Can Alibaba Shares Climb Wall of Worry?

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By John Kimelman
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On Friday, investors with connections to big Wall Street institutions will be able to buy shares of Alibaba Group, the giant Chinese e-commerce site. And by most accounts, the demand will be strong, despite several risks not normally known to shadow U.S.-based companies going public.

As Bloomberg put it in a lengthy scene-setting article Wednesday, U.S. fund managers studying an investment in Alibaba "are worried about everything from corporate governance to bull market fatigue. They're buying anyway, afraid of missing a bargain."

Bloomberg reported that in interviews with more than a dozen fund managers with about $400 billion under management, about half of those that routinely participate in initial public offerings said they'll buy shares. "The results mirror a poll of securities professionals by the brokerage ConvergEx Group Inc., which found 49 percent of respondents interested in owning the stock, a level it said represents 'remarkable' enthusiasm," the article stated.

Shares of Alibaba could benefit from an opening-day pop as many investors view the Internet retailer as an atypical IPO—a company that, despite its huge size, has strong earnings-growth prospects in the coming years relative to its projected price-to-earnings ratio.

But the Alibaba IPO is also facing scrutiny in the financial press because of the nature of its ownership structure.

In a coluimn in the New York Times Tuesday, Lucian Bebchuk, a professor who heads Harvard Law School's program on corporate governance, writes that investors need to "keep their eyes open to the serious risks accompanying an Alibaba investment."

For one, insiders have a permanent lock on control of the company but hold only a small minority of the equity capital," Bebchuk writes. "Then, there are many ways to divert value to affiliated entities, but there are weak mechanisms to prevent this. Consequently, public investors should worry that, over time, a significant amount of the value created by Alibaba would not be shared with them."

Bebchuk points out the concerns run deeper with Alibaba than with those other leading companies from emerging markets.

"Many public companies around the world, especially in emerging economies, have a large shareholder with a lock on control," Bebchuk adds. "Such controlling shareholders, however, often own a substantial portion of the equity capital that provides them with beneficial incentives. In the case of Alibaba, investors need to worry about the relatively small stake held by the members of the controlling Alibaba Partnership."

After the IPO, writes Bebchuk, Alibaba's executive chairman, Jack Ma, is expected to hold just 7.8% of the shares, and all the directors and executive officers will hold together 13.1%. "Over time, insiders may well cash out some of their current holding, but Alibaba's governance structure would

ensure that directors chosen by the Alibaba Partnership will forever control the board, regardless of the size of the stake held by the Partnership's members," Bebchuk adds.

Concerns like this are reportedly keeping Mark Mobius, one of the most well-known emerging-market stockpickers, on the sidelines, at least for now.

In a piece on the CNNMoney site, Mobius, emerging-market chief for Franklin Templeton Investments, cautioned that Alibaba's structure will leave shareholders with almost no influence over management -- and little legal recourse should problems emerge at the company.

He described it as a "very dangerous situation" for shareholders.

One concern is that Alibaba is listing as a "variable interest entity" or VIE. "Necessary to get around China's strict foreign investment rules, the arrangement produces a complicated ownership structure that could mean major headaches for investors seeking to take legal action against the company," CNNMoney writes.

Mobius told CNNMoney that any shareholder litigant would have to go to a Chinese court and it "would be very difficult, maybe even impossible. The founders have control of the key assets of the company and if something goes wrong there's nothing you can do about it. This is the bottom line."

Another CNNMoney article Wednesday listed the "five risks for investors" buying Alibaba shares.

Besides the corporate governance concerns, the article also points out the nagging problem of counterfeit goods on the site. Though Alibaba is seeking to rid its virtual shopping malls of such goods, industry experts and company executives say that "fakes still flourish on Alibaba's marketplaces and insist the company must do more to crack down on unscrupulous sellers. Some brands report that up to 80% of their goods listed on Alibaba's Taobao website are fakes."