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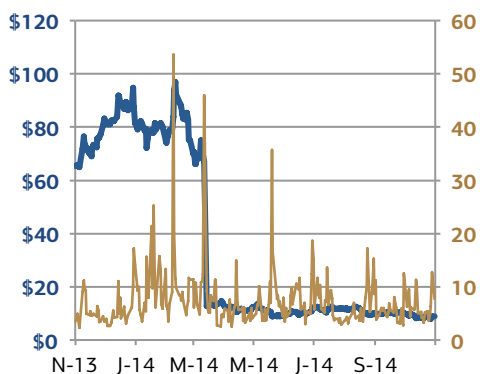
China | Real estate and internet

SouFun (SFUN US)



Underground lender

SouFun Holdings (SFUN US) one-year share price in USD (blue) and volume (gold, in mln shares)



Source: Bloomberg Nov. 20, 2014

SouFun Holdings (SFUN US)

Price	USD 8.90
Rating	SELL
Price target	USD 4.28
Difference	52%
Market Cap	USD 3.7 bln
Simple Moving Avg.	5.64 mln shares
P/E	4.1x
Float	100%

Source: Bloomberg Nov. 20, 2014

+ Leveraged to a sick property market

As SouFun becomes more transaction-based, it will become even more exposed to China's property slowdown. SouFun has significant credit risk in the property sector that is not priced in by the market.

+ Is SouFun really dominant?

If SouFun were really China's market leader why does it need to pay large "commitment deposits" to secure advertising contracts, including to companies owned by SouFun execs? And why has Leju's e-commerce growth outstripped SouFun's, despite SouFun's apparently stronger brand and market presence?

+ Risky counterparties, poor credit assessment

SouFun's counterparties have much higher credit risk compared with peers. When SouFun grants credit, every fourth customer defaults.

+ Capital management at chairman's whims

SouFun has always been active in financing the real estate sector and has a propensity to make unsecured loans to property developers. "Deposits for non-current assets" are actually unsecured developer loans.

+ "Internet finance" and agency buying spree

SouFun has started to do P2P lending and crowd-financing projects. This increases SouFun's credit risk, as SouFun provides guarantees. SouFun is also seeking to buy stakes in three brick-and-mortar real estate agencies, though the agencies lose money.

+ Valuation: \$4.28

SouFun is a value trap. Given a lack of earnings visibility, we think DCF is not an appropriate valuation tool. We use a forward P/E multiple of 10x to value SouFun at USD \$4.28. The market is not pricing in SouFun's leverage to a sick property market, high credit risk, poor corporate governance, and weak business model.

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The underground bank of Mo

SouFun is supposed to be China's market-leading real-estate portal. SouFun makes money from selling real estate advertising and listings on its website and by selling discount vouchers on property projects. This is a pretty straightforward business model, however as with a lot of things with SouFun, it's not that simple.

SouFun is an underground lender

SouFun also engages in other activities more closely related to finance and we question whether SouFun really has a market-leading position, given the constant morphing of its business model.

We view SouFun as more akin to an underground bank. Banks by their nature are risky black boxes, and so is SouFun. Banks take people's money, make credit-risk decisions, and lend out money. So does SouFun.

The difference however, is that a bank's core competency is credit-risk management. **A real estate portal like SouFun shouldn't be making money from credit risk.** But this is the way SouFun is run. Shareholders by now should be aware that their money will be loosely used by SouFun and not necessarily to grow online advertising revenues.

We believe that the latest iteration of SouFun's model, which is to become more transaction-based, makes **SouFun even more geared and exposed to a falling property market.**

Moreover, a range of questionable transactions and a generally cavalier approach to capital management make SouFun even less attractive. In many regards, SouFun seems to just be another shadow-banking conduit to the property industry. Shareholders are subject to the whims of Vincent Mo.

SouFun has **significant credit risk in the property sector**, and this is not priced in by the market.

Is SouFun really dominant?

More transactions = more exposed to sick property market

For a company that is supposed to be China's market-leader, we wonder why:

- SouFun needs to pay large commitment deposits to secure advertising contracts, including to companies owned by SouFun

executives.

- Property agencies have boycotted SouFun’s website.
- Leju’s e-commerce growth has outstripped SouFun despite SouFun’s arguably stronger brand and earlier market presence.

Commitment deposits – where’s the bargaining power?

In its September 2010 SEC filing, SouFun noted that:

*“Recently, we have observed instances in China where real estate sales agents provided commitment deposits to property developers in order to secure a role as the exclusive sales agent for specific projects of the property developers. We believe securing the exclusive provision of online marketing or listing services is helpful for us to maintain or increase our market share. **Accordingly, we have occasionally provided commitment deposits to selected customers after evaluation.** For example, we will only consider providing commitment deposits to customers who have the authority to appoint us as an exclusive provider of online marketing or listing services for a particular project.”*

At least some of the commitment deposits were for SouFun executives themselves:

“This amount was partially offset by a...US\$2.2 million deposit paid to a Hainan property developer specified by Dong Fang Xi Mei, a company 80.0%-owned by Mr. Mo, our founder and executive chairman, and 20%-owned by Mr. Dai, our president and chief executive officer, for the purpose of providing commitment deposits to this property developer to secure future online marketing business relating to its property projects in Hainan, China.”

“Commitment deposits” for SouFun execs

If the company’s chairman and previous CEO required good-faith money before agreeing to advertise with their own company, it hardly seems like a vote of confidence.

SouFun boycotts show the old business model is broken

Boycotts of SouFun’s website by property agencies have been widely publicized throughout 2014. Falling property transactions, especially in the secondary market, as well as SouFun’s high fees have hurt agencies. Most of these agencies have been losing money, a point publicly acknowledged by SouFun, who cut their

listing prices by 40%.

E-commerce business model easily overtaken by Leju

The e-commerce business has only been running since 2011 and was started because of slowing advertising revenue growth. This despite SouFun being the apparent market leader in the real estate portal space. The model was based on earning revenue from the sale of discount coupons used for property purchases.

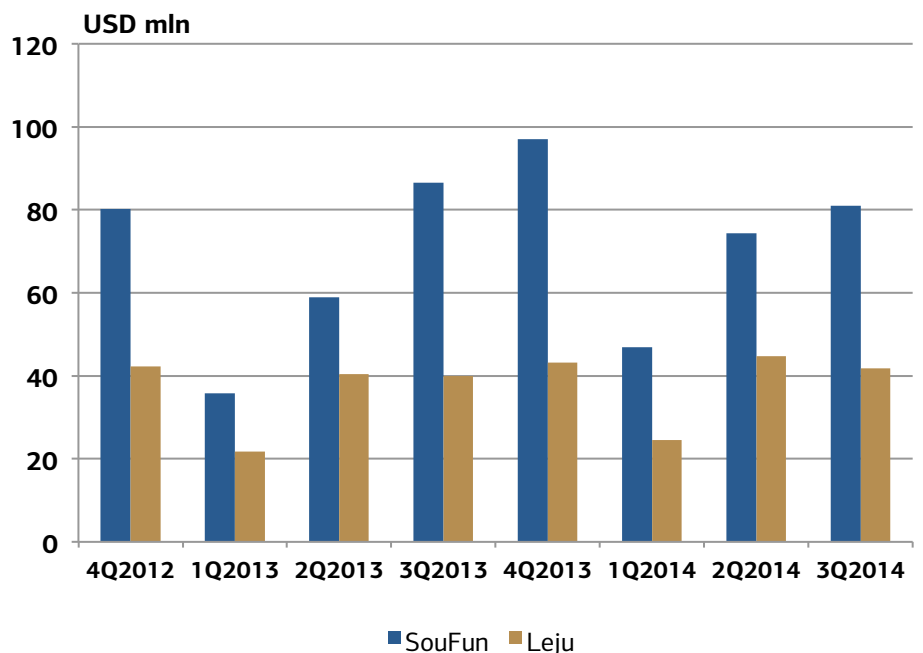
Agencies have been losing money and boycotted SouFun

While SouFun has been able to maintain advertising revenue of at least 1.5x that of Leju, Leju’s e-commerce business has been able to rapidly gain market share and actually overtake SouFun’s.

In 4Q 2012, SouFun’s e-commerce revenue was 3.4x that of Leju’s, but, less than one year later (Q3 2013), Leju had overtaken SouFun. SouFun’s e-commerce revenue is now 20% less than Leju’s. This shows that SouFun’s apparent market leadership is brittle and that barriers to entry are low.

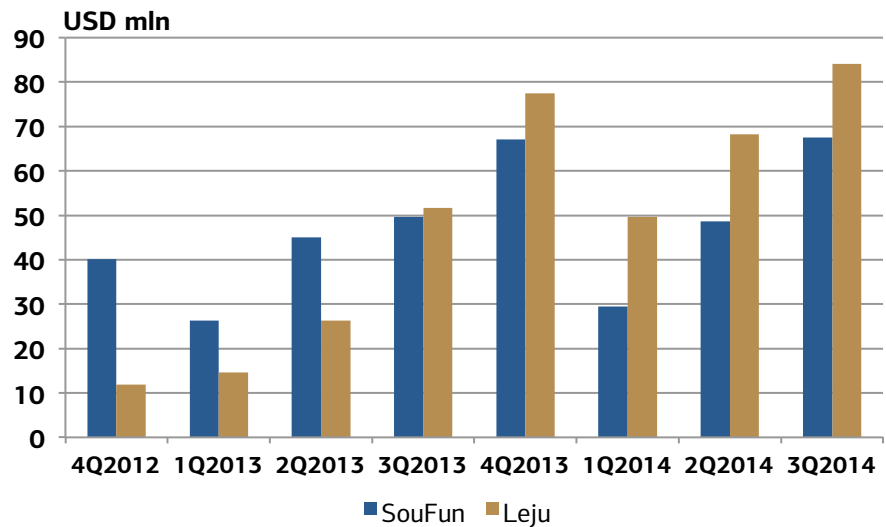
While SouFun’s 3Q 2014 e-commerce revenue grew 36% YoY after a much slower 1H 2014, this is way down on Leju’s growth of 63%. In particular, one year ago, SouFun and Leju’s e-commerce revenue was virtually the same. This suggests that SouFun’s business model is not robust and its management less skilled.

Chart 1. SouFun’s advertising revenue remains higher than Leju’s



Source: Company financials, J Capital Research

Chart 2. But Leju has quickly eclipsed SouFun in e-commerce



Source: Company financials, J Capital Research

Real estate decline shows up in SouFun’s numbers...finally

The key issue facing SouFun is the declining real estate market. Its customers have shown dissatisfaction and voted with their feet.

It has been remarkable that, up until 3Q 2014, SouFun continued to have strong revenue growth, despite the negative real estate environment.

If you believe the reported numbers, SouFun has been adept at continually milking the real estate industry for revenue through constant evolution and shape-shifting. The negative 3Q 2014 numbers, which saw 3Q 2014 NPAT fall 40.6% YoY, finally brought a sense of reality to SouFun’s business, but we think this is the only beginning.

The reality is that, in the medium to long-term, SouFun doesn’t really have a fundamentally solid business model. SouFun’s latest pivot to a more transaction-based model makes it even more sensitive to China’s over-leveraged property market.

3Q 2014 decline only the beginning

It’s possible that 4Q 2014 could see a rebound in SouFun’s revenue from higher transaction volume, but, in the medium term, as the real estate market continues its inevitable descent, SouFun’s business will continue to be exposed.

Skepticism about the numbers

In addition, not only is SouFun geared to real estate transactions,

questions about SouFun's corporate governance and accounting remain.

SouFun's capital management is cavalier. The lack of transparency and a number of questionable transactions make us highly skeptical about SouFun's stated numbers.

For now, Vincent Mo has been skilled at spinning SouFun, even successfully rebutting allegations by Glaucus Research. However we think that, in the end, all dodgy business models will be exposed. Given the backdrop of a falling property market, we think it's only a matter of time before the full SouFun story is unveiled.

Soufun is becoming even more leveraged to property

Soufun is becoming more transaction-based. This means Soufun's fortunes will become even more leveraged to transaction volumes in the property market.

In the Q3 2014 earnings call, Vincent Mo noted:

"I think based on the current situation, as we mentioned, it is really SouFun's long-term strategy that we are going to do things as close to the transaction stage, as close to the money stage as possible."

The change in strategy has been motivated by a fall in growth of the e-commerce business.

As close to the transaction stage as possible

Mo also said the latest shift is about *"trying to separate the advertising and the real e-commerce business..."* as *"...Before this refinement our e-commerce business and advertisement business, they were somewhat mixed up."*

However such a shift has yet to eventuate. SouFun noted in its Q3 2014 earnings call that its advertising business had fallen 6.4% due in part to more advertising clients using e-commerce services instead of marketing services. Which shows that the advertising and e-commerce businesses are still "somewhat mixed up".

It's also interesting that two of SouFun's peers, Leju and the A-share listed House365, had positive YoY advertising revenue growth, albeit in single digits. SouFun appears to be having some serious business issues compared to its peers.

Table 1. SouFun's 3Q14 ad revenue suffered

Ad rev growth	1Q13	2Q13	3Q13	4Q13	1Q14	2Q14	3Q14
SouFun	4.6%	5.9%	8.5%	21.0%	31.2%	26.1%	-6.4%
Leju	5.1%	12.0%	0.8%	2.3%	13.2%	10.7%	4.5%
House365	13.0%	26.1%	18.9%	41.8%	71.6%	21.2%	6.4%

Source: Company financials, J Capital Research

Low visibility business

SouFun's revenue has low visibility. In Q2 2014, Mo said that he was confident that SouFun would maintain its marketing services growth rate in 3Q and 4Q. However, marketing services fell 6.4% YoY in 3Q 2014, after seeing 20%+ YoY growth in the previous three quarters.

Given the dismal state of the property market, a fall in advertising is not surprising. What truly surprised was the >20%+ YoY growth in advertising revenue in previous quarters despite the bad property market.

With SouFun becoming more transaction-based, it is likely that SouFun is now more sensitive to property transaction volumes. This potentially makes SouFun's earnings more visible, as its stock price should correlate with new project starts.

Counterparty and credit risks

SouFun's counterparties have much larger credit risk compared with those of Leju and Sina. SouFun's bad debts/accounts receivable are 25%, much higher than Leju (7%) and Sina (5%). In addition, Soufun's write-offs are many multiples of Leju's and Sina's.

In FY2013, 25% of SouFun's accounts receivable were written off. This is actually low for SouFun – FY2011 saw 53% written off. Leju and Sina had low-mid single digit write-offs.

Effectively, when SouFun grants credit, every fourth customer defaults. Bad debts have consistently been above 23% of accounts receivable since FY2008.

Table 2. High bad debt %

**1 out of 4 accounts
receivable go bad**

Bad debts / Accounts Receivable	FY2011	FY2012	FY2013
SouFun	25%	29%	25%
Leju	n/a	8%	7%
Sina	7%	8%	5%

Source: Company financials, J Capital Research

Table 3. When SouFun sells on credit, there is a high likelihood of a write-off

Write-offs % A/C Receivable	FY2011	FY2012	FY2013
SouFun	53%	32%	25%
Leju	n/a	6%	5%
Sina	0%	3%	3%

Source: Company financials, J Capital Research

Another possibility is that SouFun is using accounts receivable write-offs to work cash off the balance sheet. Allowance for doubtful accounts has averaged 3.2% of revenue since FY2008. They have averaged USD 14 mln since FY2011 – a nice sum to line one’s pockets. Note that allowance for doubtful accounts is not explicitly disclosed in SouFun’s P&L – you need to look in the cash-flow statement.

**Are write-offs a way to
work cash off the balance
sheet?**

Given the consistency of write-offs, SouFun’s questionable corporate governance and the lack of transparency over write-offs, it would not be surprising if write-offs were being used to work cash off the balance sheet.

Either way, as the slowing property market has finally started to impact SouFun’s business, write-offs will likely spike in FY2014. FY2011 saw the highest amount of write-offs, at USD 16.4 mln and 4.8% of revenue. Write-offs of this level in FY2014 would not be surprising.

Table 4. With a slowing property market will write-offs hit FY2011 levels?

Bad debts	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013
A/c Rec. write-offs (\$m)	1.2	3.3	4.1	14.8	9.5	11.0
% of revenue	1.2%	2.6%	1.8%	4.3%	2.2%	1.7%
Allowance for doubtful accounts	3.2	4.4	6.8	16.4	12.3	13.4
% of revenue	3.1%	3.5%	3.0%	4.8%	2.9%	2.1%

Source: Company financials, J Capital Research

Unsecured developer loans

SouFun states that it is moving into financial services. The reality is that SouFun has always been active in financing the real estate sector, and further moves increase SouFun's credit risk to the sector.

SouFun has always been active in financing real estate

SouFun's loose capital management is shown by its propensity to make unsecured loans to property developers. It appears that the SouFun way is to raise money from unsuspecting lenders offshore and then use this money to lend unsecured to property developers.

In FY 2012 and FY 2013, SouFun had USD 8.75 mln and USD 38.14 mln of "Deposits for non-current assets." This increased to USD 86 mln as at 3Q 2014.

SouFun disclosed that the USD 8.75 mln in FY2012 was a "refundable deposit" for the purchase of an office building in Hengshui, Hebei Province. Soufun ended up withdrawing from the purchase due to "changes in government planning regulations which resulted in the office building no longer being suitable..."

SouFun then started chasing the outstanding amount in July 2013. The counterparty apparently signed a repayment agreement, which allowed the counterparty to repay the USD 8.75 mln in installments without interest. However, only USD 713,000 had been repaid six months later, but, according to SouFun, the remaining USD 8.037 mln was repaid in February 2014.

Given that the first repayment occurred six months later, it looks like the counterparty wasn't following a very strict repayment

schedule. Furthermore, it suggests that SouFun either didn't really worry too much about getting repaid, or had no real sway to make the counterparty repay. In any case, this was not a "deposit" but an unsecured loan for one year.

The FY2013 amount of \$38.14 mln is also an unsecured property developer loan masquerading as a "deposit." SouFun discloses that the USD 38.14 mln is a "deposit...for the purchase of 22,402 square meters of an office building in Chengdu, Sichuan."

More unsecured developer loans

SouFun also states that it may request a refund if *"the office building is not completed by March 30, 2015. The development of the office building is expected to be completed by December 31, 2014. If the real estate developer were able to complete the office building by December 31, 2014, the deposit is considered as an interest-free non-refundable payment."*

Essentially, SouFun paid the full purchase price of an incomplete office building on Day 1. Unlike most property purchases, it was not a phased payment process. If the developer, which is Greenland, were to go bankrupt, **SouFun would lose the entire USD 38.14 mln.**

SouFun's deposits for non-current assets have doubled, to USD 86 mln as at Q3 2014. Unsurprisingly, there is no disclosure on what has caused the higher exposure.



Greenland Window Project | Photo by J Capital

Why is SouFun making interest-free, unsecured loans?

The answer is most likely so that SouFun can win the advertising account for the Greenland property project. Sure enough, this particular project, called “Greenland Window Project,” is advertised on SouFun’s website:

http://chuangyuanzhongxin.fang.com/office/house/office/houseDetail_info.php?newcode=3211103746&page=1

The Greenland Window Project has a checkered history. The Window Project used to be called “Chuangyuan Centre,” and construction was supposed to begin in 2013. The original developer was Chengdu Hailian Industrial Development Co. Ltd. However, construction was repeatedly postponed and, at the end of the year, the name of the project was changed to “Greenland Window Project.”

In October 2013, Greenland appears to have purchased a 51% share in Chengdu Hailian. The repeated postponements, plus the name change, suggest that Chengdu Hailian had run into cash-flow difficulties and was unable to develop the project.

SouFun then paid USD 38.14 mln to Greenland in December 2013 to buy floors 13-25 of building No. 1 of the Greenland Window Project, even though construction had yet to start.

Trust Vincent

We visited the project. The office building was still under construction, though near completion, as it appeared that the outer glass was being installed. A salesperson told us that sales of the office building had yet to begin. The building is located in the New District where there is a glut of empty office buildings

Nonetheless, the fact that SouFun was willing to give an unsecured loan to such a risky project shows a few things:

- **SouFun has very poor capital management.** Clearly, there is scant regard for shareholders’ funds.
- **SouFun’s market leverage is not as strong as it suggests** – if developers were beating doors down to advertise on SouFun’s website, why would SouFun have to resort to unsecured long-term lending?

Funds and Loans Receivable – more trust needed

SouFun has other unsecured exposures on its balance sheet. Again,

shareholders are being asked to trust Vincent Mo’s capabilities as a money-lender and risk manager.

Funds Receivable

Funds Receivable first appeared in FY2012. Funds Receivable is “cash from SouFun membership services due from a third-party payment service provider for clearing transactions.”

Loans receivable are back

This appears to relate to SouFun’s e-commerce membership business. Customers presumably pay membership fees to the undisclosed third-party payment service provider, who passes the money on to SouFun.

The amounts of USD 7.6 mln in FY2012 and USD 37.1 mln in FY2013 are not immaterial – The FY2013 figure is almost equal to accounts receivable of USD 44.5 mln. As at 3Q 2014, funds receivable were USD 43.9 mln.

SouFun states that it “...carefully considers and monitors the credit worthiness of the third-party payment service provider used.” So far, no bad debts have been recorded against Funds Receivable, but the key issue is that this is yet another unsecured exposure and shows the large credit risk that SouFun is exposed to.

Loans receivable

Loans receivable are a controversial item on SouFun’s balance sheet. In FY2011, the USD 26.1 mln of loans receivable were loans to property developers. They were the subject of reports by Glaucus and questions from the SEC.

After Glaucus and SouFun traded public statements in April 2012 about various issues including loans receivable, SouFun appears to have taken a breather from this type of dodgy activity. But not for long.

Recurring issues

Perhaps SouFun management is so cynical to think that investors have short memories, for loans receivable reappeared on SouFun’s balance in 1H 2014 at a sizeable USD 21.9 mln. It further increased to USD 36.5 mln in 3Q 2014.

Table 5. Loans Receivable – The Bank of Mo

\$ mln	FY2010	FY2011	FY2012	FY2013	1H2014	Q32014
Loan rec.	10.6	26.1	0.0	0.0	21.9	36.5

Source: Company financials, J Capital Research

\$14.8 mln loan to Dandong Yuanlong Villa Management

Both the SEC¹ and Glaucus² were interested in a USD 14.8 mln loan made by SouFun to Dandong Yuanlong Villa Management Company (“Dandong”) in 2012 and the relationship between Beijing Hengxinjiahua Investment Consultant Ltd (“HXJH”) and Dandong.

SouFun never disclosed that the SEC had enquired about this transaction until Glaucus published its research.

The sell-side has hardly held Mo to account

SouFun’s response to the SEC claimed that Dandong was an independent third party. As shown by Glaucus, Dandong is owned by Vincent Mo’s friend Deng Wei.

The issues raised by this transaction are the same as other questionable SouFun transactions:

- **Lack of transparency:** In a September 2010 filing, SouFun stated that *“Going forward, in the interest of good corporate governance, we will not enter into any new commitment deposit or loan arrangements with related parties.”* Whether or not Dandong was technically a related party, this transaction clearly is skirting a fine line on the definition of a related party.
- **Poor credit risk assessment and loose capital management:** In its SEC submission, SouFun stated it gave the \$14.8 mln loan to Dandong to acquire Sanya properties, but soon after Dandong had “liquidity issues” and was unable to repay the loan. Firstly, why is SouFun making loans to property developers and secondly, what is SouFun’s competency in credit risk assessment, particularly as Dandong ran into “liquidity issues” so soon after gaining SouFun’s loan?
- **Lack of sell-side scrutiny:** In the 1Q 2013 earnings call following Glaucus’ reports, there was only one question asked by a sell-side analyst about the Dandong transaction. Vincent Mo’s explanation was very brief, and the questioner didn’t follow up. **Most analysts actually congratulated SouFun on the quarterly results.** This sycophantic coverage of SouFun is unfortunately the norm, and it’s puzzling that sell-side analysts have not held SouFun to account over poor corporate governance.

¹ <http://secfilings.nyse.com/filing.php?doc=1&attach=ON&ipage=8936762&rid=23>

² https://glaucusresearch.com/wp-content/uploads/downloads/2013/04/GlaucusResearch-SouFun_Follow_Up-SFUN-Strong_Sell-April_16_2013.pdf

The latest – entrusted loans

Getting into P2P lending, because that’s what you do when advertising revenues slow

The whole idea that SouFun is “developing” its financial services program is farcical. This is purely spin for risky lending that SouFun has always engaged in.

The latest incarnation is USD 21.9 mln in entrusted loans provided to developers and home buyers in H1 2014. In typical SouFun fashion, there was little disclosure on to whom these loans were made and for what duration.

In the H1 2014 earnings call, SouFun made general comments which were not very illuminating:

“...yes, we’ve had loans to developers and home buyers and the like. It goes through a review process, of course, similar to all the loan companies and banks within our system. And then, to a certain extent, we’ll make sure that there’s enough collateral for a large amount of loans to further mitigate the risk.”

The two channels of “internet finance” that have popped up on SouFun’s website are: “Tianxiajin” and crowd-sourcing.

Tianxiajin

Tianxiajin is a P2P financial product which sources loans for developers. Investors are sought to lend a minimum of RMB 1k in various offerings ranging from RMB 50k to 1 mln. Lending terms are from 3-12 months with an annualized return of 9-10%.



项目名称	投资金额	剩余投资期限	预期年化收益	进度	起投资额	操作
天下金 201411124574	1,000,000.00元	6个月	年化 10.00%	89%	5,000.00元	投资
天下金 201411122131	1,000,000.00元	6个月	年化 10.00%	0%	5,000.00元	投资
天下金 201411122592	1,000,000.00元	6个月	年化 10.00%	100%	5,000.00元	查看

Above: Screen shot of SouFun Tianxiajin

Demand from investors appears strong. From August 10, 2014 to November 17 2014 we counted 211 Tianxiajin products on SouFun’s website. A total of RMB 62 mln of products had been sold.

The average fund size increased from August to October, with October seeing a number of RMB 1 mln products funded.

SouFun stands in the middle of the transaction and likely charges the developer a higher interest rate and makes a spread – it sounds like good business for SouFun. Assuming SouFun earns a 5% fee on the total funds raised, we estimate SouFun has so far earned around RMB 3.1 mln from Tianxiajin. However, this is small when compared to 3Q 2014 e-commerce revenue of USD 67.6 mln. Clearly, based on what we found on SouFun’s website, Tianxiajin is not responsible for most of the growth in e-commerce revenue.

Table 6. Tianxiajin funds raised

RMB	Total funds raised	Average size	Assumed fees @ 5%
August (10th-31st)	6,230,000	95,846	311,500
September	14,600,000	194,667	730,000
October	24,500,000	720,588	1,225,000
November (1st-17th)	16,700,000	439,474	835,000
Total	62,030,000	293,981	3,101,500

Source: SouFun website, J Capital Research

What happens if the borrower defaults?

What about risk management?

Actual details about the underlying borrower are sketchy – the following description was given about the underlying borrower of one fund:

“The company has developed more than one high-quality real estate project. Development projects are located in prime locations, surrounded by schools, supermarkets and other supporting facilities, the project financing amounts to 20 million, over a six-month period, mainly for working capital turnover.”

SouFun maintains that Tianxiajin is a “low risk product” and if the underlying borrower is unable to repay interest, collateral will be disposed for repayment.

SouFun also attempts to reassure investors by stressing its “many years of experience in real estate”, its “careful” assessment of borrowers and “strict standards for auditing, mortgages and regulation”.

Collateral and guarantee

Given the product is so new, it's not known what would happen if the underlying borrower defaults. Soufun's website states that a 100% guarantee of principal and interest is provided by a "strongly capitalized" financial guarantee company. Underlying security includes assets worth RMB 40 mln.

High expected returns The following, however, is clear:

- **SouFun's leverage to the property market is accentuated by Tianxiajin.** If the underlying borrower defaults, it's not clear who is on the hook (is the guarantee provided by SouFun?), but it wouldn't be surprising if SouFun has to foot some of the bill.
- SouFun is not a bank, but is clearly behaving like a money lender.
- Tianxiajin is a black box.

Crowd financing

SouFun's crowd-financed product or "zhongchou" pools together groups of investors who typically invest RMB 1k each to jointly buy a discounted property. This property is then auctioned and investors are told to expect gains of 40%.

We interviewed people involved in zhongchou who related that developers are less willing to pay upfront advertising costs. Zhongchou projects are a way of paying SouFun for advertising costs and also create hype.

Below is a zhongchou example from SouFun's website – 500 investors each contribute RMB 1k to buy a property worth RMB 1 mln for a price of RMB 500k. In one week's time it is sold for RMB 700k and after fees each investor pockets RMB 1.4k.

Our very own zhongchou



Soufun zhongchou example

We counted 35 zhongchou projects on SouFun's website as at 17 November 2014. For a full list see Appendix A.

- 30 had finished fund-raising, while five were in the process.
- **More deals released over time:** One was in August, 11 in October and 18 in November.
- Apartments were mainly in 2nd and 3rd tier cities such as Changzhou, Chongqing and Zhengzhou. There were a handful of deals in Beijing, Shanghai and Guangzhou. Developers were mainly local developers, but also included large developers like Vanke, Shimao, Longfor and Poly.
- **The average discount to the stated value of the apartment was 43%**, with the largest discount at 58% for a Wuhan project and the smallest discount at 25% for a Tianjin project. The average apartment size was 80sqm and 2.2 bedrooms.
- **Average purchase price was RMB 431,000** vs an average stated value of 751,000, and total funds raised were RMB 15 mln. The average number of investors per product was 304.
- **Sold projects:** We have so far found 7 projects that have sold, and the average gross return (before SouFun's fees), was 37%.

Our investment in a SouFun zhongchou

To gain a deeper understanding of zhongchou, we invested in one.

We were able to invest RMB 1,000 in a Greenland project called “Chengdu Greenland Center 468” located in the Third Ring Road of Chengdu. Bidding opened at 10am on 4 November and was initially limited to local Chengdu investors. After 10 minutes, 18% of the targeted RMB 468,000 (5,270/sqm) had been raised. When bidding was opened to all investors at 1 pm, it only took two minutes to fill the pool, with each investor limited to RMB 1,000.



The “468” project under construction. | Photo by J Capital

The apartment’s initial stated value was RMB 825,840 (9,300/sqm), so, along with 467 other investors, we apparently bought the property at a 43% discount to “market value.”

The apartment can be found here:

<http://txdai.com/zhongchou/NewHouseDetail/Index.html?id=75413b8d434b4eca90adf4ae3fcd23f0>

We visited the 468 project. A salesperson told us it had been

completely sold out, including our zhongchou flat. However, construction is behind schedule. Greenland used a planned shopping center and office block to attract buyers, but neither is under construction. Chengdu's property market is not healthy. Another salesperson told us 40% of buyers were speculators.

On 11 November, the apartment was sold via an online auction for RMB 656k. The current ASP of the project is RMB 86,000/sqm, so for an apartment of 88,800sqm, the market price should be RMB 763,700. Therefore the final zhongchou transaction price of RMB 656,000 is 14.1% lower than the RMB 763,700 market price and 20.6% lower than SouFun's stated initial value of RMB 825.8k.

SouFun provides a guarantee

Bidding lasted for around 1 hour with 25 bids placed. A "Mr Zhou" was the successful bidder at 10:59:55. Mr. Zhou had to pay the premium of RMB 188,000 over the initial zhongchou purchase price within three working days, followed by the 468,000 within one month. Seven days after payment, zhongchou investors (including J Capital) were to receive their principal and interest. On November 20, 2014 we received payment, realizing a gain of 33%.

The auction result can be found here:

<http://tao.fang.com/pai/32110707101634/>

成都 绿地中心468公馆 3期5号楼1004号 搜房网第966轮 [已结束]



11月11日早上10:00-11:00竞拍, 本次房源竞拍, 价高者得

出价记录

搜房网友	出价	出价时间	状态
周 (189****5351)	65.6万元	2014-11-11 10:59:55	赢得竞拍
李 (159****2380)	65.5万元	2014-11-11 10:59:42	出局
刘 (132****0001)	65.3万元	2014-11-11 10:59:33	出局

Successful auction: Our zhongchou project. The successful bid can be seen at the bottom. The numbers in red show the initial purchase price (RMB 468k), initial stated value (825.8k) and final selling price (656k).

Like a hedge fund – how SouFun makes money

SouFun charges 10% on the investment gain as a service fee and

3% as a **guarantee fee**.

- Service fee would be around RMB 18,800: $(656,000 - 468,000) \times 10\%$.
- Guarantee fee of RMB 14,000: $468,000 \times 3\%$.

33.2% return: In total, SouFun earned RMB 32,800 from the zhongchou and investors get around RMB 155,100, which is a 33.2% rate of return.

Of the 35 zhongchou projects on SouFun's website:

- SouFun would have earned RMB 452,000 of guarantee fees ($3\% \times \text{RMB } 15 \text{ mln}$).
- Of the 7 projects that have sold so far, the total profit was RMB 1.43 mln, so SouFun would have earned RMB 143,000.

Can SouFun really continue to double direct sales every month?

But not much revenue so far

Thus far, if there have only been 35 zhongchou projects (and assuming that there are no other projects which have been taken off SouFun's website), **SouFun has earned around RMB 955,000 from zhongchou, which is not that much** – certainly not enough to move the needle to make a sustainable new e-commerce business model.

RMB depreciation risk

Questions, questions

Yet again, as there is very little transparency, we can only speculate on:

- **Guarantee:** SouFun provides a guarantee in exchange for collecting a 3% fee. Therefore if the property was sold for less than the initial purchase price, SouFun would presumably have to make good to investors at par value. This is another off-balance sheet credit risk that SouFun is exposed to.
- **Where does SouFun procure the properties from?** It's likely that developers have excess inventory that they are trying to offload at a discount and zhongchou is currently a trendy way to sell.
- **Who are the buyers?** They could be anyone, including SouFun or the developer. We need to do further research to understand who is actually buying properties via this process.

- **Are the zhongchou financing downpayments?** We think it's possible that developers are using zhongchou funds to borrow from banks and on-lend. This is the subject of further research.

“1000 units a month”

In SouFun's Q3 earnings call, Vincent Mo noted that direct sales via SouFun's online transaction platform had doubled every month.

“...in August, September and October, the last three months is we are seeing the record sales that's past 1,000 units. And in the coming months...it's going to double every month.”

Mo also noted that in Q3 2014 SouFun had done more than RMB 200m of lending via their loan referral business. Mo said that *“it's the bank's money, not our own money. And for this month [November], we are going to see this number ...to be four times of last month.”*

We haven't been able to verify Mo's claims, but attempt to estimate what impact it would have on SouFun's revenue.

- Assuming SouFun was able to sell 1,000 units at an average purchase price of RMB 1 mln and received a 3% commission (SouFun disclosed they earn 1-3% in the 3Q earnings call), this would be RMB 30 mln or USD 4.88 mln.
- Assuming November was double October and December was double November, **Q4 2014 revenue would be USD 34.2 mln. This would be just over half of Q4 2013's USD 67 mln.** Even with other e-commerce related revenue (zhongchou, Tianxiajin), it would be surprising if SouFun could achieve positive YoY revenue growth for 4Q 2014. In addition, NPAT is likely to be lower given higher costs associated with direct sales.

What are short-term investments?

If the whole industry continues to see falling transaction volumes we struggle to see how SouFun will be able to continue doubling sales every month, particularly as competitors like Leju and 365 House start to copy SouFun's model.

SouFun might have 2-3 quarters of strong e-commerce revenue growth, but this is unlikely to be sustainable – as shown by the e-commerce voucher model, barriers to entry are low, with SouFun quickly overtaken by Leju.

Asset/liability mismatch, high gearing, RMB risk

SouFun has borrowed short-term and long-term USD offshore. These loans are secured by RMB denominated bank deposits in China. **As loans and interest payments are USD-denominated, while earnings are in RMB, SouFun is exposed to RMB depreciation risk.**

As at 3Q 2014, SouFun had short-term USD borrowings of USD 81 mln. This was secured by RMB bank deposits worth USD 97 mln. These pledged deposits are classified as “restricted cash, current” on SouFun’s balance sheet.

Likewise, SouFun had long term loans of USD 100 mln as at FY2013, secured by RMB bank deposits worth USD109 mln.

The short-term loan is payable on demand, while the long-term loan is also payable on demand if certain covenants are breached.

Table 7. Different forms of cash

USD mln	FY12	1Q13	1H13	3Q13	FY13	1Q14	1H14	3Q14
Cash	118	178	256	294	581	288	239	386
Short term loans	271	271	271	271	90	0	0	81
Restricted cash, current	0	0	0	217	256	0	0	97
Long term loans	81	81	81	181	181	181	181	100
Restricted cash, non-current	391	392	398	293	257	206	206	109
Convertible senior notes	0	0	0	0	350	400	400	400

Source: Company financials, J Capital Research

SouFun potentially has an asset/liability mismatch from its myriad forms of property and internet finance and its funding base.

- If short-term loans of USD 80 mln were called in, SouFun appears to have sufficient cash to repay this loan.
- However if USD 100 mln of long-term loans and USD 400 mln of convertible notes were called at the same time, SouFun may have issues repaying these loans from existing cash. Convertible note holders have the right to require SouFun to repurchase for cash all or part of their notes on 15 December 2016, at a repurchase price equal to 100% of principal, plus accrued and unpaid interest. It would not be surprising if all lenders wanted their money back at the same time – there

Agencies are losing money

would be a high correlation to a SouFun credit risk event.

Apart from USD 386 mln of cash, SouFun's balance sheet is not that liquid. Accounts receivable (USD 55 mln), funds receivable (USD 44 mln) and loans receivable (USD 37 mln) which are all subject to significant credit risk can't be relied upon for liquidity.

SHORT Hopefluent?

SouFun does have USD 510 mln of short-term investments, which are supposedly money-market instruments invested for 90 days. Given the average interest rate earned on these "fixed rate time deposits" has been consistently higher than China's benchmark deposit rate (average rate of return from fixed deposits in FY2011 was more than double the benchmark rate), we query whether these are actually vanilla bank deposits. Perhaps the majority are (with a portion in shadow lending), in which case SouFun should be able to satisfy any liquidity call.

It is curious nonetheless that SouFun earns much higher returns than that normally offered by banks.

Table 8. High returns from fixed time deposits

USD mln	FY2009	FY2010	FY2011	FY2012	FY2013
Fixed rate time deposits	21.2	50.6	7.9	25.5	10.1
Interest income	0.3	1.1	2.3	0.8	0.8
Average rate of return	1.8%	3.2%	7.9%	5.0%	4.3%
China 1-yr benchmark deposit rate	2.25%	2.5-2.75%	3-3.50%	3.25-3%	3.0%

Source: Company financials, J Capital Research

The other issue is that SouFun is intending to buy stakes in 3 real estate agencies totaling USD 262 mln:

- USD 120 mln for World Union.
- USD 91 mln for Hopefluent.
- USD 51 mln for Century 21.

So far, none of these transactions has completed (further detail below), but if they were to complete, **cash would be reduced to USD 124 mln**. This would amplify SouFun's liquidity risk.

High gearing

SouFun's debt / equity ratio is a high 106%. While SouFun is net

cash on a net debt / equity basis, this could be a smokescreen. As shown above, net debt / equity could also be high if SouFun purchases the 3 real estate agencies and short-term investments are not able to be accessed for liquidity.

Offline agencies increase risk

SouFun has gone on a \$262 mln real estate agency acquisition spree. However so far SouFun hasn't actually completed any of these transactions.

From a strategic point of view, it's a poor strategy.

- **They don't make money:** SouFun themselves acknowledged that most of their agency clients were not making money in 2014, so why move into such a competitive space? Century 21's 3Q 2014 **net loss** was RMB 25.1 mln, up from a net loss of 17.7 mln in 3Q 2013.
- **Higher cost, lower return business:** Hopefluent's 1H 2014 results show falling margins from higher selling expenses. Hopefluent's selling expenses increased 25% YoY, vs a 17% increase in revenue. NPAT margins fell to 5.7% from 8.8%. Why buy into businesses which are seeing falling margins from higher costs?
- **Potential reason to SHORT Hopefluent:** SouFun will own 13.86% of Hopefluent after the transaction. Soufun's purchase price of HKD 3.00 is already 24% underwater with Hopefluent's share price at 2.28. If SouFun runs into liquidity issues, SouFun may be forced to sell its HopeFluent shares, which would put downward pressure on Hopefluent's share price.
- **Closer to transactions:** Online advertising revenue is falling, so SouFun is trying to get closer to transactions – this increases leverage to a falling property market.
- **Secondary market not healthy:** SouFun and Leju have both had poor growth in their secondary market businesses. The secondary market is the main business of the bricks and mortar real estate agencies and it is not doing well.
- **Agency boycotts:** Agencies have boycotted SouFun in Shanghai, Beijing, Chongqing, Qingdao and other cities. By trying to elbow its way further into this space, SouFun will likely irritate other existing agency clients.

-
- **“Internet financing”**: In its justification for the SouFun transaction, Hopefluent notes the opportunity to conduct real estate financial and internet financial services. Hopefluent has already set up a micro financing subsidiary in 2013. Again, what competency does SouFun and Hopefluent have in assessing credit risk?
 - **Integration with 3 companies at the same time?** It’s hard enough integrating with 1 company – how will SouFun manage the integration of 3 different companies at the same time?
 - **Yet to complete:** None of the 3 transactions have completed yet. We don’t know why they haven’t completed, but we should have colour on the transactions soon. Hopefluent have set a completion date of 31 December 2014.

Valuation

It’s a challenge to accurately forecast how SouFun’s balance sheet will look like, even on a quarter-on-quarter basis. Every quarter new exposures suddenly appear with minimal disclosure.

SouFun is a value trap

Similarly, SouFun’s earnings visibility is very low. Even if you give SouFun the benefit of the doubt and believe that it is focused on its “new” e-commerce business model, it is hard to gain confidence on forecasts even 2-3 quarters out. Therefore, given how volatile SouFun’s earnings are, we don’t think DCF is an appropriate way to value SouFun.

In the 3Q2014 earnings call, Vincent Mo guided 6-8% revenue growth YoY for 4Q2014. We take him at face value and assume FY2014 revenue will come in around USD \$681.5 mln.

We assume the following for FY2015e:

- **Advertising revenue grows 5% YoY**, vs 2% YoY in FY2014e. We think this is a conservative assumption in SouFun’s favour.
- **E-commerce revenue grows 20% YoY**, vs 18% YoY in FY2014e. This gives the “new” model the benefit of the doubt.
- Gross margin falls to 74% from 77%.
- **SG&A expenses increase 20%** as SouFun needs to spend

more on the offline sales strategy. We think this is conservative given selling expenses will increase around 54% YoY and G&A expenses will increase around 40% in FY2014e.

- **NPAT falls 8% to \$200 mln vs \$218 mln in FY2014e.** NPAT margin falls to 26% from 32%.

Table 9. FY2015e P&L

USD mln	FY2014e	FY2015e	Growth
Advertising	285	299	5%
E-commerce	221	277	25%
Listing services	160	165	3%
Other income	15	15	0%
Total revenue	682	755	11%
Cost of services	155	196	26%
Gross profit	526	559	6%
Gross margin	77%	74%	-4%
Selling expenses	157	188	20%
G&A expenses	116	140	20%
Other income	1	1	0%
Operating income	254	231	-9%
Interest income	44	44	0%
Interest expense	17	17	0%
Govt grants	9	9	0%
EBT	290	267	-8%
NPAT	218	200	-8%
NPAT margin	32%	26%	-17%
Diluted EPS	0.49	0.43	-13%

Source: Company financials, J Capital Research

Price target of \$4.28

Our price target is \$4.28, which is 10x our forecast FY2015e earnings and 48% downside from SouFun's price as at 19 November 2014.

Based on Bloomberg consensus, SouFun is currently trading at 14x 2014e P/E and 13x FY2015e P/E. For China's no.1 real estate portal this looks cheap and risk/reward looks compelling. Leju has a higher valuation and is trading at 17x FY2014e and 12x FY2015e consensus.

However SouFun is a value trap. Based on our estimates, which we think are conservative in SouFun's favour (particularly on the revenue side), SouFun is currently trading at 17x FY2014e P/E and

19x FY2015e. Moreover, we think the market is not pricing in:

- **SouFun's leverage to transactions lack of earnings visibility** from its business model experimentation. As the property market slows, SouFun will be even worse off.
- **A continually slowing property market and a potential freeze in secondary market transactions** – to gain a sense of this, read SouFun and Leju's earnings calls and the nature of analyst questioning on whether there has been a rebound in transaction volumes – the analysts have no idea on the direction of the property market and are merely hoping for a rebound to support their high price targets. **We don't think 3Q 2014 is a bottom in SouFun's earnings.**
- **SouFun's credit risk and poor corporate governance:** SouFun has a history of engaging in very nefarious deals which expose it to high credit risk. As SouFun ventures more into "internet finance", we think its credit risk profile will increase.
- **Poor strategy of buying bricks and mortar agencies:** The agencies will continue to lose money as the property market slows and this increases SouFun's exposure.

Risks

- **Private equity buys in:** Vincent Mo is a wily operator, and if SouFun's price continues to fall, we think he could hatch an escape plan.
- **Chinese property market rebounds:** If this happens, either the primary or secondary market, we are wrong on SouFun.
- **E-Commerce outperforms despite a slowing property market:** In more conventional markets, online listings businesses are enormously profitable. It is certainly possible that SouFun returns to this business model and the market picks up. But we struggle to see how this could occur when the business is now so transaction-based.

Appendix A – Zhongchou projects

(as of 17 Nov 2014).

Date	Project	Developer	City	Size (sqm)	Beds	Initial price (RMB k)	Offer price (RMB k)	Discount	Selling price (RMBk)	Gross Return	Investors
24-Aug	万科城众筹买房苏州	Vanke	Suzhou	100	3	900	540	40%	735	36%	540
09-Oct	新世纪君汇半岛东莞	Dongguan CMG	Dongguan	108	2	927	550	41%	741	35%	181
10-Oct	新城悠活城	Xincheng	Changzhou	75	3	400	240	40%			134
10-Oct	新城香溢紫郡	Xincheng	Changzhou	99	4	533	320	40%			320
10-Oct	新城香溢俊园	Xincheng	Changzhou	89	3	610	370	39%			370
29-Aug	联发瞰青	Lianfa Group	Chongqing	145	3	960	535	44%			174
01-Oct	美克嘉美湾众筹	Meike	Tianjin	108	3	700	350	50%			101
16-Oct	世茂首府众筹	Shimao	Ningbo	104	3	2,070	1,240	40%	1,500	21%	700
21-Oct	鸿坤理想湾众筹	Zhuozhou	Beijing	88	3	752	380	49%			380
22-Oct	时代倾城众筹	Times Property	Zhuhai	78	2	730	440	40%	570	30%	186
22-Oct	万科mixtown	Vanke	Shanghai	86	3	750	450	40%	675	50%	450
28-Oct	永恒理想世界	Yongheng	Zhengzhou	88	2	987	495	50%	736	49%	495
04-Nov	绿地中心468公馆	Greenland	Chengdu	89	3	826	468	43%	656	40%	468
06-Nov	创融嘉天地	Chuangrong	Shanghai	35	1	492	250	49%			250
07-Nov	凤翔湖滨世纪	Fengxiang Group	Fuzhou	49	1	374	224	40%			224
10-Nov	龙湖时光星座	Longfor	Chengdu	34	1	340	200	41%			200
11-Nov	开维生态城	Hainan Weide	Hainan	63	1	509	370	27%			199
11-Nov	诺德名筑众筹	Panyu Liren	Guangzhou	86	3	1,334	859	36%			404
11-Nov	恒基旭辉府	Xuhui	Hangzhou	90	3	742	447	40%			163
11-Nov	保利东江首府	Poly	Guangzhou	136	3	2,019	1,260	38%			265
11-Nov	珠江悦公馆	Zhujiang	Shanghai	73	2	1,380	620	55%			620
11-Nov	万科海上传奇	Vanke	Nanchang	95	3	860	520	40%			520
11-Nov	郡原小石城	Hualing	Shenyang	59	2	353	147	58%			147
14-Nov	尚湖熙园	Hanjiang Hongsheng	Wuhan	84	2	800	480	40%			480
11-Nov	钱隆学府	Qianlong	Tianjin	82	2	562	422	25%			262
11-Nov	鸥鹏·泊雅湾	Yuanou	Chongqing	54	1	357	160	55%			160
11-Nov	智慧城淘公寓	Hankou International	Wuhan	36	1	200	100	50%			100
11-Nov	景园悦海湾	Chengmai Hengrun	Haikou	76	2	550	350	36%			170
11-Nov	万朋商城	Wangpenghu	Beijing	12	Shop	563	280	50%			280

14-Nov	邦华·星际	First Investment	Guangzhou	39	1	728	438	40%			188
Current	旭辉香樟公馆	Hunan Ronghui	Changsha	70	2	540	270	50%			
Current	盛泰·南湖明珠	Shengtai	Tangshan	93	2	537	300	44%			
Current	绿地启航国际	Greenland	Chengdu	51	1	280	146	48%			
Current	群力玫瑰湾	Harbin Comp. Dev.	Harbin	140	3	1,187	600	49%			
Current	农房索河湾	NGS Zhen Hua	Zhengzhou	82	2	426	255	40%			

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