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Headline: Alibaba's China base in both good and bad news E-COMMERCE GIANT'S US LISTING...

Alibaba's China base is both good and bad news

E-COMMERCE GIANT'S US LISTING PROSPECTUS SHOWS THERE ARE BIG RISKS FOR INVESTORS

BLOOMBERG
HONG KONG

IT'S EASY to get caught up in the glossy numbers within Alibaba Group Holding's IPO prospectus: 44-per-cent profit margins, 72-per-cent revenue growth, and 231 million active buyers last year.

Beyond page 19 of the document, though, lies a stark reminder that investing in a Chinese company, especially one as sprawling as Alibaba, is also a wager on how well it can get along with Beijing. The company may raise as much as $20 billion (Bt653.4 billion) in its initial public offering later this year, 100 times more than the average Chinese IPO in the US

Alibaba owes some thanks to government policies that have enabled its ascent, and a successful US listing will highlight Alibaba's value to China. At the same time, the government could alter Alibaba's contract with US shareholders, censor its platforms and restrict the payment service that is vital to its business, any of which could impact its value to investors.

"As an investor, you are placing a bet on management's ability to negotiate what is happening on every day of the week," said Duncan Clark, chairman of BDA China, a Beijing-based consultant to technology companies. "The management is going to be the shock absorber that navigates the big risks."

China support

China has a stake in the success of Alibaba and its peers. More than 10 million people are employed in the nation's e-commerce sector, a survey by the Ministry of Human Resources and Social Security, posted on Alibaba's blog, shows.

While it is common for companies to outline the worst-case scenarios in IPO filings, some of the risks Alibaba raises are already affecting Chinese companies traded in the US

Chinese affiliates of the largest US accounting firms have been barred from leading audits of US-listed companies. The ban came after they refused to hand the Securities and Exchange Commission documents relating to Chinese operations because doing so is prohibited under Chinese law.

JACK MA

While Alibaba's auditor, the Hong Kong affiliate of Price-waterhouseCoopers, isn't subject to the ban because it's not based in mainland China, it could still be affected. If PwC can't properly inspect Alibaba's mainland-China operations, the company will need to find a new auditor or, in the worst case, pull the IPO, according to the prospectus.

"At best, it is uncertain; at worst, you have a real downside with the SEC ban," said Brian Fox, the Nashville-based president of Confirmation.com, a maker of technology used by accounting firms to find fraud. "If they can't have one of the top accounting firms, that would reduce the enthusiasm to some extent and increase the risk, which would equate to the stock price eventually."

PwC's work also isn't fully inspected by the independent Public Company Accounting Oversight Board, an agency created by Congress to oversee audits, due to restrictions from the Chinese government, the filing shows.

"The Chinese government won't let outside regulators review the underlying work files to ascertain if the work was done according to standards," Fox said. "We've seen more fraud coming out of China as a result."

Meanwhile, Alibaba's payments affiliate, called Alipay, faces tightening government oversight and anything that limits transactions on Alibaba's platforms could impact growth. The business had been planning to offer virtual credit cards until China's central bank blocked their issue in March.

Alibaba says its position as a "trusted platform" depends on Alipay, which processes more than three-quarters of all transactions on Alibaba's Chinese online marketplaces. In 2010, Alibaba transferred ownership of Alipay to a company controlled by company founder Jack Ma, a move that it said was necessary because of Chinese restrictions on foreign ownership.

"Alipay is so central to payment and it is why Jack decided to put it back into domestic shareholding, to insulate it effectively", BDA China's Clark said, referring to Ma. "A lot hangs on Alipay."

Like many Chinese companies, Alibaba will rely on a legal structure known as a variable interest entity, or VIE, required by the Chinese government for certain industries. The VIE gives overseas investors exposure to gains and losses through contracts rather than direct ownership.

While Alibaba gets most of its revenue from wholly foreign-owned enterprises, it could be impacted if China revokes its VIE license, the filing shows.

"Investors should be aware that you are not really owning the business as most people would think in the States," said Eric Jackson, president of Ironfire Capital, a hedge fund with offices in the US, China and Canada.

"You are owning a piece of the entity far removed from the business, so there is always the risk that the Chinese government could wake up tomorrow morning and nullify those structures."

In many investors' minds, the chance for returns in Chinese e-commerce, outweighs the risks, according to JMP Group's Carter Mack.

"There are unique risks with Alibaba's exposure to China," said Mack, president and co-founder the San Francisco-based investment bank. "Those are probably unavoidable for China-based companies, so investors have to take that as part of what they are buying into."