Alibaba IPO bulls are missing some red flags

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By Chuck Jaffe
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Shares in Alibaba are like a new high-end sports car, where all anyone can talk about is how fast it goes, how good it looks, and how they wish they could take it for a little spin.

At some point soon, however, the topic will change from the cool new toy to the vehicle that seems dangerous, with underlying chassis problems that make it particularly hard to control at full speed.

All of the dangers are present as Alibaba Group Holdings goes through one of the largest initial public offerings in history. Investors are so enamored of the speed and power of the deal that they're not only forgetting that IPO in Wall Street terms stands for "it's probably overpriced," they're ignoring the rules of the road that most average investors follow.

Alibaba, the Chinese e-commerce giant, has been Wall Street's dream IPO for a few years now, a dominant presence in the world's largest emerging economy bringing dynamite profit margins and global potential — and listing its shares in the United States. Experts have said that Alibaba controls 80% of China's booming e-commerce market, noting that its Taobao and Tmall marketplaces handled nearly $250 billion in online transactions last year, more than Amazon and eBay combined.

So it was no surprise that with all the buzz, Alibaba priced out at the high end of expectations, at $68 per share, raising nearly $22 billion and giving the stock a market capitalization of roughly $170 billion. That meant that before it sold its first share and the first bit of IPO buzz pushed the stock a penny higher, it was already one of the largest companies listed in the United States. (By comparison, Amazon.com has a market capitalization of about $150 billion.)

Lost in all of that hype, however, is any real examination of what investors are getting.

Start with a simple valuation concern, especially when some experts say the stock could rocket off its IPO price and quickly double in value. If that happened, Alibaba would have a market capitalization in the realm of Google , territory no one seems to think it actually belongs in; that fact suggests that Alibaba's upside potential is less than many starry-eyed admirers expect.

While stock jockeys and speculators argue about market-cap potential, average investors are more likely to (or at least ought to) take a Warren Buffett-like approach, where they buy into a business rather than purchase a stock.

For all of the hype, there are legitimate questions about who would buy Alibaba if they read through the paperwork and understood the risks.

Alibaba investors aren't actually getting control of the company, because that is permanently locked off with a group of insiders who have all of the power despite holding a small minority of

the company's equity capital. The Alibaba Partnership — made up entirely of managers from Alibaba Group — has the exclusive right to nominate candidates for a majority of the board seats and is even allowed to give nominees who fail to gain shareholder approval a board seat anyway under a clause giving the Partnership the ability to appoint directors "in its sole discretion and without the need for any additional shareholder approval."

For some investors, that's a dealbreaker. Sandy Lincoln, chief investment strategist for BMO Asset Management, noted that he wouldn't "want to own a stock where you can't make any impact as a stockholder."

But the clause about board appointments is hardly unusual for companies coming out of emerging economies; what's unique is that those deals typically leave the power with a group that holds the majority of shares anyway, a status that makes votes moot. Alibaba's politburo, in contrast, controls less than 20% of the shares.

The executives, in fact, have larger stakes in some of Alibaba's related businesses, things like Alipay — which does all of the financial processing for Alibaba — which is fully controlled by Jack Ma, Alibaba's executive chairman. That can lead to all kinds of little deals – things the Securities and Exchange Commission likes to call "related transactions" — where any number of potential conflicts and problems get explained away in footnotes to financial documents that the public generally ignores right until they trigger a corporate implosion.

Then there's the complicated ownership structure. Chinese law forbids foreign ownership of "strategic assets" in the country, so Alibaba is going the route of others like Baidu, and selling interest in an entity registered in the Cayman Islands that is under contract to get the profits from Alibaba's Chinese assets without actually owning them.

Buried in the firm's SEC filing is an admission that if laws in China change, authorities there would have "broad discretion" in dealing with the problems.

While there's no reason to believe that all of these things must become the cause of future problems, investors all hot to go racing with Alibaba should consider that there have been other deals from Chinese companies that couldn't generate the same pre-IPO buzz, but that have left investors' ears ringing.

Most recently, China Commercial Credit went public late last year in an offering that raised about $9 million, but that was touted by sharpies because the micro-credit firm was seen as having huge market potential due to the acquisitive nature of the growing middle class in its home country.

Instead, CCCR had massive governance and control issues — including over $1 million transferred without authorization to the personal account of a former officer — which led to Nasdaq suspending trading in the shares on Sept. 11. The IPO went off at $6.50 per share; the stock traded at just under $3 when trading was halted, and observers believe that when the company satisfies Nasdaq information requests, it will emerge being traded for pennies per share on the pink sheets.

Alibaba isn't pre-destined for a similar fate, but there's always a danger in letting the hype drown out the concerns.

Harvard University Professor Lucian Bebchuk, director of the Harvard Law School's Program on Corporate Governance, noted that the governance issues "are concerns that go to the economic value of the shares at present. To the extent that public investors can be expected not to share a significant portion of the value will produce, that should be reflected in investors' current valuation of the stock."

Eventually, it will be reflected in the stock price, but not until the market has test-driven its new sports car for a while.

Josef Schuster, chief executive officer at IPOX Schuster — which tracks the IPO market and runs an index tracking new issues that is the basis for the First Trust U.S. IPO exchange-traded fund — noted that negatives like these typically don't have much impact as a touted company first goes public.

"Someday it will be significant, but not today," Schuster said, "and maybe not for five or 10 years, until shareholders see what is going on and are frustrated by having no say over it. … Fundamentals and governance catch up eventually."