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ALIBABA: OPEN SESAME

Case overview

In 2013, Alibaba Group Holdings Limited (Alibaba) wanted to go for an Initial Public Offering (IPO) and was contemplating the viability of three stock exchanges– Hong Kong Exchanges and Clearing Limited (HKEx), New York Stock Exchange (NYSE) and NASDAQ. Their first choice was to list on HKEx. However, their application was turned down because Alibaba's unique 28-man partnership structure did not meet HKEx's listing requirements, and was similar to a dual-class structure. Alibaba's failed listing on the HKEx then kick started regulatory and public debate about potential changes to existing listing rules, for fear of losing more future listings. The purpose of this case is to allow a discussion of issues such as dual-class share structure; mismatch between share ownership and control; and the tension between regulatory and commercial motivations of stock exchanges.

Background

***"Nobody wanted to believe Jack Ma."* - Jack Ma¹**

Not even HKEx when Jack Ma, Chairman of Alibaba, brought an attractive proposal to the table in 2013 – listing his wildly successful e-commerce brainchild Alibaba. After weeks of intense negotiation, the listing was rejected on the premise that its unique 28-man partnership structure did not meet HKEx's listing requirements.

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Ma was now faced with a tough decision. Change the partnership structure that has worked so well for the US\$168 billion e-commerce giant²? Or abandon his dreams of a Hong Kong (H.K.) listing and head for greener pastures on the NYSE or NASDAQ?

The birth of an E-commerce hero

Jack Ma began his career as an English tour guide in Hangzhou, China³, and had no experience with computers or any technology-related equipment. This changed when he discovered that internet searches brought up no information about China⁴. Ma realised that this was his opportunity to fill a gaping hole on the internet, and proceeded to set up China's first commercial website, China Pages⁵.

Ma's business competed with China Telecom and when the state-owned company offered to embark on a joint venture, Ma found the offer too good to refuse⁶. Although Ma was a director, he had no control over the five-man board and his ideas were turned down and outvoted time and again⁷. With his hands tied and no way to move his ideas forward, Ma decided that his best option at that point was to resign.

In early 1999, Ma decided to give his entrepreneurship dream another chance. He envisaged a global e-commerce company and shared this dream with the 18 others he had gathered in his apartment⁸. That night turned out to be the turning point in Ma's e-commerce journey. With just US\$60,000 to its name, Ma and his 18 partners started the company, Alibaba, a name chosen for its simple spelling and its association with the well-known "Open Sesame" command⁹.

Ma believed in his approach to create a successful business for the Chinese context – global vision, local win¹⁰. Unlike many other Chinese entrepreneurs who adapted successful U.S. internet business models¹¹ that managed Business-to-Consumer (B2C) and Consumer-to-Consumer (C2C) transactions¹², Alibaba created its own business model. It focused on the Business-to-Business (B2B) sector and connected small and medium sized companies with one another¹³.

The Alibaba Group

Today, Alibaba is the largest provider of online and mobile marketplaces in China, making up 80% of China's B2C and C2C markets. Alibaba also accounts for more than 70% of the parcels delivered in China and its dominance in parcel delivery continues to grow¹⁴. On a global basis, Alibaba has outperformed both eBay and Amazon in terms of gross merchandise value, which generated US\$67.8 billion and US\$87.8 billion respectively in 2012¹⁵.

Alibaba has several key lines of business - Alibaba.com, Taobao, Tmall and Alipay. Alibaba also offers cloud computing and other peripheral services¹⁶.

Alibaba.com

Alibaba.com was the Group's first foray into the e-commerce sector in 1999. It is a B2B online portal connecting Chinese manufacturers with buyers all around the world. Alibaba.com's business model is based on two observations of the Chinese market. First, the Chinese are cost-conscious. This led Alibaba.com to provide basic services¹⁷ to both its buyers and sellers at no cost¹⁸. To cater to sellers who are slightly less price sensitive, Alibaba.com offers extra services¹⁹ and online advertising options²⁰. Second, Chinese consumers are concerned about the reliability of sellers. To address this matter, sellers listed on Alibaba.com can opt to have their claims reviewed by independent third parties through its Independent Verification Service (IVS). To date, Alibaba.com has more than 4.4 million registered users from over 200 countries and territories²¹.

Taobao and Tmall

In 2003, the Group launched Taobao, the Chinese equivalent of eBay, becoming the market leader in China's C2C market within two years of its commencement²². In 2010, Alibaba launched Tmall.com, a spin off from Taobao. It has since become China's most popular B2C online shopping platform. In 2012, Taobao and Tmall.com generated a combined gross merchandise volume of RMB1.1 trillion (US\$171.2 billion)²³.

Alipay

Alipay is China's leading online payment service, dominating 80% of China's online transaction market share, and close to US\$150 billion in FY2013 reported revenue²⁴. The Alipay system supports all of Alibaba's online transactions. This system allows sellers to collect money for goods up front and places the amounts in an escrow account, ensuring buyers do not default on payment²⁵.

28 men at the helm

Alibaba has a 28-man partnership structure, consisting solely of founders of the company and key senior executives²⁶. These 28 partners do not sit on the board of directors but they have the power²⁷ to nominate a simple majority of the directors²⁸.

Although nominations are primarily made by the 28 partners, all shareholders have the right to vote for or against the nomination according to their shareholdings. The 28 partners hold a combined 13% of Alibaba's total shares, while Yahoo! Inc. (Yahoo!) and SoftBank Corporation (SoftBank) hold 24% and 37% respectively²⁹. The remaining shares are held by dispersed minority shareholders. However, if the nominated candidates are rejected, the partners are able to nominate other suitable candidates³⁰. This process repeats itself until the board of directors is formed.

The purpose of this partnership structure, according to Ma, is to ensure that the company is operated by "a group of people who are passionate about the company and are mission-driven."³¹ This view is supported by Joe Tsai, Group Executive Vice-Chairman, who believes the partnership structure helps to preserve the company's innovative culture even if the initial founders leave the company, assuring the company of a long-term strategic focus rather than myopic or short-term gains³².

Alibaba's genie lamp - A Stock Exchange listing

Alibaba has been successful in the e-commerce industry over the last decade, as evidenced by the twelve different valuation estimates compiled by Bloomberg in 2014 that put its value at about US\$168 billion³³.

Listing was the next logical step for Alibaba. The Group wanted to be listed on a stock exchange in order to raise capital for further expansion in the promising mobile shopping and social media sectors³⁴.

A Tale of Two Cities – Pearl of the Orient or The Big Apple

In July 2013, Alibaba was ready for an IPO but was still deliberating between the three stock exchanges it had shortlisted – NYSE, NASDAQ and HKEx³⁵. At the heart of it, Alibaba's decision boiled down to a simple dichotomy between two countries – H.K. or the United States (U.S.).

A U.S. listing has several advantages over a H.K. one. First, the U.S. stock exchanges allow for Alibaba's existing partnership structure³⁶. On the other hand, HKEx adopts a "one share, one vote" principle and does not allow Dual Class Share (DCS) structures except under exceptional circumstances³⁷.

Second, the world's largest technology firms, such as Facebook and Amazon, are listed on the U.S. stock exchanges, with most of them listed on NASDAQ³⁸. In contrast, H.K. does not have many "high-tech" or "internet"³⁹ companies listed.

Third, western investors have a better grasp of the technology sector, boosting the accuracy of their valuations of tech companies⁴⁰. Furthermore, NYSE and NASDAQ are the world's largest stock exchanges in terms of market capitalisation⁴¹.

Fourth, NASDAQ does not require companies to have earned a profit for three years before going public⁴², unlike H.K. which has the requirement⁴³.

On the other hand, a U.S. listing also has its disadvantages over a H.K. listing. The U.S. has a litigious culture⁴⁴ which may be a problem for Alibaba if it does not provide timely disclosures, as they would face potential lawsuits⁴⁵. This is a concern for Alibaba as Taobao has faced problems with counterfeit goods in the past⁴⁶ and had tried to resolve the problem but to no avail⁴⁷. Conversely, H.K. does not have a class-action legal system⁴⁸.

In addition, the U.S. also scrutinises its financial markets more closely than any other country in the world⁴⁹. U.S.-listed companies face higher compliance costs due to the additional regulations required by the Sarbanes-Oxley Act⁵⁰.

Next, Chinese companies listed in the U.S. are undervalued⁵¹. There have been many accounting irregularities, frauds and scandals in the U.S. by Chinese companies over the past decade, leading to lower investor confidence⁵² towards this class of companies.

Last but not least, it would be easier for Alibaba to maintain status quo even after listing because H.K. has a similar culture, uses the same language, and enjoys geographical proximity to China⁵³. This is particularly relevant as Alibaba's revenues are mainly generated in China.

In September 2013, Alibaba decided on a H.K. listing and submitted its application to HKEx. In order to list, Alibaba would have to gain the approval of both the Hong Kong Securities and Futures Commission (HKSF) and the Stock Exchange of Hong Kong (SEHK).

The genie's lamp shatters

In late September 2013, just weeks after submitting its application, negotiations with HKEx fell through⁵⁴.

The reason for their rejection stems from Alibaba's listing proposal which grants additional powers to the 28 partners at the helm. HKEx claims that such powers undermine the "one share, one vote" principle as it closely resembles a DCS structure that grants more power to a small group of people who hold fewer shares⁵⁵.

Charles Li, CEO of HKEx, reinforced this stand by explaining that HKEx adopts a "one share, one vote" principle and does not allow DCS structures unless under exceptional circumstances⁵⁶. Li also highlighted that the exchange is not ready to "bend existing rules just for one applicant"⁵⁷.

Between a Rock and a Hard Place – HKEx's Dilemma

***"It is very important for HKEx to not make exceptions and to maintain market integrity, especially in light of what has happened with Chinese companies in recent years... There are plenty of companies in Hong Kong and China that would want to do similar things, so making an exception creates a very difficult scenario."*⁵⁸ – Arjan Van Veen, Analyst at Credit Suisse.**

***"Losing one or two listing candidates is not a big deal for Hong Kong; but losing a generation of companies from China's new economy is. And losing it without a proper debate is even more unacceptable."*⁵⁹ – Li, CEO of HKEx**

Although it might seem that Alibaba's proposed IPO should have been a straightforward accept or reject situation, the deliberation process was anything but simple.

Painful Deliberation Process

Throughout the year leading up to the rejection of the IPO, Alibaba and HKSF held private discussions related to the listing. During this period of negotiation, HKSF opposed Alibaba's proposed partnership structure and both parties could not come to a consensus⁶⁰. Reportedly, HKEx submitted a consultation draft to HKSF regarding changes in listing rules. HKSF has since sent back the paper with a series of adjustments⁶¹.

In late September 2013, HKEx rejected Alibaba's IPO. However, the following month, HKEx's listing committee kick-started a discussion about the types of shareholding structure that the exchange should offer.⁶² They decided that a public poll may be required in the near future to decide on the appropriate direction on the matter⁶³ and on any issues that require public input. The relevant authorities have repeatedly emphasised that their debates regarding share structures were not a result of the Alibaba IPO incident but a response to the ever-changing economic climate in H.K.⁶⁴.

Yet at the same time, Li said that the "Alibaba's proposal has propelled the management to review" their existing operating model, and that "the eventual loss may be even larger" if they do not "undergo reforms"⁶⁵.

A Mix Up of Motivations

Being the regulator and front line enforcer of stock exchange listing rules, the regulatory arm of HKEx has to ensure companies abide by their listing rules. These powers and responsibilities extend to taking action against companies that flout any rules or regulations so as to maintain the financial integrity of the country's financial system⁶⁶, and to make sure that the listing directives and procedures are duly followed.

On the other hand, the business promotion arm of HKEx is charged with the task of attracting more companies to list on their exchange. HKEx has to identify profitable companies with growth potential and maximise the revenue generated through the stock exchange. Ultimately, HKEx is a business with bottom line considerations and has its own set of financial duties and obligations to deal with. It has to consider both the benefits of potential listings, and attract these profitable companies to list on the stock exchange, which in this case is Alibaba.

Should the listing of companies such as Alibaba⁶⁷ be construed as a violation of listing rules and a regulatory lapse or as a means of promoting their business⁶⁸?

A new pasture

With no further progress apropos any changes to the listing framework in H.K., Alibaba issued a statement on 16 March 2014 about its decision to embark on a U.S. listing⁶⁹. They returned to the drawing board and were expected to file an IPO with either NYSE or NASDAQ within the next few days.

Epilogue

Following the announcement of Alibaba's intention to list on a U.S. stock exchange, NYSE and NASDAQ stepped up their wooing efforts, in a bid to attract the largest tech listing⁷⁰. Finally, NYSE emerged the winner, and Alibaba launched its IPO on 21 September 2014. The listing held the record of biggest IPO, and raised a total of US\$25 billion. On its first trading day, the stock soared more than 35% over its IPO price of US\$68⁷¹ to close at US\$93.89⁷², and fell just slightly below US\$90 on the second trading day⁷³. On the other hand, after the consultation drafts exchanged between HKSF and HKEx, the HKEx decided to further the discussion on listing rules changes. After a comprehensive round of public consultation, it appears that the Exchange would allow for weighted voting rights structures, with more details to be released in the third or fourth quarter of 2015⁷⁴. However, on 25 June, the HKSF said that it opposes the plan to offer dual-class shares⁷⁵. This probably killed the proposal.

Discussion questions

1. Briefly discuss dual class shares and how such a structure is similar to or differs from Alibaba's 28-man partnership system. Does Alibaba's partnership system increase stakeholder value?
2. Why might the major shareholders, Yahoo! and Softbank, be willing to approve the 28-man partnership structure?
3. Are there some companies that are more suited for a dual class share structure and other companies that are less suited for it? List some examples of companies that have run into trouble as a result of such models and some examples of companies that have been highly successful at implementing dual class shares.
4. Did HKEx do the right thing in rejecting Alibaba? Do you think it is advisable for HKEx to re-look at revising its rules on dual class share structures?
5. Singapore is amending its Companies Act to allow public companies to issue dual class shares. This may open the door for companies with dual class shares to list on the SGX. Discuss whether it is advisable to permit the listing of dual class share companies in Singapore. If so, what safeguards, if any, would you propose?

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