Alibaba's IPO

_The Conglomerate_

By Usha Rodrigues

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Despite a delayed start, Alibaba's IPO seems to have gone off without the technical glitches that have marred some recent public offerings. Priced at the very top of its range at $68, it opened at $92.70. That's some kind of pop!

Investors apparently aren't listening to Harvard Law's Lucian Bebchuk, who earlier this week expressed governance worries about the firm, particularly its control by insiders.

In Alibaba, control is going to be locked forever in the hands of a group of insiders known as the Alibaba Partnership. These are all managers in the Alibaba Group or related companies. The Partnership will have the exclusive right to nominate candidates for a majority of the board seats. Furthermore, if the Partnership fails to obtain shareholder approval for its candidates, it will be entitled “in its sole discretion and without the need for any additional shareholder approval” to appoint directors unilaterally, thus ensuring that its chosen directors always have a majority of board seats.

For my money (or lack thereof--not a penny of mine is going to Alibaba), the bigger concern is the VIE structure whereby Americans can invest. As Dealbook explains, "the company that is going public is technically an entity based in the Cayman Islands that has contractual rights to the profits of Alibaba China, but no economic interest."

The concern is that Chinese courts will fail to honor these contractual rights. Dealbook quotes a U.S. lawyer who has worked in China as saying "‘It’s prohibited for foreigners to own an Internet company of any kind in China — not discouraged, but prohibited’ ... “Every lawyer agrees that if this goes to court in China, those contracts are void; they’re illegal.”

In a letter to the SEC, Senator Bob Casey tried to link VIEs to fraud-plagued Chinese reverse mergers of the past. This comparison misses the mark. In a reverse mergers a shell corporations that is publicly traded acquires a pre-existing Chinese corporation. The Chinese firm avoids the IPO process entirely, hence the colloquial "back-door IPO" moniker. It turns out that many of these firms had shoddy accounting practices, and some U.S. investors got burned.

The risk of accounting fraud appears to me to be a risk that you run when investing in any publicly traded company where you know that the firm's main asset never got that initial SEC scrutiny and, while subject to the '34 Ac'ts periodic disclosure requirements, operates overseas in a country where corruption and fraud are widespread. That seems...risky. Whereas with Alibaba you're buying into a structure knowing that the Chinese government could declare it illegal and worthless at any time. That seems...like an act of faith.

Mark Mobius of Franklin Templeton and the WSJ editorial page share my skepticism about the VIE structure. Let's see how it goes.