Alibaba IPO comes with unusual structure

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In this photo taken Friday May 9, 2014, Jack Ma, founder and Executive Chairman of Alibaba Group, speaks to newly weds employees of the company during a group wedding held 102 couples in Hangzhou in east China's Zhejiang province. Foreigners who want to buy Alibaba Group shares in the Chinese e-commerce giant's U.S. public offering will need to get comfortable with an unusual business structure.(AP Photo) CHINA OUT

Foreigners who want to buy Alibaba Group shares in the Chinese e-commerce giant's U.S. public offering will need to get comfortable with an unusual business structure.

Alibaba's online and mobile commerce businesses will be controlled by a "variable interest entity," an arrangement meant to allow investors to buy into Internet and other businesses in which Beijing bans or limits foreign ownership.

Used since the 1990s by Internet operators such as Baidu Inc. and Sina Corp., VIEs are based on contracts that say an offshore entity in the Cayman Islands or another corporate haven will control a Chinese company. Foreign shareholders get a stake in that offshore vehicle and profits but no ownership of the Chinese company.

"The VIE structure is the only way at present to play this game," said Paul Gillis, a professor at Peking University's Guanghua School of Management. "So if you want to invest in restricted sectors of China's economy, you have to get comfortable with the VIE structure."

Chinese regulators have left the status of VIEs ambiguous. Most operate uneventfully, but courts have rejected contracts if they were deemed to be an attempt to evade ownership curbs.

Regulators could shut down VIEs, but "that would be too disruptive," said Gillis. "They don't mind the ambiguity because it puts them in a position of strength over the companies to make sure that they comply with government policy."

Such uncertainty is one of a number of risks investors have accepted to gain a stake in China's economy. Even after a steep deceleration in growth, it is forecast to expand by about 7 percent annually in coming years.

And Alibaba, based in founder Jack Ma's hometown of Hangzhou, southwest of Shanghai, represents an especially appealing industry.

Its Taobao, TMall and other platforms account for some 80 percent of Chinese online commerce. Online spending by Chinese shoppers is forecast to triple from its 2011 size by 2015. And Alibaba is expanding into online banking, entertainment and other services.

Analysts believe demand for shares will be so strong that Alibaba could surpass the $16 billion raised by Facebook Inc. in 2012. That would value Alibaba at $150 billion to $200 billion, making it one of the most valuable U.S.-traded companies.

In a filing with U.S. regulators, Alibaba says licenses for its online and mobile commerce businesses are held by Chinese citizens to comply with legal restrictions but VIE contracts will give shareholders "effective control." Still, it warns regulators "may not agree" they are legal.

An Alibaba spokeswoman, Florence Shih, declined to comment, citing the "quiet period" required by U.S. securities rules ahead of an IPO.

Investors can find a VIE gives them less control than they expect, according to a March report by Tom Pugh, a lawyer for the firm Mayer Brown JSM in Hong Kong. He cited the case of shareholders who lost control of a Chinese company when its founder blocked them from firing him by seizing the seals used to sign corporate documents.

In a dispute, foreign shareholders have to work through the Chinese legal system, which "may not be adequate or effective," Pugh wrote.

In 2012, China's Supreme People's Court threw out contracts used by a Hong Kong businesswoman to invest in China Minsheng Bank. The ruling said agreements that "conceal illegal intentions" were invalid. A year earlier, an arbitration panel rejected a VIE contract involving Singapore-based GigaMedia Ltd. and a Chinese online gaming business.

Alibaba appears to have done its best to avoid problems by keeping the amount of business done through VIEs to a minimum, said Peking University's Gillis.

Only 11.8 percent of Alibaba's revenue last year was generated by VIEs, according to its filing with the U.S. Securities and Exchange Commission. The rest went to entities that can be directly owned by foreign shareholders.

"They have one of the better VIE structures among Internet companies," said Gillis.

The ruling Communist Party promised last year to open online commerce to foreign competitors as part of efforts to make China's state-dominated economy more productive. That has raised hopes they might lift the ownership ban.

"There is some hope that China will fix this problem," said Gillis, "and that will be a good thing for investors."