China-Focused Manager Seeks to Debunk the JD.Com Myth

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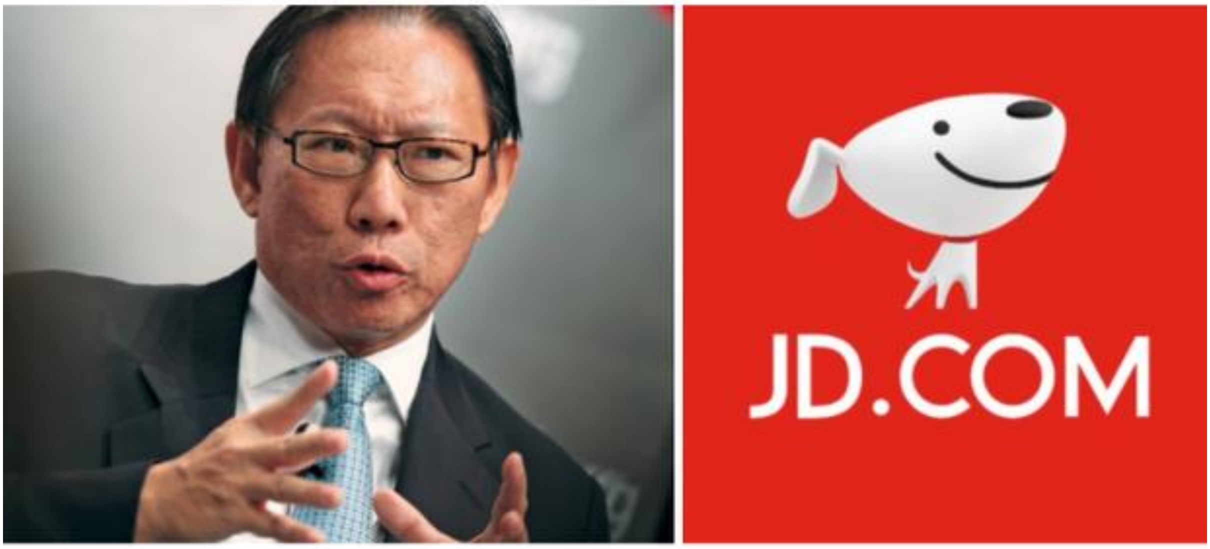
JD:US



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SumZero Q&A featuring: **Wong Kok Hoi**
Founder & CIO, APS Asset Management

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Read the Original JD.Com Report

Wong Kok Hoi, founder and CIO of Singapore-based APS Asset Management has been bearish on JD.com for years. Last week, SumZero published his full-length short report on the e-commerce giant, whose $60B valuation he deems "unjustified". We sat down with Wong for an in-depth dissection of his thesis and more detail on the red flags investors are either missing or underestimating.

SumZero: In an interview a while back, you said "don't do what others do." To get started, tell us a bit more about the salient features of APS' investment philosophy and how this has informed your thesis on JD.

Wong Kok Hoi: We put on three hats when we do research. First, we put on the "Benjamin Graham" hat. This is something our peers already do. While necessary, we believe this is insufficient for success. Applying this lens to JD, we might dare say Benjamin Graham would be disturbed at JD's fundamental lack of profitability. He would note the immense speculation on JD's future profits.

Second, we put on the "Sherlock Holmes" hat. This refers to investigative research, which includes forensic accounting analysis. The forensic accountant in Sherlock Holmes might point out how JD's fixed assets are lower than its peers, or that it has an illogical way of managing its cash. The detective in Sherlock Holmes would talk to past JD employees, suppliers and customers to get their views on the business.

Finally, we put on the “Robert Kuok” hat. Robert Kuok is arguably the most successful Asian businessman of my time. We perform deep business research from the viewpoint of a businessman, rather than a security analyst. Is JD running a profitable business? Does the company make shrewd investments? These are the questions a businessman would ask.

SZ: Much of your argument is that JD.com is involved in "brushing orders," a form of fraud that you've identified as part of the case brought by Noah Holdings. That's a huge accusation. How is that case progressing and what legal outcome, if any, do you predict for JD.com and Camsing?

WKH: For Camsing, given the way the share price has reacted, investors seemed to have concluded it is a fraud. The scale of the fraud implicating Camsing and its ecommerce clients as alleged by its factoring companies is shocking for a small and relatively unknown company, exceeding a billion dollars. If fraud is proven, the chairman will have to go to jail.

JD has publicly admitted that Camsing was a supplier of 3C and electronic goods. Noah has asserted publicly that it has financed JD’s receivables from 2015, amounting to a couple of billion dollars. We don’t know the full details of the intricate web of trade receivable financing, and therefore cannot make any accusation. Nevertheless, the authorities have reportedly called it a massive case. A leading and credible newspaper, Caixin, has released shocking findings not previously known to investors.

It is possible that the receivables were indeed faked by Camsing without knowledge of JD's management. In this case, JD will get off scot-free. But there are troubling facts investors should know.

First, Caixin reported that the procurement manager of JD's telecom products department, surnamed Xu, was detained for interrogation. Several members of his team have also departed.

Second, the sums involved are in billions of USD spread over a number of years, so this is not an isolated incident involving several million dollars. There is either some level of executive knowledge, or there is a total absence of operational processes, procedures and risk controls.

Third, Noah has a long-standing relationship with JD where payments were made from JD's corporate bank accounts, which according to Chinese bankers are hard to fake.

That said, analysts should wait for the police investigation, the likely imminent criminal lawsuit and the subsequent civil lawsuits run their full due course. We just have to be aware of the risks. The investigation and lawsuits will surely bare open to the public the details of wash sale schemes, involved parties, guilty parties, and losses.

SZ: You've been exceptionally bearish on JD.com since 2017. Your most recent report claims that JD.com will be a washout, but they've been handily outperforming the market during a huge crisis. What makes you so confident that your thesis will be borne out?

WKH: We believe we know the company well. Our investment thesis is based on our holistic, primary, in-depth, ground research done over many years, rather than on hearsay or gut feel.

We have spoken to JD’s key competitors, their former employees, their merchants, their factoring company, and newspaper reporters over many years. We have spoken to about a dozen of their former employees. From them, we gained insights and a balanced understanding how they run their business, of the company’s culture, who calls the shots in the company, how they work with their merchants and what the merchants think of the company’s modus operandi and their staff.

We have also probed every footnote to the financial statements in the last seven years. We have also compared their product prices with their offline and online competitors so we can model future profit margin based on their ability to increase prices.

We have dialled into every quarterly earnings call since its IPO, so we can tell whether management has been consistent in their narrative over time, and whether they walk their talk. In order to help us interpret correctly what its CFO, Sidney Huang, tells shareholders and analysts, we studied the recorded earnings calls when he was CFO at Vance Information, his previous employer before joining JD.com.

From its financials we discovered things like JD paying a hefty price of USD1.5 billion, in shares, for Yihaodian, an online grocer with net assets of just USD10 million. We then picked up in the following year's audited statement that Yihaodian financials were not separately disclosed, because the company stated that acquisition was deemed minor. We learnt that JD lost USD70 million trading capped options of its own stock. We also learnt that its previously reported gross margin of 15% was misleading, but was actually half that figure (taking in fulfilment costs) over multiple years.

We have pointed out many risk factors in our earlier reports, and we think the latest numbers vindicate our position. For example, we stated several years ago that JD essentially runs a low-margin online retail business of primarily 3C and household appliances, and this is a dog-eat-dog business. In 2019, 1P gross margin collapsed to a historic low of 3.6%.

We are also confident in our thesis as we see that management does not practice what it preaches. Three years ago in 2017, JD announced it planned to build one million convenience stores in five years, and be profitable from day one. We rubbished that claim. We researched how 7-Eleven, after 100 years in the business, haven't even built 70,000 stores globally. Today, including Japan stores, 7-Eleven only has just over 90,000 stores. As for JD, there is no evidence that it has even built 5% of that one million stores.

JD's attrition rate of senior management is also way too high for a rapidly growing company. In the last two years, JD's CTO, CFO and general counsel have resigned. Now, there is a police investigation against JD and Camsing for alleged fraud and imminent civil lawsuits. We thus believe many of these risks are not known to many foreign investors and therefore the stock will have to reflect them one day.

Truth be told, JD's share price strength made us do even more research and made us revisit our investment thesis. However, we have not found anything new to make us waver.

SZ: JD's stock price is up >10% YTD after a strong performance last year. What would you attribute the strong performance to and, as an investor, how do you square JD's success against your short position?

WKH: In our humble opinion, few foreign investors and analysts understand JD. Not to be disrespectful to my peers, but I think JD's strong stock performance is due primarily to this lack of understanding and hence misplaced confidence.

JD's sizable USD2 billion share buyback program announced this year might have also given investors the comfort that they have a put option against the company, somewhat like how US equity investors felt on Powell and Trump, until markets turned after Feb 19.

We think it is interesting to note that foreign investors are profoundly more bullish than Chinese investors on JD.

Benjamin Graham once noted that 'In the short-run, the stock market is a voting machine, but in the long run the market is a weighing machine'. Nobel Prize winners and behavioural finance professors Daniel Kahneman and Richard Thaler have also produced convincing empirical evidence that investors can be irrational in their decision making.

If these three highly intelligent men are to be believed, trying to understand and explain a stock's or stock market's short-term behaviour is not a very useful thing to do. To APS, a stock in the final analysis can continue to go up only if it continues to make meaningful profits, pay reasonable dividends, and pay a decent amount of taxes. After 17 years in the business, we have seen none of that for JD.

SZ: Under what circumstances would your assessment of JD.com be incorrect?

WKH: In the investing business, we must be open-minded. Industries evolve and companies change. If we find evidence that JD is turning profitable because it is outdoing its competitors, deploying its capital prudently and wisely to increase its competitiveness, pay taxes and so on, we must and will quickly abandon our current negative view.

M&A and consolidation in the industry is another potential catalyst to watch out for. If JD fully acquires Yonghui Superstores, which it already owns 10+% of, and reaches a truce with Alibaba and even merges with Suning (20% owned by Alibaba) to reap further supply chain and economies of scale efficiencies, then we might have to reconsider our view.

In our profession, we will not be given a medal for misplaced conviction. When the stock price proves us wrong, we check our data again, verify our information by talking to more people, ask why other investors hold opposite views to ours, and brainstorm again our thesis internally.

Yet we have yet to find any evidence that our thesis is misplaced. When the gross profit margin of its 1P business in Q4 2019 is at 2%, when JD's major competitors except Alibaba are bleeding, and when the company is reportedly trying to raise more capital with its Hong Kong IPO even in the middle of the biggest market downturn since the 2008-9 financial crisis, what does the future hold for JD?

SZ: What are the 2-3 key things you would want readers of your report to take away from your report? Why do you think a value investor should short JD.com if it has been quite successful for their long positions?

WKH: One key takeaway is that investors should not take reported figures at face value. What you see and what you hear is often not what you get in the e-commerce business. Investors should not be beguiled by attractive, double-digit industry growth rates because brush sales inflate those numbers, as persistently reported by the Chinese media. Insiders and merchants routinely tell us that anywhere from 20% to even half of merchants' revenue might be brushed.

A second takeaway is that JD is not a tech e- commerce company. There is no basis for the comparison of JD with Amazon or Alibaba, for there is absolutely no evidence that JD is a tech stock. JD also is definitely not a value stock as it sells at 6 times NAV and 80 times recurring earnings. It still carries a cumulative loss of USD3.5bn.

You make money by investing in stocks with improving fundamentals and rising profitability that are not discounted yet. At the end of the spectrum, if you had made a decent profit where you now believe that there is evidence of rising risks and low or no future profitability the obvious thing to do is to take profits. No?

SZ: Finally: what do you think the biggest mistakes that investors make during a bear market? Where do you think this market is heading over the next 9 months and how are you navigating it?

WKH: This bear market has been unexpected, vicious and sharp. Bullish investors ushering the New Year with leverage and big long bets have been hit real hard and will capitulate if they have not already. Optimism, which returned this week, seems a little premature to us. Investors might make the mistake of buying too early.

To use baseball parlance, Covid-19 is probably only in the third inning in the US. Macro data and corporate earnings, not just for the US but for the world, will be very ugly for at least two quarters. This bear market might turn out to be the worst bear market I have ever experienced. And I have experienced quite a few in my career.

https://sumzero.com/headlines/consumers_and_retailing/JD:US/467-debunking-the-jd-com-myth

That said, I will not wait for improving macro and earnings data before I take the plunge. If we are in the seventh inning of capitulation, it might be a good time to consider getting back in. I will also be guided by valuation.

In this situation, investors tend to make the mistake of being guided by past or even future expected earnings. They tend to make the mistake of buying companies with weak balance sheets. I will instead place more weight on net asset value, especially companies with productive assets generating return on assets of 10% or more. I will also look at companies with strong balance sheets, because in tough times, companies with weak balance sheets will be the first to go belly-up.

Finally, I would like to point out an interesting piece of recent research. A team of scientists from Harvard, Dartmouth and New York University put forth a new theory that humans are victims of “prevalence-induced concept change”, which was researched in a June 2018 study. Several groups of American college students were shown a series of 1,000 dots that ranged in colour from very blue to very purple. The participants had to answer just one question: Is the dot on the screen blue or not?

The study found that as blue dots became rare, participants start calling purple dots blue — the “blue dot effect”. When the “signal” a person is searching for becomes scarce, the person naturally responds by broadening his or her definition of the signal, and therefore continues to find it even when it is not there. Importantly, this “prevalence-induced concept change” occurred even when participants in the study were forewarned about it, and even when they were instructed and paid to resist it.

It is rather shocking to learn that our brains are faulty. Applying this “blue dot effect” on investor behaviour, investors would buy stocks because of their previous pleasant experiences of making good profits, rather than making decisions based on cold, hard rules.

The brain can’t learn. I think we saw this phenomenon of the ‘blue dot effect’ in US stocks in the just-ended 11-year bull run. Investors last year were willing to pay multi-decade high PE multiples for stocks when there were already signs that earnings were peaking. This is completely devoid of investing logic. When the opposite happens, it might be a good time to take the plunge.

Please visit the APS Asset Management profile on SumZero's Cap Intro platform to learn more about their time-tested, China-centric strategy.

For a warm introduction to Wong and his team, please reach out to access@sumzero.com.