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The Next Chapter of Alibaba and the 106 Hedge Funds

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The world's biggest IPO opened the door to double-digit gains this fall, but the luster could be wearing off.

Alibaba founder Jack Ma (Bloomberg)

True believers in the future expansion of Chinese Internet commerce say Alibaba Group Holding's stock stands to double as the company grows in the next several years. But of the 106 hedge funds holding it as of the end of September, according to data compiled by the portfolio research firm Novus Partners in New York — including 16 Tiger Management Corp. descendants — many bought the initial public offering because they had a chance to capture the market euphoria over a red-hot launch. The stock, however, is leveling off from its meteoric rise following the $25 billion launch in September that made it the largest IPO ever. Detractors like James Chanos, president of Kynikos Associates in New York, and Carson Block, founder of the short-selling research and trading firm Muddy Waters Research in New York, have been very vocal in their view that if Alibaba isn't riding a rapid upward trajectory, it has limitations as a long investment play — and maybe even a short one.

"It probably made sense to subscribe to the IPO," says Block. "If you go long and it tanks, you're not going get a lot of flack from investors, but if you don't and the stock goes up, investors will want to know why you didn't get in on it." This is as much praise as the company is going to get from the man who spotted fraudulent practices at Sino-Forest Corp. and other U.S.- and Canada-listed Chinese companies in 2011 and 2012, and made money short-selling them, while John Paulson, CEO of Paulson & Co. in New York, lost $462 million on Sino-Forest.

The Securities and Exchange Commission's 13F filings for the third quarter of 2014 show that as of the end of September, Alibaba was a top stock in many large fund portfolios. For Daniel Loeb's Third Point it was the third-largest holding after Dow Chemical Co. and Ally Financial. David Tepper's Appaloosa Management bought more of Alibaba than any other stock. It was the largest holding for Julian Robertson Jr.'s Tiger Management Corp., comprising 34.1 percent of the portfolio. Barry Rosenstein's Jana Partners, Lee Ainslie III's Maverick Capital, Louis Bacon's Moore Capital Management, Leon Cooperman's Omega Advisors, Paulson & Co., Paul Tudor Jones II's Tudor Investment Corp. and O. Andreas Halvorsen's Viking Global Investors all held substantial shares.

Alibaba debuted on the public markets with a price of $68 per share, though it quickly rose and ended its first trading day, September 19, at $93.89. In December it was hovering in the $103 to $110 range. Someone has been shorting the stock as well, though not with any serious conviction so far. A study by Novus Partners shows that Alibaba short sales represented less than 1 percent of all of its shares traded. In late November that figure rose to 1.84 percent of all shares, a very low figure for a high-multiple stock.

Paul DeSisto, who manages value portfolios, including hedge funds, for the $625 million wealth management firm M&R Capital in New York and was previously a portfolio manager at Bank of New York Mellon, has holdings in Amazon.com, Google and Yahoo, which owns 22.6 percent of Alibaba. But he hasn't invested in Alibaba itself because he is concerned that the share price isn't justified if China's growth slows further, which would be likely to cut into the growth of its e-commerce consumption. The World Bank forecasts that China's GDP growth will be about 7.4 percent this year, down slightly from 7.7 percent in 2013 and 2012. Chanos has also said the stock is no longer cheap and that the risks a slowdown in China would pose to the global economy are increasing.

DeSisto thinks $90 a share would be a reasonable price to pay.

There could be a reckoning point coming, as the lockup period ends for stock held by executive chairman and founder Jack Ma and other insiders, who hold some 85 percent of the stock. Some eight million shares will be unlocked on December 19, and then another 429 million will be available in March and 1.8 billion in September. Stock prices often drop about 1 percent to 3 percent, often permanently, at the end of a lockup period.

If the share price were to look undervalued at some point, you wouldn't see Daniel Loeb challenging management with a proxy campaign. Alibaba has 27 controlling partners who have retained an exclusive right to nominate the majority of the board. That was the governance issue that caused the Hong Kong Stock Exchange, Alibaba's first choice for a listing, to turn the company down on the grounds that it violates Hong Kong's "one shareholder, one vote" rules. The SEC has similar rules for U.S.-based companies but uses less stringent standards for foreign listings in the U.S.

Right now Alibaba has so much clout that Hong Kong's financial regulatory body, the Securities and Futures Commission -- stung by having missed out on the world's largest IPO — is in the midst of evaluating the case for relaxing the rules. Hong Kong's SFC introduced a concept paper on the question asking for market participants to submit views and is now reviewing the feedback, according to a spokesman for the commission.

"I'd be disappointed if they changed their high standards of governance," says Muddy Waters's Block. "Hong Kong showed some real backbone there."

Block's bigger concern with Alibaba, however, is a lack of transparency. In reporting revenues and profits, the company classifies all of its businesses as one reporting unit. Because Block can't examine figures from different lines of business and get a sense of what's actually going on, he hasn't shorted Alibaba.

"To short a company we need to research it," he says. "We look backward at the numbers and try to answer questions about whether they're reflective of economic reality. With Alibaba it's difficult to look backward and answer those questions."

Among the questions a potential short-seller might want to ponder is the data from the Chinese retailers that sell merchandise over Alibaba. The company's revenue figures, say analysts, depend on the reporting from those retailers, and if any of them turned out to be reporting inaccurate figures, that could skew the rosy growth picture.

Block doesn't like the way Alibaba CEO Jack Ma treats his investors. "There's never a good reason for poor disclosure from the investor perspective, and look at how Ma took Alipay in the middle of the night," says Block, referring to Ma's secretive 2011 spin-off of Alipay, the online payment services division of Alibaba, a move Yahoo's directors said they didn't know about until five weeks after the fact.

But if the growth picture gets marred for this high-growth stock, hedge fund managers themselves would have no choice but to sell while the getting is still good or bet on a decline.