

Long and Short the China Dream

Micro to Macro

JCAP

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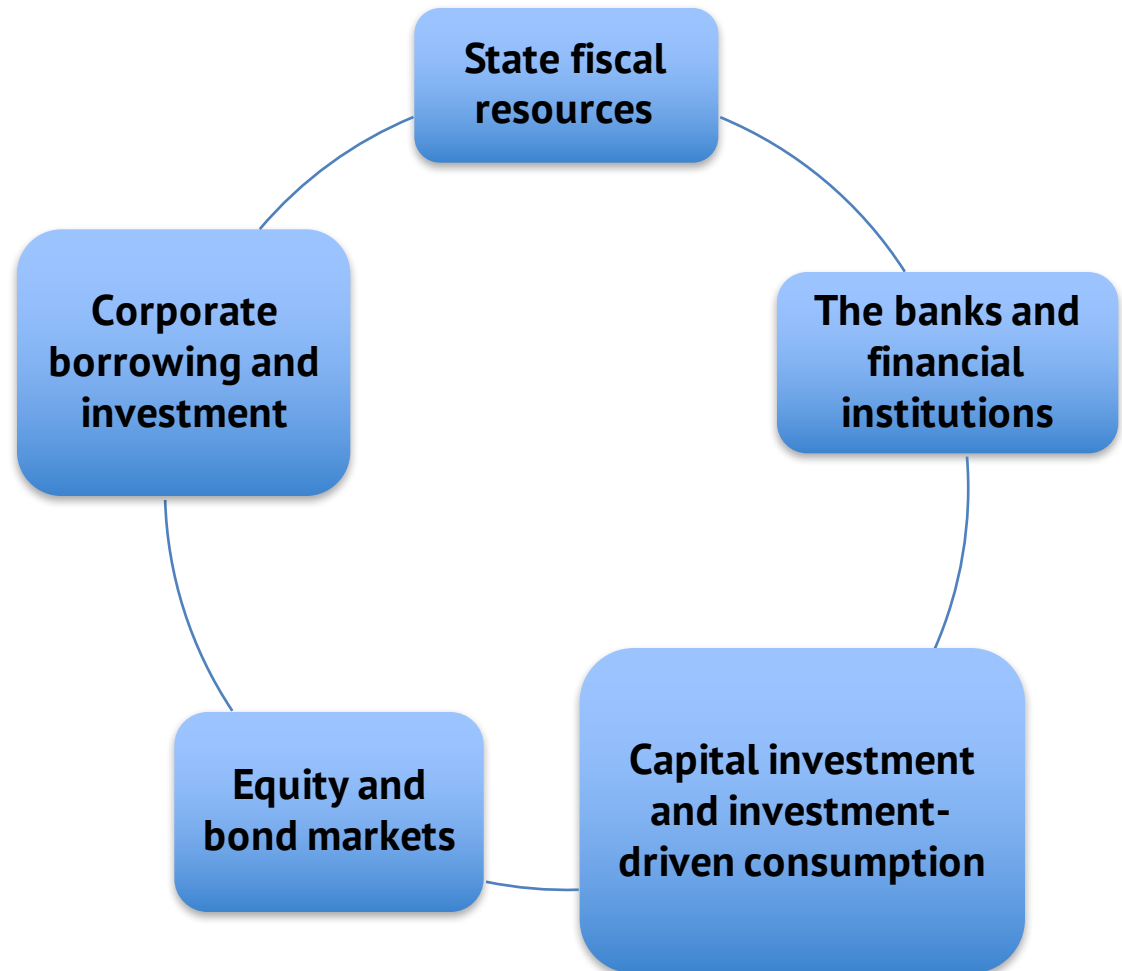
China has been a Silicon Valley ca. December 1999—since 2006.

- ▶ China's excess of capital leads to focus on volume growth over profitability.
- ▶ Continuing fragmentation from regulatory and financial sources.
- ▶ Executives are rewarded for raising capital and use that in turn to create their own growth.
- ▶ Cash is power: important to hold a lot of it
- ▶ But cash also makes companies a target for the government.

Neither source of large capital flows, State or foreign, offers any real return.

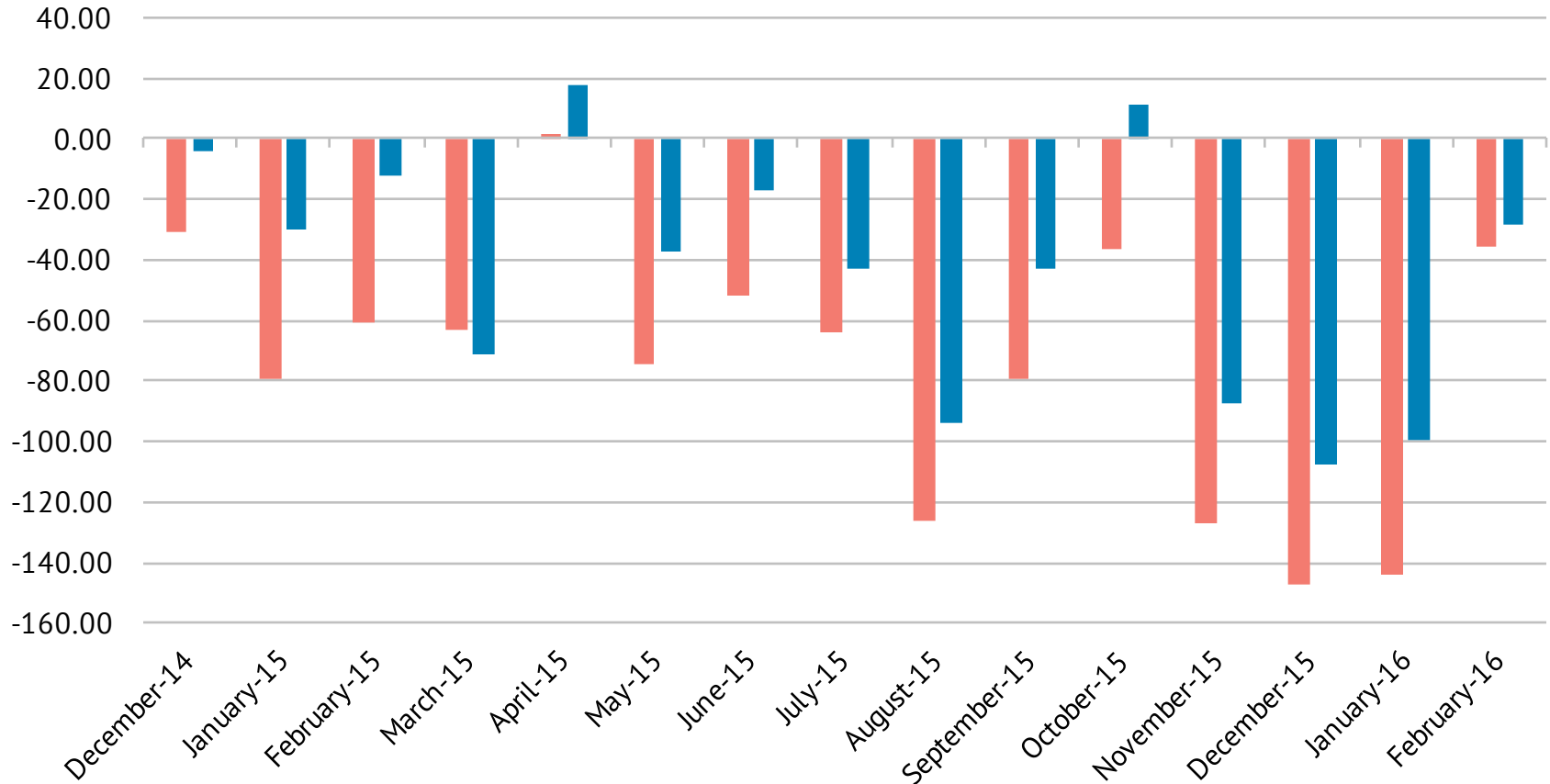
- State fiscal resources are ported to the banks and re-invested in State companies, which use the capital to generate top-line growth.
- The growth story prompts foreign investors to bet more heavily on the 1 billion shirttails story.

China's virtuous circle of capital



The currency is the ultimate corrective.

Reported Capital Flight (bln USD)



Source: PBOC, Customs, MOC, SAFE, J Capital

Poster children

BABA short

- ▶ Current price: USD 75.86
- ▶ Target price: USD 36.58
- ▶ Market cap: USD 188.83 bln
- ▶ P/E: 18.43x
- ▶ Av volume: 8.83 mln shares

Tingyi (0322 HK) long

- ▶ Current price: HKD 7.77
- ▶ Target Price: about HKD 15
- ▶ Market cap: HKD 43.65 bln
- ▶ P/E: 16x
- ▶ Av volume: 15.85 mln shares

Four reasons to short Alibaba



- ▶ As an ecommerce platform, it's maxed out
- ▶ A terrible investor of shareholders' money.
- ▶ Likely using investor capital to generate its own revenues.
- ▶ The Chinese e-commerce story is exceedingly unlikely.

Maxed out?

Av take rate by category (as % of merchant turnover)
based on J Cap interviews

	Fashion	Consumer Electronics	Food
BABA	30%	15%	10%
JD	25%	13%	10%
VIPS	25%	13%	N/A

Source: J Capital

- ▶ Ebay, whose model is the same as BABA's, reports 10.5%.
- ▶ Baba's calculated rate is 3% despite its monopoly status. This is probably a function of overstated GMV.

Components of misleading GMV

- ▶ Uncompleted and returned orders
- ▶ Balance transfers
- ▶ Fulfillment cost
- ▶ Free-of-charge wholesale transactions
- ▶ “Craig’s List”-style listings of industrial goods etc. closed outside the platform but that count in GMV.
- ▶ Reciprocal purchases to acquire volume, credit card points, or to move product through tax-efficient localities
- ▶ Brushing or totally faked orders

Dubious assets

- ▶ Alibaba has accumulated USD 25.8 bln in goodwill, intangibles, and investment in associates (at end 2015 exchange rate).
- ▶ The acquisitions have virtually no accretive value.
- ▶ Our research on companies like Wasu Media, Citic21, Koubei etc. suggests that friends and family are probably being paid more than the companies are worth.
- ▶ Many of the acquisitions—Haier assets, Evergrande's soccer team, Suning, Intime—look either like loans or like seeding own revenue.

A little help for BABA's friends?

BABA's Dubious Assets

(RMB mln)	FY 2012	FY 2013	FY 2014	FY 2015	As of Dec. 31, 2015
Investment in equity investees	1,642	1,555	17,666	33,877	79,235
Intangible assets	355	334	1,906	6,575	5,980
Goodwill	11,436	11,294	11,793	41,933	81,645
Total	13,433	13,183	31,365	82,385	166,860

Source: Company reports.

The company carried \$25,870 bln in such assets as of December 31.

Whom is the company being run for?

- ▶ Share-based compensation is about 16% of revenue and 35% of profit.
- ▶ Even as revenue rose 45% in FY2015, income from operations declined by 7% “due primarily to a significant increase in share-based compensation expense.”

Alibaba is the most profitable of all e-commerce companies. So why does it need so much capital?

Cumulative cash flows from operating versus financial activities 2012-2015

(in mln USD except for BABA)

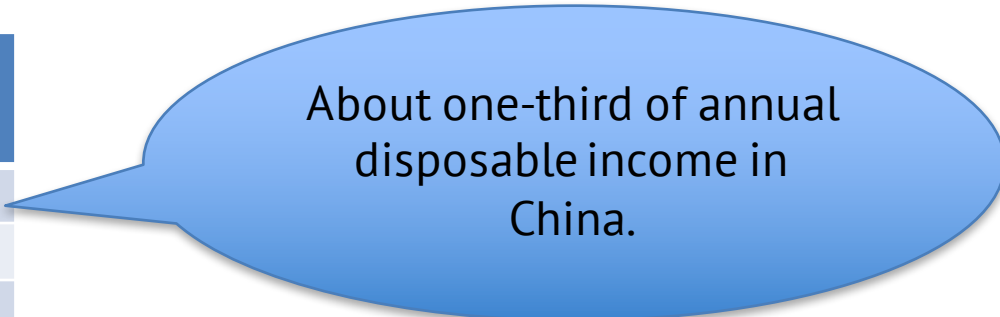
Alibaba (mln RMB)		FB	
Operating	91,347	Operating	19,890
Financing	95,930	Financing	8,769
Amazon		NFLX	
Operating	28,417	Operating	-613.54
Financing	2,389	Financing	2663.84
eBay		GOOG	
Operating	18,543	Operating	72,219
Financing	-4,979	Financing	-260

Source: Company reports

And it's just really unlikely

Average annual spend per active user 2014	
Alibaba	\$1,075
JD.com	\$502
eBay	\$597
Zulily	\$246
Amazon	\$330
VIPS	\$159

Source: Company reports



About one-third of annual disposable income in China.

- Using 2013 numbers, the Chinese retail industry was measured at USD 3.71 trn. The US retail was about USD 4.5 trn that year. Therefore, Chinese retail was reportedly 83% of U.S. retail. But the U.S. economy is 40% larger than China's, and US consumption is more than double Chinese as a proportion of GDP.
- Alibaba continues to accelerate as the rest of the economy declines. Category sales on Alibaba are greater than all such category sales recorded by the NBS.

When to short Alibaba: Watch the capital flows



- ▶ BABA has already issued equity and two tranches of debt. It also borrows from its merchants.
- ▶ For BABA, incoming capital makes it possible to create GMV and revenue. The group will try to IPO Ant Financial and eventually China Smart Logistics. BABA may also issue new equity and debt. If it cannot get these fundraises out, the coast will be clear to short.
- ▶ It seems significant that no Chinese banks are involved in the IPOs, bonds, and credit facilities.

Long: Tingyi



- ▶ Tingyi is the largest maker of instant noodles and beverages in China, with annual sales of ~USD 10Bn
- ▶ Tingyi is a play on instant noodles
 - Noodles comprised ~97% of Tingyi's earnings in 2015
 - Tingyi's beverages business comprises ~60% of sales, but a small fraction of earnings due to the listco's 47% ownership of the beverage business and lower OP margins in beverages
- ▶ Tingyi has a long runway for growth in noodles in China
 - Noodle consumption per capita in China is half that of Taiwan and HK
- ▶ There is an upgrade path to bowl noodles from packet noodles
 - In Taiwan, cup and bowl noodles make up 47% of the noodles market. In China, this figure is a scant 17% of the market. Cup and bowl noodles cost 3-4x the price of packet noodles
- ▶ Tingyi dominates the bowl noodles market in China
 - Tingyi's market share in bowl noodles is especially strong at 67% of the market, vs. its overall market share in noodles of 44%

Tingyi enjoys economies of scale

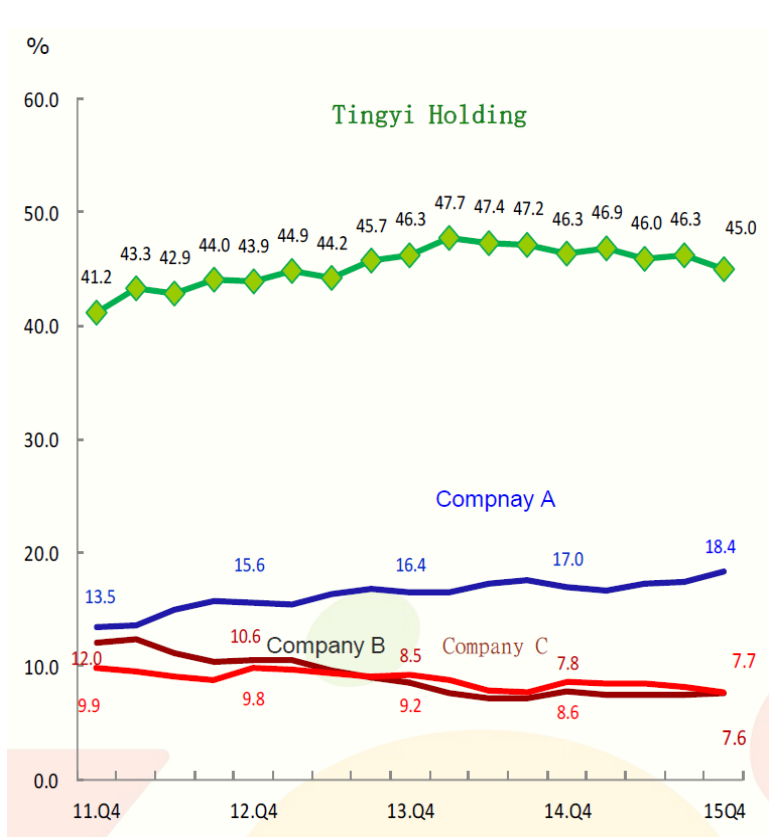


- ▶ Tingyi and Uni-President China (UPC) both began operations in the 90s, UPC has traditionally emphasized product development while Tingyi has focused on scale and aggressive pricing.
- ▶ In mass-market food and beverage, brand awareness and access to consumers are key advantages
- ▶ Today, Tingyi is undeniably the market leader in the instant noodles category in China, with noodle sales 3-4x that of UPC

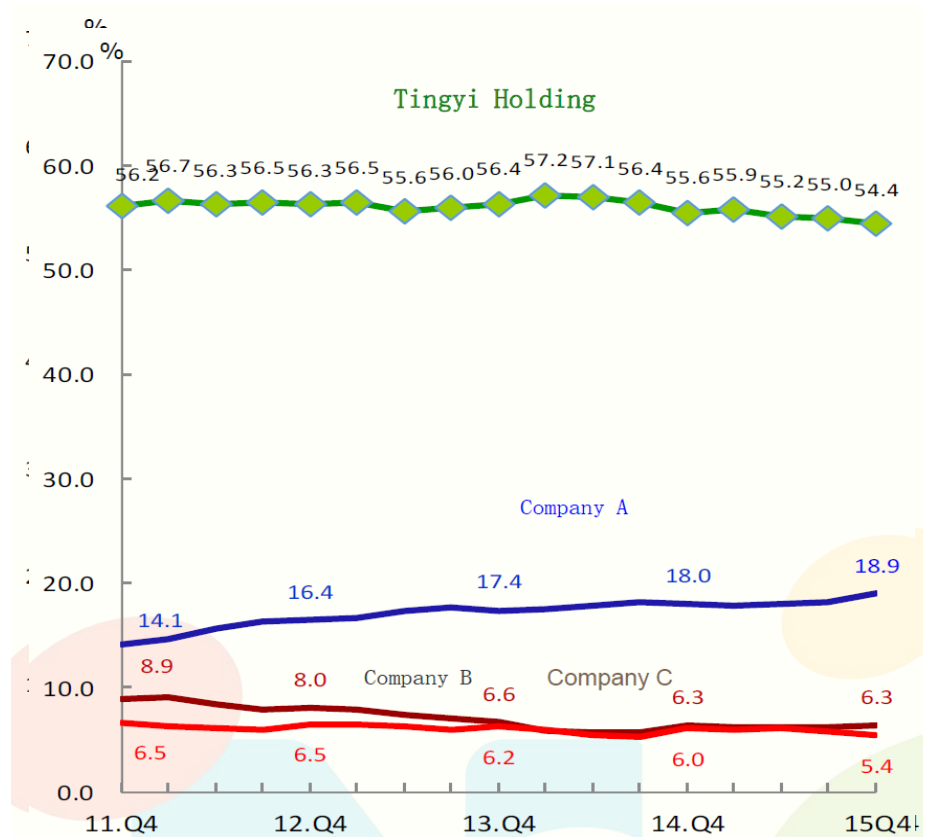
Tingyi enjoys economies of scale



Tingyi Noodle Market Share by Volume



Tingyi Noodle Market Share by Value



Tingyi and UPC have been locked in a battle for share



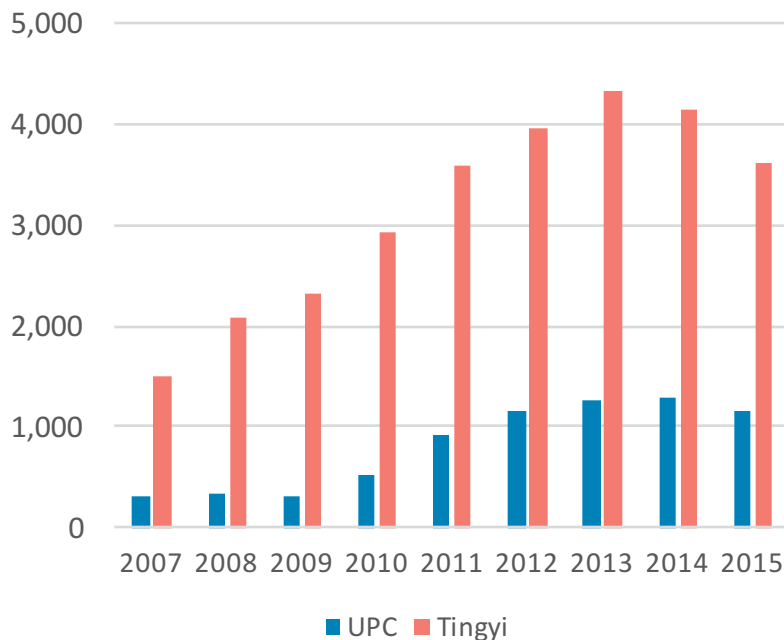
- ▶ Tingyi's main competitor, UPC, has proven more innovative than Tingyi in developing “hero” products
- ▶ However, Tingyi mimics hit flavors that UPC develops, and then rolls them out with greater scale, marketing budget, and at a very competitive price point
- ▶ Tingyi and UPC have both spent heavily on promotions like free sausage, two-for-one deals on drinks, etc.

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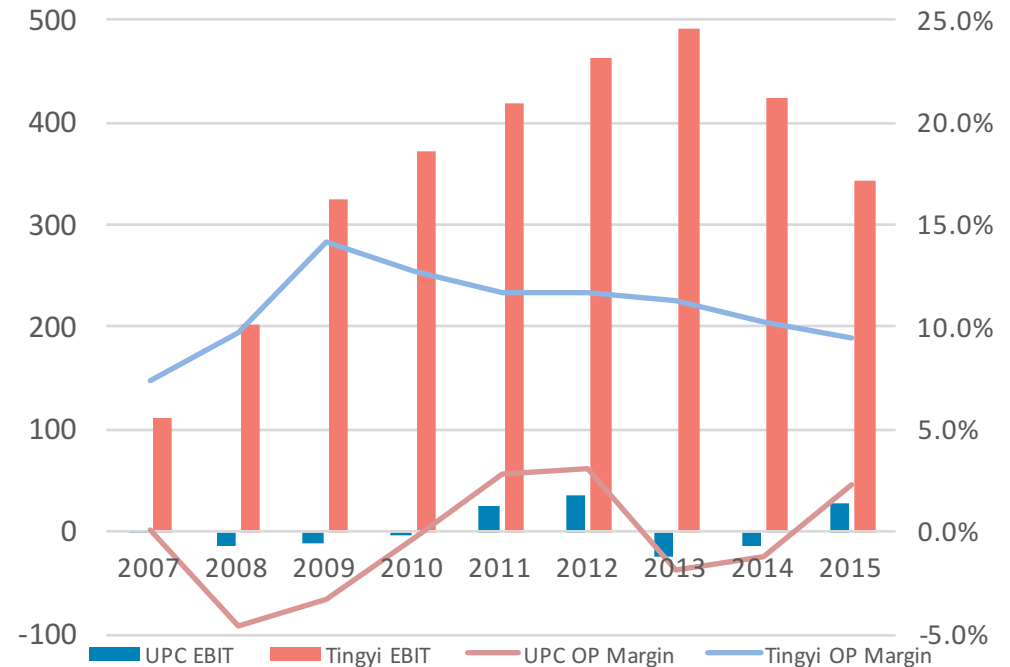


- ▶ Throughout this battle, Tingyi has consistently retained the lion's share of industry profit
- ▶ With low profits, UPC funded its expansion using debt

UPC vs Tingyi: Noodle Sales (USD)



UPC vs Tingyi: Noodle Operating Profit (USD)





Competition is thinning

- ▶ Strapped for cash, UPC issued a rights offering in June 2014 to repay some of its short-term bank borrowings
 - HKD 3.3Bn was raised at a price of HKD 4.56 per share, diluting shareholders by ~17%

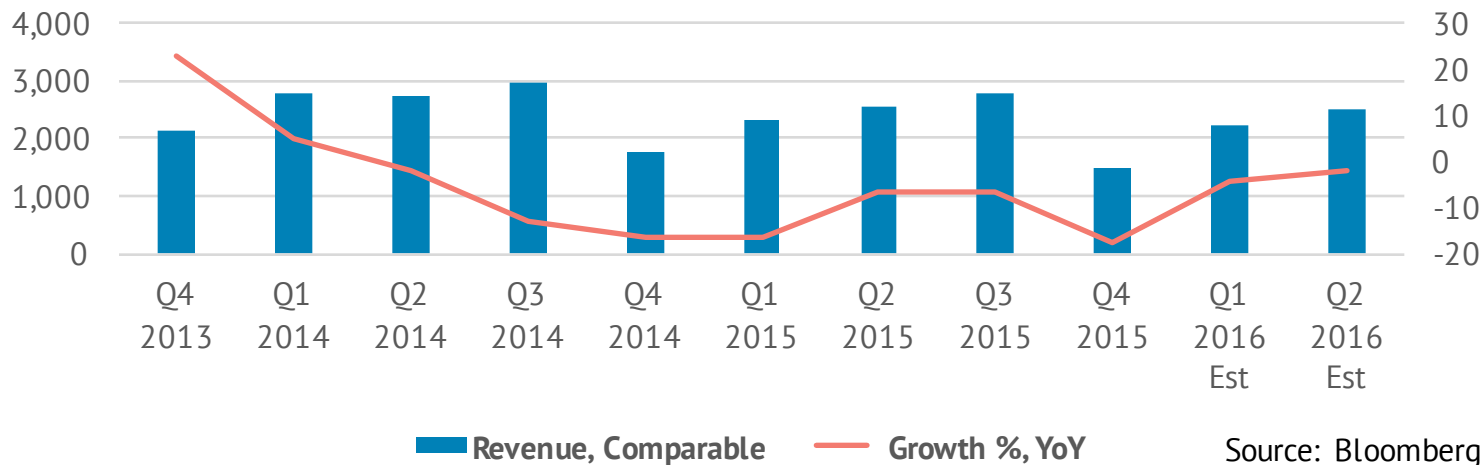


- ▶ Post equity raise, UPC is seeking to transform its noodles strategy, increasingly focusing on niche categories where it competes less directly with Tingyi
- ▶ Less direct competition should result in better profits for both competitors

Anticipating easing competition, Tingyi implemented a mistimed product upgrade in Q4 2015



Tingyi Revenue by Quarter YoY



- Tingyi's price hike turned out to be premature, as Tingyi's main competitor, UPC, has not followed suit
- Tingyi profit dived last quarter, as distributors have been cautious to re-stock on Tingyi's upgraded products
- Investors worry Tingyi is losing share in the noodles segment

The long term story for Tingyi remains intact



- ▶ Tingyi enjoys scale advantages over its closest competitor, UPC
 - Tingyi is over 3x the scale of UPC, providing 3x the marketing budget of its closest competitor, and a lower cost basis for distribution
 - Tingyi will continue to accumulate the lions share of profits in the noodles business, year after year
- ▶ Tingyi's distribution network is highly coveted by international brands seeking access to the China consumer
 - Tingyi's TAB subsidiary (Tingyi's beverage sub) is now Pepsi's exclusive franchise bottler and distributor in China for Pepsi's carbonated soft drinks and Gatorade brands
 - Pepsi and Tingyi are also co-branding their juice drink brands using the Tropicana brand name under License from Pepsi
 - Starbucks partnered with Tingyi in 2015, where Tingyi will manufacture and distribute Starbucks' RTD products

A shift is on the horizon



- ▶ UPC is expected to push new noodles products and hike prices by Q2 2016, concentrating on niche markets where it will have less direct competition with Tingyi
- ▶ Current channel inventory for Tingyi remains light, as distributors have been reticent to stock up on higher priced inventory

Icing on the Cake – Beverage Recovery?

- ▶ Tingyi's primary earnings driver is the noodle business, but Tingyi is likely under-earning on beverages
- ▶ In 2008, Tingyi's OP margins were ~13%
 - By 2015, beverage EBIT margins compressed to 2.8%
- ▶ Over the past 2 years, Tingyi has been digesting the Pepsi acquisition
 - Termination benefits of USD 43Mn were expensed in 2015, and another 31Mn is expected to be expensed in 2016. For context, EBIT was ~USD 150Mn for the segment in 2015; termination expenses were meaningful for the year
 - If OP margins return to their historical norm of ~10% (in line with many global mass market beverage peers), Tingyi's beverage earnings would increase by a factor of 3-4x
- ▶ We believe Tingyi's integration of Pepsi is nearing completion, and increased profitability in beverages should begin to materialize by EOY 2016

And finally, the biggest short of all: the Renminbi

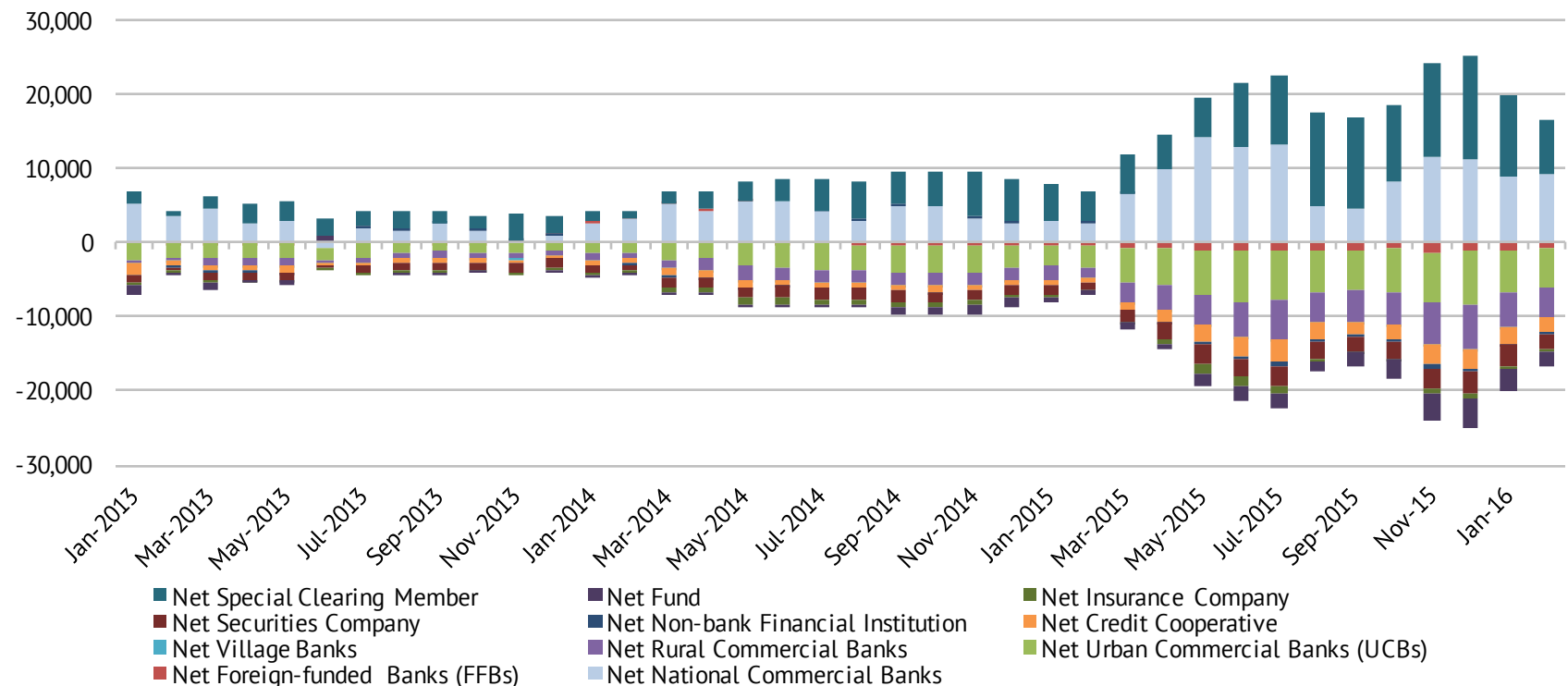
- ▶ China, with help from the Fed, has persuaded markets that it has achieved a soft landing. Shorts in the currency have been smoked, and equities in cyclical industries like mining and construction equipment are rallying.
- ▶ Don't fall for it. Nothing has changed except for the degree of desperation at the political level. Investors are being played.

Managing the unholy trinity: exchange rates, capital flight, and interest rates

- ▶ China has had a long run of expanding its domestic money supply with an appreciating rate due to incoming flows of capital from the U.S. quantitative easing program.
- ▶ In 2014, the stream of capital began to reverse.

Without constant injections of cash, the financial system would not be able to transact.

Net Injections to the Financial System by Type of Institution

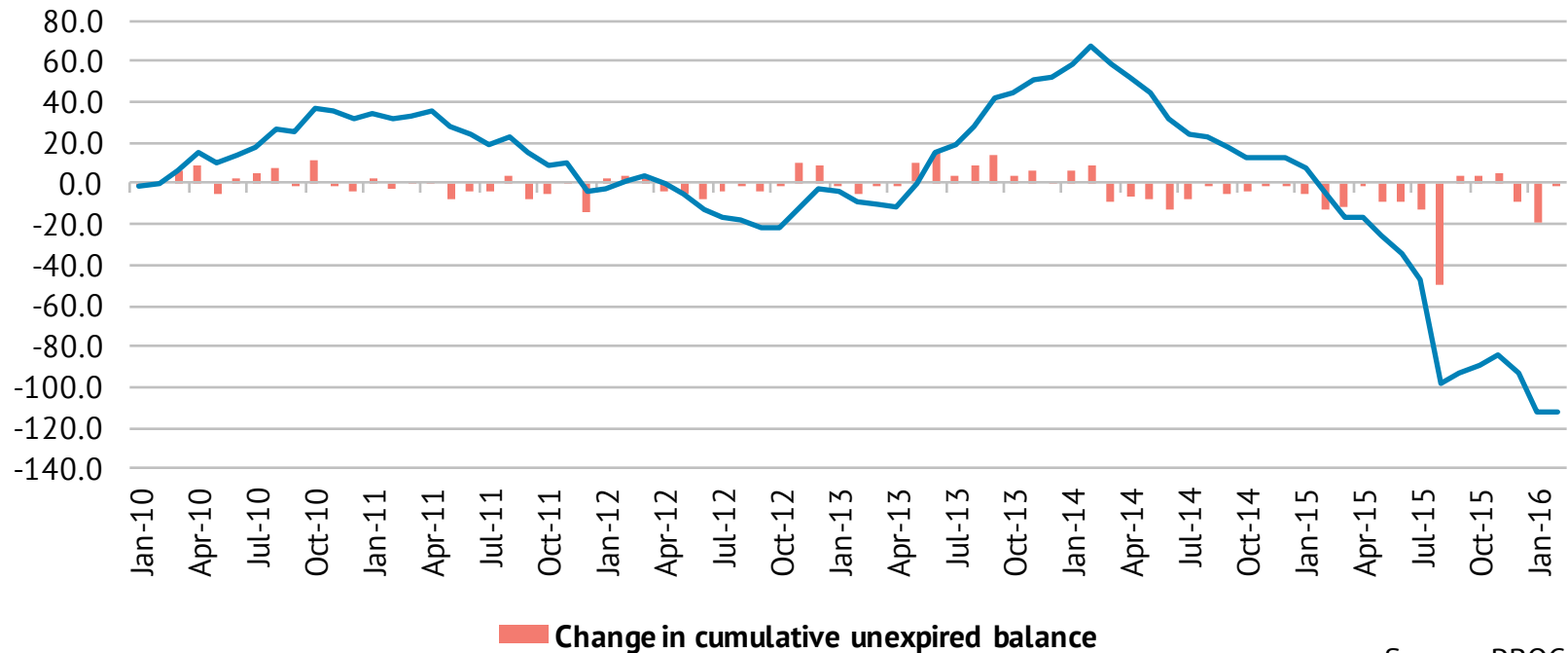


Source: PBOC, J Capital

Liquidity needs are on the order to RMB 70 trn per year:

The PBOC is using forwards and other techniques to hide outflows.

The volume of swaps, forwards, and options now totals USD 4.4 tln since October. Deposits against those swaps could be as high as USD 800 bln. Some of that money may be obscuring the decline in Forex reserves.



Source: PBOC

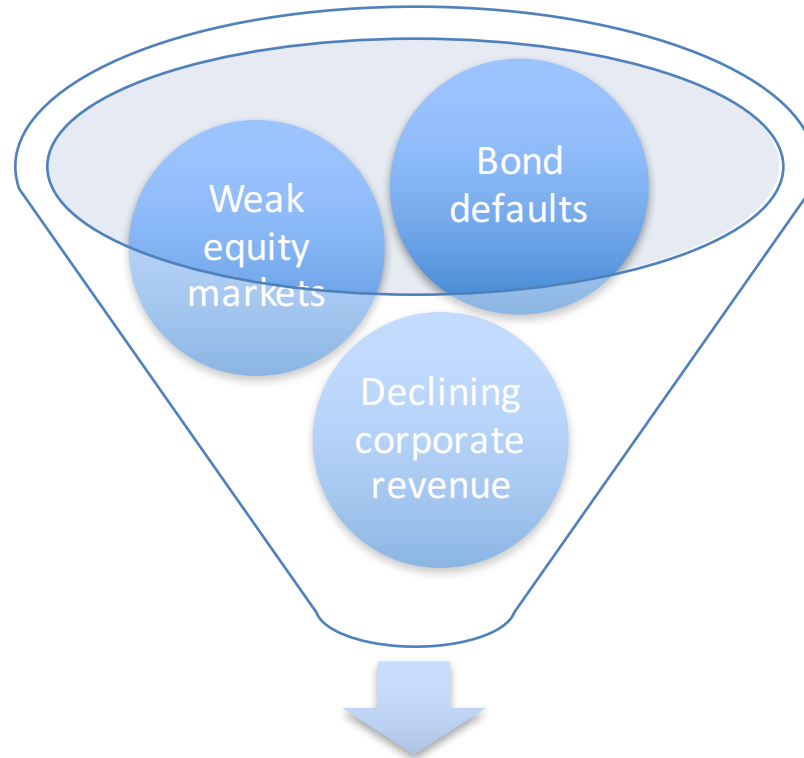
In all, China probably has around 9 months before the reserves are run down to a perilous point.

China's Forex Reserve Composition: Estimates

Asset	Currency	Approx value counted in reserves, (in bln USD)
U.S. Treasuries	USD	1,237.9
Euro bonds	EUR	600
Japanese government bonds	JPY	79.17
Korean government bonds	KW	13
CIC (and its subsidiary funds, including Central Huijin and China Jianyin)	USD	267
China Development Bank	USD	320
Eximbank	USD	350
European Financial Stability Facility bonds	EUR	50
National Social Security Fund	HKD	20
TOTAL		2,937.07

Government agencies, press reports, J Capital

Emerging markets will not be the only victims of Chinese depreciation.



As went luxury, so will go the loved consumer names of yesteryear.

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