‘Vipshop: As the Manipulation Continues, Pay Attention to these Numbers’

DISCLAIMER NOTICE

Mithra Forensic Research initiated coverage on Vipshop Holdings on May 12, 2015. Our quantitative models suggested large scale manipulation of various accounts and led us to issue a price target of $0.

In recent weeks, a number of investors have asked if, in light of recent performance at Vipshop, our view has changed. With this update, we say, unequivocally, our view has not changed.

In fact, recently reported results and company statements have only served to increase the number of red flags highlighted by our forensic models and our previous research.

Now that Vipshop has dazzled the market with its figures, allow us to add a few more impressive numbers for investors to consider: 92, 30, 800, 50, 2, and 5.

While the numbers may resemble the entries of a Powerball Lottery series, make no mistake that these figures suggest continued misfortune for investors who are long Vipshop.

Number 92: Ending balances for Property Plant & Equipment, Land and Deposits for Land reveal that at least $92M is missing or has been redirected

Sandwiched between its guidance on 4Q2015 and the announcement of its share repurchase program, VIPS' management slipped in that it had spent RMB837M ($128M) in Capex to secure land for future office space.

> "**Donghao Yang** - Chief Financial Officer Looking at our business outlook for the fourth quarter of 2015, we expect our total net revenue to be between RMB 12 billion and RMB 12.5 billion, representing an year-over-year growth rate of approximately 43% to 49%. In order to secure the necessary land for the future office space in the Pazhou Internet Innovation zone we at least have incurred a capital expenditure of RMB 837 million in the third quarter of 2015.
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> Lastly, the Board of Directors has approved a share repurchase program whereby we made purchase up to $300 million of our ADS over the next 24 month period. We expect to fund the repurchase from our existing cash balance including cash generated from operations.[1]"

Capex spend at VIPS has been a key concern of ours. In our initial report, we asserted that VIPS' Capex spend was excessive when analyzed from multiple perspectives: VIPS' own history, its closest competitors' histories and various operational metrics as revealed by the ratio of forecasted value of inventory at the warehouses to total square meters of warehouse space.

Mithra's chief concern was, and remains, that VIPS may be redirecting excess Capex spend to related parties who, in turn, use the funds to transact fake sales transactions with VIPS. We further suggested that VIPS was capitalizing operating expenses to accurately reflect increases in PPE and Land. Over the last six months we have monitored both Capex and the growth in PPE and Land for evidence of

[1] http://seekingalpha.com/article/3696006-vipshop-holdings-ltds-vips-ceo-eric-shen-on-q3-2015-results-earnings-call-transcript?part=single

mismatches between reported Capex spend and increases in tangible assets. Our analysis of this quarter's results revealed that 92M of the Capex spend for Land is missing or has been misclassified.

In Q32015, VIPS reported $507.1M total in Property, Plant &Equipment, Deposits for Land, and Land. The values for the individual components in the last two years were as follows:

	Q2 2015	Q3 2015	Delta
Property, Plant & Equipment	414.6	406.7	**(8.0)**
Deposits for Land	37.5	69.3	**31.8**
Land	27.3	31.2	**3.9**
Total	479.4	507.1	**27.7**

Source: Vipshop Holdings SEC Form 6K 11/20/15

In same period, VIPS reported that the sum of Land and Deposits for Land increased by a mere $35.7M. Therefore, the Land accounts are missing $92M ($128M - 35.7). CFO Yang clearly stated in the above quote that VIPS incurred capex expense for land in Q3. Where is it? Why are the Land totals short $92M.

We analyzed the quarter-over-quarter changes in other asset accounts and found that the only long term asset account that grew by more than $90M is the category "Other Long Term Assets". Typically this dumping-ground asset category is often used by companies to account for things such as Deferred Pension Costs, Idle Physical Plants and, sometimes, "Advances made to Directors or Shareholders not due within one year". If this is the account where the Capex for "Land" is reflected, then VIPS should provide more detailed disclosure urgently as this accounting treatment suggests that our view that these funds are being redirected to related parties may well be confirmed with this transaction.

Investors need to know if/where the Land Capex spend is recorded? Why it is not properly classified as land or a deposit for land. If it is being aggregated in "Other Long Term Assets", what is the business and accounting rationale for including it here? Have the funds potentially been given as Advances to Directors or Shareholders? What else is in included in the "Other Long Term Assets" account which now accounts for over 6% of total assets? Have other expenditures for Capex been redirected to this account?

Without further clarification, we are left to conclude that $92M has gone 'missing' or has been purposefully misclassified to obscure the real use of these proceeds.

Number 30: Quality of Earnings was negative in 2014 and still dismal at 0.30 year-to-date

We rely upon a number of forensic models and metrics to identify and assess companies that are potentially manipulating their financial statement. A key metric that we monitor is the trend in the Quality of Earnings ratio--Cash Flow from Operations divided by Net Income. Our analysis shows that VIPS scored poorly on Quality of Earnings for 3Q YTD and for FY2014 when CFFO is adjusted to remove benefit of extending payables.

Companies with good Quality of Earnings consistently report QoE ratios in excess of 1.0; the higher the ratio, the more robust we assess the financial statements. We calculated VIPS 3Q YTD Quality of Earnings ratio to be 0.30—a markedly low figure for QoE.

We also found that in absolute terms, VIPS generated only $49M in year-to-date CFFO compared to the more impressive reported figure of $194M for first three quarters in 2014.

Trends in CFFO and Net Income		
CFFO	**2014**	**2015**
1Q	84.1	79.6
2Q	29.6	(75.4)
3Q	80.8	45.0
1Q to 3Q Cumulative	**194.5**	**49.2**
Net Income	**2014**	**2015**
1Q	26.6	55.1
2Q	26.4	61.9
3Q	27.7	46.1
1Q to 3Q Cumulative	**80.7**	**163.1**
Ratio of CFFO to NI	**2014**	**2015**
1Q	3.2	1.4
2Q	1.1	(1.2)
3Q	2.9	1.0
1Q to 3Q Cumulative	**2.41**	**0.30**

However, VIPS reported CFFO figures for all of 2014 are actually artificially higher due to the company's policy of significantly delaying payments to its vendors. We detailed our concerns regarding the impact of the ballooning Accounts Payables and Accrued Expenses in an update on June 30, 2015. If VIPS had paid its vendors according to terms it disclosed to the market[2] and in-line with key competitors, it would have shown Adjusted FY2014 CFFO of -$88M versus, a reported $505M. VIPS' Quality of Earnings ratio using FY2014 Adjusted would have been a dismal -0.64. Hence, the company has had nearly two years of poor QoE.

In its most recent earnings call, VIPS stated that the poor cash generation is partly as a result of its policy of supporting its 'ecosystem' of vendors. We believe that the company's results as presented during the last 9 months of 2015 accurately reflects the company's performance when it pays its vendors on time.

Management further explained that it plans to resume cash generation in the final quarter[3].

> **Alan Hellawell** - Deutsche Bank
> Great. Thank you. First question, just I was noticing that DSOs have risen somewhat, payables have come up a tiny bit, but the overall cash conversion cycle has risen somewhat. Can you give us a sense – I know you mentioned a couple of initiatives, but what might be driving that, and what we should anticipate going to the end of the year and into next year?...Thank you.
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> **Eric Shen** - Chairman, Chief Executive Officer and Co-Founder
> Alan, thank you for your questions. Let me take your first question. So – well, it has always been the – this management's goal to help our suppliers to grow their business, and then as a result of that, we can – I think can have more products to sell, inventory to sell through us which will benefit our business eventually. So, we have been leveraging our large cash balance at Vipshops to first shorten the payment terms for our suppliers, and second to offer supplier financing to our suppliers. So, this is critical for a established retailer to build in healthy and fast growing ecosystem. And this quarter, our operating cash flow situation is much better than the previous quarter, and as I explained earlier to our investors that this -- we've changed our payment policy earlier this year, and the impact on our operating cash flow will be only temporary. Going forward in Q4, our operating cash flow even better going forward, the cash conversion cycle will return to its normal level.

2 BNP Paribas Research, "Vipshop Holdings: Compelling Growth Story", June 25, 2014.
3 http://seekingalpha.com/article/3696006-vipshop-holdings-ltds-vips-ceo-eric-shen-on-q3-2015-results-earnings-call-transcript?part=single

Our view is that the company will likely return to its policy of significantly delaying payments to achieve a more impressive CFFO.

Regardless of VIPS' financial maneuvering, the last 21 months have proven that VIPS' core business does not generate significant and sustainable CFFO which partly explains why the company has gone to the capital markets so frequently.

Number 800: Despite a lack of sustainable CFFO, VIPS claims that it will continue to invest about $800M in Capex and Share Repurchase over the next two years

What does a company with a poor record of generating sustainable cash flow do to prop up its shares? It announces huge expenditures, of course --$800M over 2 years.

Regarding Share Repurchase:

> "Lastly, the Board of Directors has approved a share repurchase program whereby we made purchase up to $300 million of our ADS over the next 24 month period. We expect to fund the repurchase from our existing cash balance including cash generated from operations.[4]"

As we highlighted above, the company struggles to generate sustainable CFFO without the aid of extending its payables. So despite CFO Yang's statement above, VIPS will be funding the share repurchase largely with existing cash balances.

In our original report, we raised concerns about the availability of the amounts reported as Held-to-Maturity investments. We cited the possibility that HTM were in fact amounts lent to related parties. If so, VIPS' reported Cash balance of $557M is not sufficient to support the planned expenditures for both the Share Repurchase and Capex.

Regarding Capital Expenditures:

> "**Henry Guo** - W.R. Hambrecht + Co./Summit Research
> Hey thanks for taking the question, so quick one, so, on the warehouse capacity, so what is the utilization rate, for now. From a management view, what is the best utilization rate coming into the Q4 this year? And also CapEx, do you guys have any visibility in terms of CapEx or second half of this year and next year? Thank you.
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> **Millicent Tu** - Director, Investor Relations
> Okay. So obviously as you are aware we are still building and adding more capacity, so we are not running at full utilization, but will you think it's with the current capacity we have not experienced any bottleneck for our business. And obviously July is the low season so there is still room to improve back that utilization rate.
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> **Donghao Yang** - Chief Financial Officer
> And there is very strong seasonality in our business as we, as thy mitigate power retailer in China and every year our Q4 is our peak season. So we're expecting the utilization rate of a warehouse to go up significantly as we are getting

[4] http://seekingalpha.com/article/3696006-vipshop-holdings-ltds-vips-ceo-eric-shen-on-q3-2015-results-earnings-call-transcript?part=single

to the fourth quarter of this year. And about the CapEx, we have told our investors that this year and most likely for the next couple of years, we're going to spend about $250 million every year on our warehouse expansion project.[5]"

Consider that:

- As of Q3 2015, VIPS has 1.6 million square meters of warehouse space; we highlighted how capacity at YE2014 was excessive in our initial report and continue to hold that view;
- On several recent earnings calls, VIPS management admitted that warehouses were still not near capacity;
- VIPS is obligated to pay nearly $170M in in non-cancellable leases through 2020;
- The company has recently moderated its growth rate for top line revenue.

The fact that there has been no change in the company's aggressive Capex budget despite the issues raised above, give us further confidence Capex is a means of funneling cash into the hands of related parties to support fake revenues.

Number 50: Vendor financing with an average daily balance $50M provides yet another lever for manipulating accounts and funneling cash in and out of VIPS

During the Q2 2015 earning call, VIPS announced the importance of its vendor financing program.

> **Thomas Chong** - Citigroup
> Hi, thanks management for taking my questions. I have one question regarding the supplier balance in business, can you comment about the scale of this business in the second quarter and also a fairly – this business is upon the double business? Thanks.
> **Donghao Yang** - Chief Financial Officer
> Oh sorry, okay let me take that question. Although we started our supply chain financing business in September 2013 so it's a little less than three years. As of the end of the second quarter of this year, 2015 the daily balance of our factoring business was about RMB350 million. So it's growing very fast, it's still not a profitable business at the current scale, but we believe over the long run, number one our factoring business will support our suppliers to do more business with us and number two, the factoring business itself will become a profitable business.

VIPS claims that by providing vendor financing it is providing necessary assistance to its 'ecosystem' of vendors.

While there are a number of internet companies in China that provide factoring for their vendors, the practice raises some serious concerns from both an operational and governance perspective.

Some of the operational and financial concerns would include:

- Does VIPS have the knowledge/ resources to manage such a program?
- What is the maximum amount of receivables purchased in any given period and for any given vendor?
- What percent of vendors need financing because VIPS is delaying payment to these very vendors?

[5] http://seekingalpha.com/article/3428776-vipshops-vips-ceo-eric-ya-shen-on-q2-2015-results-earnings-call-transcript?part=single

- What impact does the factoring program have on VIPS' on cash flows?
- Why is the program still not profitable after having been in operation for over 2 years?
- When should we see the program becoming profitable?

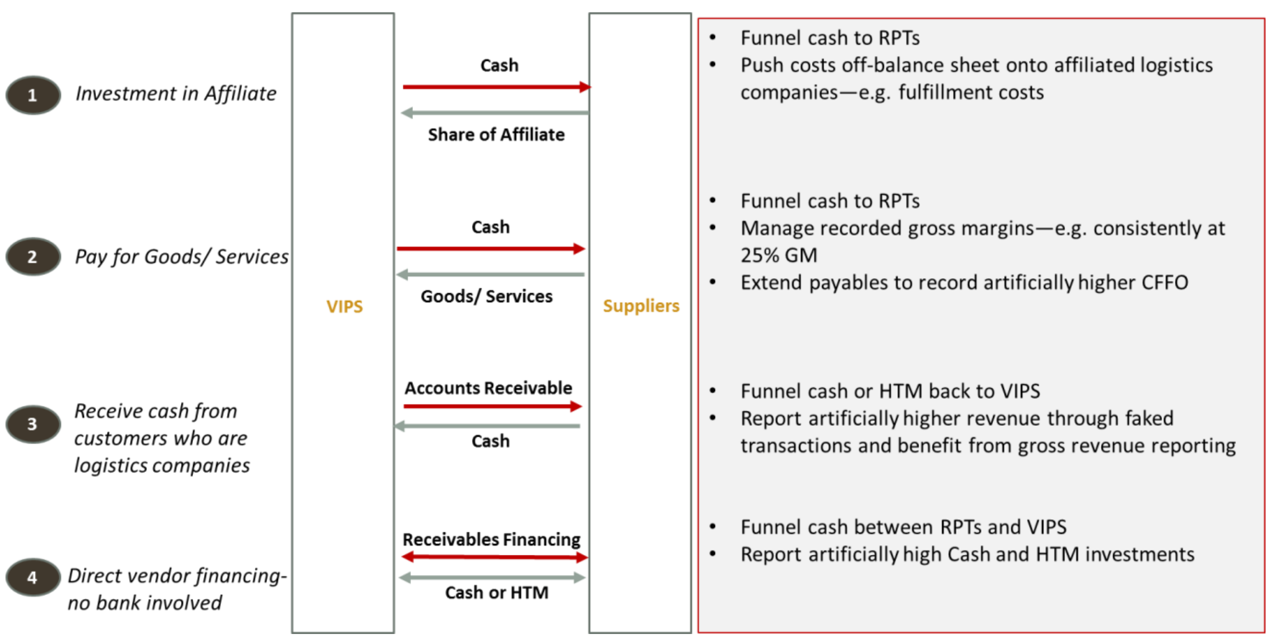
However, the governance issues are far more disconcerting. The vendor financing program is yet another opportunity for VIPS to establish reasons for multiple flows of cash between VIPS and its related parties.

VIPS has, over the last several years, taken minority investment stakes in a large number of logistics and product (e.g. Ovation) vendors. With the establishment of a vendor financing program, VIPS has established yet another cash spigot.

As we have stated multiple times before, our key concern is that the use of multiple related parties allows VIPS to report improvements in multiple financial accounts.

Typically, flows of funds between a company and its vendors flow in only one direction; the company pays its vendors as outlined in transaction #2 below. However, based upon its own disclosures, VIPS has established multiple touchpoints with a large number of its vendors.

Multiple transactions with affiliated vendors allows for potential large scale manipulation of multiple accounts



At VIPS we have at least 4 types of transactions that happen between the listed-company and a large number of its vendors. Besides serving as vendors, many of these companies are also investee companies of VIPS. Several of the logistics companies, it could be argued, are also VIPS customers. As we show in item 3 above, VIPS depends on logistics providers to collect cash payments from some end users. The logistics companies then pass the cash on to VIPS. In fact, VIPS Accounts Receivable disclosures for 2014 reveal that the debtors are not the retail customers, but actually the logistics companies.

The proliferation in the number of related and affiliated parties, combined with the multiple flows of funds between VIPS S and its vendors should raise serious concerns for investors. If VIPS wanted to engage in large scale manipulation, which our quantitative models suggest, it could use each of the above arrangements to impact its reported results to achieve:

- Impressive rate of revenue growth over the last 3 years;
- Consistently improving GM;
- Impressive growth in Operating Profit margin;
- High levels of HTM investments.

Number 2: VIPS' revised guidance on Q3 results 2 days before release date, was followed by a series of questionable excuses for the delay

While VIPS has cited the dreaded El Nino earnings monster for its miss, a number of sell side analysts have dismissed this excuse in favor of the more palatable 'loss of market share argument'. Most are probably thankful for the opportunity to dial down their ridiculously optimistic fore casts which, in a few cases, had been issued less than two months ago. Regardless of the excuse for the miss, we think the greater concern is unbelievable excuses management gave for the delay in the announcement.

> **Eric Shen** - Chairman, Chief Executive Officer and Co-Founder
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> "Well, thank you, Wendy, for your question. Your first question about our preannouncement, I believe. Well, as a publically traded company, we at Vipshop is required legally to disclose any material information to the public as soon – immediately. So, the reason it took so long for us to make this preannouncement was because of the few things.
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> One, it took some time for the auditor to complete their review process before we make this announcement. And secondly, we missed our guidance, you said by 6%, its midpoint, it's actual to midpoint of our guidance but it's less than 5%, if you compare our actual number against the low end of our guidance, so – which usually viewed as not material. So it took for management sometime to consider whether or not we should do it.
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> We finally decided to make the preannouncement, because this was the first time ever we missed our guidance during the past tough quarters and it might have a pretty significant impact on the margin. So, going forward, Vipshop will continue to be fully compliant with all legal and regulatory requirements and follow the highest standard of information disclosure.[6]"

Firstly, as their own financials clearly state, these are unaudited financial statements so why VIPS needed to wait for Deloitte's review of their numbers is unclear.

Secondly, with the quarter closing at the end of September, required 6 weeks to determine that it had materially missed its guidance. As VIPS eventually surmised, the company had never missed guidance

[6] http://seekingalpha.com/article/3696006-vipshop-holdings-ltds-vips-ceo-eric-shen-on-q3-2015-results-earnings-call-transcript?part=single

before so the debate over whether 4% or 6% was material was a moot point. We find it especially galling that VIPS and Deloitte needed nearly 6 weeks to determine that there was a material guidance miss when only 1 week after Singles' Day, on the Q3 call, Eric Shen was able to tout VIPS' achievement:

> "On the famous Singles' Day, November 11, we achieved a GMV three times that over last year's Single Day. New active customer for this event also tripled year-over-year. This gave us strong boost to our platform and helped us improve the new customer growth momentum.[7]"

A mere 7 days after Singles' Day, VIPS trumpets its blockbuster sales, but somehow needs 6 weeks to determine if a guidance miss merits an announcement to the market. Seems a bit convenient that good news can be dispensed so quickly and bad news is delayed to the last minute. The timing raises suspicion that VIPS wanted to offer some equally good news (inclusion in the MSCI Emerging Markets Index, Share Repurchase) with the very bad.

Number 5: Our estimated $5M cost of an investigation pales in comparison to the $7 billion Cost of Confidence

When we initiated covered in mid-May, Vipshop's market capitalization approximated $16.2 billion. Over the course of the last several months, the company's market capitalization has made a steady but decidedly consistent march downward. As of today, the VIPS' market cap stands at $9.8 billion—a loss of value of nearly $7 billion. In recent weeks, the loss had been even greater. See chart 1.

Source: CNBC.com

The chart highlights that:

- VIPS missed out on the rally in Chinese shares that occurred in June 2015;
- VIPS had already suffered material loss in its share price prior to the October 2015 selloff;

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[7] http://seekingalpha.com/article/3696006-vipshop-holdings-ltds-vips-ceo-eric-shen-on-q3-2015-results-earnings-call-transcript?part=single

- Despite several confirmations or even upgrades by sell-side analysts in the period May to late October, VIPS was not able to achieve any sustained uplift in its shares from.
- VIPS briefly achieved uplift in its shares in late October, possibly due to media coverage indicating that Chinese technology ADRs would be included in MSCI Index[8].

We believe that much the loss in value at VIPS is due to questions about its accounting and disclosure policies or, as one analyst on the Q3 noted, a 'crisis of confidence'.

We would have expected that in order to address these questions and lingering investor concerns, VIPS would have commenced a truly independent and transparent forensic investigation into the issues that we highlighted in our initial report. It has not. Clearly VIPS' strategy of speaking directly to institutional investors in one-on-one meetings and issuing terse press releases repeating their disclosures has not worked.

We must ask therefore, why has VIPS not tried to regain investor confidence, and consequently share value, by announcing a robust investigation into the issues raised in our reports. Our estimate is that a thorough forensic investigation conducted by truly independent legal and accounting experts would likely not exceed $5 million. An expenditure of $5M to recoup billons in lost market value seems a far better return on investment than the huge sums that have been announced for Capex and Share Repurchase.

Current and potential investors should be asking themselves why the VIPS Christmas shopping list fails to include the most cost effective and most relevant of expenditures.

[8] http://www.barrons.com/articles/shifts-in-msci-index-offer-possible-profits-in-chinese-stocks-1414819074