How to understand Alibaba's business model

Alibaba Group Holding Ltd. dominates China's e-commerce market, which by one measure is now the biggest in the world.

The best way to understand Alibaba is as a mix of Amazon.com, eBay and PayPal with a dash of Google thrown in, all with some uniquely Chinese characteristics.

Unlike Amazon, which buys goods from suppliers and sells them to customers, Alibaba has always acted as a middleman, connecting buyers and sellers and facilitating transactions between them. While it isn't an auction company, its middleman role is similar to the one played by eBay.

Taobao, Alibaba's biggest website, is like a gigantic Chinese bazaar with about 760 million product listings from 7 million sellers. Merchants don't pay to sell products on Taobao--and that fee-free model is a big part of its appeal in China. Instead, they pay Alibaba for advertising and other services to allow them to stand out from the crowd. Much like on Google, the ads from merchants appear with Taobao's product-search results.

While Taobao is mostly for small merchants, Tmall, another shopping site run by Alibaba, is designed for bigger merchants, including some well-known brands such as Nike and Gap. Earlier this year, Apple Inc. opened its store on Tmall. Unlike Taobao, Tmall, which has about 70,000 merchants, charges each seller a deposit, annual fee and a commission fee on each transaction.

What sets Alibaba apart is size. The company has said Taobao and Tmall account for more than half of all parcel deliveries in China. By one measure, Alibaba has already surpassed U.S. e-commerce firms. In 2012, the combined transaction volume of Taobao and Tmall topped one trillion yuan ($162 billion), larger than the 2012 totals for Amazon and eBay combined.

Alibaba's revenues are a fraction of Amazon's because it doesn't actually sell the products on its site. But the Chinese company is far more profitable. In the three months through September, the most recent numbers available, Alibaba's revenue rose 51% to $1.776 billion from a year earlier. Net profit stood at $792 million, giving the company a net profit margin of 44.6%, according to shareholder Yahoo Inc., which owns a 24% stake in Alibaba. In the same quarter, Amazon posted a loss of $41 million on revenue of $17.09 billion.

The company has also emerged as a huge player in China's creaky financial system. To solve the problem of buyers trusting the merchants on the site, Alibaba created Alipay, which is a payment system that protects buyers if sellers don't deliver. Alipay has become so ingrained in China, that when the company launched a money-market fund, it grew to be one of the world's largest in just eight months.

Alibaba now does micro lending and is taking part in the Chinese government's program to set up five private banks on a trial basis in some big cities. Run by an affiliate of Alibaba, the payment system has allowed the company to accumulate a vast amount of information on Chinese small businesses, consumers and their online transactions.

Even though Alibaba is still by far the biggest player in China's fast-growing e-commerce market, the company is facing stiffer competition as more Chinese consumers use smartphones. In this new environment, social media and online gaming giant Tencent Holdings Ltd., which operates massively popular WeChat mobile messaging application, is emerging as a powerful competitor to Alibaba, because of its ability to use WeChat as a mobile-based platform to offer other services such as e-commerce. To further bolster its e-commerce capabilities, Tencent earlier this month announced a deal to buy a 15% stake in JD.com Inc., China's second-largest e-commerce firm.

Alibaba has fought back with a string of deals, including its offer last month to pay $1.13 billion for the 72% stake in Chinese online map company AutoNavi that it didn't already own and a $585.8 million investment last year for a 18% stake in Sina Weibo, the popular microblogging site majority-owned by Sina Corp. Weibo unveiled plans Friday to sell $500 million of stock in the U.S.

Alibaba was founded in 1999 by Jack Ma, an English teacher in the eastern Chinese city of Hangzhou, when the Internet as a concept was still foreign to many Chinese businesses even though the dot-com bubble was taking the U.S. by storm. Mr. Ma and 17 other founding members launched Alibaba.com., a trading website that connects Chinese manufacturers with overseas clients. Shortly after eBay entered the Chinese market by buying a stake in a local e-commerce company, Alibaba launched Taobao in 2003 to enter a consumer e-commerce business, at a time when China's Internet user population was growing rapidly.

Write to Juro Osawa at juro.osawa@wsj.com