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VIPSHOP: WE ARE NOT BUYING THE FINANCIAL STATMENTS

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VIPSHOP: WE ARE NOT BUYING YOUR FINANCIAL STATEMENTSR

China's leading discount ecommerce retailer has been flagged as possible manipulator by reliable forensic accounting quant models. Our qualitative analysis of the company's financials also reveals possible improper GAAP accounting and financial anomalies that suggest that the quant models are indeed correct. In our opinion, VIPS may have grown its 2014 Gross Profit by $573M by possibly diverting funds to related parties to be used to transact fake sales.

SUMMARY

Mithra Forensic Research is initiating coverage on Vipshop Holdings Limited (VIPS) with a Strong Sell / Sell Short recommendation.

- VIPS is China's leading discount electronic retailer. The company offers branded, out-of-season goods, at deeply discounted prices, to consumers residing primarily in Tier 2 and Tier 3 cities.

- Since its IPO in March 2012, the company has reported 16 straight quarters of staggering and uninterrupted growth in Revenues, Gross Profit and Gross Margin. Operating expenses, as a percent of sales, have been in steady decline.

- VIPS' share price has enjoyed a spectacular ride, appreciating 115% in the last twelve months. The company's market capitalization now stands at around $16.2 billion, a far cry from the paltry $268 million value at IPO.

- Vipshop's results are astonishing for good reason. Our quantitative screen and our assessment of VIPS' financial statements revealed anomalies that suggest VIPS may be manipulating its financial statements.

- One of the most reliable quantitative models used in the detection of potential financial statement manipulation indicates that VIPS has a higher risk rating than that of Longtop Financial or China MediaExpress in the year before those Chinese frauds were uncovered.

- Chief among VIPS' potential GAAP violations is the fact that the company reports revenue on a 'gross' basis, despite the fact that even the company's CFO admits that the vast majority of the company's sales are under a consignment arrangement.

- Inventory account values at VIPS show potential evidence of the company improperly accounting for consignment goods—counting inventory held-on-consignment as its own. VIPS' inventory figures seem to contradict statements by management about its accounting policies. The benefit to VIPs is higher reported Ending Inventory and lower reported Costs of Sales for each of the last 3 years. In 2014 alone, the artificially lower Costs of Sales results in an uplift of $151M in reported Gross Profit

- Research into the year-over-year change in Gross Profit from 2013 to 2014 reveals that VIPS announced 4 key initiatives that required significant and immediate cash outflows. The value of these inflated cash outflows combined with the uplift in Gross Profit from Inventory commingling, account for 98% of the delta in Gross Profit.

- If VIPS were able to divert funds from the overspend initiatives we suspect, it potentially Grossed Up receipts from Related Parties (RPTs) to report even higher Sales and Costs-of-Sales figures.

- We believe VIPS grossly overpaid for Lefeng and Ovation. Prior to acquisition, Lefeng and Ovation had negative equity and reported significant annual losses.

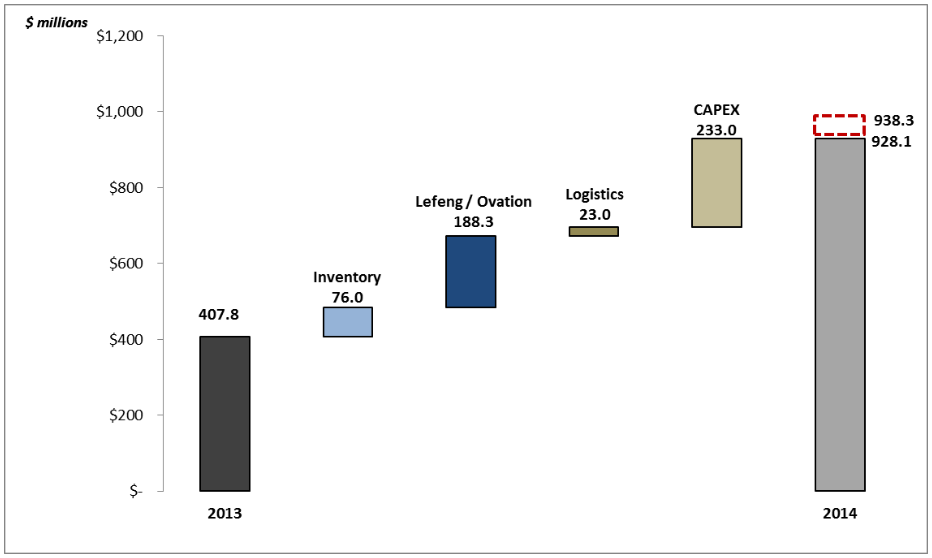
- At the time of acquisition, the company seems to have led the market to believe that revenue at Lefeng had been around $150M in 2013, when in fact, financial statements indicate that VIPS had less than $65.1M in revenues in 2014. As such, Lefeng was purchased at price of at least 2.7x Sales at a time when VIPS itself was trading at 2.37x Sales.

- VIPS has directed over $300M into an accelerated CAPEX program. Although VIPS had indicated to the market that it would spend $200M in total over 3 years, in 3Q2014, VIPS announced that it urgently needed warehouse capacity and was going to spend aggressively on CAPEX before the end of 2014.

- However a review of VIPS statements and its operational metrics indicate that at current levels, VIPS has more warehouse capacity than its Chinese e-commerce competitors. In fact, on one metric, VIPS has more warehouse space than even Amazon.com—a company with sales 23.5x that of VIPS.

- VIPS invested nearly $23M in a number of logistics companies; however, VIPS has provided little to no disclosure on those companies. It even labels one such investment as ‘a PRC logistics’ company.

- We believe that by employing these various accounting manipulations, VIPS has been able to artificially inflate its Gross Profit, and consequently, its Revenue and Costs of Sales figures. See figure below.



- We also have grave concerns about the reported balances in the Held-to-Maturity investments which account for in excess of 20% of total assets. The interest earned on these investments suggests that the return is lower than what could be earned on loans and even term bank deposits of similar maturity.

- Moreover, VIPS previously reported that HTM was comprised of a total of 5 securities. We find it an odd coincidence that VIPS has 5 founders and 5 HTM securities. We suspect that HTM is in fact an accounting for undisclosed loans to related parties. Loans that, if HTM balances are to be believed, amount to $607M.

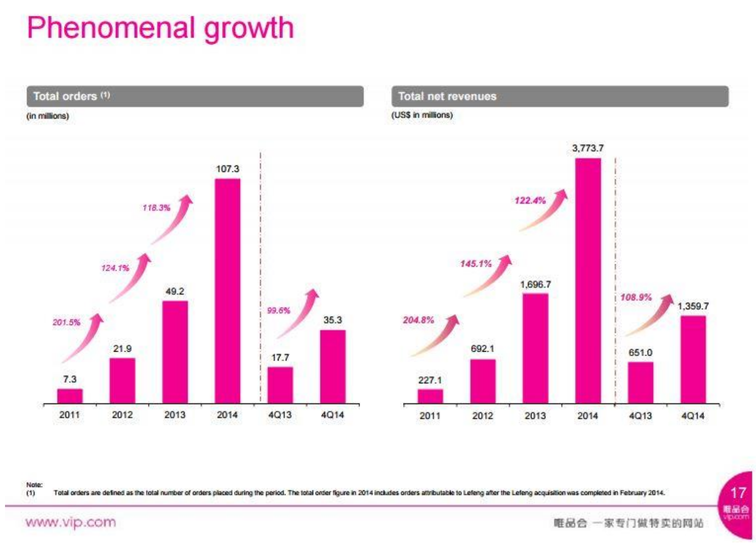
- VIPS' Cash Flow from Operations is driven not by earnings, but by significant growth in both Accounts Payables and Accrued Expenses as a result of not paying its bills. VIPS' management claims that it receives cash from customers within 2 days and pays suppliers in 30 to 45 days. Yet, our calculation of VIPS' Days Payable Outstanding indicates that the company pays its suppliers, employees and other vendors, on average after 120+ days. VIPS is clearly delaying payments in order to disguise what we believe to be a lack of cash on hand.

- Vipshop's Board and its audit firm present corporate governance challenges; there are numerous conflicts of interests which place minority shareholders of Vipshop at a clear disadvantage:
  - The Independent Directors are closely associated/ aligned with two of VIPS' historically large and prominent shareholders, VC investors, DCM and Sequoia Capital.
  - Auditors, Deloitte Touche, served as advisor to each of the 3 corporate entities on the Lefeng and Ovation acquisitions; this is the same Deloitte Touche that failed to identify frauds at Longtop Financial and China MediaExpress.
  - Given the Board and the Auditor's potential lack of independence and multiple conflicts of interest, we have serious concerns as to whether the Ovation and Lefeng deals were, in fact, 'arms-length' transactions and negotiated as such.
- In our view, if VIPS has indeed relied upon the financial manipulations that we identified, VIPS significantly inflated its earnings and revenue projections. Our view is that if VIPS were forced to report on a Net Revenue basis, it would have reported $938M in revenues in 2014, the figure it currently reports as Gross Profit. Subtracting out the $573M which we suspect was diverted to related parties and booked as artificial revenues, VIPS would have reported only $365M ($938 - $573) in sales for 2014. <u>Hence, our view is that VIPS is actually achieving revenues of around $365M, not $3.8billion. Consequently, if the market maintained a Price-to Sales ratio at the current 4.26x level for VIPS, the company should actually trade at a price of $2.70, for total market capitalization of $1.5 billion</u>.
- Given our multiple concerns, on May 11, 2015, we sent this report and a letter summarizing our findings to VIPS' management, Board, and Auditors. Furthermore, we requested that VIPS' authorize the commencement of an independent investigation into its accounting practices.
- As our concerns include questions about management, Board and Auditor independence, we asked that the Board allow any such investigation to be led by a firm chosen by a group of VIPS' other large institutional holders (e.g. T. Rowe Price, Tiger Global, Lone Pine Capital).
- The potential issues we have identified, if true, are clearly in the public interest and pose a threat to a large number of minority investors. We therefore, also submitted copies of our report to the SEC and NYSE.

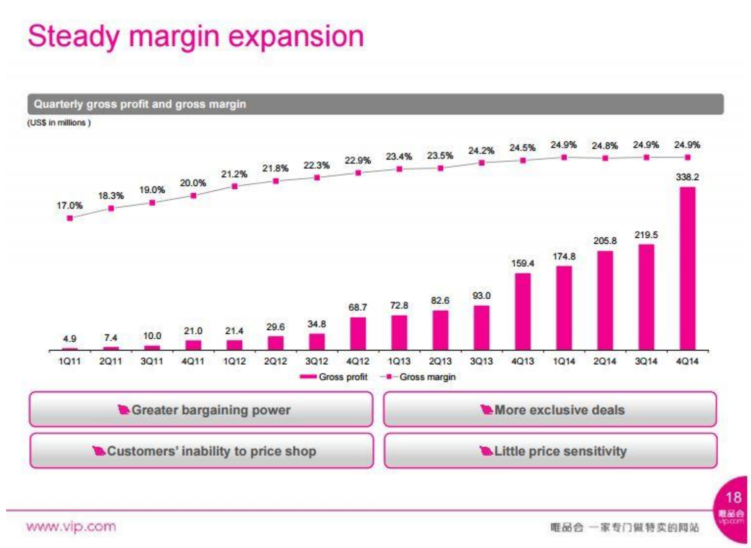
1. VIPS HAS RECORDED CONSISTENTLY IMPRESSIVE RESULTS SINCE ITS IPO

Since listing on the NYSE in 2012, Vipshop Holdings Limited has been a stellar equity performer, posting astounding revenue and gross profit growth year after year.

As the two slides below highlight,[1] over the period 2011 to 2014, Vipshop experienced growth in revenues and orders of **1,562%** and **1,370%** respectively.



Vipshop has had 16 consecutive quarters of uninterrupted growth in revenue, gross profit and gross margin.[2]



1 Vipshop Holdings Limited, Investor Presentation, February 2015
2 Vipshop Holdings Limited, Investor Presentation, February 2015

Equity markets have rewarded the company with equally impressive growth in the price of its shares. Share appreciation year-to-date (May 8, 2015) stands at 45%, whereas the S&P500 grew only 2.4% in the same period. Vipshop's market capitalization is around $16.2 billion[3], having IPO'd at a mere $268 million.[4]

Vipshop's consistent outperformance has garnered many fans among equity analysts and investors. The majority of sell-side analysts covering VIPS maintain very a bullish outlook for the company. In fact, of the 25 sell-side analysts covering the stock, 21 have 'Strong Buy' ratings, 2 have 'Outperform' ratings and 2 have 'Hold' ratings on the stock .A recent contributor to Seeking Alpha summed up the market's general attitude towards VIPS when he authored a piece titled 'Vipshop: Even after a 2,660% Rise, There is Still Potential'.[5] Another analyst at BNP Paribas, under the headline, 'When will this phenomenal growth story end?' suggested that 'there is still potential to outperform'. He also pointed out that 'the strong financial performance seemed to surprise even the company itself...'[6]

After an analysis of information in the public domain, Mithra Forensic Research believes that Vipshop management was probably not surprised by its success; in fact, our view is that the quantitative models that are warning of large scale manipulation are likely correct. In the last fiscal year, VIPS has made a series of large and unplanned cash expenditures. The rationale provided by management for these expenditures are not supported by financial statements, management projections or management comments in various forums. We assessed the amount of overspend that VIPS made in 2014 and find it suspicious that the amount of overspend closely approximates the amount of VIPS growth in Gross Profit.

3 http://data.cnbc.com/quotes/vips
4 http://www.forbes.com/sites/techonomy/2012/03/28/china-ipo-winter-continues-as-vipshop-flops/
5 http://seekingalpha.com/article/2238673-vipshop-even-after-a-2660-percent-rise-theres-still-potential
6 http://www.bnppresearch.com/?E=dccegkbfjga

VIPS' financial statements also seem to reflect multiple violations of US GAAP accounting guidance, resulting in grossly overstated revenues, assets and profits.

Over the last several years, multiple Chinese listed-companies have been involved in 'pump and dump' or 'prop and tunnel' schemes. Central to the success of many of these Chinese frauds has been the use of abusive Related Party Transactions (RPTs). Interestingly, in 2014, VIPS increased the number of disclosed RPTs and the amount of trading associated with these RPTs. We have serious concerns that VIPS' may be funneling the cash overspend to these RPTs who subsequently return the cash or receivables to VIPS in the form of fake sales revenue.

If our estimates are correct, 98% of the $538M increase in Gross Profit in the last year can be attributed to a handful of significant overspends. In this report we identify the various levers VIPS may have used to achieve its reported results.

We also have grave concerns about one of the largest and fastest growing asset accounts, Held-to-Maturity investments. Based upon our analysis, VIPS is earning less interest on these securities than it would by keeping the cash on deposit in a local bank. Again, a number of recent Chinese frauds have featured asset misappropriations that were later found to have been conducted using inflated cash and investment account.

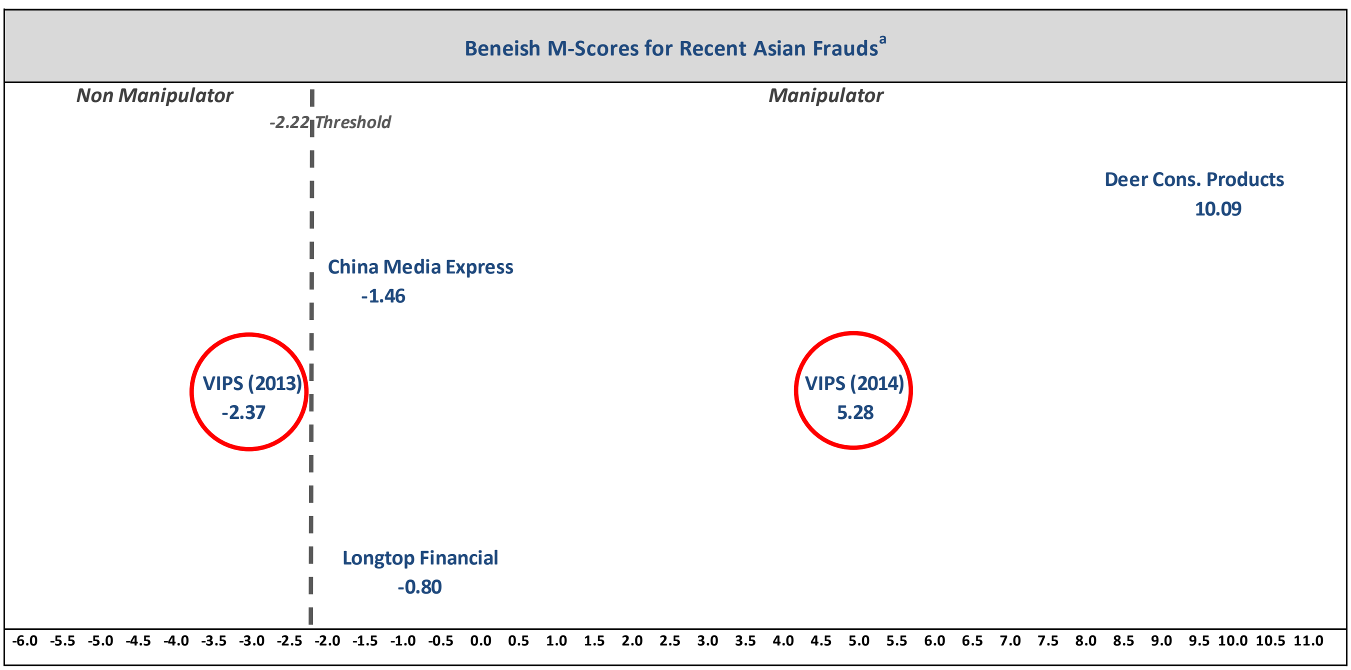
Our research and VIPS' financials raise multiple red flags. Each of these issues requires greater disclosure and more specific commentary for us to dismiss the quantitative models which currently suggest that VIPS is potentially engaging in inflating various financial statement accounts.

2. A RELIABLE FRAUD INDICATOR WARNS THAT VIPS IS A POTENTIAL MANIPULATOR

A number of the quantitative models used by Mithra Forensic Research flagged VIPS as a potential financial statement manipulator.

We rely upon both quantitative and qualitative research to identify potential short candidates. We began our research by evaluating VIPS' reported financial results against a number of proprietary and academic quantitative models. These models use reported financial data as inputs to predict possible financial statement anomalies. One model we monitor is the Beneish M-score which has been a trusted forensic screen in identifying potential frauds. The M-score successfully identified 15 of the 20 largest frauds in US history[7].

But the model's success is not limited to US companies. The Beneish[8] model has been tested over multiple periods and in various market environments and jurisdictions. The model successfully identifies financial statement manipulation and fraud 76% of the time. The M-score incorrectly identifies a company as a manipulator about 17% of the time. An M-score greater than -2.22 is indicative of financial manipulation or fraud. The greater the M-score, the greater the likelihood a company is engaging in some form of financial statement chicanery. We computed VIPS' M-score for the years 2012/2013 and 2013/2014.



SEC filings for each company; Longtop for 2007-2011, China Media Express for 2008-2010, Deer Cons. Products for 2009-2011, and VIPS for 2012-2014

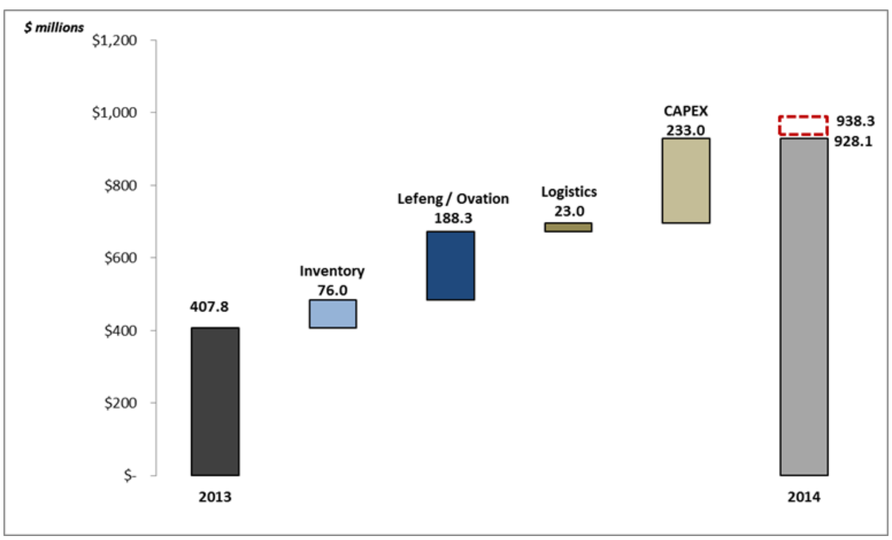
7 http://www3.nd.edu/~carecob/Workshops/07-08%20Workshops/BeneishPaper.pdf

8 Mehood Beneish, "The Detection of Earnings Manipulation," Financial Analyst's Journal, September/October 1999: 24-36.

In 2013, VIPS' M-score of -2.37 placed it on the cusp of being labeled a manipulator. However, VIPS' 2014 M-score indicates that the firm is highly likely to be engaging in financial manipulation. In fact, VIPS' M-score for 2014 exceeds M-scores for two recent high-profile Asian frauds, Longtop Financial and China MediaExpress. Indicators within the M-score model point to specific accounts that should be investigated for evidence of manipulation. For VIPS, indices on Sales growth, Receivables growth, Asset Quality and Expense Capitalization were flagged. Using the M-score as a guide, we investigate a number of accounts for possible evidence of manipulation in 2014. Our research suggests that there are strong indications that VIPS potentially:

- relied upon incorrectly applying Gross Revenue Basis reporting in order inflate its Revenues and increase its equity valuation (see **Section 4**);
- improperly commingled Inventory-Held-on-Consignment with Purchased Inventory, thereby increasing its reported Ending Inventory and decreasing its Costs-of-sales (see **Section 5**);
- grossly overpaid for stakes in Lefeng, Ovation and several logistics companies in transactions that were possibly not negotiated at arms-length (see **Sections 6 & 7**);
- exaggerated and accelerated CAPEX spend to industry-leading levels despite having significant excess capacity (see **Section 8**);
- recorded increased levels of 'Other Receivables' which potentially reflect abusive RPTs **(**see **Section 9**);
- extended low-interest loans to RPTs, possibly VIPS' founders (see **Section 10**).

The impact of the above schemes in 2014 would have allowed VIPS to grow its reported Gross Profit to $938.3M:



We believe that VIPS should be reported on a Net Basis and, as such, revenues would equal what is currently being reported as Gross Profit. If we subtracted the impact of the 2014 initiatives from the $938M, we would see that VIPs is should be reporting revenues of only $368M in 2014 ($938M - $573M).

3. THE MULTIPLIER EFFECT: IF VIPS USES CASH FROM RELATED PARTIES, IT CAN GROSS THEM UP TO REPORT EVEN HIGHER FAKE SALES

We believe that if VIPS diverted the proceeds of its overspending to RPTs, it likely inflated its reported sales. Evidence from financial statements seems to suggest that VIPS is in fact growing its profit as a result of diverted funds to RPTs.

Depending upon the nature of its sales transactions, VIPS acts as either a principal or an agent. VIPS reports that for the vast majority of its sales, it reports on a Gross Revenue basis, essentially as a principal[9]. If the M-score is correct in flagging anomalies with VIPS' sales and receivables growth, it is likely that VIPS used its dual revenue reporting ability to its advantage. VIPS could have recorded cash proceeds from RPTs as Gross Profit. VIPS could then back into inflated Revenue and Costs of Sales figures. Based upon our research, we believe that VIPS has overspent on various initiatives totaling $573M, and that these funds were likely recorded as Gross Profit. In fact, if VIPS had accounted for these funds as Gross Profit, almost 98% of the growth in Gross Profit from 2013 to 2014 can be attributed to the overspends.

With $573M in cash recorded as Gross Profit, VIPS could set a target Gross Margin figure and use it to back into fake Revenue and Costs of Sales figures as demonstrated below:

(millions) How to Gross Up your Revenues and Gross Out your Investors		
Revenue' from RPTs are booked as VIPS' Net Sales	Gross Margin [A]	573
Determine a Gross Margin target for the year	*GM % [B]*	*24.9%*
Compute the implied Revenue increase	Net Sales [C] = [A] / [B]	2,301
Compute the implied COS increase	COS [D] = [C] -[A]	1,728
Check that GM equals 'cash' from RPTs	GM [D] = [A]	573
	GM %	*24.9%*

In our opinion, if VIPS used the proceeds of its overspending to conduct round-trip transactions with RPTS, it could increase its revenues by an additional $2.3B and its Costs of Sales by an additional $1.7B, assuming a target Gross Margin of 24.9%.

Central to employing this manipulation would be VIPS' ability to utilize Gross Revenue reporting.

[9] http://www.sec.gov/Archives/edgar/data/1529192/000104746915003885/a2222963z20-f.htm

4. THIS IS DOWNRIGHT GROSS

Vipshop reports its revenue on a Gross Basis, yet VIPS management freely admits that VIPS acts primarily as a consignee. Consignees primarily report on a Net Basis—as agents.

In the Internet and e-commerce sectors, companies are keen to show large and growing revenue figures. One reason for the focus on revenues is that many of the companies are at early stages of growth and have little to no earnings to report. Another, more critical reason is that revenues serve as an important input a common valuation method for ecommerce firms, Price-to-Sales. Many internet companies would prefer to report the higher revenues allowed under Gross Revenue accounting. Consequently, a number of firms (e.g. Groupon) have been forced to restate their financials when regulators find that they have applied Gross incorrectly[10].

GAAP accounting, as it relates to revenue recognition, presents challenges for many internet companies. GAAP provides guidance on what factors should be considered in reporting as a principal (gross) and an agent (net). There are several determinants, and no individual determinant outweighs the others in importance. Hence, many companies, in consultation with their auditors, make a judgment based upon their own interpretation. It is not uncommon for companies in the same industry and with similar business models to report revenues differently.

Companies that report on a gross basis are allowed to account for all of the revenues and costs relating to the transaction. Companies reporting on a net basis are only allowed to account for their portion of the revenues in a transaction, i.e., net of costs of sales. For example, eBay provides a marketplace for consumers to buy and sell goods. eBay collects a percentage of the sales for the use of its platform. Assume an eBay vendor sells a bicycle for $200, and eBay earns 1% commission on the sale. If eBay is reporting on a gross basis, eBay would record revenue of $200. If eBay reports on a net basis, it would record only the $2 in commission it has earned as revenue. The key determinant over whether a company can record revenue on a gross or net basis revolves around which party in the transaction assumes the majority of the risks and rewards of the sale of products or services.

In the above example, eBay takes on limited risks from the sales and has minimal to limited discretion in key aspects of the transactions, and as such, eBay should report the revenue on a net basis.

10 http://dealbook.nytimes.com/2011/09/23/groupon-changes-its-revenue-accounting/?_r=0

Grant Thornton provides a discussion on the determinants in its guide on Revenue Recognition[11]. We have used this and other Gross/Net discussions to evaluate VIPS' claims that it has sufficient indicators to report on a Gross (principal) basis.[12]

4.1 VIPS presents a rationale for reporting Revenues on a Gross Basis

VIPS' revenue recognition policy highlights those elements of its business which it believes are more indicative of principal activity and which would suggest reporting Revenues on a Gross Basis.

Revenue recognition

We recognize revenue when persuasive evidence of an arrangement exists, products are delivered, the price to the buyer is fixed or determinable and collectability is reasonably assured. We utilize delivery service providers to deliver goods to our customers directly from our own warehouses. We estimate and defer revenue and the related product costs that are in-transit to the customer, which generally takes about three days. The three-day estimate was determined based on the average delivery days for sales made during the last month of the reporting period, derived from customer locations and delivery reports. A one-day change in the estimated good in-transit period would result in an increase or decrease of US$18.69 million to our total net revenues in 2014.

We offer our customers an unconditional right of return for a period of seven days and forty-five days upon receipt of products, respectively, on sales from *vip.com* and *lefeng.com* platforms. We defer sales revenue from *vip.com* platforms until the return period expires as we cannot reasonably estimate the amount of expected returns. We recognize sales revenue from *lefeng.com* platforms when products are delivered to customers because historical returns on sales from *lefeng.com* are insignificant.

Revenue was recorded on a gross basis, net of surcharges and value added tax of 17% of gross sales. Surcharges are sales related taxes representing the city maintenance and construction tax and education surtax. We have evaluated whether it is appropriate to record the gross amount of product sales and related costs or net amount earned as revenue. We recorded revenue on a gross basis because we have the following indicators for gross reporting: we are the primary obligor of the sales arrangements; we are subject to inventory risks of physical loss; we have latitude in establishing prices and discretion in selecting suppliers; and we assume credit risks on receivables from customers. We retain some general inventory risks despite our arrangements to return goods to some vendors within limited time periods. We generally have the right to return unsold items within a period after the end

4.2 However, Management freely admits that it operates as a consignee and has no intentions of becoming a principal.

In response to an analyst's question on the 4Q 2013 earnings call, Donghao Yang provides the clearest evidence yet that VIPS is fully aware that it is violating GAAP guidance on Gross Revenue reporting[13]:

- John Choi – Daiwa: Good evening guys. Congratulations on a great quarter and thanks again for taking my question. I have two questions. My first question is regarding the business model, right now, Vipshop obviously moved majority of the products is more or less through a consignment business model, but that didn't have any plans to extend on I guess, it's kind of a follow-on question for the first time one of the questions before, but have any plans to become more doing more principal owners of the inventory like more of a traditional B2C products by offering more diverged products to the customers at a more reasonable price, but on the other hand, we will also have to bear the inventory risk? (…)

11 https://www.grantthornton.com/~/media/content-page-files/technology/pdfs/TIP-revenue-recognition-tips-for-tech-companies.ashx
12 Securities & Exchange Commission Filings Vipshop Holdings Limited, Forms 20-F 4/25/14
13 http://seekingalpha.com/article/2066613-vipshop-holdings-ceo-discusses-q4-2013-results-earnings-call-transcript

- Donghao Yang - Chief Financial Officer: Let me take this one. Thank you for coming to the call. Our business model now you are right we don't take – we don't purchase the inventory upfront, which enables us to use very little working capital to support such a faster top line growth. And going forward, I don't think that we are going to increase the amount of inventory that we purchased at the current level. So meaning we don't want to become the principal owner of the inventory unless we have to. For example, currently, about 10% of the inventory in a warehouse has to be purchased from the supplier. And understandably if those suppliers are big suppliers like Nike, but going forward as we become bigger with greater marketing power, we believe that more and more suppliers will allow us to take their inventory without having to purchase upfront.

Similarly, a report by BNP Paribas cites the uniqueness of the VIPS consignment model:

- 'To the best of our knowledge Vipshop is one of the very few B2C e-commerce companies in China, as well as globally, that operates on a consignment model –afforded by Vipshop's unique and leading position as a preferred inventory clearing solution for brands. Approximately 10% of Vipshop's inventory is purchased from suppliers, which are usually stronger brands such as Nike and Adidas. For the sale of the remaining 90% of inventory, Vipshop gets paid by the customer almost immediately, while it typically pays the supplier in 1-1.5 months following the sale. As a result Vipshop bears minimal inventory risk.'[14]

4.3 Elsewhere in VIPS' financial disclosures, the company describes it business model which seems very much akin to a consignment model, and which would argue for Net Revenue accounting.

Summary–level details about VIPS' business model are as follows[15]:

- VIPS sells out-of-season excess inventory of branded-goods;
- the company has over 7,000 suppliers;
- VIPS pays upfront for no more than 10% of the products in its warehouses;
- VIPS undertakes best-efforts to sell products to end-customers via a week-long flash sales format;
- customers pay in advance or cash-on-delivery;
- customers have a 7-day window in which they can return products for a refund;
- in the vast majority of cases, VIPS has the right to return any unsold product to suppliers; and
- VIPS pays the suppliers in installments and does not transmit final payment until 1 to 1.5 months after goods have been sold to end-users.

The VIPS business model, as described, is clearly that of a consignee company:

14 BNP Paribas, Vipshop, Compelling Story, June 25, 2014, page 6

15 SEC Form 20-F 4/24/14

- merchandise is forwarded by the consignor to the consignee to be sold at a profit;
- the consignee pays a small deposit for the goods transferred to its warehouses;
- however, ownership of the merchandise remains with the consignor and hence is not be reported on the financial statements of the consignee;
- the risks and rewards of ownership remain with the consignor, particularly inventory loss and credit risk;
- unsold merchandise is returned to the consignor; and
- the consignee is paid a commission as a percentage of merchandise value sold and deducts his commission from the proceeds of any sales.

By definition, consignment arrangements are established between principals (consignors) and agents (consignees)[16]. As an agent, the consignee should report revenue on a Net Basis[17].

4.4 An assessment of the key determinants for Gross reporting, reveals that VIPS fails on most characteristics.

We also examined guidance from FASB, as disclosed online, and concluded that VIPS fails GAAP against most of the key determinants for Gross Reporting.

GAAP Determinants for Gross Reporting	Our Assessment of VIPS against GAAP Guidance	Explanation
Is VIPS the Primary Obligor?	NO	VIPS states in multiple earnings calls thatt the company does not purchase more than 10-15% of products available for sale. As such, VIPS does not have title to nor does it have control over the products. VIPS is the primary obligor for the fulfillment and transportation element of most of its transactions. As such, VIPS should only report revenues from the fulfillment portion of these transactions.
Does VIPS have Inventory Risk?	NO	VIPS claims to have inventory risk, yet, it does not own the vast majority of the the goods in its warehouses. It can not have invetory risk unless it actually owns inventory. As such, the only inventory risk that the company has relates to the 10-15% of goods that it owns.
Does VIPS have latitude in setting price?	LIMITED	VIPS sells out-of-season branded products to consumers looking for a bargain. As a consignee, VIPS will attempt to get as high a price as it can, although prices will have to be at a deep discount to new products offered by the suppliers. Hence, most suppliers are likely to provide pricing guidance to VIPS for the sale of their excess inventory.
Does VIPS change the product or service?	No	VIPS does not change the products.
Does VIPS have discretion in choosing suppliers for the goods and services?	NO	While VIPS has thousands of suppliers of branded-goods, the essence of its business model does not allow for substitutions. If, as part of a flash-sale, a customer purchases a 300 ml bottle of Lancome lotion, VIPS is not able to substitue that with a 300 ml bottle of Estee Lauder lotion. So while VIPS has discretion over the suppliers it will work with, VIPS does not have the ability to change the supplier on any of its sales.
Does VIPS have a role in determining product or service specifications?	NO	VIPs does not determine specifications of the products.
Does VIPS have physical loss inventory risk?	LIMITED	VIPS has some risk with respect to physical loss of purchased or consigned goods in its possession.
Does VIPS have credit risk?	NO	VIPS does not have credit risk; its end-users pre-pay or pay cash-on-delivery; customers have a 7-day return option; the vast majority of unsold goods can be returned to suppliers. VIPS, oddly enough reports growng Account Receivables balances, but upon further inspection, these balances are made up of amounts owed to VIPS by suppliers and delivery companies--not customers.

16 http://legal-dictionary.thefreedictionary.com/consignment
17 Wiley GAAP 2015: Interpretation and Application of Generally Accepted Accounting Principles, by Joanne M. Flood

It should also be noted that typically a consignee is paid a fixed fee or on a commission basis. While we have not seen any of VIPS' supplier agreements, VIPS indicated that as a condition of its purchase of Lefeng and investment in Ovation, the company had agreed to purchase a minimum $148M of Ovation product. VIPS stated that it would receive 'commission payments' for any sales in excess of this amount. The company uses the term 'commission' only in its 20-F statement for 2013—page F-47. In subsequent filings, VIPS refers to the payments as 'rebates'.

Nonetheless, here we have VIPS earning 'commissions' from a non-marketplace supplier (which VIPS correctly accounts for on a net basis). Commission arrangements are a strong indicator for reporting revenues on a net basis. We believe that most, if not all of VIPS' agreements involved fixed-fee or commission structures and argue for net revenue reporting.

4.5 Recent changes to US GAAP Revenue Recognition policy are likely to force VIPS to revise its accounting by December 2016.

We cannot say if VIPS will soon change its Revenue Recognition policy, on its own or at the request of the SEC. However, VIPS is likely to have to revise its accounting to Net Basis, given recent changes in US GAAP. On page 88 of the company's recent 20-F, VIPS references an Accounting Standards Update (ASC 2014-09, here) which is due to come into effect by the end of 2016. Section 606-10-55-37 (page 57) provides detail on changes to Principal versus Agent revenue recognition guidance. We believe that this more stringent standard will eventually compel VIPS to move to Net Revenue reporting. VIP's view as highlighted in the 20-F on page 89:

- 'We will need to conduct a detailed review before we can determine if the adoption of this ASU will have a material impact on our consolidated financial results or disclosures.'

Our read of this ASU suggests that the ASU will have a significant impact on VIPS' financial results.

Despite the company's own admission, the features of its business model, and its failure to exhibit key determinants necessary for Gross Reporting, VIPS continues to report revenues on a Gross basis. Were VIPS forced to restate its financial statements and report on a Net revenue basis as an agent/consignee per GAAP guidance, VIPS' would be required to report only those revenues that relate to its commissions.

Net revenue reporting at VIPS would result in the company reporting as sales those figures that are currently shown on the Gross Profit line: $154.4M, $407.8M and $938.3M for the years 2011, 2012 and 2013 respectively. We believe that VIPS is reporting on a Gross basis in order to enhance its reported revenue and hence increase its equity valuation. Revenues of $938.8M applied against the Price-to-Sales valuation metric would result in a much lower implied valuation for VIPS. Using the company's current P/S ratio of 4.26x, VIPS's market capitalization would be $4.0 billion ($938M x 4.26) instead of the current $16.0 billion ($3.8B x 4.26). For Vipshop, it seems Gross is good—an extra $12B in valuation of good.

5. INVENTORY: WHAT'S MINE IS MINE, AND WHAT'S YOURS IS ALSO MINE

Management's statements about purchased inventory seems to be contradicted by its own financial statements; VIPS, in violation of GAAP, seems to be reporting some Inventory-held-on-Consignment as owned inventory, resulting in uplifts of reported Gross Profit of $75M and $151M in 2013 and 2014 respectively.

Several times in the last year, VIPS has provided an estimated percentage of the amount of goods in its warehouses for which the company had paid. I previously referenced the following statements in the section on Gross Revenue, but I repeat the disclosures here to highlight the consistency of the figures provided by management:

- 'For brands where we have established long-term relationships, we typically do not pay any deposit on the products we purchase. For other brands, however, we generally pay a deposit ranging from 10% to 15% of the total price for each purchase order.[18]

- Donghao Yang – '(…) Our business model now you are right we don't take – we don't purchase the inventory upfront, which enables us to use very little working capital to support such a faster top line growth. And going forward, I don't think that we are going to increase the amount of inventory that we purchased at the current level. So meaning we don't want to become the principal owner of the inventory unless we have to. For example, currently, about 10% of the inventory in a warehouse has to be purchased from the supplier. And understandably if those suppliers are big suppliers like Nike, but going forward as we become bigger with greater marketing power, we believe that more and more suppliers will allow us to take their inventory without having to purchase upfront.'[19]

Management refers to 'goods in a warehouse', which in accounting terms should equate to Goods-Available-for Sale (GAFS). The GAFS balance changes constantly as a result of inflows from Inventory purchases, outflows from sales, and write-downs. The GAFS balance can be calculated using the following mathematical expressions:

(a) Beginning Inventory + Purchases = Goods Available for Sale

(b) Goods Available-for-Sale – Ending Inventory - Inventory write-downs = Costs of Sales

We examined data from VIPS' financial statements to assess whether VIPS is correctly accounting for the two classes of Inventory which it manages:

- Inventory which VIPS has purchased and should be reflected in VIPS' financial statements, and

18 SEC Form 20-F 4/24/14, p46

19 http://seekingalpha.com/article/2066613-vipshop-holdings-ceo-discusses-q4-2013-results-earnings-call-transcript

- Inventory-Held-on-Consignment which VIPS has not purchased and must not report as owned Inventory on its balance sheet.

We did not have data which provided information on VIPS' daily balances which would have been in flux due to the timing of purchases, sales and write-downs. However, if we make the very conservative assumption that (i) all Purchases occurred on the first day of each period, and (ii) all Costs-of-Sales are accounted for on the last day of the period, we can determine the maximum GAFS possible for each reporting period. This front-loaded assumption around purchases eliminates the need to have information about daily inflows and outflows.

$ millions	2012	2013	2014	2014 Q1	2014 Q2	2014 Q3	2014 Q4
Beginning Inventory [A]	70	144	270	270	306	335	469
plus Purchased [B]	612	1,415	3,143	527	556	758	2,944
Goods Available for Sale [C]	682	1,559	3,413	797	862	1,093	3,413
less Ending Inventory [D]	144	270	578	306	335	469	578
Cost of Goods Sold [E]	538	1,289	2,835	491	527	624	2,835
Ending Inventory as % of Goods Available for Sale [D] / [C] *	*21.1%*	*17.3%*	*16.9%*	*38.4%*	*38.9%*	*42.9%*	*16.9%*
Purchases as indicted by CFO Yang; using midpoint of 10-15% range [F]	*12.5%*	*12.5%*	*12.5%*	*12.5%*	*12.5%*	*12.5%*	*12.5%*
Implied Max Ending Inventory [G] = [F] * [C]	85	195	427	100	108	137	427
Overstated Ending Inventory [D] - [G]	59	75	151	206	227	332	151
Reported Revenues	692	1,697	3,774				
Revised COGS (Overstated Ending + Reported COGS)	596	1,364	2,986				
Revised Gross Profit	96	333	787				
Reported Gross Margin	*22.3%*	*24.0%*	*24.9%*				
Revised Gross Margin	*13.8%*	*19.6%*	*20.9%*				

** Impairments of $12.2M and $33.9M are included in COS for 2012 and 2013 respectively; information for 2014 was not available at time of publication.*

Using the mid-point of management's estimate of 10%-15% of Inventory having been purchased, we can see that at no point should the Ending Inventory balances have exceed $85M, $195M, and $427M in the years 2012, 2013 and 2014 respectively. Yet, the Ending Inventory balances for each year exceeded the maximum expected amounts. Moreover, quarterly Inventory figures for 2014 suggest that purchased Inventory in 1Q, 2Q and 3Q 2014 accounted for nearly 40% of Ending Inventory.

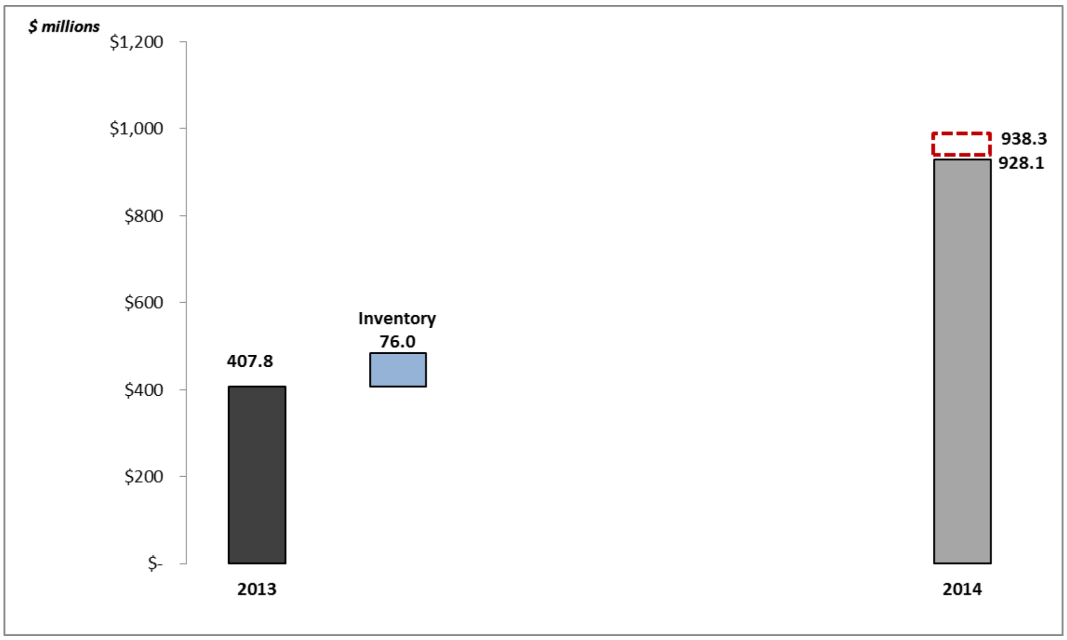
Based upon this analysis and VIPS management's assertions, we conclude that VIPS is inflating its Ending Inventory values. VIPS has commingled Inventory-held-on-consignment with purchased and owned-Inventory in violation of GAAP, essentially claiming Inventory that it does not control or have title to as its own.

The inflated Ending Inventory figures provide VIPS with the benefit of an inflated Gross Profit. By increasing the reported Ending Inventory figure, VIPS manages to report a lower Cost of Sales and hence higher Gross Profit:

Goods Available-for-Sale – ↑Ending Inventory - Inventory write-downs = ↓Costs of Sales

Had VIPS correctly accounted for Inventory, the company would have reported Gross Margins of 13.8%, 19.6% and 20.9%, in 2012, 2013 and 2014 respectively. Instead VIPS reported Gross Margins of 22.3%, 24.0% and 24.9%. VIPS recently revised its statement about the percentage of Inventory purchased; in the 2014 20-F, VIPs states that it pays for 10-30%, but as the numbers above suggest, even this updated and revised figure is inaccurate given levels observed in the first 3 quarters of 2014.

Inventory manipulation accounted for $76M ($151M - $75M) of the delta between 2013 and 2014 reported Gross Profits.



6. LEFENG AND OVATION: SWEETHEART DEALS ON VALENTINE'S DAY?

In our view, VIPS grossly overpaid for stakes in Lefeng and its parent company, Ovation. In our view, someone at VIP has a wicked sense of humor. VIPS acquired 75% interest in cosmetics ecommerce retailer Lefeng on February 14, 2014, and then took a 23% stake in Ovation, Lefeng's parent company, on February 21, 2014.

The Valentine's Day purchase of Lefeng amounted to $132.5M, including cash consideration and financing related to assumed liabilities. Prior to the sale, Lefeng had undergone a corporate restructuring. Management cited the fact that the online platform business had not been previously separated from other group businesses as the reason for the restructuring. As such, Ovation had the opportunity to decide which assets, liabilities and employees would be moved with Lefeng prior to selling it. This discussion can be found in the share purchase agreement for the Lefeng transaction that was included in the SEC Form 20-F filed in April 2014.

VIPS then paid $55.8M for a 23% stake in Ovation, which resulted in VIPS owning 80.75% of Lefeng. VIPS management highlighted the fact that its investment in Ovation would allow the company to access to Ovation's own-branded cosmetics and apparel. The terms of VIPS' investment in Ovation can be found here. VIPS further agreed to contingent consideration which committed VIPS to selling at least $148M of Ovation product in 2014.

An M&A transaction is not, per se, suspicious or odd. In fact, M&A has become a common means for companies to secure or competitive advantage. Additionally, companies paying dearly for acquisitions are not rare either. However, overpaying for assets as a means of asset misappropriation has also been a key feature of several recent Asian frauds and is why we have serious concerns about these two transactions. Our analysis suggests that the Lefeng and Ovation investments may have been transacted in order to divert funds to RPTs. Our key concerns are that:

- valuations are excessive in light of financial data reported pre- and post-investment;
- both companies were loss-making enterprises and have accelerated the rate of loss in the 10.5 months VIPS has held them;
- VIPS secured short-term financing and subsequently accessed the capital markets to pay for the investments, despite reporting significant and growing Cash balances;
- management's initial high optimism and intended 2014 priority, quickly turned to near silence on progress of the integration;
- the key assets purchased are intangibles which are difficult for both management and investors to assess; and
- Eric Ya Shen, the other Board Members and the Auditors had multiple conflicts of interests in these transactions.

Lefeng had negative book value, resulting in 123% of the Purchase Price being allocated to Intangibles and Goodwill.

VIPS will certainly not be the first company to have overpaid for an acquisition, but Lefeng and Ovation seem to have been valued at levels well in excess of shareholders equity. Both companies seem to have had poor operational and financial histories. Based upon information provided in VIPS' SEC Form 6-K for 1Q 2014, we were able to estimate the purchase price allocation for Lefeng. The cash paid by VIPS implies a total value for Lefeng of $177M.

(millions)	Total	Vipshop (Controlling Interest)	Ovation (Non Controlling Interest)
Purchase Price	176.7	132.5	44.2
Allocation of PP to Intangibles	214.7	161.0	53.7
Allocation of PP toGoodwill	2.4	1.8	0.6
Implied Value of Lefeng's Shareholder Equity	(40.4)	(30.3)	(10.1)
Intangibles/Goodwill as % of Purchase Price	*123%*	*123%*	*123%*

However, since large values were recorded in Intangibles and Goodwill, and the sum of those values exceed the purchase price, we calculated that Lefeng had an implied Negative Shareholders Equity value. Consequently, a whopping 123% of the cash paid for Lefeng was allocated to intangibles. The company owned little in hard assets. Moreover, the fact that Lefeng had not been a separate operating unit prior to its sale to VIPS, raises questions about the process of allocating various assets and liabilities to Lefeng prior to February 14, 2014. Did Ovation offload a disproportionate share of liabilities onto Lefeng? Did Ovation 'pretty-up' its balance sheet in the process?

6.1 VIPS paid 2.7x Sales for Lefeng; not 1.2x Sales as has been assumed by several market commentators.

Since Lefeng was a private company and historically had not been reported as a separate business unit, historical financial data is not readily available. However, management of either VIPS or Lefeng seemed to have seeded market commentators with information on Lefeng's historical and projected revenues. See here and here. In fact, the report by Standard Chartered revealed Gross Merchandise Value, Principal Sales, Margin and Profitability at Lefeng, information that would have been readily available in the public domain. The report further cites data for VIPS, Jumei and Lefeng as from the 'companies, on page 83. Standard Chartered estimated Lefeng's 2013 'principal revenues' of RMB 900M whereas Barron's projected 2014 total revenue figures of RMB 900M. If we assume that total 2013 revenues were $149M as suggested by the Standard Chartered report, we would have assumed that the purchase price was reasonable. According to Barron's, the implied total valuation of Lefeng was $177M [$132M / 23%]. Against sales of $149M, Barron's estimated that VIPS was getting Lefeng for the price of 1.2x sales. This seems a fair price particularly if you compare the P/S ratio to VIPS' same-day valuation of 2.37 x sales, as reported by Barron's.

However, as part of its disclosure, VIPS provides information on Lefeng's revenues which is at odds with what market commenters reported, based upon 'management' sources. As opposed to $147M in sales, Lefeng had less than $65.1M in in sales in the year preceding acquisition. In its SEC 20-F filing[20], VIPS reported that government notification requirements for M&A transactions between Chinese companies are triggered when both of the companies involved in a transaction have revenues in excess of $65.1M. According to VIPS, revenues from Lefeng are lower than the $65.1M threshold and are thus exempted from the reporting requirement:

- 'We believe that the turnover of acquired business of Lefeng in 2013 is less than RMB400 million (US$65.1 million) within China and have not sought clearance from the Ministry of Commerce, but we cannot assure you that the Ministry of Commerce will not take a view contrary to ours.

Also, according to company disclosure on page F-28, Lefeng operates in primarily in China, so the difference cannot be explained by the fact that the company may have sales outside of China:

- 'On February 14, 2014, the Group acquired a 75% equity interest of Lefeng.com from Ovation Entertainment Limited ("Ovation"). Lefeng.com owns and operates the online retail business conducted through lefeng.com, an online retail website specialized in selling cosmetics and fashion products in China.'

- On page 13 of the 20-F, VIPS explains risks to the Group's operations by stating that "the retail industry, including the online retail sector in general and the flash sales business in particular, is highly sensitive to general economic changes. Online purchases tend to decline significantly during recessionary periods and substantially all of our total net revenue is derived from online retail sales in China.'

If Lefeng had recorded $65.1M in revenue (though actual figures may be even lower), VIPS, at the very least, paid 2.7 times both 2013 and 2014 estimated earnings. Note that this figure at the date of acquisition was paid for a negative book value company with no stand-alone history. Hence Lefeng's implied Price/Sales ratio was greater that the ratio public markets valued VIPS itself.

6.2 The 2014 combined losses of Lefeng and Ovation were approximately 33% of the consideration paid for the firms.

We do not have enough information on Ovation to conduct similar analysis on valuation, but data provided via SEC Form 6K for 4Q 2014 provides some insight into the impact Ovation and Lefeng had on VIPS' financials in 2014. The data suggests that both Lefeng and Ovation are cash burning and loss-making entities that are having a significantly negative

[20] Securities & Exchange Commission Filings Vipshop Holdings Limited, Forms 20-F 4/25/14 and 6K 2/17/15

impact on VIPS' earnings. As majority-owner of Lefeng, VIPS reports consolidated financials inclusive of Lefeng. However, since Ovation maintains a 25% ownership stake in Lefeng, Ovation's Non-Controlling Interest is deducted from VIPS' reported Profit and Loss Statement. We have used the information reported as 'Loss Attributable to Non-Controlling Interests' (Ovation) to back into Lefeng's net loss for 2014.

VIPS has a Non-Controlling Interest in Ovation. Ovation's financials are not consolidated with VIPS, but as NCI in Ovation, VIPS reports the change in the value of its investment in Ovation on its Profit and Loss Statement under 'Share of Loss from Affiliates'. We have used the Share of Loss from Affiliates to back into the Ovation's net loss for 2014.

(millions) M&A Transaction	Purchase Price [a]	Description in Financials [b]	10.5 months [b]	Annualized [c]	% held by NCI [a]	Implied Total Annual Loss [d]	Attributable to VIPS [e]	Attributable to Ovation [e]
75% of Lefeng	132.5	Loss Attibutable to Non-controlling interests	(14.5)	(16.5)	*25.0%*	(66.1)	(49.6)	(16.5)
23% of Ovation	55.8	Share of Loss of Affiliates	(10.2)	(11.7)	*23.0%*	(50.8)	(11.7)	(39.1)
Total	188.3	Total	(24.7)	(28.2)		(117.0)	(61.3)	(55.7)
		2014 Losses at Lefeng & Ovation as % of Purchase/Investment Price				*-62.1%*	*-32.6%*	
		Analyst estimate of Lefeng's 2013 Net Income [f]				(24.0)		
		Ratio of 2014 Lefeng loss to 2013 Lefeng loss [g]				*2.8* X		

a. SEC Form 20-F filed 4/25/15, pages F-4 and F-5.
b. SEC Form 6-K filed 2/16/15, page 8.
c. Divide 10 month data by 10, and then multiply by 12.
d. Divide Annualized figures by % held by NCI.
e. Attributable to VIPS equals Total Annualized loss multiplied by 25% for Lefeng; Attributable to VIPS equals Total Annualized loss multiplied by 23% for Ovation.
f. China Internet: E-commerce in Transformation, Standard Chartered Research, p82.

Some key takeaways from this analysis are:

- The two companies had losses totaling $117M in 2014 with Lefeng accounting for $66M and Ovation accounting for $50.8M.
- The annualized losses from both companies attributable to VIPS' in 2014 totaled $61.3M.
- Total losses for both companies represent about 62% of the combined $188M VIPS invested in 2014.
- Data from Standard Chartered had indicated that in 2013, Lefeng had a net loss of RMB400 or ($24M); the loss in 2014 was therefore 2.8 times greater than the 2013 estimated figures.[21]

It seems someone had a nice Valentine's Day, but it certainly wasn't VIPS or its minority shareholders.

21 China Internet: E-commerce in Transformation, Standard Chartered Research, p82.

6.3 Despite having over $700M in Cash and HTM at the beginning of Q1 2014, VIPS secured bridge financing and subsequently capital market proceeds to fund the acquisitions of Lefeng and Ovation.

The investments in Ovation and Lefeng were significant and material to VIPS, but could have been paid from Cash on hand or Held-to-Maturity balances. Yet, despite its reported $720M in cash and HTM securities at the beginning of 1Q 2014, VIPS secured short-term financing from Wing Lung Bank and China Merchants Bank. Subsequently, on March 17, 2014, VIPS secured $632.5M from the capital markets to pay off those bank loans and to fund 'other general corporate purposes, including expenditures related to the planned expansion of the Issuer's logistics network and warehousing capacity.'[22] VIPS Executives, Directors and 'certain shareholders' also liquidated holdings, selling $188M worth of American Depository Shares.

In a number of prior Asian frauds[23], cash on hand often turned out to have been significantly less than that reported. The fact that VIPS has frequently accessed bank and capital market sources raises our suspicions about the company's reported cash balances. We explore this issue later in this report (Section 10), but the frequency at which VIPS has accessed capital markets while holding substantial cash balances, is in our opinion a red flag in the Asian context.

6.4 After much fanfare on the Q1 call, management declared Lefeng small and insignificant three months later.

Upon announcing the Lefeng and Ovation deals, management cited several key benefits of the Lefeng and Ovation deals. These included expanding the VIPS' customer base, securing access to Ovation-branded products and diversifying VIPS' revenue base. On the 1Q 2014 call, management declared the integration of Lefeng and Ovation a top priority:

- Eric Ya Shen-CEO Last, our integration with <u>Lefeng is on top and there will be extensive focus in 2014</u>. The integration we are along at the benefit of, one, streamlining our cosmetic offerings, two, reducing our combined procurements and marketing expenses, and three, cross-selling between Lefeng and Vipshop user basis.[24]

- "The acquisition of Lefeng supports our goals of diversifying our product offerings, expanding our customer reach and further enhancing our customers' experience", said Mr. Eric Shen, chairman and chief executive officer of Vipshop. "With this addition to the Vipshop platform, we will be able to immediately augment our cosmetics offering, further expanding upon our leadership in China's

22 http://www.sec.gov/Archives/edgar/data/1529192/000110465914018630/a14-7455_11fwp.htm
23 http://www.chinaaccountingblog.com/weblog/auditing-cash-in-china.html
24 http://seekingalpha.com/article/2221703-vipshops-vips-ceo-eric-shen-on-q1-2014-results-earnings-call-transcript

> discount retail market. We're very excited to work with Jing Li and the Lefeng team and look forward to our strong future together.[25]

As part of the acquisition announcement, management pointed to the promising demographics of the Lefeng customer base: 8 million female consumers, living in predominantly Tier 1 cities, willing to pay higher price per ticket than VIPS' customers. VIPS seemingly had high hope for the company and its potential impact on consolidated financials. Standard Chartered stated that the average ticket size for Lefeng (RMB 300) was 46% higher than the average ticket size for VIPS[26].

The integration's success and promise of increased ticket sizes was called into question on the call in 2Q 2014; the Investor Relations Director struggled to explain Lefeng's negative impact on average ticket size:

- Weibo Hu - Goldman Sachs …And my first question is in terms of the order size. We find that the second quarter order size declined 2% year-on-year and 9% quarter-on-quarter. So, would you mind sharing with us how much is caused by the dilution from Lefeng, and how much is due to the promotion of other factors…?

- Millicent Tu - Director, IR The decline in (indiscernible) is actually back in the second quarter it's a little deepened whereby we're selling mainly some clothing, whereas in Q1 it's the weakest season. So obviously the (indiscernible) is higher compared to the second quarter.

The communications line issues don't help, but it seems that VIPS is struggling to explain why average ticket sales are declining, when a key selling point of the deal was Lefeng's higher average ticket size per customer[27].

On the same call, management refused to provide data on revenue growth at Lefeng:

- Karen Chan - Jefferies & Company …Secondly, what's the current revenue contribution from Lefeng and can you update us the progress of this integration in terms of supply chain marketing etcetera? Thank you very much.

- Donghao Yang – CFO …We don't report Lefeng's revenue separately because it's less than 5% of our total revenue, it's relatively small and insignificant[28].

25 http://www.sec.gov/Archives/edgar/data/1529192/000110465914010792/a14-5979_1ex99d1.htm

26 China Internet: E-commerce in Transformation, Standard Chartered Research, p83

27 https://research.standardchartered.com/configuration/ROW%20Documents/China_Internet__E-commerce_in_transformation_07_07_14_10_46.pdf

28 http://seekingalpha.com/article/2424115-vipshop-holdings-vips-ceo-eric-shen-on-q2-2014-results-earnings-call-transcript

And with respect to the Lefeng's Gross Merchandise Value in the year ago quarter and prior to being purchased by VIPS:

- Ella Ji – Oppenheimer Yes, my question was on pro forma basis. I'm not sure if you added Lefeng's 2Q GMV last year. What year-over-year growth are we seeing?
- Donghao Yang – CFO Well we can -- we don't have that number right now, but we can probably do that after the call.
- Ella Ji – Oppenheimer Sure. So, you said that 1Q the cosmetics GMV is $167 million, is that right?
- Donghao Yang – CFO Yes.
- Ella Ji – Oppenheimer Okay, so then if I do a quick calculation the Q-on-Q growth is about 6% and that seems a little bit lower than your total sales growth. So, can you give us some color so, are you continuing to see apparel maybe grow faster than the cosmetics?
- Donghao Yang – CFO Well some of this seasonality in the cosmetics business, Q2 is again the low season in the year. So, 6% Q-over-Q growth may seem a bit low compared to our core apparel business where it's still not so bad if you can consider the seasonality element.

By 3Q 2014, Lefeng is mentioned only three times during the call. Management reinforces its intentions of being the largest in the cosmetics vertical and announces the combined GMV is $191M[29]. And by 4Q 2014, Lefeng was mentioned only twice—once by management in relation to the sizeable amortization expense associated with the acquisition and once by an equity analyst inquiring as to the GMV of the cosmetics business[30].

So much for being 'on top' and getting extensive focus. We believe that since Lefeng was had more than $65.1M in revenue, management was correct in declaring it small and insignificant. However, size of the transaction required VIPS to overemphasize the importance and potential impact of the deal in order to justify the price paid. The quick change in tone and focus indicates to us that Lefeng touted as important in 1Q 2014 in order to support the significant amount paid for both assets.

29 http://seekingalpha.com/article/2695865-vipshop-holdings-vips-ceo-eric-shen-on-q3-2014-results-earnings-call-transcript
30 http://seekingalpha.com/article/2923466-vipshops-vips-ceo-eric-ya-shen-on-q4-2014-results-earnings-call-transcript

6.5 Lefeng's Invisibles—excuse us—Intangibles.

VIPS identified a total of 4 websites as assets being transferred into the Lefeng entity in connection with the VIPS investment. However, there is only 1 functioning website, lefeng.com; lefeng.cn seems to be a mirror site to lefeng.com.
The other two websites have been under construction for some time; as of publication date, they remain inoperable.

Domain	Status	Created
lefeng.com	Operational	2001
lefeng.cn	Operational; mirror site to lefeng.com	2005
fengxiangbiao.com	Not functioning-error page	2007
imglefeng.com	Not functioning-error page	2012

It is difficult to assess the value of a website, but we are curious how VIPS allocates nearly $146M to trademarks and domain names while only having one operational domain and company trademark, particularly given the fact that said company had negative shareholder's equity and reports growing earnings losses.

6.6 VIPS' Corporate Governance seems to be weak it is possible that the acquisition were not negotiated at arms-Length.

Lefeng and Ovation are correctly identified in 2014 financial statements as RPTs given VIPS investments in them. As a result of its stakes in Lefeng and Ovation, and Eric Ya Shen's control of the Boards at both companies. Again, these dynamics have been seen frequently in prior Asian frauds—dominant majority shareholder, with majority voting power, works with RPTs to engage in asset misappropriation.

While we have no evidence that Eric Ya Shen is indeed engaging in such activities, the corporate governance issues combined with the financial statement anomalies and the quant model indicators, should compel any minority shareholder to ask pose serious questions about the M&A transactions and the effectiveness of VIPS governance structure.

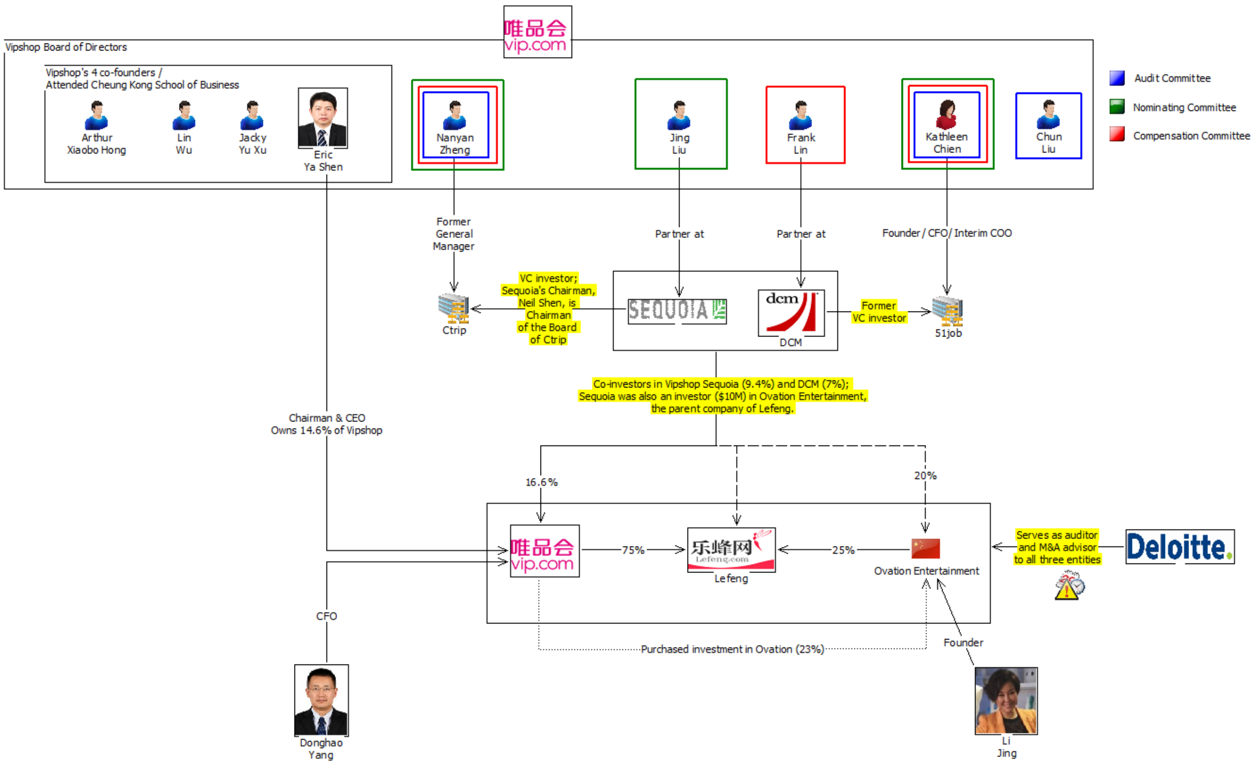
Also, over the course of the last years, VIPS has expanded the total number of disclosed and undisclosed RPTs. Most importantly, several new partners and entities are listed as generic entities--'a PRC company' or 'leading supplier'. See below for examples of recent additions to VIPS' list of RPTs.

2013 20-F	2014 20-F
Companies owned by founders	Companies owned by founders
'Supplier A' as reported in Accounts Receivable	'Supplier A' as reported in Accounts Receivable
'Supplier B' as reported in Accounts Receivable	'Supplier B' as reported in Accounts Receivable
Loans from founders to VIPS	Loans from founders to VIPS
	Lefeng
	Ovation
	Explink
	Various un-named logistics companies, including 'a PRC company"

Again, while the existence of these RPTs is not in and of itself a problem, the potential for abusive round-trip transactions is great, particularly in this context. We believe that the financials suggest potential use of RPTs to artificially inflate its revenues via transactions with Lefeng and Ovation.

VIPS governance structure presents a number of challenges with respect to management, the Board of Directors and the auditors. VIPS has failed address or explain how it manages conflicts of interest.

We created a map of key relationships between VIPS, various related entities, Board Members, and Deloitte Touche. We believe it highlights a number of issues suggesting potential for managing earnings, misappropriating assets or engaging in other activities detrimental to VIPS and its minority shareholders.



We think the key takeaways from this diagram are that:

- Sequoia and DCM were early VC backers to VIPS and continue to hold significant shares of VIPS stock; both firms have Board representation in Jing Liu and Frank Lin respectively[31].

- Sequoia was also a VC investor to Ovation/Lefeng[32] and, as such, profited from selling its stake in the companies, particularly if the valuations were inflated. Recall that both Ovation and Lefeng operate at a loss. Those losses have accelerated in 2014 and it raises questions in our minds as to whether either company would have been good IPO or trade sale candidates in 2014 or in the near future. Our initial concerns are: How did VIPS and Sequoia handle the conflict of interest issues? How did the Board manage it? Can this truly be considered an arms-length negotiation.

[31] http://www.sec.gov/Archives/edgar/data/1529192/000104746914004168/a2218799z20-f.htm
[32] http://www.avcj.com/avcj/news/2329142/vipshop-buys-majority-stake-in-vc-backed-china-cosmetics-site

- Kathleen Chien and Nanyan Zheng serve as Independent Directors. However, both have long histories with at least one of the VC firms and as such questions should be raised about whether their independence could have been compromised.
    - Kathleen Chien sits on each of VIPS' Committees and chairs VIPS' Audit committee. She is a founder of 51job, a publicly listed firm which received VC funding from DCM. DCM's founder, David Chao, chairs the 51job board and sits on all three of 51job's board committees[33].
    - Similarly, Nanyan Zheng serves on all three of VIPS' standing committees and chairs the Nominating and Compensation Committees. Zheng previously worked as an executive at Ctrip where Neil Shen, Chairman of Sequoia and Co-founder of Ctrip served as president[34].

- Deloitte Touche served as auditor, not only to VIPS, but to Lefeng and Ovation as well. This also raises questions regarding D&T's independence: how were conflicts managed and how can D&T assure investors that its opinion was not compromised. It should be noted that Deloitte reported fees of $1.1M, $0.7M. $1.0M in the years 2011, 2012 and 2013 respectively. However, Deloitte earned $1.8M in fees from VIPS in 2014, a full 80% increase over the prior year. How can Deloitte assure investors that the ability to earn higher fees did not factor in its assurance and consulting advice to VIPS.[35]

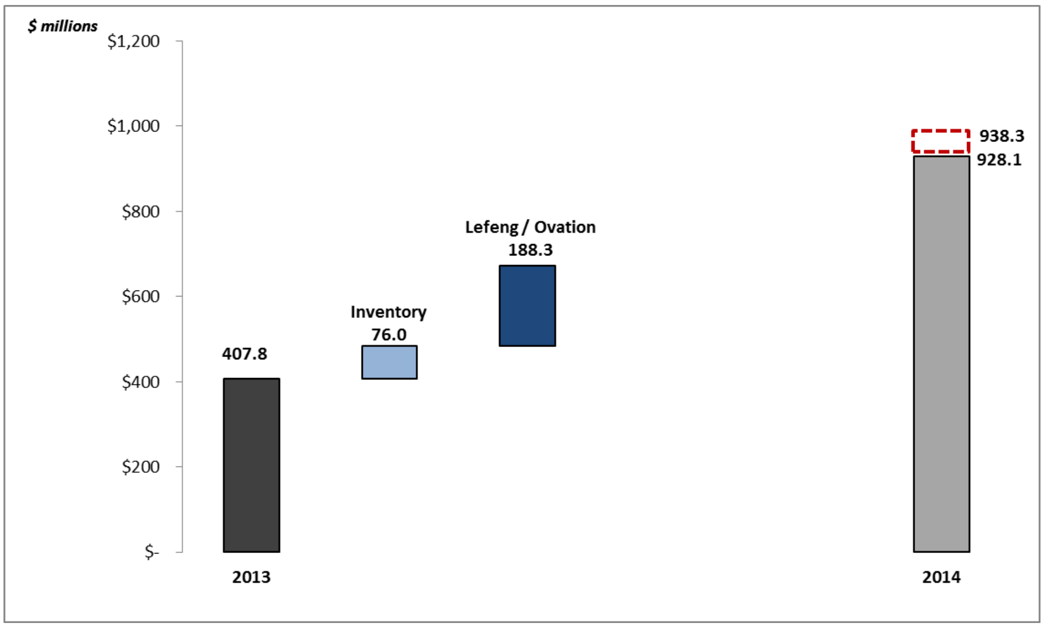
- Eric Ya Shen owns 62.5% of voting shares and with the remaining founders of the company accounts for a significant majority of VIPS' outstanding shares. Eric Ya Shen also maintains the dual role as Chairman and CEO. Management warns investors in their annual filing: 'our existing shareholders have substantial influence over our business and corporate matters, including without limitation, decisions regarding mergers and consolidations, asset disposals and director elections. They may exercise their shareholder rights in a way that they believe is in their best interest, which may conflict with the interest of our other shareholders. These actions may be taken even if they are opposed by our other shareholders.[36]' However, Eric Ya Shen should assure minority investors and regulators that despite the above-referenced disclosure, that he and the Board have acted in good faith and have lived up to their fiduciary duties to VIPS and ALL of its shareholders, not just Eric Ya Shen.

In our opinion, this Board is both 'cozy' (interlocked and familiar) and 'busy' (multiple directors multiple VIPS responsibilities as well as other high-profile professional commitments). Various conflicts, alignments and relationships raise questions about various members' ability to act as truly independent directors and hence raise serious questions about the firm's governance structure. The fact that the Board is Chaired by CEO Eric Ya Shen, and that the company's

[33] http://www.sec.gov/Archives/edgar/data/1295484/000110465915024169/a14-25053_120f.htm
[34] http://www.sec.gov/Archives/edgar/data/1269238/000110465913025802/a13-5968_120f.htm
[35] http://www.sec.gov/Archives/edgar/data/1529192/000104746914004168/a2218799z20-f.htm
[36] http://www.sec.gov/Archives/edgar/data/1529192/000104746914004168/a2218799z20-f.htm

financial statements reveal multiple questionable transactions or anomalies should disturb most minority investors, particularly those in the US who have limited voting power, limited ability to initiate shareholder actions and few, if any, legal options to recover any potential losses as a result of any asset misappropriation or financial statement manipulation.

We believe that the amount paid for both Lefeng and Ovation were excessive and likely used to funnel proceeds to RPTs for use in round trip transactions. If VIPS, like several Asian firms before it, used the M&A transactions to funnel cash to RPTs in order to inflate Gross Profit and Sales, VIPS could have diverted $188.3M to RPTs.



7. LOGISTICS INVESTMENTS: THE LAST MILE MAY BE THE LAST STRAW

The Lefeng and Ovation transactions were the largest of VIPS' 2014 investments, but VIPS also took stakes in several logistics companies. VIPS has stated that investing in logistics companies will allow the company to minimize its largest single expense item, fulfillment expenses, and shorten delivery times.

- Donghao Yang-CFO 'Moreover, on the delivery solution side, we began in early 2014 to invest judiciously in several courier companies with superior services. In some select cities, we are also preceding to launch our own national deliveries services. We believe that by integrating our logistics solutions, we will enjoy greater economies of scale as we continue to grow our order volume. Over the next two years, we aim to scale our last-mile capabilities to support 70% to 80% of total orders on our platform.[37]'

7.1 Approximately $23M is of Non-Current Assets is recorded on the 2014 balance sheet and cannot be attributed to Lefeng, Ovation or CAPEX; we believe these accounts reflect investments in Logistics companies.

VIPS explains in the annual report that its investments include an IT company, Explink, and 'a PRC Logistics Company' in the account labelled 'Investment in Affiliates'. VIPS further states that it controls 37.5% and 30% of the two companies respectively. Those two investments accounted for only about $1.3M. We find it odd that the 30% interest in the logistics company, was not enough to allow the company to disclose the firm's name. Again, as we mentioned in the section on corporate governance, several recent Asian frauds were conducted through RPTs and that fact that VIPS fails to identify these companies arouses our suspicions that these may be RPTs.

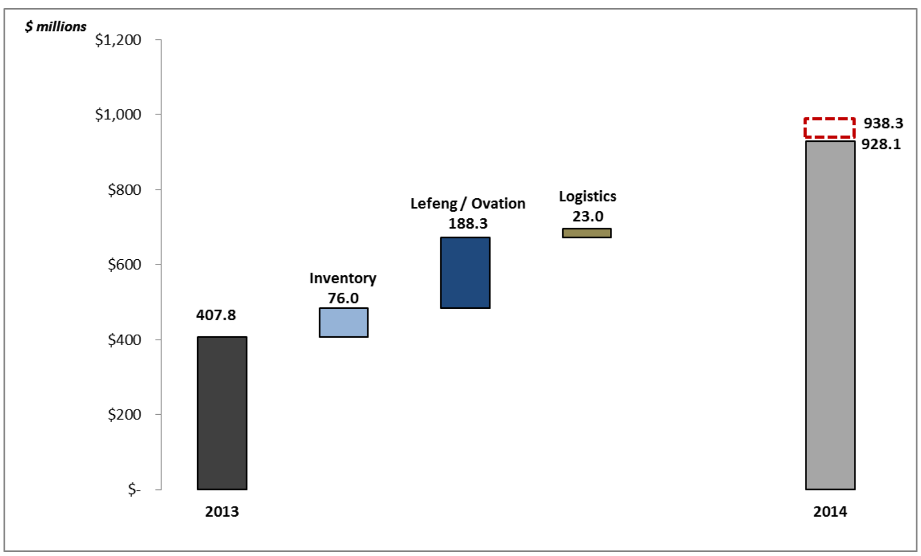
The majority of funds relating to investments can be found in the 'Other Investments' and 'Other Long Term Assets' accounts which grew from $0 in 2013, to $23M in 2014. VIPS explains that 'Other Investments' totaling $16.6M, includes equity stakes in companies which VIPS does not maintain control. There is no explanation of the account 'Other Long Term Assets' totaling $6.6M but we have assumed that this account also relates to investments in logistics companies. VIPS provides no further detail about these investments other despite its grand ambitions for the last mile delivery initiative. We do not have a schedule which highlights the names of the companies, the associated investment amounts, or the extent to which these companies are RPTS—which we suspect is very likely. Given that the Fulfilment expenses account for such a significant portion of total revenues, AND that Fulfilment expenses have dropped precipitously over the last 4 years, there is a real and significant concern that one of the ways VIPS is able to continually reduce costs associated with Fulfillment expenses is by pushing them off of its balance sheet, and on to the balance sheets of these unconsolidated entities.

37 http://seekingalpha.com/article/2695865-vipshop-holdings-vips-ceo-eric-shen-on-q3-2014-results-earnings-call-transcript

7.2 Management seemingly ignored a direct question about last mile, leading us to be even more suspicious of the $23M spend.

- Muzhi Li - Arete Research … regarding the balance sheet impact from the investment in the logistic companies. Where we can find these numbers from the balance sheet instead from the P&L?
- Donghao Yang - Chief Financial Officer So the fulfillment expenses declined year-over-year, largely because of, first, due to our growing scale. We have greater bargaining power, so that we can have a lower rate with most of the company partners who we work with. And secondly, our average ticket size went up significantly year-over-year, and then also helped drive down the fulfillment cost per order.
- Operator- The next question comes from the line of John Choi of Daiwa[38].

VIPS never provided an answer to the analyst, and while the 20-F provides some additional disclosure, VIPS has yet to disclose the names of the companies that have received the $23M in investment, nor has it provided details about those companies businesses, other than to provide the limited disclosure that VIPS recorded $1.0M in impairments from these investments in 2014. Again, these funds could well be part of a scheme to divert funds to RPTs and have them return as artificial Gross Profit which could then be Grossed up into artificial sales. We have assumed this to be the case and show it as an initiative used to further boost reported Gross Profit in 2014.



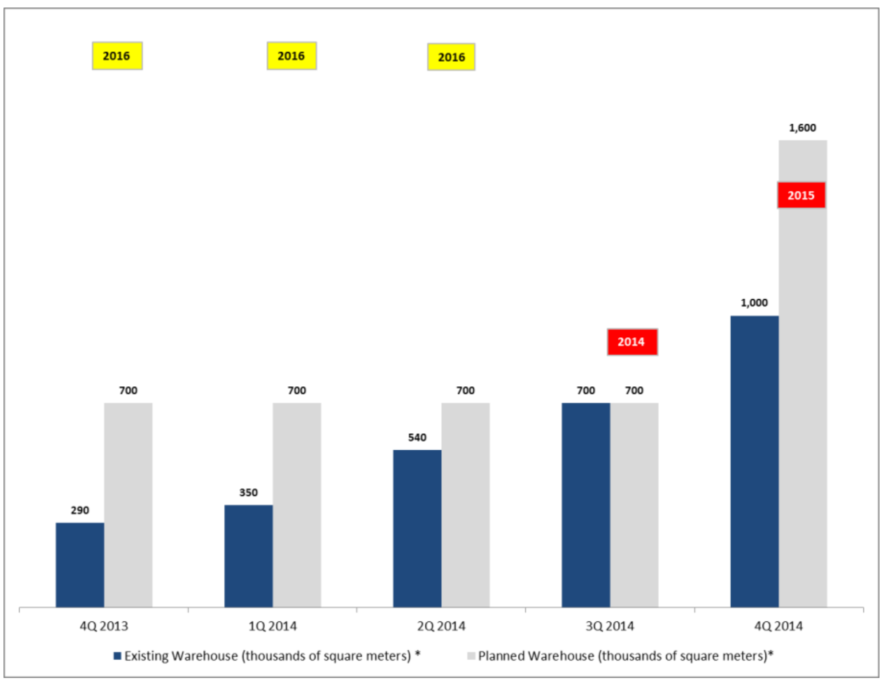
[38] http://seekingalpha.com/article/2923466-vipshops-vips-ceo-eric-ya-shen-on-q4-2014-results-earnings-call-transcript

8. CAPEX: AREN'T WE ALREADY SWIMMING IN EXCESS CAPACITY?

In late 2014, VIPS revised prior guidance on its CAPEX projections and accelerated both the timeline and the amount of spend to a level that is 8x VIPS' historical rate and nearly 2x the rate of its largest competitor. Management's rationale for the sudden and significant spike is not supported by the company's own financial statements.

For over a year--3Q 2013 to 3Q 2014—Vipshop had been consistent in its messaging about projected CAPEX spend. The company reiterated multiple times that it would spend a total of $200M over the course of the next 3 years--2014 to 2016--to grow its owned-warehouse capacity from 290,000 square meters at the end of 4Q 2013, to 700,000 square meters by the end of 4Q 2016. Each quarter the mantra was repeated--$200M, 3 years, to get to 700,000 square meters.

However, in November 2014[39], Vipshop suddenly changed course; it announced that it had already reached 700,000 square meters—2 years early—and was on track to spend well in excess of the $200M that had been predicted for the build out.



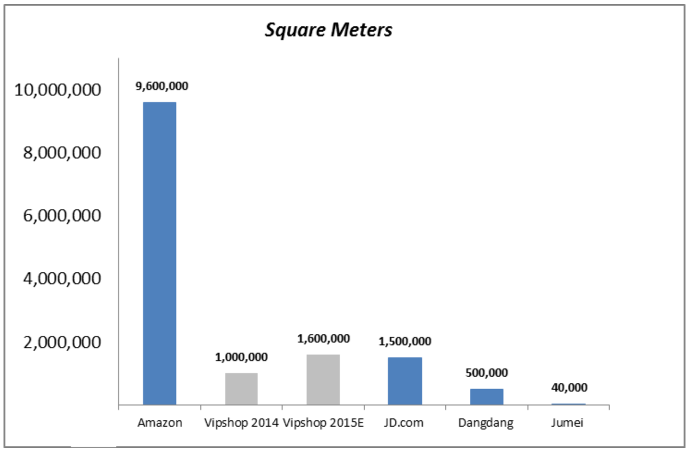
VIPS further revealed that there was an additional 600,000 square meters under construction at the time. Chairman & CEO Eric Ya Shen appears to state on the audio recording of the earnings call that Vipshop would have a total of 1.6 million square meters of warehouse capacity by the end of 2015 (audio is unclear and transcripts are not consistent but we believe the figure mentioned is 1.6M):

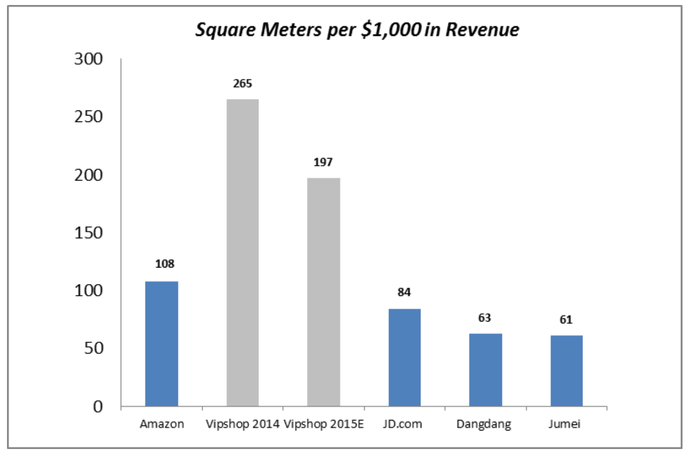
39 http://seekingalpha.com/article/2695865-vipshop-holdings-vips-ceo-eric-shen-on-q3-2014-results-earnings-call-transcript

- 'So Wendy, for 2015 it's going to be another investment year for Vipshop. We are going to continue to invest into our infrastructure. In particular, our warehouse capacity is anticipated to reach around 1.[6] million square meters by the end of 2015.[40]

8.1 In comparison to larger national and global competitors, VIPS' warehouse capacity appears excessive.

While 1,600,000 square meters of capacity does not seem like a great stretch, the figures rank VIPS as having the largest warehouse capacity among Chinese e-commerce companies.





Moreover, when comparing the amount of warehouse space to the amount of sales, we see, that at current levels, VIPS has nearly 4x as much space per $1,000 in reported revenue as the average Chinese online retailer.

Global industry leader, Amazon.com maintains 108 square meters per $1,000 in revenue and as such, in 2015 will have 55% fewer square meters for every $1,000 in revenue than VIPS does.

8.2 Management even admits to having more than enough capacity on the 3Q 2014 call.

- Unidentified Analyst: Hi. Thanks for taking my questions. I would like to ask about current warehouse utilization and whether you the utilization going from third quarter to fourth quarter. (…)
- Millicent Tu - Investor Relations: [Foreign Language]
- Eric Shen - Chairman of the Board, Chief Executive Officer: [Foreign Language]
- Millicent Tu - Investor Relations: Okay, because we have continuously adding and building more warehouse capacities, so the current utilization rate is low.

[40] http://www.thestreet.com/story/13049247/5/vipshop-holdings-vips-earnings-report-q4-2014-conference-call-transcript.html

Essentially, on the same call, Shen is admitting that he desperately needs additional warehouse capacity AND that current utilization rates are low.

8.3 VIPS' projected revenue figures for 2015, also do not support the argument for the dramatically revised levels of CAPEX spend

Management provided guidance on its 1Q 2015 Revenue in its 4Q 2014 6-K filing.[41] The company is projecting between $1.25 and $1.3 billion in sales for the quarter. We conducted an analysis that shows the trend of revenue by quarter as a percentage of total revenues. Our analysis suggests that, on average, 16% of total revenues are accounted for in the first quarter. This figure implies that the annual estimated revenue guidance is approximately $8.1 billion ($1.3b / 16%). Furthermore, we estimate Goods-Available-for-Sale of $6.7 billion [($8.1B x 75% Costs of Sales) + (Beg. Inventory of $0.6M)].

(millions)		1Q	2Q	3Q	4Q	Total
Revenue						
	2014	701.9	829.4	882.6	1,359.7	3,773.7
	2013	310.7	351.3	383.7	692.1	1,737.8
	2012	101.3	135.3	155.9	299.6	692.1
	2011	28.9	40.6	52.5	105.3	227.2
% of Total Revenue by Quarter						
	2014 % Rev by quarter	*18.6%*	*22.0%*	*23.4%*	*36.0%*	*100.0%*
	2013 % Rev by quarter	*17.9%*	*20.2%*	*22.1%*	*39.8%*	*100.0%*
	2012 % Rev by quarter	*14.6%*	*19.5%*	*22.5%*	*43.3%*	*100.0%*
	2011 % Rev by quarter	*12.7%*	*17.9%*	*23.1%*	*46.3%*	*100.0%*
	Average	*16.0%*	*19.9%*	*22.8%*	*41.4%*	*100.0%*
Est. Annual and Quarterly Revenue						
	2015 Projection [a]	1,300.0	1,621.4	1,856.1	3,371.0	8,148.5
	COGS at 75%	975.0	1,216.1	1,392.1	2,528.2	6,111.4
Est. Goods Available for Sale						
					2015 Beg Inv	578.0
					2015 Purchases	6,111.4
					Goods Available for Sale 2015	6,689.4
					Goods Available for Sale 2013	1,432.0
					Expected increase in Goods Available for Sale 2013 to 2015	*367.1%*
					Expected increase in Revenue 2013 to 2015	*380.2%*
					Expected increase in Warehouse Capacity	*451.7%*

a. Guidance for 1Q 2015 was provided in 6-K, 2/16/15; using 1Q figure to estimate annual and quarterly figures based upon historical distribution of Revenue by quarter

Vipshop expects us to believe that over the period from 2013 to 2015, it will record growth in revenues of 380% and growth in Goods-available-for-sale by 367%, while simultaneously growing its warehouse capacity by 452%, 72 to 85 basis points higher. This is despite the fact that the company itself admits in 3Q 2014 that it has significant excess capacity already.

41 Securities & Exchange Commission Filings Vipshop Holdings Limited, 6K 2/17/15, p. 5.

It should be noted that VIPS is reporting $235.7M of Construction in Progress. VIPS also reports more warehouse locations, but these are leased. In fact, despite management's focus on moving to owned warehouses, leasing expense continues to grow, $7.5M, $13.7M, and $26.6M in 2012, 2013 and 2014 respectively. Leasing expenses in 2015 are expected to grow to $37.4M. If VIPS truly needs warehousing space, it is not getting it from newly built warehouses just yet. The growth in warehouse space is coming from additional lease commitments, not from the as yet uncompleted warehouses.

It is our opinion that VIPS does not need additional warehouse capacity. We believe that like many Asian frauds, VIPS may be using the proceeds of the CAPEX overspend as funds for RPTs to transact fake sales via round robin transactions. We believe any requirements for warehouse capacity have been more than addressed by the additional leased facilities.

8.4 In our opinion, VIPS recorded, at a minimum, $233M more in CAPEX than was required for its current and future growth profile.

Using the metric CAPEX spend as a percentage of Sales, we evaluated VIPS' CAPEX spend to (a) VIPS historical spend rate and (b) VIPS' competitors current and historical spend. We then estimated what VIPS would have recorded in CAPEX had it not accelerated these expenditures.

(millions)		2012	2013	2014	*2011-2014 CAGR*	*2013-2014 YoY*
JD	Sales	6,642.0	11,454.0	17,755.0	*63%*	*55%*
	Capex	192.0	215.0	799.0	*104%*	*272%*
	% Capex to sales	*2.9%*	*1.9%*	*4.5%*		
Dangdang	Sales (RMB)	5,194.0	6,325.0	7,957.0	*24%*	*26%*
	Capex (RMB)	137.6	93.7	103.8	*-13%*	*11%*
	% Capex to sales	*2.6%*	*1.5%*	*1.3%*		
Jumei	Sales	233.0	482.0	652.0	*67%*	*35%*
	Capex	2.0	5.0	10.0	*124%*	*100%*
	% Capex to sales	*0.9%*	*1.0%*	*1.5%*		
Vipshop	Sales	692.1	1,696.7	3,773.7	*134%*	*122%*
	Capex [A]	7.8	12.9	323.9	*544%*	*2419%*
	% Capex to sales	*1.1%*	*0.8%*	8.6%		
Average % for JD, Dangdang & Jumei		*2.1%*	*1.5%*	2.4%		
2014 Capex at 2.4% of Sales [B]				90.6		
2014 Capex overspend [A] - [B]				233.3		

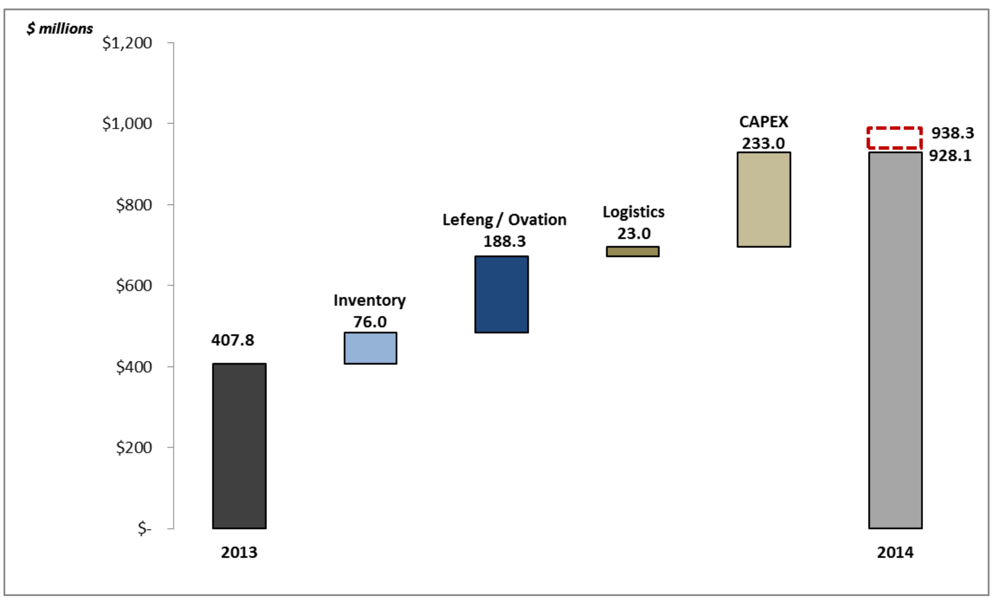
Source: SEC filings for Jumei, Dangdang, JD.com and VIPS for 2012-2014.

The key takeaways here are that:

- In comparison to VIPS' spend for 2012 to 2013, amounts spent in 2014 were in excess of 700 basis points higher.

- In comparison to spend at key Chinese competitors, VIPS' CAPEX spend as a percentage of sales, exceeds even the next highest spender, JD.com, by 400 basis points.
- CAPEX as a percentage of Sales at VIPS outpaces levels reported at Chines competitors on a three year CAGR as well as on a year-over-year basis.

It is the opinion of Mithra Forensic Research that VIPS is possibly accelerating the pace and amount of its CAPEX for reasons not related to expectations around demand or lack of space. We believe that VIPS may actually be capitalizing items not related to its warehouse program (e.g., Fulfillment Expenses, as has been done in previous Asian frauds). In addition, we believe that VIPS may have diverted the funds for this urgent 'CAPEX' program to RPTs which returned to VIPS in the form of artificial sales in 2014. A number of the RPTs are likely those companies that are listed as distributors and suppliers in the accounts receivable notes and those companies that are part of VIPS' 'lasts mile' initiative. Over the course of the last year, VIPS has not only expanded the spending on CAPEX, it has also expanded the number of potential and confirmed RPTs. We believe that non-controlling stakes in various logistics companies may be a way for VIPS to transfer sizeable amounts of Fulfilment and other OPEX expense off if its financial statements. The difference between the $324M reported CAPEX (including deposits for PPE and land use rights) and the $90.6M normalized CAPEX we calculated above is the amount we believe VIPS sent to RPTs which could have returned as inflated sales.



<u>Hence, VIPS' manipulations of Inventory, its routing cash from M&A and CAPEX to RPTs has resulted in growth in Gross Profit of $520.3M from 2013 to 2014, or roughly 98% of the change year-on-year.</u>

9. AS RPTS GROW, SO GROWS 'OTHER RECEIVABLES'

Again, while we have no evidence to prove that the excess funds have been diverted to related parties, it should be noted that in the last year, the balance sheet has shown a rapid increase in non-trade receivables which are typically where RPTs would be reported.

In 2014, VIPS added over $100M in various 'Other Receivables' accounts. In recent Asian frauds, Other Receivables has been the account where most abusive RPTs have been recorded[42].

	As of December 31, 2013 USD (Unaudited)	As of December 31,2014 USD (Unaudited)	Δ
CURRENT ASSETS			
Cash and cash equivalents	334,715,019	772,128,894	
Restricted cash	0	64,526	
Held-to-maturity securities	385,841,626	607,345,904	
Accounts receivable	3,055,446	24,997,405	21,941,959
Amounts due from related parties	0	4,994,873	4,994,873
Other receivables	16,481,032	88,663,626	72,182,594
Inventories	270,126,305	578,329,704	
Advance to suppliers	13,216,869	13,208,263	-8,606
Prepaid expenses	2,384,801	3,440,660	1,055,859
Deferred tax assets	11,126,647	37,576,691	
Total current assets	1,036,947,745	2,130,750,546	
Increase in Non-trade Receivables			**100,166,679**

Even standard Accounts Receivables contain disclosures about receivables to partners and suppliers—no accounts with end-customers. VIPS' largest Accounts Receivables are with Delivery Service Providers and Suppliers. Since VIPS claims to be the primary obligor for most of its sales, the fact that VIPS lists Delivery Service providers as accounts receivable is unusual.

The largest component of AR in 2013 is 'Other Receivables'. Again, these amounts do not relate to transactions with customers, but with suppliers and vendors. The use of the AR for advances to suppliers is unusual and should probably be recorded as advances or pre-payments to suppliers.

There is a separate but similarly named account for 'Other Receivables' which shows a jump of $72M in 2014 as a result of VAT and Deposits paid to vendors for advertising. Similarly 'Pre-paid expenses' which would likely include amounts paid to logistics companies and possibly RPTs also show an increase.

42 http://www.beyondproxy.com/detecting-accounting-fraud-asia/

The presence and rapid growth in these accounts further serve to raise our concerns regarding VIPS and various disclosed and undisclosed RPTs. Some key questions that need to be addressed with respect to these accounts are as follows:

- Why would there be large outstanding balances with Delivery Service Provider? Should these amounts not be in Cash-in-Transit if VIPS is awaiting transfer from providers who collect cash? Does the growing sum indicate problems with some Delivery Service Providers or possibly issues with end-customers not paying—despite claims of operating on a cash-on-demand model?
- Why would the largest component of A/R in 2013 consist of loans to suppliers? Who are these suppliers? Are they related parties? Why is it accounted for as A/R and not as loans?
- Other Receivables have often been used by a number of Chinese companies to siphon cash out of the business, so Vipshop should explain why it makes loans to vendors? What is driving the growth in Other Receivables from $16M in 2013 and $88M in 2014? Is it truly VAT receivables and why is it growing so rapidly? Why is the Other Receivables account 3.5 times greater than what we report as Accounts Receivable which theoretically relate to cash expected from 'Customers'?
- What is the difference between Advances to Suppliers and Accounts Receivables or Other Receivables? How does Vipshop differentiate between each of these accounts given the similarity of terms used in reporting accounts and sub-accounts?

It is our view , VIPS likely used excess spend of $573M and routed it to RPTs. Those RPTs helped VIPS generate fake sales. The existence of several unusual and growing 'Other receviables' is a clear red flag to us and and supports our view that RPTs are behind the huge growth in Gross Profit and Sales reported in 2014.

10. HELD-TO-MATURITY: IS THIS ANOTHER NAME FOR 'RELATED-PARTY LOANS'?

VIPS maintains a significant and growing balance of short term Held-to-Maturity (HTM) investments. In fact, HTM has accounted for more than 20% of total assets in the last two years. We have some concerns about HTM investments, particularly with respect to the rates of interest earned on them which seems significantly lower than what we would expect from other investments of similar maturity. Our concerns are that HTM investments may be loans to Related-Parties.

10.1 The interest earned on the HTM accounts in each of the last 3 years, is less than the rate of interest VIPS would have earned on both a high-grade government 1 year loan as well as a 3 month timed deposit.

We examined the purchases and redemptions of HTM over the course of the last 3 years. We computed averages HTM balances and compared these to interest earned on HTM as reported in the Cash Flow statement of VIPS annual reports[43].

(millions)	2012[a]	2013	2014 as Reported with summing error	2014 as Adj. by lowering Interest
Held-to Maturity Investments				
Beginning Balance	-	86.1	385.8	385.8
Purchases	101.3	615.2	1,018.2	1,018.2
Redemptions	(16.2)	(321.2)	(809.2)	(809.2)
Interest earned	1.0	4.3	19.3	12.5
Ending Balance	86.1	384.4	614.1	607.3
Change yoy	86.1	298.3	229.7	222.9
Average HTM Balance	43.1	235.3	499.2	495.8
Average interest income	1.0	4.3	19.3	12.5
Annualized Interest rate	*2.32%*	*1.81%*	*3.87%*	*2.52%*
Bank of China--Deposit rates				
3 month [b]	2.85%	2.85%	*2.60%*	*2.60%*
6 month [b]	3.05%	3.05%	*2.80%*	*2.80%*
12 month [b]	*3.25%*	*3.25%*	*3.00%*	*3.00%*
Bank of China--1 year Loan rates	*6.00%*	*5.60%*	*5.35%*	*5.35%*

a) HTM is first reported in Q3 2012.
b) Rates presented are Bank of China benchmark rates.

[43] http://www.sec.gov/Archives/edgar/data/1529192/000104746915003885/a2222963z20-f.htm

It should be noted that we believe we identified an error in the computation of the HTM ending balance for 2014 as the figures provided do not sum to the reported total. We therefore evaluated interest earned on HTM in 2014 using our adjusted figures which assumes that the difference of $6.8M is related interest on cash balances and not HTM balances.

Our analysis reveals that for 2012, 2013, Reported 2014 and Adjusted 2014, the annualized interest earned on HTM is less than rates for a high-grade 1 year loan. Most strikingly, the rate of interest earned on HTM is less than that achieved on a 3 month term deposit for 2012, 2013 and Adjusted 2014.

Why would HTM investments be earning significantly less than loans or even term deposits of similar maturity? We believe that the HTM account reflects balances on loans that have been extended to Related Parties. Those RPTs may well be VIPS' founders or companies owned by VIPS' founders, as this has been a common theme of prior Asian frauds.

10.2 VIPS provides limited disclosure on HTM generally but in 2012 disclosed that HTM was concentrated at 5 financial institutions

VIPS explains its accounting for the HTM account briefly in single paragraph entries in each of its annual reports for the last three years. This is despite HTM's relative size (36% and 22% of total assets in 2013 and 2014, respectively) and importance. The disclosure statement on HTM has remained broadly the same over the years, but in 2013 and 2014, the HTM explanation did not include a reference to the number of securities as had been disclosed in 2012. In the 2012 explanation of HTM, VIPS stated the following[44]:

> **5. Held-to-maturity securities**
>
> As of December 31, 2012, the Group's held-to-maturity securities consist of five debt securities carried at amortized cost of $86,097,191, which approximate the aggregate fair value. All of these securities mature within one year and are classified as current asset. The amount of unrecognized holding gain as of December 31, 2012 was $1,026,325.
>
> There has been no impairment recognized and no sales of any held-to-maturity securities before maturities during the periods presented.

It may be a coincidence, but the number of HTM securities matches the number of VIPS founders--5. Each of the VIP founders also maintains corporate entities in the British Virgin Islands which could make associating the HTM with the founders more difficult for auditors. While this may be sheer coincidence, the fact that VIPS has changed the disclosure and the fact that there are already concerns about the growth in number and importance of RPTs, leads us to believe that HTM balances may not be accessible to VIPS for use in the operation of the business.

44 http://www.sec.gov/Archives/edgar/data/1529192/000110465913028264/a13-4788_120f.htm

10.3 The fact that VIPS needed to access the capital markets for its M&A and CAPEX spend further suggests to us that HTM is not accessible to the business.

As mentioned in section 6.4, despite having $720M in cash and securities at the beginning of 1Q 2014, VIPS secured short-term financing from local Chinese banks to conduct the Lefeng and Ovation transactions. Subsequently, VIPS secured another $632.5M from the capital markets to pay off the loans and to fund 'other general corporate purposes, including expenditures related to the planned expansion of the Issuer's logistics network and warehousing capacity.[45] VIPS Executives, Directors and 'certain shareholders' joined in on the action by selling $188M worth of their American Depository Shares. VIPS pointed to the M&A and CAPEX initiatives as the proposed uses for its proceeds.

But VIPs and its key shareholders have regularly returned to the capital markets, cap in hand. In fact, VIPS has accessed the capital markets every year since the IPO in 2012. Founders and other key shareholders have also used these opportunities to offload shares concurrent with such fund raisings[46].

<u>The below disclosure indicates that VIPS and its key shareholders have raised nearly $1 billion from the capital markets since 2012.</u>

16. Capital Structure

Initial public offering

In March 2012, upon the completion of the Company's initial public offering, all Series A Preferred Shares and Series B Preferred Shares issued in 2011 were automatically converted into 20,212,500 and 12,682,206 ordinary shares respectively. In addition, as part of the initial public offering, the Company issued 22,009,200 ordinary shares. The gross proceeds received were US$66,022,797 and the related issuance costs were US$3,332,962.

Follow-on offering

In March 2013, the Group completed its follow-on public offering. The Company issued 8,000,000 ordinary shares. The gross proceeds received were US$91,920,000 and the related issuance costs were US$1,571,688.

Issuance of convertible senior notes

On March 17, 2014, the Company completed a public offering of 1,140,000 ADSs by certain of the Company's selling shareholders, representing 2,280,000 ordinary shares, at a public offering price of US$143.74 per ADS, and US$550,000,000 aggregate principal amount of the Company's 1.50% convertible senior notes due 2019. Concurrently, the underwriters exercised in full the option to purchase an aggregate of 171,000 additional ADSs from certain selling shareholders at the public offering price of the offering and up to an additional US$82,500,000 aggregate principal amount of the Company's 1.50% convertible senior notes due 2019.

Dual-class share structure

On September 15, 2014, the Company's shareholders voted in favor of a proposal to adopt a dual-class share structure, pursuant to which the Company's authorized share capital was reclassified and re-designated into Class A ordinary shares and Class B ordinary shares, with each Class A ordinary share being entitled to one vote and each Class B ordinary share being entitled to ten votes on all matters that are subject to shareholder vote. Both Class A ordinary shares and Class B ordinary shares are entitled to the same dividend right. The holders of the Group's ordinary shares are entitled to such

It is our view that VIPS depends upon the capital markets for cash since the balances reported in Cash and HTM may not be accessible or may have been transferred to RPTs. If this is the case, VIPS is very much following in the path of many

[45] http://www.sec.gov/Archives/edgar/data/1529192/000110465914018630/a14-7455_11fwp.htm

[46] http://www.sec.gov/Archives/edgar/data/1529192/000104746915003885/a2222963z20-f.htm

Asian companies that have engaged in propping and tunneling. Management and the Board need to convince investors that, despite many similarities to recent Asian frauds, VIPS is not engaging in financial statement manipulation.

10.4 VIPS reported over $500M in Cash Flows from Operations, but closer analysis reveals that the company is achieving this by significantly deferring payments to suppliers.

VIPS reported healthy and growing Cash Flows from Operations for the last three years--$111M, $437M and $506M, in 2012, 2013, and 2014 respectively. However, a closer analysis of the drivers of this growth reveal that significant growth in Accounts Payables balances and Accrued Expenses balances have allowed the company to report such impressive figures. Essentially, VIPS is significantly delaying payment to various parties so that it can show these healthy figures.

	Year ended December 31,		
	2012	2013	2014
	$	$	$
CASH FLOW FROM OPERATING ACTIVITIES:			
Net (loss) income	**(9,472,074)**	**52,299,863**	**122,789,192**
Adjustments to reconcile net (loss) income to net cash by operating activities:			
Allowance for doubtful debts	—	(31,090)	671,545
Prepaid expenses write-down	222,999	343,015	—
Inventory write-down	12,166,659	33,883,024	35,585,311
Depreciation of property and equipment	4,527,122	8,838,893	17,945,376
Amortization of intangible assets	4,801	229,456	40,328,316
Impairment loss on intangible assets	—	—	2,724,963
Loss on disposal of property and equipment	20,670	52,712	31,907
Share-based compensation expenses	7,596,949	12,456,263	36,790,447
Share of loss of affiliates	—	—	10,232,492
Impairment loss of other investment	—	—	1,006,083
Interest income on held-to-maturity securities	(1,026,325)	(4,256,810)	(19,278,368)
Amortization of debt issuance cost	—	—	4,303,481
Changes in operating assets and liabilities:			
Accounts receivable	(2,866,381)	3,791,431	(21,941,959)
Amounts due from related parties	1,924,616	177,237	(4,994,873)
Other receivables	(583,406)	(6,512,714)	(64,912,801)
Inventories	(86,388,390)	(160,045,398)	(337,003,681)
Advances to suppliers	2,859,976	(3,789,748)	8,606
Prepaid expenses	390,318	(1,697,925)	(850,747)
Prepayment of operating lease	—	—	(13,214,473)
Deposit related to acquisition of land use right	—	—	(7,168,459)
Deferred tax assets	—	(11,126,647)	(26,450,044)
Accounts payable	105,435,451	283,392,054	448,569,630
Advance from customers	40,567,356	75,833,038	97,553,687
Accrued expenses and other current liabilities	26,009,941	143,651,077	179,536,879
Amounts due to related parties(note a)	(168,989)	805,655	3,026,275
Deferred income	10,347,912	8,788,414	9,651,357
Deferred tax liability	—	—	(9,279,689)
Net cash from operating activities	**111,569,205**	**437,081,800**	**505,660,453**

VIPS has stated on prior calls and in its disclosures that it receives payment from customers within 2 business days and that it usually pays suppliers between 30 and 45 days after the each promotion[47]. Why then has VIPS' Days Payable Outstanding been in excess of 125 days for each of the last 4 years?

$ millions	2011	2012	2013	2014
Accounts Payble	88.0	193.5	476.8	986.6
Costs of Sales	183.8	537.6	1,288.9	2,835.3
Days Payable Outstanding (DPO)	*172*	*130*	*133*	*125*

We suspect that VIPS does not pay its vendors more quickly because it does not have the cash on hand to do so. We believe that the company may be relying upon the capital markets to fund its business and to dress up its financial statements.

47 http://seekingalpha.com/article/2221703-vipshops-vips-ceo-eric-shen-on-q1-2014-results-earnings-call-transcript?part=single