS
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BREAKINGVIEWS
NOTE FROM THE EDITOR

Breakingviews has been closely following Alibaba’s journey towards an initial public offering for over a year. Back in April 2013, we started digging into what the company might be worth. The article that opens this collection is the result. To see how our view has evolved since then, check out the piece that closes this book, “Six steps to Alibaba’s twelve-figure valuation”.
Could Alibaba be China’s next $100 billion stock market listing? The Hangzhou-based e-commerce giant continues to be coy over when it will take the plunge. But sooner or later founder Jack Ma will need to offer some kind of exit for his backers, not to mention employees, and an initial public offering is the most likely solution. Now is a good time to start asking how the company should be valued.

Alibaba’s main business is selling. Its Tmall online stores provide a shop front for brands like Nike and Unilever, while Taobao is focused on consumer-to-consumer trade. The closest U.S. peers might be Amazon and eBay. Sadly for valuation purposes, there’s no perfect match: unlike Amazon, Alibaba doesn’t hold inventory or manage warehouses, and unlike eBay, it gets most of its revenue from advertising, not charging users.

What is Alibaba worth?
Flex the numbers to see what China’s e-commerce giant might fetch in an IPO

<table>
<thead>
<tr>
<th>How fast can Chinese e-commerce grow in 2014?</th>
<th>What is Alibaba’s “take” on transactions?</th>
<th>What operating margins can Alibaba achieve?</th>
<th>What multiple of 2014 earnings is Alibaba worth?</th>
</tr>
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<tbody>
<tr>
<td>31%</td>
<td>3%</td>
<td>48%</td>
<td>30</td>
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</table>

Goods sold 2014: $326bln
Revenue 2014: $9.8bln
Earnings 2014: $4.0bln
Implied value: $120bln

John Foley, Robyn Mak, Katrina Hamlin, C. Trevethan 07/05/2014
Note: Assumes 84% market share and 15% tax rate in 2014

Click on the graphic to view online, interactive version.
Meanwhile, its range of services gets ever wider, and potentially harder to value. As well as accounting for the majority of China’s e-commerce, a market worth $204 billion in 2012 according to the China Internet Network Information Centre, Alibaba now has a mobile operating system, offers trade financing to vendors and may even start offering consumer loans. The company’s chief strategist says it aims to be “the world’s biggest data sharing platform”.

**Magic number**

Fortunately, there are two numbers that really matter. One is how much Alibaba can sell. The other is what percentage “take” it gets from each transaction on its sites. That take might come through advertising or through transaction fees, or a mixture of both. But ultimately, it represents the cash the company can squeeze out of its sellers. Other services like lending may create revenue, but for now they are mainly ways to lock in users and maintain market share.

Consider a back-of-envelope valuation exercise. The first question is how big the overall market can get. Say e-commerce in China grows 35 percent a year for the next two years, and that Alibaba can keep its current market share of around 80 percent. That would give it just under $300 billion of transactions in 2014 – over four times what eBay’s marketplaces handled in 2012.

Now imagine Alibaba can raise its “take” to 5 percent – roughly double what it gets now. For now, Taobao sellers use the site for free, but having reached critical mass, Alibaba should be able to exploit the “network effect” of its 500 million users to generate higher income, either by introducing transaction costs or selling more targeted ads. A 5 percent “take” would still be just a third of what eBay gets from many of its sellers, and would generate $15 billion of revenue for Alibaba.

The next question is profitability. Apply a 30 percent operating profit margin – roughly the level in September 2012, the last period for which there are reported numbers – and the 15 percent tax rate many of China’s high-tech companies enjoy, and 2014 earnings would be $3.8 billion. On a forward earnings multiple of 25 times, the recent average for listed Chinese gaming network Tencent, that suggests a market value of $95 billion.
Opening sesame

In reality, many more factors will affect Alibaba’s magic number. Ma will need to time the stock market cycle, but also the tech cycle. With many foreign backers, Alibaba will most likely need to list on foreign markets, where stock buyers will be influenced by what they think of China’s regulation, economy and accounting practices. Valuations for companies like Baidu, Renren and Sina show gyrations not always explained by the performance of their underlying businesses.

Valuations change quickly. Facebook’s went from $50 billion in its fundraising at the end of 2010 to $104 billion at its IPO in 2012; the company now trades at just two-thirds that value. When Yahoo recently sold half its Alibaba stake back to the company, the deal valued the company at just $40 billion. But a bilateral negotiation with a troubled U.S. company is very different to a stock market listing.

Watch: Alibaba still needs Jack Ma
Alibaba may be undergoing a leadership change ahead of its anticipated IPO, but the firm still needs its billionaire founder to smooth the way with Beijing, says Breakingviews’ John Foley.
Besides, internet companies are inherently volatile. Super profitability attracts super competition, and disruptive technologies can take even established models by surprise. Netscape and Microsoft both showed how supposedly unassailable market positions can be lost as well as won. If a twelve-digit valuation is within reach, it makes sense for Alibaba to open the cave sooner rather than later.

**ALIBABA SPOTS PRICEY TREASURE IN WEIBO’S NETWORK**

**BY PETER THAL LARSEN**

**APRIL 30, 2013**

Alibaba has spotted hidden treasure in Sina Weibo’s social network. The e-commerce giant is paying a punchy price for roughly 18 percent of China’s microblogging phenomenon, a business that has not yet celebrated its fourth birthday and is still working out how to generate revenue.

Alibaba has taken a positively contrarian view of Weibo’s worth. The $586 million investment implies a valuation of $3.26 billion – close to the entire pre-announcement market value of Sina Corp, Weibo’s parent company. The implication is that Sina shareholders are putting no value on the company’s existing web portal business and $700 million in cash and short-term investments. If Alibaba is right, the 9 percent jump in Sina shares on the news is far too stingy.

Weibo’s new valuation looks demanding, however. Like their counterparts at Twitter and other Western equivalents, the company’s management is struggling to convert enormous clout on the web into cash in the bank. Weibo started experimenting with ads last year. In 2012, they provided just 12 percent of Sina’s advertising revenue – about $50 million.

The investment has potential benefits. It could help point Weibo’s 46 million daily users towards Alibaba’s online stores, or give retailers seamless access to Weibo’s platform. The two reckon such vague synergies will generate more than $120 million in additional annual revenue for Weibo over the next three years.
But Alibaba may be thinking less about gains than about potential losses. Roughly four out of every five yuan currently spent on e-commerce in China travel across its platforms. Alibaba wants to defend this from potential rivals such as Tencent, which has captivated users with its WeChat free mobile messaging service. WeChat doesn’t currently enable e-commerce, or make any money, but such innovations cannot be ruled out. With a high-profile initial public offering in the works, Alibaba could use Weibo to give its own mobile strategy a boost.

Even so, more than half a billion dollars in cash – more if Alibaba exercises an option to raise its Weibo stake to 30 percent – remains a big bet. Alibaba must hope that its prospective investors share its enthusiasm.
ALIBABA’S NEXT SUPERLATIVE: CHINA’S TOP FEE PAYER
BY JOHN FOLEY
MAY 20, 2013

Alibaba’s initial public offering is going to be less about the forty thieves, and more about the fight for fees. The unlisted Chinese e-commerce giant is already an important source of advisory and financing revenue in a weak market. If a highly anticipated stock market listing comes to pass, it could become China’s biggest payer of fees to global investment banks in a decade.

Alibaba and the fight for fees
Top investment bank fee payers in China and Hong Kong, 2003-2013, US$mln

Totals include M&A advice, plus fees for arranging and underwriting debt and equity issues.

*Includes arrangement fees for $6.5 billion syndicated loans, at estimated 1.7pct
**Includes fees for theoretical $15 billion IPO at 1.75pct rate of commission

Catherine Trevethan / John Foley / Robyn Mak
Source: Thomson Financial/Freeman & Co/Reuters Breakingviews estimates
As the company has expanded, Chairman Jack Ma has overseen the listing and de-listing of subsidiary Alibaba.com, the arrangement of a $3 billion syndicated loan, the restructuring of payment engine Alipay, and a buyback of shares from U.S. investor Yahoo. Such deals generated combined fees of $176 million since 2007, according to Thomson Reuters Freeman data, based on public disclosures and proprietary estimates. That’s more than any other non-state Chinese company over the same time.

The treasure keeps coming. Alibaba recently secured another $6.5 billion syndicated loan from a consortium led by nine banks, according to IFR. Based on an average arrangement fee of around 1.7 percent, the payday was worth about $110 million.

The next big event could be an initial public offering. The company doesn’t comment on its plans. But given that valuation expectations range from $60 to $100 billion, it’s no stretch to think that Alibaba and its backers could sell $15 billion of stock, a bit less than Facebook did in 2012. Apply a 1.75 percent commission, and the spoils could be $260 million.

All in, that would take Alibaba to roughly $550 million in fees over a decade – ranking only behind oil producer CNPC and lender ICBC in Greater China. Moreover, unlike Alibaba, CNPC and ICBC have paid the lion’s share of their fees to domestic institutions.

Even after an IPO, Alibaba is likely to continue generating fees from acquisitions and share trades, as big shareholders like Yahoo sell down. Little wonder, then, that battle lines are already being drawn. SoftBank, the Japanese company that owns a third of Alibaba, recently warned banks not to finance a rival bid for U.S. telecom Sprint, or risk being left out of the e-commerce giant’s flotation, sources told Reuters.

That may be an idle threat, but given Alibaba’s prospects, few investment banks would be prepared to put it to the test.
Alibaba isn’t a bank. But for customers it’s getting hard to tell the difference. Users of China’s dominant e-commerce website can now deposit funds, make investments, take out loans and even give out gifts of virtual cash. In taking on China’s lenders, Alibaba and its online rivals may be taking on bank-like risk.

Banks typically offer savings, loans and transactions. Alibaba’s foray into finance has seen it target all three. While the amounts remain small compared with China’s towering mainstream lenders, the growth rates have been rapid. No wonder: state-owned banks have for years benefited from a tightly-regulated oligopoly.
Alibaba has long handled payments through Alipay, its version of PayPal. Now it allows users to invest surplus cash through a service called Yu E Bao. The funds, which are invested in low-risk securities like government bonds and interbank loans, offer a return of about 6 percent, double what savers get on one-year bank deposits. It’s a money market fund, not a bank deposit. But for customers there is little substantive difference.

Alibaba is now getting into longer-term investments. A fixed-term product to be launched through Yu E Bao on Feb. 14 will give customers an expected 7 percent yield, by investing in property and equities among other things.

The company also offers loans to small and medium-sized companies who sell on its Taobao marketplace. By February it had made 170 billion yuan ($28 billion) of loans. While Alibaba doesn’t have a bank’s lending expertise it does have masses of data on borrowers’ transaction habits.

The clever part is that Alibaba isn’t doing the financial heavy lifting. Yu E Bao and the new fixed-term product are structured and operated by third parties. The e-commerce group acts as a conduit. Alibaba isn’t technically on the hook for users’ cash, nor does it pick investments, according to a person familiar with the situation.

Strictly speaking, this means Alibaba isn’t taking the liquidity risk that banks face if depositors decide to withdraw their money en masse. That is why it doesn’t need a bank deposit-taking licence, and avoids onerous regulation from the central bank.

But Alibaba is straying into a grey area. China’s immature financial industry still hasn’t been through decisive tests of who takes responsibility when investments go wrong. For Alibaba, this risk may be heightened. Its users are young and financially unsavvy – Yu E Bao savers have an average age of around 28 – and trust for Alibaba’s brands runs high, thanks partly to founder Jack Ma’s self-styling as a champion of the little guy.

Even if Alibaba has no explicit responsibility to pay back investors, it may decide to do so to protect its reputation. The situation with Yu E Bao is further complicated by the fact Alibaba owns 51 percent of Tianhong, the fund management company that structures the products.
For now, Alibaba and its online rivals are more of an annoyance for banks than a real threat. But while Alibaba is decidedly not a bank, the biggest risk is that customers treat it like one. If that happens, it’s a fair bet regulators will too.

**SOFTBANK’S ALIBABA STAKE BOTH BLESSING AND BURDEN**

**BY UNA GALANI**

**FEBRUARY 27, 2014**

SoftBank’s investment in Alibaba must be one of the most successful of all time. Billionaire chief Masayoshi Son injected just $20 million into the Chinese e-commerce giant in 2000. Today, the 36.7 percent shareholding accounts for a large chunk of Japanese group’s market value. As Alibaba heads toward an initial public offering, however, Son’s investment blessing may become a burden.

The owner of online shopping sites Taobao and the Alipay electronic payment system is still a private company. Based on its limited financial disclosures, Breakingviews estimates it is worth around $113 billion. That values SoftBank’s stake at $41 billion, or 38 percent of the Japanese group’s total sum of the parts, according to a new Breakingviews calculator.

Many of SoftBank’s other businesses are already listed. Its 80 percent stake in U.S. mobile carrier Sprint is currently valued at $26.5 billion. Softbank’s 42.5 percent shareholding in Yahoo Japan is worth $15.3 billion. Other stakes in mobile games maker GungHo, Supercell, and handset maker Brightstar add up to $7 billion, based on market values or recent purchase prices.

**How important is Alibaba to SoftBank?**

See how the Chinese e-commerce giant’s value affects the Japanese group

![Graphic](image-url)

_U. Galani, P. Thal Larsen 27/02/2014_

_Note: Market valuations based on Feb 26 closing share prices._

*Click on the graphic to view online, interactive version.*
Then there’s SoftBank’s wholly-owned Japanese telecom business. Apply an industry multiple of 4.4 times EBITDA, strip out the remaining net debt, and the equity is worth $19.2 billion. Put it all together, and SoftBank’s parts add up to $109.5 billion.

But investors aren’t giving Son full credit for his empire, which is broadly focused on the internet. Though SoftBank shares have more than doubled in the past year they still trade 16 percent below the combined value of the company’s parts. Some discount is warranted: SoftBank can’t easily sell. However, investors also seem to be overlooking synergies: together, SoftBank’s Japanese and U.S. telecom operations are the world’s second-largest purchaser of network equipment.

The bigger question is Alibaba. Founder Jack Ma sits on SoftBank’s board, but that’s where cooperation appears to stop. For now, the investment is a blessing: SoftBank is one of the few ways for public investors to gain exposure to Alibaba. But that advantage will disappear when Alibaba goes public. At that point, Son will have to justify tying up more than a third of his company’s value in a minority stake – or find a way to part with his most successful ever investment.

Watch: Breakingviews columnist Una Galani brings us up to date
August 28, 2014
THE CAVE OPENS

ALIBABA’S TRIANGULAR DEALMAKING ADDS TO IPO QUIRKS
BY JOHN FOLEY
APRIL 9, 2014

Powerful insiders are the norm in internet companies. Alibaba’s tie-up with a digital TV company adds an extra twist. The Chinese e-commerce group, which is planning a U.S. listing, has signed a three-step deal with China’s Wasu Media that looks a little too clever for comfort.

The agreement to make and distribute content, announced on April 9, has logic. The two companies, both based in the city of Hangzhou, already make television set-top boxes together. Jack Ma, Alibaba’s colourful founder and chairman, has long talked of creating culture for China’s masses.

Employees stand next to a logo of Alibaba during a media tour at its headquarters on the outskirts of Hangzhou, June 20, 2012.
The financing of the deal is less logical. Alibaba will lend 6.5 billion yuan ($1.05 billion) to its co-founder Simon Xie at an 8 percent interest rate. He is investing the cash in a new vehicle, co-owned by Ma and another internet mogul, Shi Yuzhu. That vehicle in turn is investing in Wasu, in return for a 20 percent stake.

Alibaba hasn’t commented on the financial aspects of the deal. Nevertheless, there are two problems. First, it seems unnecessarily complex. If Wasu is a worthy partner, why doesn’t Alibaba invest directly? Twitchy Chinese regulators who closely monitor ownership of media companies may explain the need for such manoeuvres. But circumventing the spirit of the rules would hardly be encouraging.

Second, the spoils don’t appear to be evenly divided. If Wasu’s shares sink, Alibaba’s loan may be at risk, depending on the value of the collateral that Xie has pledged. If the shares rise, Ma, Xie and Shi apparently pocket the gains. They are already $245 million better off after Wasu shares rose 10 percent on April 9.

Privately-held Alibaba doesn’t have to answer to public markets. And the transaction may include other terms which somehow share the trio’s gains with the rest of the company.

But the triangular deal shows how hard valuing Alibaba will be. One of the biggest questions for future investors is what happens if insiders’ interests differ from their own. Ma and his cohort have already proposed that key individuals retain the right to nominate board directors, a requirement that scuppered Alibaba’s chances of a Hong Kong listing. The Wasu deal demonstrates how blurred the line between public and private can become.

**HONG KONG NEEDS TO DEFEND SHAREHOLDER DEMOCRACY**

**BY UNA GALANI AND PETER THAL LARSEN**

**APRIL 16, 2014**

Hong Kong needs to make a stand for shareholder democracy. Alibaba’s decision to shift its giant stock market listing to the United States has sparked a debate about control of public companies in the former British colony. Hong Kong’s stock exchange, whose rules wouldn’t have permitted a plan to let Alibaba insiders nominate a majority of board directors, is preparing a public consultation on shareholder rights. But dumping the principle of “one share, one vote” would be a mistake.
For a city that likes to bill itself as China’s gateway to global capital markets, missing out on the initial public offering of the largest e-commerce company in the People’s Republic is a symbolic blow. The snub raises fears that other fast-growing Chinese companies will choose to raise capital elsewhere, leaving the Hong Kong exchange as a stagnant backwater dominated by local tycoons and stodgy Chinese state-owned companies. Weibo, another hot Chinese tech company, is also planning a New York IPO.

In the United States, insiders can control public companies even when they no longer own the majority of the shares. Google and Facebook – to name just two of the companies Alibaba views as its peers – have blazed a trail by creating multiple classes of shares with different voting rights.

Canning Fok, chairman of HK Electric Investments, reacts after hitting a gong during the debut of at the company on the Hong Kong Stock Exchange, Jan. 29, 2014. REUTERS/Bobby Yip
Proponents of change argue that, in order to remain competitive, Hong Kong must take a similar approach. This thinking is wrong-headed, for three reasons.

First, companies aren’t actually abandoning Hong Kong in large numbers. Although some Chinese groups have chosen to list on U.S. exchanges, the exodus doesn’t warrant an identity crisis. Hong Kong was the world’s second biggest market for IPOs by proceeds in 2013, according to Thomson One, ahead of the United Kingdom and Singapore. Large companies like pork producer WH Group are preparing to raise capital there this year. That’s a big achievement for a financial centre that doesn’t have a large home-grown base of institutional investors.

Second, companies that reject Hong Kong may do so for reasons other than corporate governance. Only half the mainland businesses that listed in the United States over the past three years have adopted multiple share classes. Another factor driving them away is the requirement that companies have to be profitable for at least three years – or meet certain other financial criteria – before they are allowed to list in Hong Kong. That rule has kept away small weak companies, but also some fast-growing start-ups.

In the past, Chinese companies chose the United States because of a perception that investors and analysts there better understand technology. However, the rise of Chinese internet groups like Hong Kong-listed Tencent is evidence of growing interest in the industry from Asian investors. Poor research coverage in the United States has prompted some U.S.-listed Chinese companies to go private with a view to returning to Asia.

The third reason for Hong Kong to defend the status quo is that its corporate governance is already weak. Local tycoons exercise power through cascades of partially-listed subsidiaries, each often controlled by a parent company. Li Ka-shing’s empire is a prime example. Meanwhile, many Chinese state firms are opaque and make decisions with little consideration for external shareholders.

Loosening Hong Kong’s rules would allow controlling shareholders to exert an even tighter grip. That was the threat in the 1980s, when local trading house Jardine Matheson proposed creating a class of non-voting
shares. Two conglomerates controlled by Li tried to follow suit, prompting the regulator to step in and ban the practice. In the United States, the prevalence of class action lawsuits helps to keep companies and their founders in check. But Hong Kong’s legal system is a lot less friendly to litigious shareholders.

A successful capital market needs to be attractive to both issuers and investors. If Hong Kong were to relax its rules, it might attract some new listings or entice large companies back from the United States. However, it would dilute shareholder protection – which could push up the cost of capital for the broader market.

Many public company investors are currently willing to give up voting rights for exposure to fast-growing technology companies, but their enthusiasm has not yet been tested in a downturn. Though the loss of Alibaba is a setback, loosening Hong Kong’s rules would bring greater risks for uncertain rewards. All the more reason to make a firm stand for shareholder democracy.

Watch: Hong Kong’s Alibaba loss is New York’s gain?
Chinese Internet giant Alibaba has chosen New York over Hong Kong for its $15 billion IPO. Breakingviews’ Peter Thal Larsen and Rob Cox debate the pros and cons for the company and the exchanges.
ALIBABA’S BIG REVEAL: HIGH GROWTH, ODD GOVERNANCE
BY JOHN FOLEY
MAY 7, 2014

There are two things to know about Alibaba, which filed for an initial public offering in New York on May 6. First, China’s dominant e-commerce company is huge, and could be even bigger. Second, new investors will have little say in how it is run – the founders are keeping a firm grip.

Last year, Alibaba processed 11.3 billion orders with a value of $248 billion through its main sites, Taobao and Tmall. That’s two-thirds more than Amazon and Ebay combined, and a staggering 84 percent of China’s total online shopping haul. Unlike most online retailers, Alibaba doesn’t sell or deliver goods itself. Instead, it acts as a shop-front, charging sellers for advertising and taking some commissions.

Growth will come from two sources: increased online shopping, and Alibaba extracting more money from sellers. Its revenue of $7.8 billion in calendar year 2013 amounted to just 3 percent of goods sold. By comparison, ebay’s take is 10 percent. Alibaba’s orders tend to be small – averaging around $22 apiece versus $64 for rival online retailer JD.com. But its dominance should enable it to keep a bigger share.

Alibaba Group’s main shareholders, assets
Co-founders Jack Ma and Joseph Tsai are among the largest individual shareholders

Note: *Ownership as of July 11, 2014 filing. Son is also a director on Alibaba Group’s board of directors. Sources: Alibaba Group; Thomson Reuters.

C. Chan 17/07/2014
Governance is the sticking point. A group of 28 partners, led by chairman Jack Ma and his number two Joseph Tsai, will nominate the majority of Alibaba’s board of directors. Big shareholders Yahoo and Softbank have pledged to back the partners’ choice, ensuring that a majority of shares will vote in favour.

The theory is that this structure is more democratic than the super-voting shares used by the founders of rival tech companies like Facebook and Google. But it’s also less transparent, and therefore harder to value. Alibaba’s partnership will remain in place unless 95 percent of shareholders vote to dissolve it. Though Ma and Tsai can be removed by a simple majority of the partners, the chances of that happening seem remote.

It’s understandable that Alibaba wants to preserve the culture that contributed to its extraordinary success. New shareholders can have no doubt about who calls the shots. But business conditions and cultures change. Alibaba has been rapidly expanding into new areas, from internet TV to mapping and online video, where the founders may be less expert. Growth without good governance is like an online retailer without a returns policy.

**Watch: Tencent, JD.com team up to take on Alibaba**

Tencent’s purchase of a stake in online retailer JD.com is less about the financials than a shared desire to challenge Alibaba’s choke-hold on China e-commerce, says Breakingviews’ Peter Thal Larsen
Alibaba’s secret weapon is its payment division. Yet Alipay isn’t part of the Chinese e-commerce company’s upcoming initial public offering. The company is “conceptually” thinking about reuniting them, according to people familiar with the situation. But the status quo, however strange, looks better.

Founder Jack Ma spirited Alipay, which handles 79 percent of purchases on Alibaba’s sites, into a vehicle he controls in 2011. His reasoning was that regulators planned to introduce tough rules for payment operators with foreign investors. But the rules never materialised.

Rather than put Alipay back, Ma struck a deal. The payment unit pays 49.9 percent of its pre-tax profit to Alibaba and gives it preferential terms on
commissions. If Alipay is floated or part-sold later, its former parent gets cash equivalent to 37.5 percent of the unit’s value, up to $6 billion.

Today, that arrangement looks attractive. Though Alibaba’s Chinese sites account for just over a third of Alipay’s total transactions, the e-commerce group still gets half the division’s pre-tax profit. The only snag is that Alibaba’s cash payout is capped. Alipay, which made almost $230 million of pre-tax profit in 2013, could soon reach the point where that $6 billion looks light.

Changing that needn’t mean a cash deal. Alibaba could swap its future claim on Alipay’s IPO proceeds for an equity stake of the same size. Work the deal out now, and it might help bump up Alibaba’s IPO price.

But politics is a reason not to proceed. Chinese regulators have encouraged Alipay to disrupt the traditional banking and payment system. That would be harder if foreign investors openly shared the spoils. Alibaba would also have to negotiate with Ma, its own chairman. It would be hard to convince incoming investors a deal was done on truly impartial terms.

That makes the simplest course the best: to leave well alone. The most valuable thing for Alibaba is the preferential rates it gets on the billions of transactions it runs through Alipay. Those are safe for 50 years. The risk is that Alipay turns into a real giant, and Alibaba misses out on a windfall. But on balance, a status quo that investors can quantify is better than a stake in a privately-held company, and a heap of political risk, that they can’t.
Alibaba boss Jack Ma is busy preparing for a U.S. initial public offering, potentially valuing his company at more than $100 billion. But if he really wants to make it big in America, he may have to buy his way in. There are at least two deals he could strike. Buying Yahoo would tidy up some corporate and tax-related loose ends as well as providing a U.S. bridgehead. The stronger industrial logic, though, could eventually suggest a tilt at eBay.

Ma’s goal early on was for Alibaba to become a top-10 internet firm and last 102 years. In 2011, he hinted at interest in Yahoo. At the time, Alibaba wanted to reduce foreign ownership and Yahoo’s valuation was depressed. The U.S. search firm’s stake is now smaller and its stock richer. Ongoing efforts to make acquisitions in China and take small stakes in U.S. companies with relevant technology, along with going public, may mean Ma has enough on his plate without the financial and political risks of a big American transaction.

Yet making it big in the United States as well as China could well require a trusted U.S. brand. Moreover, Yahoo has a problem. When it sells shares in Alibaba, the Internal Revenue Service takes perhaps 30 percent of the proceeds. Yahoo’s current roughly 23 percent stake could be worth $27 billion before tax at a $120 billion valuation for Alibaba. Avoiding a tax hit approaching $10 billion altogether would be a big deal for a company whose own market capitalization is $34 billion.

If Alibaba bought Yahoo, in essence buying back the U.S. company’s stake, the tax treatment could be far more favorable. Ma might also gain an extra housekeeping opportunity. Yahoo’s other big Asian holding is Yahoo Japan, a joint venture with Masayoshi Son’s SoftBank. Some kind of exchange involving that stake and SoftBank’s 34 percent of Alibaba could one day help Ma reduce his other big foreign shareholding too.

Yahoo’s mostly stagnant business is less compelling. Strategically, Ma’s more natural U.S. target would be the $65 billion eBay, with its auctions
and e-commerce – and even the PayPal business to go along with Alibaba’s sister company Alipay. That would, of course, be a huge bite even if Alibaba’s IPO turns out to be a blockbuster. But for Ma to go after his biggest inspiration would surely not be out of line with his ambition.

Alibaba versus major tech companies

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<table>
<thead>
<tr>
<th>MARKET CAPITALIZATION</th>
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<td>400</td>
</tr>
<tr>
<td>Google</td>
<td>300</td>
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<tr>
<td>eBay</td>
<td>200</td>
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<td>Alibaba (est.)</td>
<td>100</td>
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<tr>
<td>Facebook</td>
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<table>
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<tr>
<th>WORKFORCE</th>
<th>Thousand persons</th>
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<td>120</td>
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<tr>
<td>Google</td>
<td>90</td>
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<tr>
<td>eBay</td>
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<td>Alibaba</td>
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<tr>
<td>Facebook</td>
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REVENUE: Alibaba’s revenue for the calendar years 2013 and 2012 calculated using quarterly figures quoted in Yahoo filings. MARKET CAPITALIZATION: Amazon, Google, eBay and Facebook based on close of trading on July 16; Alibaba based on internal valuation given in Alibaba filing on July 11. WORKFORCE: Amazon includes full-time and part-time staff; Google includes full-time employees as of end 2013; eBay includes temporary employees; Facebook as of end 2013; Alibaba as reported in updated filings on July 11.

Sources: Companies; Thomson Reuters.

C. Chan 17/07/2014
Alibaba is trying out a new role: the noble monopolist. With an apparent 84 percent share of online consumer goods spending, it effectively owns the country’s internet shoppers. Its payment affiliate is the biggest game in town. Both are attractions for its upcoming initial public offering. Alibaba’s long-term challenge is to keep showing that dominance helps the market rather than restricts it.

The company isn’t like China’s traditional monopolists. It comes from popularity rather than official handouts or restrictions – unlike, say, tobacco or salt, or the oligopolies that control telecoms and banking. Where “bad” monopolists promote inefficiency, Alibaba has done the opposite, connecting buyers and sellers who would never otherwise meet.
China’s thinking on market clout is still developing. A 2008 anti-monopoly law lets multiple regulators investigate even state-owned companies if they believe harm is being done to the marketplace, like setting unjustly high or low prices. China’s National Development and Reform Commission, which regulates prices, has been investigating China Telecom and China Unicom for over two years regarding broadband tariffs.

Alibaba isn’t on the radar. A hike in annual fees by its online marketplace Tmall led to protests by small merchants in 2011. China’s Ministry of Commerce then stepped in urging Tmall to defuse the conflict. Alibaba later agreed to delay new fees for sellers with positive ratings. While there was no suggestion of anticompetitive behaviour, it showed how Tmall’s market strength makes it both visible and sensitive.

Watch: Why Alibaba “monopoly” may be good for China

E-commerce giant Alibaba’s agile, customer-centric approach make it a model for new kind of monopoly in China as the government moves to regulate dominant businesses, says Breakingviews’ John Foley.
Payment service Alipay is similarly strong, powering half of China’s online transactions last year. While not a part of Alibaba’s IPO, users registering for Tmall automatically receive an Alipay account. Other tech companies have faced scrutiny over linked services. China’s top court ruled this year software provider Qihoo 360 unfairly harmed rival Tencent by bundling software with its QQ messaging program.

For now authorities seem to buy the “noble monopolist” concept. If anything, Alibaba is helping to prize open other, less efficient market concentrations: its online money-market fund platform Yu E Bao has forced banks to offer similar products to keep up. That allows it to argue its size is for the greater good. For investors, the question is for how long that continues to ring true.

**JACK MA SOCCER BUY DOES ALIBABA INVESTORS A FAVOUR**

**BY PETER THAL LARSEN**

**JUNE 6, 2014**

Jack Ma’s decision to buy half of China’s most popular soccer club has done prospective investors in Alibaba a favour. The $192 million investment in Guangzhou Evergrande which the internet giant’s founder hatched over a drinking session this week won’t affect Alibaba’s value when it goes public later this year. But it offers a priceless insight into how the company works.

If Alibaba has a good strategic reason for owning a stake in the reigning Asian champions, Ma is keeping quiet about it. He joked at a press conference that he doesn’t know much about soccer. The investment is latest example of Alibaba’s scattershot approach to deal making, loosely designed to expand it into new areas like entertainment and health. In the last year it has bought stakes in an appliance maker, an owner of department stores, a mapping firm, an online video service and a Hong Kong-listed media group.

It’s not unheard of for companies to own sports clubs. Ted Turner used the Atlanta Braves baseball team to build his cable television business. Rupert Murdoch’s News Corporation owned the LA Dodgers baseball franchise and tried unsuccessfully to buy Britain’s Manchester United. Chinese conglomerate CITIC’s assets include a Beijing soccer club. Yet
such investments have generally been disappointing from a financial perspective. Control of sports broadcasting rights has proved more lucrative.

Ma has demonstrated a knack for identifying big trends. His approach also doubtless owes a lot to China’s business landscape, where the need to maintain personal relationships, curry favour with officials or comply with ownership restrictions can force companies to take counter-intuitive steps. And Ma’s style is no more idiosyncratic than that of Facebook’s Mark Zuckerberg, who reportedly finalised the $19 billion acquisition of WhatsApp this year while eating strawberries with the messaging service’s founder.
The Guangzhou Evergrande investment also won’t change Alibaba’s valuation, which a Breakingviews calculator estimates at $113 billion. Yet it is invaluable in demonstrating how the company operates. After the initial public offering, a group of 28 senior executives led by Ma will nominate the majority of Alibaba’s board of directors. Would-be shareholders will be passive spectators with little power. The latest deal should leave them with no illusions about what to expect.

Watch: Alibaba soccer buy shows investors the score
China e-commerce giant Alibaba decides to buy half of a soccer club over drinks, showing the company’s rather whimsical approach to investment ahead of its IPO, says Breakingviews’ Peter Thal Larsen.
RISKS AND REWARDS

ALIBABA IS CASE-STUDY IN U.S.-CHINA LEGAL GULF
BY RICHARD BEALES
JUNE 23, 2014

Alibaba’s coming U.S. initial public offering will probably value the Chinese e-commerce firm at more than $100 billion. But will shareholders actually own the business? That’s the timely concern raised by a U.S. congressional commission. Lack of legal clarity in the People’s Republic is mainly to blame.

The U.S.-China Economic and Security Review Commission, which monitors bilateral relations on behalf of Congress, on June 18 published a paper highlighting the legal risks of so-called variable interest entities (VIEs). Many Chinese companies use these contracts to give offshore investors control over – and economic benefits from – mainland businesses they cannot own directly.

An employee is seen behind a glass wall with the logo of Alibaba at the company’s headquarters on the outskirts of Hangzhou, April 23, 2014. REUTERS/Chance Chan
Investors have swallowed the risks of VIEs in plenty of other cases, like the recent U.S. IPO of microblogging site Weibo. Foreign shareholders assume the Chinese authorities would be reluctant to undermine the growing number of companies with overseas listings that rely on the structures.

Alibaba says businesses held through VIEs account for only about 17 percent of its assets. The rest goes through wholly and majority foreign-owned enterprises. Besides, the company discusses its VIE arrangements at length in its IPO documents and quotes a Chinese law firm’s opinion that everything is legal.

Still, the U.S. commission’s paper calls VIEs “an intricate ruse” and says they are “potentially illegal in China.” Even Alibaba concedes that efforts to enforce contractual rights on the mainland could be challenging. Though the company is big and entrenched enough to matter to the economy,

Watch: Why the wheels may come off for China Internet investors
Foreign investors might be able to buy a piece of Chinese Internet giants like Alibaba, but a murky corporate structure ensures shareholders will never be in the driver’s seat.
John Foley explains.
the danger for prospective Alibaba investors is that its prominence in the sensitive internet sector would put it in the crosshairs should Beijing decide to crack down on VIEs.

The commission raises another legal issue that doesn’t get as much attention. Once Alibaba lists on a U.S. exchange, it will be subject to new aspects of the sprawling Foreign Corrupt Practices Act. If, for example, the company mischaracterized corrupt payments in its accounts, American authorities could take action.

Of course, China has its own anti-graft laws, and there’s no suggestion Alibaba has done anything wrong. Yet the U.S. report is a reminder that there are risks both in the uncertainty of Chinese legal arrangements and in the certainty that U.S. law has extraterritorial reach. Investors shouldn’t forget that Alibaba is a case study in the gulf between the two legal systems.

**THE PERKS AND PITFALLS OF DEPENDING ON JACK MA**

**BY JOHN FOLEY**

**JULY 21, 2014**

Buy a share in Alibaba and you place your trust in Jack Ma. The Chinese e-commerce giant’s founder, executive chairman and spiritual sultan will remain a controlling force even after the company completes its massive initial public offering later this year. The $100 billion-plus question for prospective shareholders is whether they can depend on him to always act in their best interests.

Given Alibaba’s success, the question may sound absurd. Under Ma’s leadership, the Hangzhou-based retail marketplace has grown into a colossus. Almost 85 percent of China’s e-commerce activity passes through its Taobao and Tmall platforms. Revenue in the first quarter of 2014 increased 39 percent to 9.4 billion yuan ($1.5 billion). When the long-awaited IPO debuts in September, it could be one of the largest ever, likely surpassing the $16 billion raised by Facebook in 2012.
But the company and Ma are at a turning point. After years of expanding its market share, Alibaba is now under attack from Chinese rivals like JD.com, which resembles Amazon. The group is straying into new areas from mobile messaging and maps to cable TV and football. It has spent at least $7.3 billion on acquisitions since January 2014. What Alibaba’s leader does next is integral to the company’s value.

Ma’s influence outweighs his 8.9 percent shareholding and his official title. Besides being Alibaba’s public face, he heads a committee of 27 partners that collectively nominates more than half the company’s board of directors. Shareholders can veto each choice, but then the partners can shoehorn in an alternative until the following year. Yahoo and Japan’s SoftBank, which together could own over 50 percent of the company’s stock after the IPO, have already agreed to back the partnership’s decisions. In practice, this means outside investors will have almost no say over how the company is run.
That might not matter, except that Ma’s motivations are not quite the same as those of other shareholders. Ma personally holds some of Alibaba’s key licences through vehicles called variable interest entities (VIEs) that are necessary to get around China’s foreign-ownership rules. He also controls the vehicle that owns the company’s Alipay payment unit and its money-market fund affiliate. These businesses are not part of the IPO, but are entwined with Alibaba through a series of complex agreements, raising the potential for conflicts of interest.

Ma’s record doesn’t offer much reassurance. In 2011 he shifted Alipay out of Alibaba’s control. The reason was to ensure it got a vital licence from the central bank. But the transaction highlighted a pillar of Ma’s philosophy: sometimes tough, unpopular decisions must be made at a moment’s notice.

Other perplexing decisions seem less necessary. Take the impulse purchase of a stake in a Chinese football team. Another investment in a mainland cable TV company involved Alibaba lending cash to one of Ma’s co-founders. And in other deals, the private equity fund Ma founded has popped up as a co-investor. As the company grows, the possible transactions Alibaba could consider also get bigger: tilts at Yahoo or even eBay are in the realm of possibility.

Investors are also taking on Ma’s political persona. Alibaba has overcome obstacles that kill off many non-state companies. One reason is that the entrepreneur enjoys lashings of support from Beijing, making him a kind of political shock absorber. The company’s base in Zhejiang puts Ma in the orbit of China’s President Xi Jinping, formerly the province’s party chief. And one of Alibaba’s investors is a fund founded by the son of former premier Wen Jiabao, the New York Times reported on July 21. Ma understands the opaque rules that govern China’s system of licences and permissions, and the importance of championing consumers and small businesses. Alibaba supports almost 12 million jobs.

One risk is that Ma’s star ascends too rapidly. The ruling Communist Party loves a Chinese success story, but hates a cult of personality. Ma has compared his situation during the Alipay controversy to that of Deng Xiaoping, China’s paramount leader, as he sent tanks into Tiananmen Square to crush democracy protesters in 1989. And it’s not just politicians that might bristle at Ma’s ambition. In the financial world, Alibaba’s push
into online investment funds is a direct challenge to state banks, which make for powerful enemies.

A backlash could take many forms. Alibaba’s effective monopoly over online retail makes it a potential target for antitrust scrutiny. Alibaba’s VIEs, meanwhile, have questionable legal status in China. Shutting down the country’s favourite e-commerce operator would be unthinkable, but forcing it to restructure so that foreign shareholders must sell out, or a state investor be brought in, is conceivable.

What would Alibaba look like without Ma? It’s more than a hypothetical question for a company that says it wants to endure for at least another 87 years. The succession plan is not clear, even though the 49-year-old Ma already faces other demands on his time from philanthropic activities and ambitions to help clean up China’s environment.

Watch: Investors and the Alibaba leap of faith
Potential investors in Alibaba can probably trust founder and chairman Jack Ma to act in their interests - but with a few important caveats, says Breakingviews’ John Foley.
Alibaba’s founder is arguably modern China’s most successful entrepreneur. But he has also made little secret of where his priorities lie: “customers first, employees second and investors third.” So far, the incentives of those three groups have been aligned. If that changes, investors could find themselves powerless. Buying a share in the upcoming IPO is a vote of confidence in Jack Ma, but one that should come with hefty caveats.
Alibaba has shifted its likely initial public offering date from August to September. That means the Chinese e-commerce colossus will miss the previously mooted “double 8”. But it matters little. Whatever happens, Alibaba’s IPO is likely to generate some fantastical numbers – it can do without lucky ones too.

The eighth of the eighth has double significance, since in Chinese its pronunciation is the same as the company’s stock symbol, BABA. More significant for investors, however, are the figures Alibaba’s operating business produces. With 39 percent revenue growth in the first quarter
of 2014, and a market share of around 85 percent, Alibaba doesn’t need gimmickry. A more mundane IPO date would show future investors that common sense is prevailing over ego.

And as Facebook discovered, reaching for totemic numbers can backfire. The U.S. social network, whose $16 billion listing in May 2012 is likely to be pipped by Alibaba’s own, was designed to suck as much out of shareholders as possible. That proved a miscalculation. After floating, the company’s share price collapsed, and took over a year to recover.

When Alibaba does price its shares, it will be keen to show it is no Facebook. As for the date, though, bureaucracy probably plays more of a role than design. The New York Stock Exchange vets company filings closely, and Alibaba is only on its third round of amendments. Facebook and Groupon each had to amend and resubmit their paperwork eight times. So the magic digit may still turn up after all, just not where observers originally expected.

**YAHOO’S MAYER NEARS POST-ALIBABA RECKONING**

BY RICHARD BEALES

JULY 31, 2014

Yahoo is a big company with a much smaller one struggling to get out. A 22.5 percent stake in Alibaba accounts for well over half the U.S. internet group’s roughly $36 billion market capitalization, according to a new Breakingviews calculator. With the Chinese e-commerce giant likely to go public next month, Yahoo Chief Executive Marissa Mayer will find out how investors value the businesses she actually runs.

Alibaba is worth around $130 billion before any new money is raised, based on its latest published internal valuation. Assuming Yahoo eventually pays tax at 30 percent on its gain above the small original cost, the post-tax value of its stake is more than $20 billion. Yahoo’s other Asian holding, a 35.5 percent interest in Yahoo Japan, is worth a bit more than $6 billion after tax.
Within Yahoo’s enterprise value, after deducting net cash, of around $33 billion, that leaves the company’s own businesses worth a little over $6 billion. And two years into Mayer’s tenure, total revenue is still shrinking, second-quarter financials showed earlier this month.

Yahoo recently negotiated downward the maximum number of Alibaba shares it has to sell in the initial public offering. But offloading just over a quarter of its holding will still bring in more than $5 billion after tax, more than doubling Yahoo’s stash of cash and marketable securities.

Mayer has managed to get search-related revenue growing again, by 2 percent year on year in the second quarter using the standard accounting definition. She needs to maintain that, despite being locked into a stagnant partnership with software giant Microsoft, while also rescuing display ads, where the top line declined 8 percent. Acquisitions offer some hope of

**What’s left for Yahoo after Alibaba goes public?**
The Chinese e-commerce firm accounts for over half its value

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R. Beales, V. Flasseur 31/7/2014

* Approx. $36 on July 24-31
** $56 is internal valuation per Alibaba draft prospectus, July 11

Source: Breakingviews

*Click on the graphic to view online, interactive version.*
growth. For instance, buying internet upstart Tumblr for $1.1 billion last year injected social media credibility, though not obviously much revenue.

Mayer has sensibly promised to return at least half the post-tax Alibaba proceeds to shareholders. While rivals like Facebook splash cash on big, risky acquisitions, the Yahoo shambles Mayer inherited and has not yet fully fixed calls for some skepticism. Once Alibaba has its own U.S. listing and investors don’t need to buy Yahoo as a proxy, the value attributed to the search and display businesses will be easier to quantify. That will put Mayer under a narrower, brighter spotlight.

CHINA’S E-COMMERCE SECRET WEAPON: THE DELIVERY GUY
BY JOHN FOLEY
AUGUST 11, 2014

Want a Big Mac delivered to your door in minutes? Or a refrigerator by the end of the day? While U.S. retailers puzzle over how to make that happen, China’s e-commerce companies are already there. Servicing the country’s web-connected consumers at ever-faster speeds is driving some big businesses, not to mention stock market valuations. The secret weapon: the humble delivery guy.

Chinese e-commerce companies have taken two contrasting approaches to shipping. JD.com, the online marketplace that resembles Amazon, employs over 24,000 delivery workers, and is using the proceeds from a $1.8 billion initial public offering in May to take on more. Its closest rival Alibaba, likely to complete its own IPO in the next few months, doesn’t have its own logistics network, but depends on a huge “ecosystem” of other distribution companies. Alibaba is leading a consortium that plans to invest $16 billion in logistics.

In the West, companies like Amazon have struggled to bridge the “last mile” between warehouse and consumer at a low price. The ghost of dot-com failure Kozmo.com, which offered fast but uneconomical delivery of small items, hangs over them. By contrast, JD.com customers can place orders before 3 p.m. in some cities and receive their goods with no shipping charge by midnight the same day.
One reason is that while American e-commerce arrived when the country was already rich, China’s online shopping boom has come while the country is still relatively poor, with cheap labour. That makes the last mile easier to bridge. The median U.S. local delivery employee is paid around $29,000 a year, according to the Bureau of Labor Statistics. A busy Chinese courier can make around $8,000 a year. Yet the cost of goods often isn’t that different. The same pair of Nike Hyperdunk 2014 basketball shoes costs $118.44 on Amazon’s U.S. site and $150 on Alibaba’s Tmall marketplace. The U.S. shopper forks out $8.95 for shipping, while the Chinese buyer pays just $1.62.

Internet companies’ increasing investment into the last mile is causing upheaval in China’s express delivery industry, which has 9,000 licenced companies, and which Credit Suisse estimates employed 1 million people by the end of 2013. State-owned EMS is being challenged by local and private players now that 60 percent of express orders are generated by e-commerce.

A man rides an electric bicycle loaded with shoe boxes along a street in Beijing, May 16, 2014. REUTERS/Petar Kujundzic
That calls for a more sophisticated kind of courier. Companies like Sherpa’s, which delivers for restaurants in Beijing, Shanghai and Suzhou, have grown by upgrading the image of the ubiquitous bike guy. (Sherpa’s front-line employees, like those of most logistics companies, are overwhelmingly male.) Its 200 or so delivery workers must be tech-savvy, presentable and able to handle payment on the doorstep. Those are the same kind of staff that JD.com and peers are aiming for too.

Even for China, though, unfriendly demographics are in the post. The typical e-commerce delivery worker in big cities is male and between 20 and 30 years old. But that group could shrink 30 percent between 2010 and 2030 according to forecasts from the United Nations. Wages are growing faster for lower-income groups and economic migrants – in other words, those who deliver goods – than for the richer folk who buy them.

Productivity and scale will delay the effect. Even e-commerce companies that don’t run their own delivery have an interest in helping make courier companies more efficient. Alibaba offered weather and traffic monitoring for couriers working during its “Singles Day” online shopping festival in November last year. It makes sense: when millions of packages are late, it’s Alibaba whose reputation suffers.

Getting creative is another option. Shippers can shift delivery to local pick-up points, such as grocery stores, lockers and carts that park outside subway stops and office buildings. But the further the delivery gets from the front door, the more the advantage over traditional retail is eroded. Delivery by drone may happen one day, but not soon.

As efficiency gains fade, who bears the burden of rising delivery wages? That’s the big battle facing Chinese e-commerce. Once consumers are used to getting things for free, it will be hard to change their mindset. Sherpa’s charges clients 15 yuan ($2.40) for deliveries within 3 kilometres – and that price hasn’t changed in 15 years. If consumers won’t bear the rising costs, retailers will have to absorb them.

How this tug-of-war is resolved matters a lot for investors in a company like Alibaba, whose 46 percent net profit margin reflects the lack of its own
fulfilment infrastructure, and for shareholders in JD.com, which has incurred heavy losses by controlling its own delivery. Most likely, the two will converge. Alibaba investors may not love that result. But for the average online shopper – and the delivery guy – it’s a gift that will keep giving.

ALIBABA PAYMENTS CLEAN-UP MAKES FOR NEATER IPO
BY PETER THAL LARSEN
AUGUST 13, 2014

Alibaba just can’t stop tinkering with its corporate structure. Weeks before the Chinese e-commerce juggernaut is due to start a roadshow for an initial public offering, it has tidied up relations with its payments affiliate. Though the new arrangement is still messier than shareholders might want, it should make for a neater IPO.

Alibaba’s relationship with Alipay is complex and sensitive. The unit processes more than three-quarters of the transactions on the Chinese group’s websites, but has been owned by a private vehicle controlled by founder Jack Ma since 2011. That business, known as Small and Micro Financial Services Company (SMFSC), is also home to other ventures like its fast-growing money market funds. For customers, the units connect seamlessly. The corporate links are more complicated.

The latest reshuffle aims to draw a clearer line between the two entities. Alibaba will focus on e-commerce, while SMFSC will stick to finance. As part the deal, Alibaba is handing its affiliate a portfolio of loans to small- and medium-sized enterprises. The transfer helps to reduce the risk of meddling by Chinese financial regulators.

Under the old arrangement, Alibaba received 49.9 percent of Alipay’s pre-tax profit. The new deal entitles it to 37.5 percent of everything SMFSC brings in before tax. Alibaba thinks the claim on the earnings of a bigger business more than compensates for its reduced share. Its accountants calculate that the restructuring has boosted the company’s value by roughly 1.3 billion yuan ($211 million). However, it’s hard for outsiders to be sure because Alibaba does not tell them anything about SMFSC’s finances. Besides, Alibaba admits that if the new arrangement had been in place for the last fiscal year, its net income would have been slightly lower.
In the absence of more information, prospective Alibaba shareholders probably won’t attach much value to the relationship with SMFSC. However, the restructuring does provide them with some insurance against future embarrassment. If SMFSC turns out to be a financial behemoth and goes public, Alibaba will be entitled to 37.5 percent of the value of its equity – with no upper limit – or a 33 percent shareholding, regulators permitting. That knowledge should allow investors to spend less time worrying about Alibaba’s financial affiliate, and concentrate on its prospects in e-commerce.

**ALIBABA DEAL SPREE TURNS FROM ROMANCE TO THRILLER**

**BY JOHN FOLEY**

**AUGUST 15, 2014**

Alibaba’s investment story has turned from romance to thriller. Its Hong Kong movie-making affiliate has uncovered “possibly non-compliant” accounting just four months after the Chinese e-commerce giant bought a 60 percent stake. It’s not clear whether Alibaba’s controls were flawed – but it certainly raises questions about the value of the company’s recent investment binge.

The stake in ChinaVision, as the company was previously known, is just one of a string of recent deals. In total, Alibaba and its affiliates have spent $7.5 billion on acquisitions and investments this year, according to figures compiled by Reuters. While the company has made light of its deal-making processes in the past – founder Jack Ma supposedly agreed to buy a stake in a soccer team after a drinking session - the ChinaVision deal was approved by the board following due diligence by an outside accounting firm, according to people familiar with the situation.

Still, it’s a blow to the idea that Ma always deserves the benefit of the doubt. Like many of Alibaba’s investments, the logic of buying a film studio was fuzzy for a company whose main business is matching buyers and sellers of goods online. Alibaba did little to explain. That didn’t stop investors from rushing to ride on the company’s coat-tails. Before the shares were halted, the renamed Alibaba Pictures had a market capitalisation of HK$34 billion ($4.4 billion), more than triple the valuation implied by Alibaba’s investment.

The financial damage won’t be clear until Alibaba Pictures reveals the size of the write-downs. Its parent will no doubt have tough questions for former
chairman Dong Ping, who moved aside in June though remains a consultant and a 9 percent shareholder, and for Deloitte, the company’s long-time auditor.

The real casualty of the saga, however, is the notion that Alibaba’s investments automatically create value for its shareholders and those of its targets. Though substantial, its spending spree this year is small in the context of the group’s mammoth e-commerce business and its mooted $100 billion-plus valuation. But a glimpse of less-than-perfect judgement so close to the initial public offering is exactly the kind of plot twist Alibaba doesn’t need.

SIX STEPS TO ALIBABA’S TWELVE-FIGURE VALUATION
BY PETER THAL LARSEN
SEPTEMBER 1, 2014

How do you value a tech company? What about a dominant, fast-growing, profitable tech company with no peers that operates in an opaque economy? Fund managers need to decide as Alibaba kicks off the roadshow for its long-awaited initial public offering. Breakingviews offers a six-step guide to sizing up China’s biggest e-commerce group.

How fast can Chinese e-commerce grow?

Four in every five yuan spent on online shopping in the People’s Republic last year travelled across Alibaba’s websites. So the company’s growth depends on expanding the overall market. The omens are good. Less than half of China’s population had access to the internet last year; U.S. penetration is more than 80 percent. Alibaba signed up 24 million new active buyers in the three months to June, and the value of transactions was 45 percent higher than in the same period of 2013. Growth of 30 percent for the next two years is not a stretch.

How much revenue can Alibaba generate?

Alibaba’s business model is to capture a small slice of the value of the transactions it processes, either from advertising or commissions. In the year to March, this “monetisation rate” was 2.55 percent. But almost a
third of buying and selling in the most recent quarter took place via handheld devices, where the monetisation rate is half the level for desktop transactions. Over time, the gap should close with the figure for desktop transactions – currently about 3 percent.

*Can Alibaba stay super-profitable?*

Network effects are great for profitability. The more shoppers Alibaba attracts, the more merchants want to display their goods, luring more buyers. Meanwhile, the company’s asset-light model keeps overheads low. Alibaba’s operating margin in the year to March was an astonishing 47 percent.

But super-profitability invites competition. Alibaba may be forced to spend more on marketing and technology, or get directly into the business of storing and delivering goods. In the three months to June – the last set of financial data before the IPO – product development costs rose by almost 70 percent, while sales and marketing expenses nearly doubled. Alibaba’s operating margin fell to 43 percent – its lowest in almost two years. A still-high level of 40 percent may be a realistic forecast.

*How much should you pay for Alibaba’s earnings?*

Most tech stocks trade on high price-to-earnings ratios because investors believe future potential exceeds current profitability. Alibaba’s challenge is to grow while keeping its margins. Though stock market multiples are subjective, a market value of 30 times earnings for the year to March 2016 – the same as rival Tencent – seems a reasonable starting point.

*What about the other bits?*

Alibaba’s ambitions extend far beyond e-commerce. Its online finance affiliate, which includes payment division Alipay, is now challenging banks with small business loans and money-market funds. Though Alibaba has no ownership stake, it receives 37.5 percent of the unit’s pre-tax profit and has a right to the same proportion of its equity value in an eventual IPO.
Overseas expansion also has value. International sales accounted for less than a tenth of revenue in the most recent financial year. But a recent partnership with Singapore Post shows the company is seriously looking beyond China’s borders. In addition, Alibaba and its affiliates have spent around $7.5 billion on acquisitions and investments so far this year as the company pushes into in industries from media to mapping.

And the downside?

Alibaba’s exposure to its home country is one potential negative. The ruling Communist party could cut Alibaba down to size if it were deemed too powerful. Like other U.S.-listed Chinese companies, Alibaba is exposed to ongoing battles over accounting regulation and the semi-legal structures listed companies use to control their mainland operations.

Then there is corporate governance. Founder and chairman Jack Ma wants control of the company to remain with 27 executives, known as partners. Outside shareholders get little say. The likes of Google and Facebook also operate on the whims of their founders. But Ma has behaved unpredictably in the past, shifting the Alipay business from a listed unit to a private vehicle in 2011.

Putting it all together

Valuing future business lines is always tricky, as is putting a discount for shaky governance. The most elegant option is to assume the two cancel each other out.

Now suppose transactions grow by 30 percent annually for the next two years, and that Alibaba’s overall monetisation rate reaches 3 percent. Assume its operating margin stabilises at 40 percent, apply a historical 15 percent tax rate, and net income in the year to March 2016 would be about $5.25 billion. On a 30 times multiple, Alibaba’s equity would be worth $158 billion.

It’s not hard to get a higher figure: lift the annual growth rate to 40 percent and Alibaba’s operating margin to 45 percent, and its market value rises above $200 billion. Analysts will have their own assumptions. For investors the trick is to make sure six steps and twelve digits don’t turn into too great a leap.
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