This case study was prepared by Richard Bethune under the supervision of Professor Li Wei.

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Alibaba-Yahoo! Case B: Jack Ma Takes Alipay

“When March 31, 2011, Yahoo! and Softbank were notified by Alibaba Group of two transactions that occurred without the knowledge or approval of the Alibaba Group board of directors or shareholders. The first was the transfer of ownership of Alipay in August 2010. The second was the deconsolidation of Alipay effective in the first quarter of 2011.”

Alibaba Group founder Jack Ma had personally taken ownership of Alibaba’s online payment company Alipay. This news shocked its largest shareholders, Yahoo and Softbank. Valued in the billions of dollars by some analysts, Alipay was an important asset to a struggling Yahoo. By 2011, Alipay had six hundred million users and about half of the non-bank payment market in China. How and why did Yahoo lose Alipay?

Background

In January 2009, Carol Bartz took the place of Jerry Yang as Yahoo’s CEO. Yang and Alibaba’s Ma were friends. They had been the ones that negotiated the 2005 deal where Yahoo invested $1 billion in Alibaba Group and sold it Yahoo China in exchange for a 39% stake (later increased to 43%) Yang continued to sit on Alibaba’s board, but Bartz was in control.

On June 1, 2009, Ma made the first stake transfer of Alipay to Zhejiang Alibaba E-Commerce Co. He owned 80% of this company with trusted Alibaba co-founder Xie Shihuang owning the remaining 20%. Ma had used this structure previously. Before the 2007 Alibaba Limited (“Alibaba.com”) IPO, he restructured Alibaba Group to preserve his control. He owned 80% of Hangzhou Alibaba with Xie once again owning the remaining 20%. Hangzhou Alibaba held the Internet content provider (ICP) license that gave Alibaba Limited permission to operate in China. Ma could withhold the license if others tried to take control of Alibaba Limited.

The Alipay transfer occurred ostensibly because the People’s Bank of China had begun drafting regulations effectively forbidding third party payment companies like Alipay from having foreign investors. Ma claimed he consulted the Alibaba Board before the move, but Yahoo said otherwise.

By December 2009, Yahoo China was no longer ranked in the top ten of most visited websites in China unlike search rivals Baidu and Google.cn. That same month Yahoo partnered with Microsoft in developing search technology to compete with U.S. search leader Google. Ma was angry that Yahoo had
effectively lost its unique search technology. Bartz was increasingly frustrated with Ma’s inability to revive its struggling former property, Yahoo China. Boardroom relations frayed.

Jack Ma Takes Alipay

Jack Ma completed the transfer of Alipay to his personal company on August 6, 2010. The two Alipay transfers to Ma were made for a total of 330 million Yuan based on the "group's internal asset transfer price" according to Alipay CFO Jing Xiandong. Analysts noted that this price severely undervalued Alipay.7 Alibaba Group still controlled Alipay’s equity through a variable interest entity (“VIE”) structure. The VIE structure contractually obligated Alipay to distribute its revenue to Alibaba.8 In 2000, China online portal Sina was the first to use the VIE structure to skirt Chinese regulations and go public on an overseas exchange.9 In early 2011, Jack Ma punctured the faith foreign investors had in VIEs by becoming the first Chinese entrepreneur to unilaterally unwind a VIE when he dismantled Alipay’s. The VIE may not have run afoul of Chinese regulators, but Ma claimed he needed to terminate the VIE in case they thought that it still gave foreign investors control over Alipay. Given Alipay’s high visibility, Ma said he felt that it would not escape scrutiny.8

Alipay CFO Jing claimed there was a lot of pressure on Alibaba to comply with the new third-party payment provider regulations. He said the central bank sent them instructions in the first quarter of 2011 requesting written confirmation that Alipay was a domestic firm with no foreign investors. If Alipay couldn’t comply, it would have to seek approval from the high-ranking, but slow-moving State Council. Such approval would take some time to obtain and was not certain given the lack of official endorsements of VIE structures. Alipay’s existence could be placed in jeopardy so Ma felt he had to unwind the VIE. This meant Yahoo, Softbank and other Alibaba Group shareholders including its executives no longer had any stake in Alipay.9

The need to terminate the VIE was questioned by a People’s Bank of China official who had helped write some third-party payment regulations.

“...The central bank was unlikely to take the initiative to instruct a company to clarify whether it has a VIE arrangement or not,’ the official said. ‘The more likely scenario would be the company taking the initiative to consult central bank officials over the feasibility of the VIE.’ ‘The likely answer that Alipay would receive was: if the VIE arrangement leads to the foreign holdings in Alipay, Alipay's application should be submitted to the State Council for approval,’ the official said. ‘But that does not mean Alipay has to suspend its business, pending the approval by State Council.’ Given its market size, Alipay would have stood a chance before the State Council, the official said, since non-VIE enterprises with foreign investors have gained approval in the past.”10

Third-party payment providers like Alipay were not treated as “foreign investment restricted" or "foreign investment prohibited" companies. One of these companies’ general managers said that about half of the twenty-seven companies that received third-party licenses with Alipay in May had foreign investment. Alibaba’s Board was divided between Alibaba’s Ma with CFO Joseph Tsai and foreign investors Yang with Softbank president Masayoshi Son. Jack Ma claimed he had to make a quick decision because the Alibaba Board was too indecisive. He sent this message to the central bank, “Zhejiang Alibaba is Alipay's sole and actual controller and no foreign investors have actual controlling rights over Alipay through stock holdings, agreements or other arrangements.”11 CFO and major Alibaba shareholder Joseph Tsai explained that, “The Alipay matter is a very special case…but Taobao will not have this same kind of sensitive problem, so it’s not likely that VIE agreements will be terminated in the future.”12

Yahoo was shocked. When it invested in Alibaba in 2005, it signed an agreement with Alibaba that required Board approval for asset disposals that exceeded $10 million. Alipay far exceeded this threshold
yet Yahoo had not agreed to dispose of it as it mentioned in its May 2011 press release. How could Yahoo have responded to this contract violation? Its investors demanded answers. Alibaba Group executives and employees held about 30% of Alibaba shares and wondered how they would be compensated, too. The pressure built on Jack Ma to explain himself.

Compensation for Alipay

After announcing the loss of Alipay in May 2011, Yahoo’s stock price declined 23.8% destroying $5.2 billion in shareholder value by the time Softbank and it agreed on some compensation for Alipay from Jack Ma on July 29, 2011 (see Exhibit 1). Ma kept control of Alipay, but guaranteed a minimum $500 million payment through an upfront promissory note with a seven year maturity. This was funded by shares from Alibaba management representing 2% of Alibaba Group’s float. Alibaba Limited shares were included. The upside consisted of 37.5% of Alipay’s equity value from an IPO or other liquidity event. This was guaranteed in the next ten years with a valuation floor of $2 billion and ceiling of $6 billion. It included the upfront $500 million note, but still meant Yahoo’s indirect stake had been diluted from 43% to 16%. Alipay was an immature company focused on expansion and not likely to go public anytime soon. In the meantime, Alipay agreed to contribute 49.9% of its pre-tax income to Alibaba plus royalties. The pre-tax contribution had a floor of 30% in case of dilution, but was not expected to be significant as Alipay was only “marginally” profitable. Taobao and other group businesses would still have preferential service terms for fifty years with automatic extensions. An Alibaba Group IPO might be possible the company said.

Yahoo noted that the resolution brought it some compensation for Alipay and that the Alipay preferential service agreements would continue to boost the value of Taobao and its remaining Alibaba Group holdings. An insider said about half of Alipay’s trade volume was steered to it from Taobao meaning it was still very dependent on internal group transactions. “This is a good outcome for Yahoo and for our shareholders, as well as all the parties to this agreement,” Carol Bartz said.

In early 2011, Jack Ma had offered $3.5 billion for 15% of Alibaba from Yahoo valuing the firm at $23 billion. What was Yahoo’s Alibaba Group stake worth now that its Alipay stake had been diluted? The market had a mixed reaction. Although Citigroup noted that the deal removed some uncertainty, “Yahoo clearly was forced to sell one of its most important Asian assets.” Yahoo investor Eric Jackson of Ironfire Capital was disappointed in the $6 billion payout cap, but liked the fact that “the doors are open for a potential IPO of Alibaba Group.” David Einhorn’s Greenlight Capital had not waited for the deal. It took a loss on its investment in Yahoo given the uncertainty surrounded the value of the Alibaba investment. This was a sharp reversal given its previous confidence that the stake might equal Yahoo’s whole market capitalization. After the Alipay resolution, Benchmark Company valued Yahoo’s Asian assets at $10 billion after a liquidity and tax discount. This was about half of Yahoo’s market capitalization.

Jack Ma’s Alipay move may have reflected his disregard for investors. One investor who previously negotiated with Ma said he liked to “treat investors purely as financial investors and keep shareholders away from the company's management.” Another investor questioned Ma’s structuring of the Alibaba Limited IPO saying, “Investors were all kept at the group level while a subsidiary got listed. How would investors be able to cash out?”

Softbank’s reaction was positive, though. “This agreement was in part made possible by the strong long-term relationship and trust that exists between the principals at Alibaba Group, SoftBank and Yahoo!, and also lays the foundation for Alibaba Group to continue its impressive growth under the dynamic leadership of Jack Ma,” said Masayoshi Son said. Yet, Softbank had invested in Alibaba earlier and
already had made a good return. The most conservative estimates were that it had made ninety times its original investment.\textsuperscript{34}

Relations between Jack Ma and Carol Bartz only got worse. After losing value in its Alibaba investment, Yahoo was under pressure to realize a return on its Yahoo Japan minority stake valued at about $7 billion on March 31, 2011 (see \textbf{Exhibit 2}).\textsuperscript{35,36}

Attention may have focused on the value of Yahoo’s Asian assets given the weakness in its core U.S. business. EMarketer Inc. predicted that Facebook would take Yahoo’s spot as the top seller of display advertising in 2011. Macquarie Capital analyst Ben Schachter summed the situation up by saying, “It’s great to have resolution and we can stop talking about it -- and start talking more about the Yahoo business. But the reality of the Yahoo business is not something a lot of people want to talk about because it doesn’t look good.”\textsuperscript{37}
Exhibits

Exhibit 1:
Yahoo’s Stock Price Close, January 3-August 11, 2011

Source: Yahoo Finance, CKGSB

Exhibit 2:

a) Appendix ($bn)

<table>
<thead>
<tr>
<th>Asset</th>
<th>Yahoo Ownership</th>
<th>Total Asset Value</th>
<th>Yahoo’s Value</th>
</tr>
</thead>
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<tr>
<td>Yahoo Japan</td>
<td>35%</td>
<td>$20.70</td>
<td>$7.20</td>
</tr>
<tr>
<td>Alibaba.com</td>
<td>31%</td>
<td>$8.30</td>
<td>$2.70</td>
</tr>
<tr>
<td>TaoBao/AliPay</td>
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<td>$10.40</td>
<td>$4.50</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>$14.40</strong></td>
<td><strong>$10.30</strong></td>
</tr>
</tbody>
</table>

Source: Benchmark Company, CKGSB

Note: TaoBao numbers are estimated. Benchmark estimated that Alibaba.com and TaoBao account for over 90% of Alibaba Group total revenue.
Endnotes

5 See note 3.
6 See note 3.
8 See note 3.
9 See note 3.
10 See note 3.
11 See note 3.
13 See note 12.
16 See note 12.
18 See note 12.
19 See note 12.
20 See note 23.
22 See note 12.
23 See note 15.
25 See note 21.
26 See note 3.
27 See note 12.
29 See note 21.
32 See note 3.
33 See note 24.
34 See note 12.
35 See note 21.
See note 30.