China | Finance

# Noah Holdings Ltd. (NOAH US)

December 1, 2014

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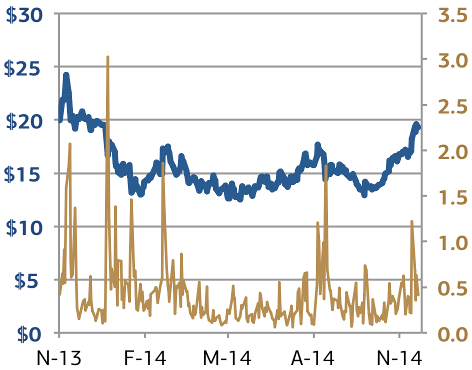
## Rising Waters

**Noah (NOAH US) one-year share price in USD (blue) and volume (gold, in mln shares)**




Source: Bloomberg, Dec. 1, 2014

**Noah Holdings (NOAH US)**

| | |
|---|---|
| Price | USD 19.39 |
| **Rating** | **SELL** |
| **Price target** | **USD 0.00** |
| **Difference** | **100%** |
| Market Cap | USD 1.07 bln |
| Simple moving avg. | 0.48 mln shares |
| P/E | 15.2x |

Source: Bloomberg, Dec 1, 2014.

### + All about real estate

Whether receiving commissions on sales of third-party investment products or investment proceeds from its own managed funds, Noah is almost a pure-play real estate investor. As such, the company will be hurt by currently falling prices and transaction volumes across China's real estate markets.

### + On its own account

Noah's disclosures suggest that it serves merely as a sales agent for investment products and also has contracts to manage funds without balance sheet exposure. However, evidence indicates that the company is heavily exposed to its investments both on its own balance sheet and via both implicit and explicit principal guarantees. We believe that the roughly two-thirds of revenue from "related party" sources contains balance sheet exposure and that Noah is therefore highly exposed to defaults. We believe that Noah's cash is compromised, whether pledged against loans and margin calls or reserved against defaults.

### + Publicly traded PE

In reality, Noah's business is to seek investment in its own private equity funds. These funds contain principal guarantees to investors, implicit and explicit, and we are confident that Noah will be held to account for losses. A case of embezzlement of a notionally third-party fund created distress at Noah in summer and appears to have led to the departure of the CFO. Much worse defaults appear likely.

### + All the revenue growth is "deferred"

Deferred revenue growth in 2014 YTD is 56% YoY—slightly higher than the 52% revenue growth for the same period.

### + Initiating coverage: SELL, PT USD 0

Noah offers some of the weakest disclosure among publicly traded companies, and we cannot model its results with precision. We do believe that real estate exposures are very significant and will ultimately cause Noah's bankruptcy.

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# Before the Flood

Noah Holdings presents itself as a successful chain of financial advisory firms, helping affluent Chinese find secure but high-return investments. In reality, Noah is in the business of recruiting money for its own, risky real estate investments. At best, the company is a bet on the riskiest parts of China's failing property markets. At worst, it may be a set of Ponzi schemes.

**What you don't Noah may hurt you**

China's Tier 3 cities are cheek to jowl with companies like Noah. There are just too many people who have realized windfall earnings from selling their land to governments, people who, before the housing boom, never had two one-kuai coins to rub together and then, after being moved from their land by local government, suddenly were sitting on bank accounts seemingly bursting with cash. All this money led to the establishment of little companies everywhere that promise returns much higher than can be had through banks: small loan companies, informally traded "private equity" funds, local OTC exchanges for unlisted companies, "crowd financing" online platforms, and more.

Noah initially survived this competition by being virtually a captive fundraiser for Sequoia China, the private equity firm that is Noah's second-biggest shareholder, after company founder Wang Jingbo. Now it survives by owning the investments rather than just taking an introduction fee. The problem with this is that the risks are so great as to mean almost certain default. Always at the bleeding edge of speculation, Noah understands this and is positioning itself as the handmaiden for a nervous upper class who want to park their capital overseas. This too is a competitive area and relies on shady channels for moving the money from the mainland to Noah's new trust in Hong Kong.

## The basics

Noah sells investment products to high net-worth individuals. Its revenue derives from two sources: commissions on the sale of investments, and management fees on funds in whose management company Noah participates. The sales commissions are paid by the recipient funds, not by investors, for whom the service is free of charge.

The company also appears to receive capital gains on some managed funds, although these one-time payments may instead represent success fees. Noah's ownership in the general

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**Noah competes by entering into the riskiest and, for now, most lucrative investment schemes in what is already a casino investment culture.**

partnerships managing the funds tends to be small.

Since its IPO, Noah has migrated from selling third-party funds to raising money for its own private equity funds and for other wealth-management products (WMPs) it designs. Under Chinese practice, there must be a licensed institution that acts as fiduciary custodian for the funds. **But the company designing the WMP typically bears at least shared responsibility for default.** For that reason, we believe that Noah should be accruing for bad loans, and, in modeling the company, we have added an annual accrual worth 0.08% of AUM. This is based on what we estimate to be a USD 8 mln interest payment due on the recent approximately USD 100 mln default. We think that Noah bears responsibility for that interest payment.

## Signs of strain

### The default

In June 2014, news reports revealed that a bank manager had “borrowed” money from a RMB 800 mln Asset-Backed Security designed and sold by Noah. The investment, called Jingtai Funds 1-3, had been made by Noah-affiliated Wanjia Win-Win or WJ Asset. Chinese authorities froze the Jingtai accounts.[1]

Noah’s legal responsibility for the funds and the direct impact of the freeze on Noah’s income are impossible to work out. Wanjia is 35% owned by Noah’s PRC subsidiary Gopher, and Noah apparently sold all the 800 mln in investment into the Jingtai funds. In 2013, Wanjia was responsible for USD 9.65 mln in revenues or about 6% of the total (USD 4.9 in one-time commissions, USD 654,842 in recurring service fees, USD 3 mln in commissions owed, and USD 1.1 mln in deferred revenues).

But the event had a puzzlingly powerful effect on Noah and suggested even deeper embroilment. Company CEO Wang wrote a letter to the staff in July 2014 indicating great consternation within the company. A news report also claimed that two-thirds of Noah’s revenue had been impacted. That claim may simply derive from the fact that about 60% of Noah turnover that comes from fixed-income products, but there is no doubt that the very public event rocked Noah to the core.

Noah has minority equity stakes in a several dozen funds, which the company says is a condition of its management fee, and each

[1] http://www.csrc.gov.cn/pub/zhejiang/zjmtbd/201408/t20140828_259737.htm

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of these funds may have a dozen subsidiary funds. What, if any, default risk Noah bears is completely undisclosed. But we believe that Noah bears much greater responsibility for investment products than it reports. Noah would likely have default risk for wealth management products it designs, and any of its own Funds of Funds or PEs would count as its own products. Although Chinese law is unclear as to liability, the record of defaults to date indicates that the company putting together loans into a package for sale ultimately is held responsible for principal.

Currently, real estate transactions have been falling for nine months, and prices are consistently down, according to our primary research. We believe that payments for some Noah projects must be delayed. The evidence of Noah's apparent scramble for cash suggests that this could be the case.

### ST loan

In Q1 2014, Noah took on short-term debt for the first time: USD 8 mln, despite having USD 207 mln in cash.

In 2013, the company had sold down its held-to-maturity investments, USD 52 mln worth. The company seemed to need cash. Noah will not release Q3 results until November 18. But in the second quarter of 2014, on the eve of the default that plagued the company's summer, Noah appears to have sold down its holdings in these firms. Cash rose by USD 54.6 mln in Q2 over Q1, while estimated EBITDA rose by only USD 8 mln.

### Q3 results

**The Q3 results suggest ever-lower investment thresholds, an indicator of Noah's intense competitive environment. The solution is to take on ever more risk.**

The results in Q3 added to the puzzlement. Noah reported a 61% increase in net revenue, to USD 41.5 million and 85% increase in net income, to USD 14 million. And yet operating cash flow fell by USD 27.2 mln from Q2 and investing cash flows rose. Short-term, liabilities rose by USD 6.7 mln, including a small QoQ rise in ST debt.

The number of registered clients increased 32%, over 500 sequentially, suggesting downward pressure on the total amount invested by each client.

To show an increase in revenue at all in the current market is no small accomplishment as transactions in China's property market are very weak and defaults have become common.

Our recent interviews with wealth management companies in

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Guangdong suggest that the results could reflect a late-cycle ramping up of risk and, consequently, return in speculative securities. Noah's February purchase of equity in the crowd-financing platform PPDAI, alongside shareholder Sequoia. The platform, like its many competitors, provides financing for down-payments on housing, short-term bridge loans to businesses, and other risky loans that yield around 14% to the investors and at least several points to the platforms themselves. In 2014, dozens if not hundreds of websites have been established to provide short-term funding for home down-payments, often offered directly by developers. Poly Real Estate Group and China Overseas Land and Investments are among the developers that have signed up with a similar site run by E House Holdings (EJ US) to offer loans that permit homebuyers to make purchases with no money down.

## Company general information

Noah was formed in August 2005, when founder Wang left Xiangcai Securities, reportedly taking her private banking team. The company was formed just as China was emerging from its banking crisis and had segregated bad assets into new asset management companies and issued a batch of trust licenses. In 2007, Sequoia Capital invested USD 5 mln, and, in November 2010, Noah listed in New York, selling 8.4 mln ADS and raising USD 100 mln. Over the four years from 2009-13, China's money supply expanded almost as much as it had in the previous 59 years, and wealth manager proliferated. Noah moved quickly into asset management, establishing Noah Upright[2] and Noah Hong Kong as subsidiaries and subsequently creating its own private equity fund in property, Gopher (sometimes rendered Gofer) or Gefei.

**In February, Noah went into crowd funding, a format that on many platforms is morphing into Ponzi schemes.**

### Products

Noah has distributed products from over 100 third-party product providers. Noah has also developed proprietary wealth management products, starting with a RMB 501 million (USD 73.9 million) fund of private equity funds formed in May 2010.

The OTC wealth management products are originated in China and issued by third-party product providers. These include four types of products:

- **Fixed income products:** mainly collateralized fixed

[2] 诺亚正行

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income products sponsored by trust companies and other products providing investors with fixed rate returns

- **Private equity fund products**, including investments in various private equity funds, the underlying assets of which are portfolios of equity investments in unlisted private companies
- **Securities investment fund products**, the underlying assets of which are publicly traded stocks
- **Investment-linked insurance products**

**WMPs are the majority of Noah products—but a WMP is just a package that can hide any random assembly of debt securities.**

Among the fixed income products, wealth management products managed by Noah account for 84.3% of the 2013 total, and the majority of these products have real estate as their underlying assets. "Fixed income" in this context indicates a quasi-guarantee of interest and therefore an obligation on the part of the issuer. Among the private equity fund products Noah distributes, wealth management products that have real estate or real estate-related business as their underlying assets accounted for 64% of the total transaction value of all fixed income products distributed in 2013.

The non-OTC products include exchange-traded funds or other publicly traded wealth management products. Noah also now engages in the business of extending small loans and has a P2P online platform. The company launched proprietary fund of funds products in May 2010, with an initial raise of RMB 501.0 million (US$73.9 million).

### Clients

- High net worth individuals
- Enterprises affiliated with high net worth individuals
- Wholesale clients, primarily local commercial banks or branches of national commercial banks, which distribute wealth management products to their own clients.

The wholesale business was discontinued in 2013 without explanation. Wholesale clients had been worth about USD 500,000 in transaction value each.

### Business model

Noah generates revenues primarily from one-time commissions

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and recurring service fees paid by third-party product providers or, for the majority of fixed income products, by the underlying corporate borrowers. Such commissions and service fees are calculated based on the value of wealth management products Noah distributes to its active clients, even though the active clients do not directly pay Noah any such commissions or fees.

The one-time commissions have fallen from 78.6% of net revenues in 2009 to 43.3% in 2013.

### Related Party Revenues

Added to commission revenues the company received from its own private equity funds, related-party revenues were USD 9.07 million out of USD 29.25 million in 2010, 12.7 mln out of USD 73.3 in 2011, USD 25.9 out of USD 91.7 in 2012, and USD 77.3 out of USD 173 in 2013, rising from 23% to 45% of total revenues from 2010 to 2013. In Q3, related-party revenues were 47% of the total.

**At this point, related-party revenues are half of the total. So its own funds are providing half the company's income.**

### Sequoia

Initially, Noah's revenues derived from agency sales for Sequoia funds. Sequoia Capital is still deeply involved with Noah and still owns 16.7% of the company. In 2007, Noah raised money for Sequoia, receiving a 1% commission on funds raised and a recurring service fee, which together equaled USD 1 million in 2008, USD 1.15 million in 2009, and USD 6.6 million or 17% of revenues in 2010. In 2013, the company reported USD 9 mln in revenues from Sequoia, totaling 5.2% of gross revenues.

### Structure

Noah operates through a holding company in China that has contractual relationships with the VIEs and conducts business through its PRC subsidiary Shanghai Noah Rongyao Investment Consulting Co., Ltd., and variable interest entity, Shanghai Noah Investment Management Co., Ltd., and their subsidiaries.

Shanghai Noah Rongyao Investment distributes OTC wealth management products and fund of funds businesses through this entity and its three subsidiaries:

- Tianjin Noah Wealth Management Consulting Co., Ltd.
- Shanghai Noah Upright Investment Consulting Co., Ltd.
- Tianjin Gopher Asset Management Co., Ltd.

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**The company is basically a lot of investment funds strung together with the equivalent of cardboard and masking tape. Neither right to income nor responsibility for default is certain.**

Noah Rongyao consistently contributes about 80% of Noah's income. Given that all the domestic VIEs contribute their income to Noah Rongyao, this suggests that a substantial proportion of revenue derives from selling and managing offshore investment funds.

Tianjin Gopher owns 35% of Wanjia or WJ Asset Management. Gopher also has at least 11 subsidiary funds.

One of the VIEs, Shanghai Noah Investment Management Co., Ltd., conducts insurance brokerage business exclusively through Noah Investment and its two subsidiaries.

- Shanghai Noah Rongyao Insurance Brokerage Co., Ltd.
- Shanghai Noah Investment Consulting Co., Ltd.

### PPDAI

In the 20-F, Noah disclosed the following:

> On February 28, 2014, the Company invested US$ 2,224,999 in PPDAI Group Inc., by subscribing and purchasing Series B Preferred Shares, representing 2.62% of the investee's issued share capital. PPDAI Group Inc. is primarily engaged in the P2P internet lending business.

**The PPDAI investment brings Noah into crowd-sourced funding, a channel that typically moves high-rate capital into the property sector and thus raises the financing costs for already-imperiled projects.**

Pai Pai Dai (PPDAI) is a co-investment of Sequoia Capital China and Lightspeed China Partners. On the Q1 2014 call, CEO Wang said that clients collateralize the products they buy with Noah for loans at PPDAI.

Pai Pai Dai differs from other crowd financing schemes in that, instead of offering investment in specific project loans, the website offers pooled loan securities of two types, advertising 100% principal guarantee. The two types are fixed-return and variable-return loan pools, with the fixed offering returns between 8.8% and 11.8% depending on whether the product will mature in three or 12 months, and the variable return pool offering 12% as a minimum for a seven-month investment. The minimum buy-in for the variable-return product is RMB 100,000 and for the fixed return, RMB 1 mln.

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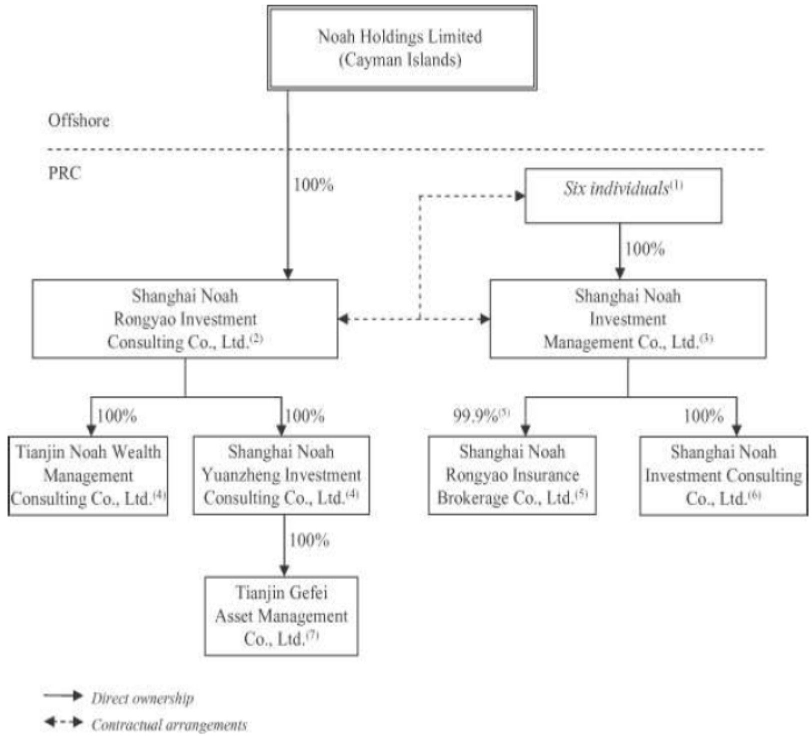
## Chart 1. Company structure




Noah may provide some of the worst disclosure of any listed company. Investors cannot know the fees paid to Noah by investment funds their agents sell, commissions earned by salespeople, how much money the company has under management, how much of its own money Noah has invested in such funds, or even where Noah's offices are.

### The market and the competition

**The only way to compete as an indepdendent in this world of fly-by-night players is to pile on risk.**

Wealthy Chinese buy substantially all investment products from banks, other than securities, which many trade through brokerage accounts. Independent companies selling investments have cropped up around the country since the 2008 stimulus but have a weak reputation for reliability. Instead, they offer high returns, often 2-4 points of interest per month on deposits. They exist in a gray regulatory area but have proliferated since Noah opened its doors. Such companies are tolerated as long as they sell on agency to licensed money managers, but they may not take deposits.

The size of the market for Noah is a matter of endless debate and appears to be very large but seems likely to shrink in the current recessionary economy. Credit Suisse estimates wealth in China in the aggregate as ranking just behind Japan, with USD 10,900 per

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adult, with a very high concentration in the top 1% or less of the population. However, we see luxury spending in sharp decline almost across categories and believe that investment should soon follow this pattern, as more Chinese capital gets trapped in illiquid real estate markets.

In its Prospectus, Noah cited The Heading Report for its data on high net worth individuals, but the company later admitted that it had commissioned the report. According to public records, Heading's owners are private equity funds.[3] Shareholders are Boxin Investment Partners, Beijing Fukai Century Investment, Beijing Detong Changtong Investments, Guangzhou Qikang Information Technology, and Chongqing Detong Venture Capital as well as one individual, Wang Canshou.

Among competitors, the biggest are divisions of insurance companies and banks, like Ping An Lufax.

Among the largest independents is Noah's cooperator, HowBuy, which was founded by Legend Holdings in 2012 and received capital investment from Tencent in 2013. HowBuy distributes Gopher Asset products, and staff say the companies are closely connected.

**HowBuy is Noah's most direct comparable.**

How Buy offers three types of products:

- "Sunshine" or OTC private equity funds: issued by trust companies with money under bank trusteeship, securities under the securities firms' trusteeship, regulated by CSRC. Minimum investment is 1 million RMB. HowBuy has 60 products available now.
- Fixed income products: mostly trusts. Real estate products used to have annual yield of 11%, corporation and state-develop projects are comparably low as 7%-8%. Minimum investment is 1 million RMB
- Private equity funds: minimum investment is 10 million RMB, with 7-8 years lock up period.

One independent competitor, based in Shenzhen, is GE Oriental, a wealth-management company that recently reversed into a Hong Kong micro-cap education company (1082 HK).

[3] Its name is: 汉鼎金融服务集团: http://www.heading-century.com/hd/contact.html

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GE Oriental has 22 branches in China, three in Japan, and one each in Singapore, Malaysia, and Indonesia. Like Noah, GE does both agency sales for financial products and its own asset management. The Shenzhen-based management team said that their key product now is overseas property investments, also assisting wealthy Chinese with obtaining residency rights outside of China. Their business increasingly consists of raising pools of managed money and earning fees. Assets under management include a hedge fund, a distressed fund for buying out listed Chinese companies, and PE funds.

**Flat sales for competitor GE Oriental.**

The GE team said that their sales are no better than flat this year and that they are migrating out of agency sales because the business is declining. The executive said he believed Noah's PE funds were doing well.

Perhaps the most important competitors to Noah currently are the wide range of "P2P" online platforms. These companies initially offered to introduce small investors to small borrowers, providing a guarantee in between but now are simply recruiters and managers of every type of investment. The best known of the category is CreditEase, founded in 2007 and now contending with thousands of copycat platforms. The industry itself claims to have transacted RMB 4 trillion.[4]

In 2014, independent vendors of financial products have become well established. Many city governments have their own companies. The city of Dongguan In Guangdong alone claims 300-400 such companies. A fly-by-night reputation clings to the companies, which suffer from frequent news stories about P2P platforms that have gone bust and fled debts.

**This type of company is a boom-time phenomenon. When returns are high, fund managers are happy to share the wealth.**

## Fine as long as there's capital

The companies offering these investment services tend to thrive only as long as they can raise new capital. HowBuy raised a B round from Tencent in 2013, and GE Capital achieved a reverse listing and is seeking a new backdoor IPO. CreditEase has raised several rounds of capital and is seeking an IPO. Noah thus far has avoided new raises but has the deep pockets of Sequoia China, as well as its IPO raise, behind it.

Each year, there is a new set of securities in China that seem to offer high return and relative safety. In 2011, SME debt exchanges were all the rage and now hardly one is to be found.

[4] Interview data, Dongguan, September 2014

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Trusts were especially popular in 2012; now, the founder of HowBuy, Yang Wenbin says, everyone is withdrawing capital from trusts and there will be only a handful left in a year or two. At the start of the year, money market funds seemed to be supplanting banks, and Alibaba's Yu'ebao raised USD 40 bln in six months. But since January, yields have been falling, new money market funds have been established, and competition seems to have eroded Alibaba's ability to raise new money, given that third-party reports put the funds under management at a stagnant or declining number. And this year, the money has migrated into crowd financing platforms, and, given the rate of failure, those will disappear next year.

**Sizing the market is a highly speculative affair.**

Each asset class becomes subject to a couple of splashy defaults, whose losses are generally apportioned among institutional investors by regulatory authorities, who appear to attach a high priority to keep individual investors whole and therefore keep the defaults as quiet as possible. Once such defaults have occurred, the money migrates into a new channel. This musical chairs appears to us to contain unacceptable risk of ultimate default.

## By the disclosures

Noah reports its revenue in two segments: Third-party Revenues and Related-Party Revenues. Because Noah takes minority stakes in the General Partnerships of its managed fund, all managed funds should be related parties. The stakes are small and not apparently in proportion to Noah's management fees, which the company says are usually half the rate earned under the fund agreements, so generally under 1% on AUM.

**Competitors are everywhere—and will be disappearing quickly.**

Revenues from fees for raising capital for those funds and from management fees therefore would both count as related-party revenues.

> In May 2010, we started our fund of funds business by forming fund of private equity funds under our management. In the second half of 2012, we began raising and managing real estate fund products. We serve as the general partner for these funds. For all the funds we serve as general partners, we are required by the limited partnership agreements to also hold equity interests in those funds.

Additionally, the company reports on one-time commission versus recurring services fees. Recurring fees could only be from funds under management or investees.

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## Table 1. Noah net revenue breakdown

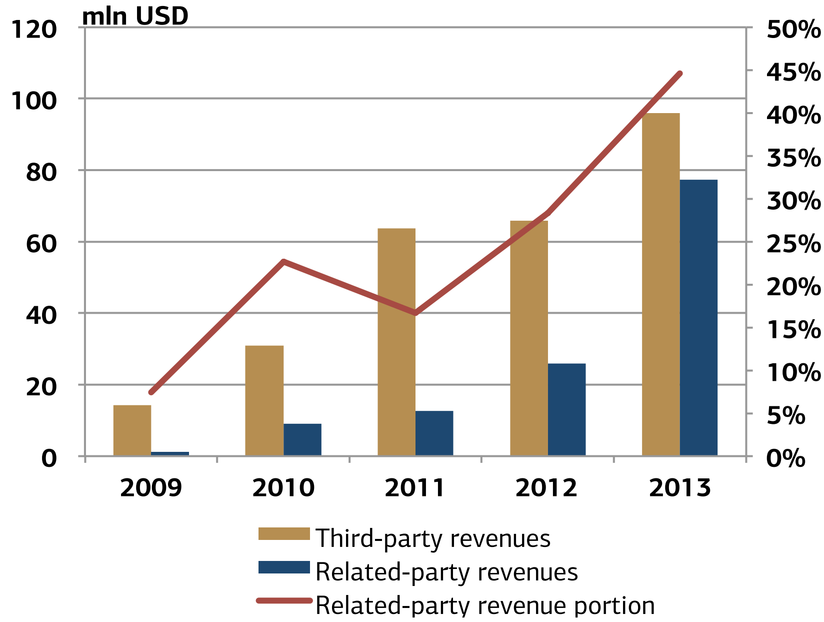
| mln USD | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|
| One-time commissions | 29.25 | 49.62 | 46.19 | 74.46 |
| Recurring service fees | 8.62 | 22.54 | 39.58 | 83.59 |
| Mutual fund service fees | - | - | 0.92 | 5.72 |
| Total net revenues | 37.86 | 72.16 | 86.7 | 163.77 |

Source: Company reports

We know that Noah receives a 1% fee on the value of assets under management for its Sequoia funds, and the company reports that its management fee is equivalent to half the fee that is charged on the fund by its general partners. If we assume, then, that Noah averages 0.5% of AUM as its recurring service fee, then the USD 13.26 mln in additional fees in 2013 over 2012 would represent USD 2.652 bln in additional AUM in 2013.

## Chart 2. Growing related-party revenues

**Just figuring out where the revenue comes from is a Talmudic pursuit.**




Source: Company reports

### Recurring service fees

Recurring service fees appear to be received under two circumstances: first, when Noah manages funds, it is paid a management fee. The managed funds should all be part of Noah's related-party revenue pool, since Noah reports that it takes equity in all managed funds.

Second, Noah has a portion of recurring service fees in addition to

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those from managed funds. Disclosures indicate that these other recurring fees are paid by some of the funds for which Noah sells investments on the portion of its clients' purchases that endure year to year. In other words, the recurring fees act as an incentive for Noah to keep existing clients invested in the same funds.

This second portion of recurring service fees should be represented by the gap between reported recurring fees and related-party revenues.

## Table 2. Recurring revenues (in USD)

| mln USD | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|
| One-time commissions | 11.44 | 29.25 | 49.62 | 46.19 | 74.46 |
| Recurring service fees | 3.12 | 8.62 | 22.54 | 39.58 | 83.59 |
| Other service fees | - | - | - | 0.92 | 5.72 |
| Third-party revenues | 14.26 | 31.00 | 63.64 | 65.78 | 95.99 |
| Related-party revenues | 1.15 | 9.07 | 12.72 | 25.98 | 77.33 |
| Total Revenues | 15.40 | 40.06 | 76.36 | 91.76 | 173.32 |
| Difference between recurring service fees and related party revenues | 1.97 | -0.45 | 9.82 | 13.60 | 6.26 |
| Portion of 3rd party sales that are recurring | 14% | -1% | 15% | 21% | 7% |

Source: Company filings

**SEC queries may provide us with more illumination.**

Given high sales growth, the portion of sales available for a recurring fee would be roughly half, except for 2012, when lower growth meant that 83% of sales could potentially have been recurring.

### Deferred revenue

Deferred revenue appeared on Noah's balance sheet in 2012, at USD 5 mln, USD 15 mln in 2013, and USD 19.8 mln as of September 30, but the company has not explained the item. Deferred revenue probably does not represent expected capital gains from the funds, because the company has said such gains cannot be anticipated or relied upon.

Instead, the deferred revenue could be commissions on sales for funds with multiple-year terms, when the commissions are paid annually. This creates a fairly significant risk of default.

## The investments

According to the website of wealth management company Rhine

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**Deferred revenue grew by 32% in 2014 YTD, just slightly slower than the 39% revenue growth for the period. But the company has not explained what this item includes.**

Wealth, Noah has raised RMB 10 bln jointly with Leju (LEJU US), a listed subsidiary of E-House Holdings (EJ US) for investment in property.[5] This money may be in funds of funds and in Noah's own asset management company, Gopher.

## Asset risk

Although the company never explicitly defines related-party transactions, it does disclose that the company is required to take an equity share in the funds from which it receives a management fee. The value of these equity stakes are likely represented in "Investment in Affiliates," a category that rises by about USD 2 mln per quarter.

Possibly related to co-investing from Noah's own balance sheet alongside its fund, the item called "Long-Term Investments" on the balance sheet is quite volatile but small part, averaging about USD 10 mln. Increasingly, Noah's principal investment vehicle is Gopher Asset Management. This PE fund has at least 11 sub funds and manages RMB 10 bln, according to Rhine Capital.[6] Gopher places money in real estate projects. In interviews with former Noah investment managers, in which they said they were free to disclose the information, we learned about 15 such projects currently under way and visited seven.

The Gopher projects are probably marginally more viable than the average real estate projects in the areas, but some are clearly halted, attract few potential buyers, and seem unlikely to pay off. All appear troubled.

## Real estate projects

On the Q1 call, CEO Wang said,

> "Yes, we have seen the slowing down of the Chinese real estate market. From the past, we have been very carefully selecting the top real estate developers as our counterparties, and also being very carefully selecting the cities or areas that the project that is going to build in."

We identified about 15 Noah projects plus several fund cooperations with developers such as Vanke and Chongqing Longcin Land. Noah also reportedly has a fund jointly with Xiamen Xinghao Investments, co-owned by Alibaba and Giant Interactive

[5] http://www.rhinewm.com/Research/Details/16407?lang=en-us

[6] http://www.rhinewm.com/Research/Details/16407?lang=en-us

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Chairmen Jack Ma and Shi Yuzhu and also Fosun and Wanda.

**Some of the Noah projects we could identify were halted, and all were in new districts with weak sales.**

We visited the following projects:

### Evergrande Qidong

Gopher has invested in Evergrande's largest project, with 48,000 units planned and completion now delayed by nearly a decade.

We interviewed executives at the Evergrande finance company based in the city of Qidong, Jiangsu, who assured us that the information was freely available to researchers like ourselves. They said that Noah had committed to provide RMB 300 mln but that it had injected only 40 mln so far.

This money has gone to three Evergrande subsidiaries, which extend loans to property buyers. The companies then securitize mortgages from the Qidong and two other Evergrande properties, pool them, and sell shares through the retail networks of Noah and HowBuy, in which Noah is invested. Evergrande is the guarantor of the product, which yields 11% over two years.

**Evergrande Qidong, from the approach road and from in front of the sales office. | All photos by J Capital**

The grandiose Qidong project includes a "seven-star hotel," gymnasium with a special building for badminton tournaments, kindergarten, and extensive grounds. Staff say that roughly 1,000 units have been sold, although the complex appears completely unoccupied. Some apartments display banners offering the units for sale. Staff estimate that the projects will be completed in 8-10 years. The land was purchased in 2006, and the need to pay the city of Qidong for the purchase motivated Evergrande's first

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attempt to IPO.

**The Qidong project appears to be an aggressive user of speculative financing products.**

Evergrande Qidong appears to be an aggressive user of speculative group financing: third parties including Soufun organize groups of investors who pool funds to buy groups of units. Evergrande offers to rent the units via a subsidiary company and suggests that returns will be at least 8% annually. Staff said that all the commercial shops have been rented out. Group buyers may sell their shares to others and are provided with incentives to sell new shares in the group. Buyers are eligible to win a trip to the Maldives.

Sales agents at the project said that none of the buyers are relying on loans from banks; they generally pay 25% up front then pay the balance in one year or else 30% up front, paying the balance in two years. There is no interest.

Evergrande staff also said that HowBuy had provided 90 mln in funding to finance housing sales on behalf of potential buyers. The company then packages these loans and sells them through the HowBuy retail network. The loans are pooled with loans from two other Evergrande projects and offer a fixed return of 11%. Staff estimate that RMB 4.2 bln in sales from the Qidong project have been created in this manner. They said that Evergrande's advertising companies purchase some units to assist with cash flow.

**The Evergrande Qidong sales office**

### Changsha COCO

Noah's Gopher fund invested in this project in late 2013. The project is in Changsha's new zone, which is almost entirely empty

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**Many of the units had been purchased by the local governments that manage the districts, suggesting bailouts.**

but plans dwellings for 260,000 people.

The first tower of seven planned at the project is almost sold out, according to sales staff, but, of the 100 units available, 40 units were purchased by the local government.

We visited four other projects in the district, all equally empty. Each had made sales to the local government At one, sales staff said that the local demolition bureau, which is in charge of clearing land for new developments, had purchased all the units that had been sold so far. The sales offices were working to organize buying groups.

**The Changsha COCO development**

### Shanghai Meilanhu

The Meilanhu project in the Baoshan district of Shanghai will have 40,000 units when completed, and the surrounding area will have 300,000 new units. Prices are as high as RMB 70,000 per m2, but transactions appear to be very slow. In the sales rooms, agents claim discounts of no more than a few points, but agents telephoned offering a few days later offering discounts of more than 20%. The project was started in 2002, when the lake was dug, and housing began construction 2006. Since that time, local agents say, prices have doubled, and many owners are selling.

Noah has provided financing to the freestanding villa development measuring 448-668 m2 each and selling for RMB 10-30 mln per unit depending on proximity to the golf course. Because of the land categorization, individuals may not purchase the villas, which are available only to companies. Sales staff said that prospective

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buyers are companies that the villas to entertain clients. All 60 units were available for sale.


**The clubhouse for the exclusive villa compound, over the golf course. Houses here start at USD 3 mln.**


**Brokerage sign offering discounts: 90 sq m for 600,000 RMB.**

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### Shanghai Star River

This development is being built in three phases, with the second now under construction. Prices are RMB 35,000-40,000 per m2. Salespeople say the units are 80% sold and that Phase 1 is 60% occupied. All the buyers, they say, are finance companies acting on behalf of groups that buy 3-5 units to share. A Noah subsidiary, the agent said, is among the buyers.

**We question the viability of new ultra-premium projects in Shanghai.**

Star River is building a project in Pudong this year that will sell for 90,000-95,000/m2, with 2,000 units planned for premium residential housing. The agent volunteered that Noah would own equity in the Pudong project.

**View of the Star River complex**

### Shanghai Fudi Shenggongguan

This project consists of luxurious residence-like office spaces that are available only to corporate buyers. Most of the buyers, staff

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said, are listed companies. The project is approved as commercial but is sold as residential, a common but risky strategy. The freestanding houses are sold for between 30-50 mln RMB, and an agent said they are 30% sold after 15 months on the market, but only one buyer was in the process of occupying the premises.

**Fosun may have purchased on distressed terms.**

This project is one-third owned by the listed company Fosun International (0656 HK), which may have purchased on distressed terms.

**The project in suburban Beijing is no longer on sale.**

### Pinggu: Xiagezhuang New Town

Noah has invested in a new zone housing project in the rural county of Pinggu in Beijing. Cities in China control large geographic areas that includes rural and suburban counties and extend over land areas as large as U.S. states. Pinggu is one of Beijing's more remote counties, under-developed, and about 60 km from the outskirts of the city proper. Like all local government's, Pinggu's has built a new district that is hopes will house schools, hospitals, shopping areas, and new highrises. But the district appears to be short of cash, with no construction activity visible on half-finished streets and towers and sales offices closed.

The Pinggu New Town project was undertaken in cooperation with Zhonghong Holdings, a Shenzhen-listed developer. We visited the sales office, but it was closed. Maintenance staff said the office had been merged into another new district sales office, but the other office could not be located. The project is empty.

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**The sales office for the Noah-financed project was closed, staff said permanently.**

**Inside, the model for the whole development was on display.**

**The new roads and housing in the zone are almost entirely abandoned, although local people say that many of the units have been sold.**

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**The impact of the Wanjia crisis is still very unclear.**

### Longxin

The Chongqing Longcin Land "Finance Street" project is identified as a joint development of Noah and Chongqing Longxin, financed, according to a November 26, 2012 press release quoting Wang Jingbo, by RMB 2 bln in financing from Gopher.

## Recent crisis

Gopher Asset Management owns 35% of Win Win Assets, also called WJ Asset and Wanjia Gongying. Last June, the WJ Asset property fund was called "Noah's safest asset-backed security." The WJ Asset product was advertised as yielding 8-9% and represented income flows from property projects. Two months later, RMB 800 mln had disappeared.

Of the 800 mln, 200 mln was used by the Bank of China Shenzhen branch to cover maturities for the Shenzhen Wusi Tranche 1-3 products, which otherwise would have defaulted. Another 590 mln is reportedly on the account of the "Jinyuan Plan"[7] and is currently frozen by Chinese authorities.

According to press reports, the ABS product originally was controlled by Shenzhen Jingtai Fund Management. Jingtai sought sales assistance from Noah, which introduced WJ. Noah Union Assets, a subsidiary of Gopher, WJ jointly conducted due diligence on the fund. During the due diligence, a branch manager of the Bank of China named Zhang Fan misrepresented himself as the

[7] "金元惠理吾思基金城中村及棚户区改造系列专项资产管理计划"

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**CEO Wang apparently sent a letter to staff that seems almost unhinged in the degree of anxiety expressed.**

deputy manager of Jingtai. This Zhang Fan introduced the Noah Union and Wanjia team to Bank of China Yunnan Province branch and made an agreement for accelerated disbursement of funds for a real estate project, to be repaid in rights to collect sales proceeds. Noah was the sales agent and Wanjia the distributor. A separate subsidiary of Noah acted as the fund's advisor.

On August 29, it was reported that the CSRC would fine three companies for the default. Caixin reported that two-thirds of Noah's revenue came from Win Win Asset Management. The report said that the three-month freeze on new business would put huge pressure on Noah. The fundamental problem, said the article, is that limits on bank exposure to property on the balance sheet coupled with a huge thirst for funds by the property sector had created a niche for shadow funds that do not have mechanisms to manage risk.

A letter purporting to be from Noah founder Wang Jingbo to company employees appeared on the Internet, and we subsequently confirmed that the letter had been distributed to employees. In the letter, Wang appears to be almost hysterical and to suggest that the company is in danger of closure. We believe that the WJ Asset crisis was likely the reason for CFO Theresa Teng to leave the company.

See the appendix for the letter's text.

We called nine ex-employees of Noah, but all of them declined to tell us about CFO changes and the WJ Asset incident. Most employees said they signed an NDA with the company before they left. All appeared to be very cautious about this topic.

## New developments

**Overseas trust**

On October 23, Noah's new Hong Kong-based trust formally opened for business. The Ark Trust provides "worldwide asset management services" to Chinese families with wealth in excess of USD 5 mln and clearly implies that its mission is to help Chinese families move money overseas. According to press coverage:

> In light of the "new normal" in the Chinese economy, a volatile Renminbi both up and down, added to a better understanding of wealth management among mainland Chinese investors, domestic entrepreneurs have continued increasing their interest in managing their assets internationally. This is the reason for third-party companies like Noah to launch trusts in

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> Hong Kong.[8]

Noah CEO Wang said this about the Trust:

> "China's capital account is not completely open, but opening is just a matter of time, and everyone needs to prepare. And after 30 years of opening and reform, the first wave of people who have aggregated a lot of assets have their assets inside and outside of China connected, and the scope and size are very large."

**What is Noah's competitive edge? Risk.**

Wang said that domestic high-net-worth individuals have a strong demand for overseas assets. **She went on to say that simply introducing funds is not sustainable.** Instead, Noah needs to provide asset-management services.

## The sales process

The fundamental problem with the Noah value proposition is that every bank, brokerage, and insurance company in China offers the same services, and these institutions offer more credibility and implicit guarantee than Noah. How many people are going to choose not to walk into a State-owned bank and instead walk into Noah's office and plunk down RMB 1 mln? Added to that problem, Noah has hundreds if not thousands of competitors, many owned by local governments.

The only way to compete from these disadvantages is to offer higher return by accepting a level of risk that more established institutions would not.

We find discrepancies between staff metrics and reported sales volumes at Noah, and we are skeptical that Noah sells its assets entirely through the retail network. There are several problems with the data:

**The quota of RMB 2 mln per month seems not to account for all the sales.**

- Noah ex employees report that Relationship Managers have a monthly minimum quota of RMB 2 mln and 30 mln annually. But based on the number of Relationship Managers, each would have had to achieve monthly average sales volume of RMB 4 mln in 2010, rising to RMB 7 mln in 2013, or 44%. This does not accord well with interview data.

  Furthermore, in 2013, Noah added 110 Relationship

[8] An October 23 article in Changweibo accessed in Google Cache: http://webcache.googleusercontent.com/search?q=cache:XRqRyEtkLxQJ:www.changweibo.com/p/2014102816464451064+&cd=2&hl=en&ct=clnk&gl=us

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Managers or 24% more than in 2012. The Relationship Managers are given a one-month training period before they are required to make quota. Missing quota two months in a row merits dismissal. Assuming only 11 effective months for the 110 new RMs, the average sales volume per veteran RM would have had to rise by 52% in order to achieve the volume claimed.

**The average transaction value per client seems to be falling.**

Noah could have added a number of RMs during the year and dismissed them before yearend. However, selling expenses rose more slowly than turnover, by 39.7%. Even if the commission on funds raised was withheld in the case of under-performing RMs, the amount of commission is insufficient to account for the discrepancy.

- Noah's calculated average transaction volume per active customer is about USD 900,000, with enterprise clients bringing up the average. But ex-Noah employees say the top used to be 1 mln RMB (USD 163,000) and now they accept minimum investments of RMB 100,000.
- Industry sources say that the average commission on selling funds like Noah's is in the 0.75-1.5% range. Given the turnover reported, Noah's commissions calculated to 1.38% for 2010, 1.40% for 2011, 1.17% in 2012, and 1.03% in 2013. This creates a slight discrepancy with reports: Noah reported a 14% decline in commission revenue in 2012 compared with 2011, but the calculated decline is 16.5%. In Q2 2014 call, Noah reported that average transaction value per RM had grown 20%.
- Commissions on wealth management products that companies design themselves tend to be much higher but contain default risk. According to interviews, when wealth management companies help with fundraising, in early 2013, companies could get they can get 2-4% commission, better than the 1.5%-2% offered from trust companies. Now commission levels have been cut in half across the board, according to interviews.
- Former Noah employees say that the RM commission on sale is 10 bps. A commission of 10 bps on turnover would generate the following commissions for the years 2010: USD 2.12 mln, 2011: USD 3.54 mln, 2012: USD 3.95 mln and 2013: USD 7.24 mln.

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- If the remainder of reported selling expenses consists of salary expenses plus marketing event and other promotional costs, then the marketing expenses would have to have been roughly USD 15 mln per year, which seems unreasonably high given Noah's relatively low profile.

**Boiler room**

- The average transaction value per active client as reported is roughly 25% higher than the average that can be calculated if "active clients" are deemed to be individuals. If all active clients are counted, then the difference is between 32-39% per year.

### Accrued salaries and bonuses

Additionally, accrued payroll and welfare expenses have ballooned to USD 29.5 mln in 2013 or 17% of total revenues. That is much more than and of the interviewed relationship managers report earning in commission revenue, even over multiple years.

The sales process as described by former relationship managers is simple: college graduates are hired and given up to one month of training in Shanghai to learn about investment products. After that, they are asked to telephone friends and family and ask them to invest. After exhausting friends and family, they cold call, but are not provided with call lists. Agents said they would look up the names of companies on line and telephone the executives. They estimates that 30 calls would generate a meeting, and around two clients per month would sign up, investing up to RMB 1 mln each.

Other wealth management companies reported that they used call centers to qualify lists purchased from companies like China Mobile. They said that roughly 200 calls would yield one interested lead, and the leads would be given to the relationship management team to pursue. Smaller companies have smaller quotas—RMB 900,000 per month seemed typical.

Marketing events include meals, films, and outings for potential customers.

All these disparities suggest that Noah recruits investments through other channels than its Relationship Managers and other sources than its active clients.

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## Table 3. Registered and Active Clients

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014H1 |
|---|---|---|---|---|---|---|---|
| Number of registered clients | 6,606 | 9,641 | 16,296 | 27,144 | 40,305 | 53,501 | 60,801 |
| YoY | 114% | 46% | 69% | 67% | 48% | 33% | |
| Number of active clients | 1,065 | 1,235 | 1,631 | 3,095 | 4,152 | 6,445 | 3,538 |
| YoY | 15% | 16% | 32% | 90% | 34% | 55% | |
| Conversion of registered to active | 16% | 13% | 10% | 11% | 10% | 12% | 6% |

Source: Company reports

**What happened to wholesale clients?**

## Table 4. Average transaction value by client type

| Client type | 2011 | 2012 | 2013 |
|---|---|---|---|
| Individual clients | $109,947 | $77,099 | $105,035 |
| Enterprise clients | $224,161 | $654,212 | $878,443 |
| Wholesale clients | $542,373 | $887,850 | $- |

Source: Company reports

In 2013, the company stopped working with wholesale clients but did not explain what had happened to change this.

In the most recent quarter, the company improved performance principally by increasing the number of clients. Noah claimed that improved efficiency was responsible for this: improving the IT system and adding Relationship Managers without commensurate cost growth.

## Table 5. H1 2014 clients and transactions

| Clients | H1 2014 |
|---|---|
| Number of registered clients | 60,801 |
| YoY | 33% |
| Number of active clients | 3,538 |
| YoY | 37% |
| Conversion of registered to active | 6% |
| Transaction Value (mln USD) | $2,971 |
| YoY | 47% |
| Transaction value per active client ('000 USD) | $839 |
| Per client transaction value YoY | 7% |

Source: Company reports

The efficiency metrics strain credulity. During the first half of

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2014, property and equipment rose by USD 690,619, but, with 121 new RMs since the end of 2013 and one new branch office, presumably staff needed workstations, so a portion of that money would have been for office kit-out and computers.

**How do they market?**

## Marketing

Noah claims that word of mouth is its most important sales channel. In 2010, the company disclosed that 60% of marketing was done via word of mouth, but now there is no disclosure. Selling expenses are 22.4% of revenues, even higher than COGS.

As for marketing events, they seem fairly small. Google searches do not find any conferences, speeches, seminars, or other public outreach events organized by or featuring Noah. Furthermore, it is very difficult to find Noah offices outside of Shanghai. The company does not disclose their locations. Searches do not find them. Job seekers in blog posts reveal that Noah offices may change locations within the same city as much as three times in a year. And yet Noah has accelerated the opening of office and hiring of Relationship Managers. How does the company recruit investment?

The number of RMs increased by 80 in Q2 2014, but the number of branch offices did not. The company says this is because of "elite relationship management" program but does not explain what that is.

We understand that Noah reaches agreement with legally established trusts to create discrete accounts managed by Noah that it can use to amass retail investment and drive it into private equity and other investments.

**Subsidies can only be for owned land.**

Noah offers products online that require minimum investments of RMB 1 mln.[9] But staff say that no clients purchase online and they offer the investments because of "fashion." The online mechanism, however, would make it easy to create unidentifiable cash flows in and out of Noah's accounts.

### Subsidies

From its inception, Noah has received cash subsidies, which it explains are incentives for investing in certain areas. The subsidies rose from USD 69,506 in 2007 to USD 5.3 mln in 2013, when the cash subsidies equaled 10% of net income. The

[9] http://www.noahwm.com/NoahProduct/pro_procolumn3.shtml

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disclosure is as follows:

> Such subsidies allow the Group full discretion in utilizing the funds and are generally provided as incentives for investing in certain local districts.

The Chinese subsidy regime, however, contains no known cash subsidies for investment. Cash subsidies are awarded to support technology development and as rebates on the VAT on exported products.

**Subsidy income is rising.**

Noah makes two kinds of investments: investment to establish new offices and minority investment in private equity funds that it manages.

Subsidies could not be for establishing offices in new areas, because Noah's branch office count has been static while subsidies have risen sharply.

### Table 6. Subsidy income and number of offices

| | 2011 | 2012 | 2013 | Q3 2014 |
|---|---|---|---|---|
| Subsidy income | $5.62 mln | $4.3 mln | $5.3 mln | $3.2 mln |
| Branch offices | 59 | 57 | 57 | 60 |
| Subsidy income per branch office | $9,531 | $75,439 | $92,982 | $53,000 Annualized: $212,000 |

Source: company reports

The subsidies therefore can only be for Noah's own investments in private equity and other funds. This is puzzling. Noah discloses that it takes very small equity shares in the general partnerships of private equity funds that it managers, in fulfillment of a commercial requirement. It is very unusual for private equity funds to receive cash subsidies and, if they did, Noah ought to be entitled to just a few percentage points. If, instead, governments are offering subsidies for investing in property projects, the subsidies would rightfully belong to the particular project, not to its PE.

Although cash subsidies would be very unusual, they would be at least within the realm of possibility for investing in real estate in a special government zone. The fact that Noah discloses cash subsidies suggests that the company has more ownership, and more liability, for the projects it is selling than would be represented by a 3% or 4% stake in the general partnership

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managing a private equity fund.

## Commission arrangements

In its Prospectus (page 63), Noah disclosed commissions both from financial managers and underlying borrowers:

> Upon establishment of a wealth management product, we earn a one-time commission from third-party product providers or underlying corporate borrowers calculated as a percentage of the value of the wealth management products purchased by our clients.

and

> We enter into one-time commission agreements with third-party product providers or underlying corporate borrowers, which specifies the key terms and conditions of the arrangement.

**Among the oddities at Noah is the fact that they use inaccurate exchange rates in their filings. A query on the point went unanswered.**

The underlying borrowers would not pay commissions to Noah unless Noah were lending directly. This suggests high exposure to the assets.

Meanwhile, the average commission rate was higher than the rates they report charging:

### Table 7. Commission rates

| Funds | Commission Rate | Recurring Service Rate | Total Rate |
|---|---|---|---|
| Sequoia Capital Investment | 1.00% | 0.46% | 1.46% |
| Tianjin Gefeixin Equity (Gopher) | 0.98% | 0.40% | 1.38% |
| Tianjin Gefeijiye Equity (Gopher) | 1.04% | 0.02% | 1.05% |
| Tianjin Gefeitaimei Equity (Gopher) | n/a | 0.36% | 0.36% |
| Tianjin Gefeixingye Equity (Gopher) | 1.03% | 0.01% | 1.05% |

Source: Noah prospectus

**We could understand a few basis points off base on the rate, but a factor of 2x?**

## Mysteries

### Exchange rate

Across multiple documents and consistently for the years 2012 and 2013, ***Noah misrepresents the RMB/USD exchange rate.*** As an example, here is a quote from page 37 of Noah's 2013 20-F:

> As of December 31, 2013, compared to December 31,

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> 2012, the aggregate value of wealth management products distributed and managed by us increased from RMB7.8 billion to RMB37.5 billion (US$3.2 billion), including (i) funds of private equity funds from RMB2.2 billion to RMB3.8 billion (US$385.2 million), (ii) funds of real estate funds from RMB460.0 million to RMB1.3 billion (US$209.6 million), (iii) real estate funds from RMB5.1 billion to RMB28.0 billion (US$2.3 billion) and (iv) funds of fixed income funds and funds of hedge funds from zero to RMB4.4 billion (US$288.4 million).

According to X-Rates,[10] the average exchange rate for one RMB to USD in 2013 was 0.1626. That rate yields the following numbers:

**Why are business taxes not a cost of sales?**

1) RMB 37.5 bln = $6.098 bln, not $3.2 bln. If what was meant was the difference between 7.8 and 37.5, then the proper amount in USD is $4.829 bln.

2) RMB 3.8 bln = USD 618 mln, difference in USD: 260.19 mln

3) RMB 1.3 bln = USD 211.41 mln, difference in USD: 136.61 mln

4) RMB 28 bln = USD 4.55 bln, difference in USD: 3.72 bln

5) RMB 4.4 bln = USD 715.54 mln

The errors appear all to be around the underlying assets rather than the stated financials, and therefore they are not broken out in the pro forma financials.

We asked the company for clarification and IR said they would respond but did not do so.

### Business tax

Noah depicts business taxes as a deduction to total revenues rather than a cost of sales. This indicates that the business tax could be paid by related-party fund managers and also suggests a higher degree of responsibility for funds sold than is obvious from the financial statements.

[10] http://www.x-rates.com/average/?from=CNY&to=USD&amount=1.00&year=2013

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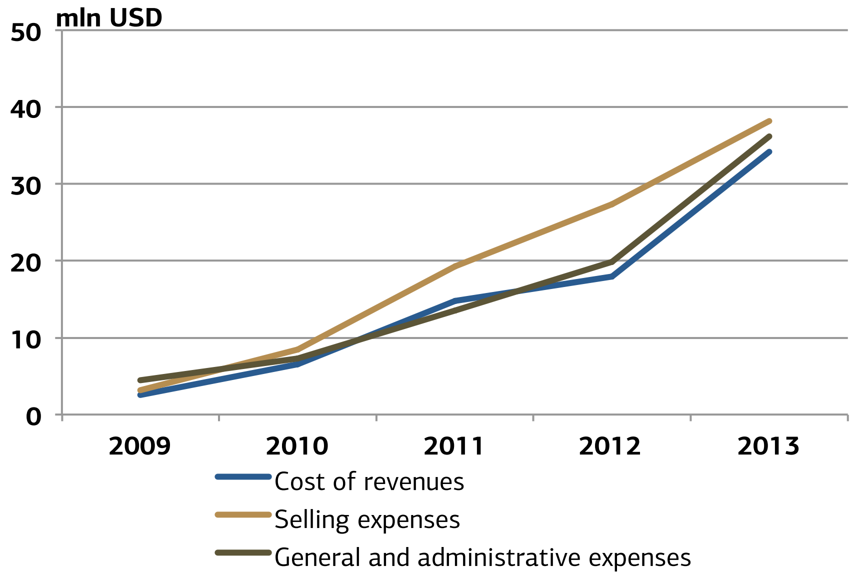
The gain on trading securities was really high back when Noah disclosed this.

## Chart 3. Cost of Revenues




### Performance fees

In Q2 2014, the company recognized USD 11.4 mln in performance fees from Gopher Asset Management. There were bonuses associated with those performance fees, but they did not disclose the level of bonus.

### Securities

In 2010, Noah reported very significant gains from trading securities. The CFO specified that the company retains its cash overseas and places some of it in safe securities

The return on Noah's investment assets was phenomenal:

| Investments | 2009 | 2010 |
|---|---|---|
| Trading Securities | 89,456 | |
| Held-to-maturity securities | 2,545,327 | 6,718,182 |
| Total | 2,634,783 | 6,718,182 |
| | | |
| Average | | |
| Trading Securities | | 89,456 |
| Held-to-maturity securities | | 4,631,755 |
| | | |
| Gain on trading securities | | 55875 |
| Income on securities held to maturity | | 120766 |
| | | |
| ROI | | |
| Trading Securities | | 62% |
| Held-to-maturity securities | | 3% |

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After 2010, the company no longer disclosed trading securities, gain on trading securities, or income on securities held to maturity, but it continued to buy USD 15.8 mln in the securities in 2011.

**The relationship with Sequoia is dense and mysterious.**

### Held-to-maturity securities

Noah does not disclose details of its held-to-maturity securities, but purchase and sales of these securities are very significant: USD 75 mln in 2012 and USD 68 mln in 20913, for example, against total revenues of USD 86.6 mln and 163.7 mln in those years and cash resources at the end of 2012 of USD 168.6 mln and, in 2013, USD 224.5 mln.

Does Noah realize commissions on its own purchases of securities? With USD 140 mln in turnover from trading securities in 2013, Noah would have earned around USD 1. 4 mln in revenue on the transactions. If the securities represent shares in funds managed by Noah, then an additional roughly USD 700,000 per year in management fees on the portion of funds from Noah would also be earned.

### Deferred revenue

Deferred revenue grew much more quickly in 2012 and 2013 than did revenue. The SEC queried Noah's disclosure in its letter filed October 21.

## Sequoia relationship

One of the biggest red flags is around the new funds Noah formed. The company formed and manages two affiliates of its shareholder Sequoia and is general partner for four funds of funds. Apart from Tianjin Sequoia, established in 2008, all were established in 2010. We could find no public information on the funds, not even their Chinese names.

In 2012, Noah entered into three financial advisory service agreements with Sequoia Capital Investment Management (Tianjin) Co., Ltd. to provide services for the formation and management of funds sponsored by Sequoia Capital Management (Tianjin) Co., Ltd. Noah charged 0.5% to 1.0% of the total fund subscription amount as one-time commission and half of the management fees charged by Sequoia Capital Investment Management (Tianjin) Co., Ltd. as its recurring service fee.

In 2013, Noah entered into one financial advisory service

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We think a default in one of the property funds is all but inevitable.

agreement with Sequoia Capital Investment Management (Tianjin) Co., Ltd. to form and manage four funds sponsored by Sequoia Capital Management (Tianjin) Co., Ltd. Noah charged 1.0% of the total fund subscription amount as one-time commission and half of the management fees charged by Sequoia Capital Investment Management (Tianjin) Co., Ltd. as its recurring service fee.

### Bona

Noah has formed a Wuhu Bona Gold Cinema City Investment Center together with Bona and Sequoia. Since its formation in August 2013, the fund has supported more than 10 films, which have earned 130 mln RMB In ticket sales. The product yields 7%, and Taobao's WMP Yule Bao sold 70 mln RMB in 48 hours.

Bona, like Noah, is an investment of Sequoia Partners and its principal, Neil Shen.

## Catalysts

### Race to the bottom

The proliferation of online platforms offering as much as 40% returns to small investors is undoubtedly one of the elements that have forced Noah into accepting lower transaction levels per client. Average transaction levels for Noah declined 22% outside of mutual fund returns, perhaps more if those returns could be accurately accounted for.

### Three CFOs, three years

Another alarming sign for Noah is the speed with which the company churns through CFOs. The last permanent CFO, Theresa Teng, resigned from her post on September 2 "for personal reasons." The Q3 report announced the appointment of Ms. Ching Tao, formerly CFO of Charter Group Holdings Ltd., a Chinese department store operator. Domestic news sources say that the Harbin-based Charter, after failing to achieve an IPO in Hong Kong, has seen gross revenues decline by about 25% and is on the block for sale.[11]

### Property

Noah's share prices has risen and fallen reliably with China's property market. The price began a sharp descent in late summer 2011, when the stock traded at USD 14 but property transactions

[11] http://www.cb.com.cn/businesses/2014_0913/1083557.html

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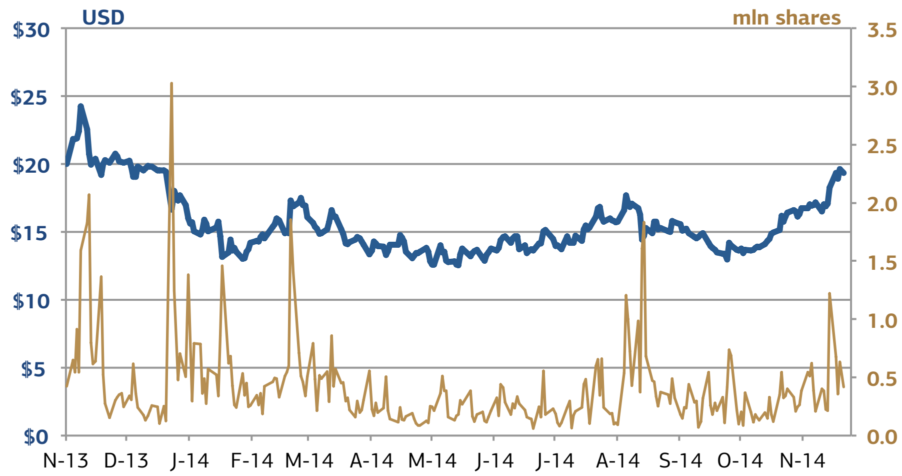
were slowing dramatically. The stock reached a low of USD 4.32 in late September 2012. At that point, financial stimulus was taking hold, and prices and transactions roared back, along with equity prices. By November 2013, the stock reached a high of USD 20.13.

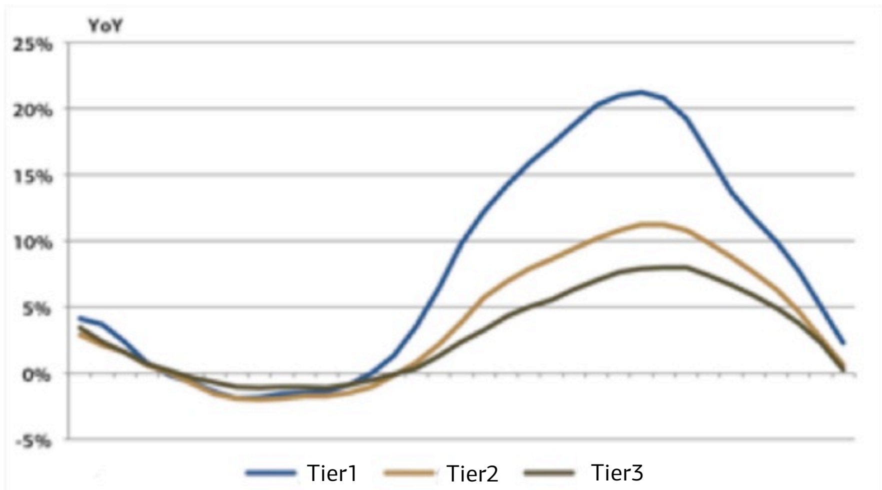
We believe the property market is dead. Attempts since April to drive down the price of mortgages and infuse cash into the market have failed to prop up prices or confidence. The October Golden Week holiday was, we believe, the market's last hurrah, and a weak one it was, with transactions still trending lower YoY. We believe that Noah will not recover.

### Chart 4. Noah share price and trading volume since October 2011




Source: Bloomberg, Dec 1, 2014

### Chart 5. Property price indices in Tiers 1-3 October 2011 - August 2014




Source: NBS

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### SEC inquiry

On October 21, the SEC sent correspondence to Noah seeking a wide range of new disclosures. Depending on how Noah responds to the demand for information, the market could lose confidence in the stock.

### Chinese investigation

An investigation of the Win Win affair is ongoing, and one of Noah's subsidiaries has been required to halt its commercial activity. Should Noah be sanctioned in the final decision, that could significantly undermine investor confidence.

## Risks

1. The key risk to a short on Noah is a take-out by Leju, E-House, Soufun, Fosun, or another investor. If such investors believe that the new Shanghai-Hong Kong Connect plan will strengthen the Shanghai market, they may see opportunity in taking Noah private and repackaging it for a Shanghai IPO. We think this unlikely but possible.

2. A secondary risk is a rally in the property market generated by stimulus.

3. More generally, a blanket monetary stimulus in China would generate more asset inflation and consequently an extension of the sellers' market in securities. This could cause Chinese to pile into new investment schemes, and Noah could get part of that business. If this happens, it will make the likelihood of a financial crisis even greater, but, in the near term. Noah will benefit.

4. Given mounting risks in China's investment environment, more Chinese are trying to move money abroad. To the extent that Noah is willing to engage in gray-market activity to capture their business, the company could make windfall profits.

## Valuation

A USD 1.1 bln stock, Noah is trading only slightly above its IPO price of USD 16.55 largely because investors are skeptical of the numbers. If investors believed that current market growth would continue and also believed the numbers, then Noah would be then even with a sharp decrease in growth, from 50% in 2014 to a

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decline of 5% in 2015, Noah should trade at about USD 11. That projection is based on a DCF valuation of cash flows through 2020. But we believe Noah to be far more exposed to losses in property than the company's disclosures would indicate. If we assume that the 55% of revenues from related-party funds represent balance sheet exposure for Noah, and we apply our view of a 30% across-the-board reduction in property prices, then we must apply a discount to the future cash flows and current assets Noah is holding, Because of weak disclosure, we cannot model these effects with precision. We do, however, believe that bankruptcy is one likely outcome for Noah.

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# Pro Forma Financials

| | 2012 | 2013 | 2014F | 2015F | 2016F | 2017F |
|---|---|---|---|---|---|---|
| mln USD | | | | | | |
| Number of Relationship Managers | 459 | 569 | 649 | 584 | 555 | 555 |
| Growth | -10% | 24% | 14% | -10% | -5% | 0% |
| est revenue per RM | 4.6 | 6.5 | 9.8 | 8.8 | 8.8 | 9.0 |
| Growth | 24% | 43% | 50% | -10% | 0% | 2% |
| annual revenue per RM calculated from reports (USD mln) | $8.59 | $12.81 | $19.21 | $14.70 | $14.70 | $14.99 |
| Est turnover from sales | $3,943.98 | $7,288.57 | $12,469.99 | $8,585.59 | $8,156.31 | $8,319.43 |
| Reported turnover | $3,949.18 | $7,236.00 | | | | |
| Av commission on funds sold | 1.17% | 1.03% | 1.03% | 1.03% | 1.03% | 1.03% |
| Commission revenue estimated from staff metrics | $46.13 | $75.00 | $128.32 | $88.35 | $83.93 | $85.61 |
| Commission revenue estimated from reported turnover | $46.19 | $74.46 | | | | |
| | | | | | | |
| Commission on third-party trusts | | | 0.8% | | | |
| Proportion of third-party trusts in turnover | | 13.0% | 10.0% | | | |
| | | | | | | |
| AUM | $1,226.16 | $6,125.40 | $9,800.64 | $7,840.51 | $6,272.41 | $5,958.79 |
| Growth | 1933% | 400% | 60% | -20% | -20% | -5% |
| Commission rate on managed funds | 0.5% | 0.5% | 0.5% | 0.5% | 0.5% | 0.5% |
| Commission on managed funds 0.50% | $6.13 | $30.63 | $49.00 | $39.20 | $31.36 | $29.79 |
| Est commission on AUM raised 1.00% | $11.66 | $0.02 | $0.00 | $(0.00) | $(0.00) | $(0.00) |
| Portion of sales available for recurring commission | 83% | $0.15 | 50% | 80% | 80% | 80% |
| Av calculated commission on available portion of sales | 0.30% | $0.00 | 0.30% | 0.30% | 0.30% | 0.30% |
| | | | | | | |
| Net Revenues: | | | | | | |
| One-time commissions | $46.19 | $74.46 | $128.32 | $88.35 | $83.93 | $85.61 |
| proportion of one-time | 50% | 43% | 64% | 57% | 60% | 61% |
| Recurring service fees | $39.58 | $83.59 | | | | |
| Recurring fees: fund management | | | $49.00 | $39.20 | $31.36 | $29.79 |
| Recurring fees: fund retention | | | $18.70 | $20.61 | $19.58 | $19.97 |
| Mutual fund service fees | $0.92 | $5.72 | $5.72 | $5.72 | $5.72 | $5.72 |
| | | | | | | |
| Total net revenues | $91.76 | $173.32 | $201.74 | $153.87 | $140.59 | $141.09 |
| Less: business taxes and related surcharges | $(5.07) | $(9.55) | $(11.70) | $(8.92) | $(8.15) | $(8.18) |
| bus tax and surcharge rate | 5.5% | 5.5% | 5.8% | 5.8% | 5.8% | 5.8% |
| Net Revenues | $86.70 | $163.77 | $190.04 | $144.95 | $132.43 | $132.90 |

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# Appendix A

## Letter from CEO Wang Jingbo to Noah staff

July 2014 (rough translation by J Capital):

Hello everyone!

I expect everyone has seen the news reports about our cooperation with one of Wanjia's products, "Wanjia Yingjingtai Fund Nos. 1-4 Dedicated Asset Management Plan" (hereinafter called Jingtai Fund) which has resulted in the misappropriation incident, and I think everyone has noticed the company's continuing support of Wanjia and efforts to protect the interests of investors. Because this case moved swiftly into a legal proceeding, the law prevents us from promptly providing a complete and clear explanation.

This incident began on June 20, when Wanjia and we discovered that the General Partner of Jingtai had breeched the partnership agreement and changed the Jingtai Fund 1 investment strategy and used the money for a different purpose. As soon as we discovered the misappropriation, we worked with Wanjia Yingtai to take measures to report the case to the police and bring charges and form a group of high-level executives to take care of the problem, first acting to control the assets and ensure that the Jingtai assets and property were sufficient to cover interest, while we also took measures to secure and freeze the assets. There has been no question about rights to the assets, but because the amount is very large, the money must be returned via a legal process.

As the investigation matures and there have been disclosures in the media, we have doubled our efforts and formed a special group, including a business resources center, a brand management center, public relations bureau, a legal bureau, a customer service department, and a crisis management center that includes Wanjia. These groups have split up the work of supporting clients, communicating with Relationship Managers, responding to the media, and coordinating with the government. Since this incident occurred, we have been working to protect our clients' rights and the company's reputation, and we believe there will be a positive result.

In the process of handling this issue, because of its sudden nature, the incident has put us under tremendous pressure, but mutual advantage remains our key goal. I believe that people are fundamentally good and that things happen in order that we may learn from them, to remind us of how to improve and guide us to a better direction.

Under pressure of time and under great stress, with the support of colleagues, I have begun to understand the meaning of this event for us: things are never ideal in our personal lives and that is no reason for depression; in our industry, when there are losses, we should seek a better understanding and promote the development of the industry. In an environment of rapid development, this incident has made me set aside my pride and more clearly recognize my limits! The dearest realization is that we live for people we love not for inanimate objects so that we may enjoy trust and human warmth, moving beyond confusion and betrayal to new motivation.

I also believe that, as we move through time and this event, clients will recognize our integrity and our determination and ability to solve problems. When it comes to personal values, I have always had my

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own code: I would never ignore a partner's interests to pursue my own advantage. Our goal is to deal with customers, partners, and government agencies ib such a way that they will emerge with deeper trust in us and a yet better relationship.

I would like to thank the crisis management group, our very able executives, and all my partners on the front lines.

# Appendix B

## Noah Subsidiary List

Holding company: NOAH Holdings Ltd.

诺亚(中国)控股有限公司

Shanghai Noah Rongyao Investment Consulting Co., Ltd.
上海诺亚荣耀投资顾问有限公司

Tianjin Noah Wealth Management Consulting Co., Ltd.

This company appears to be:

天津诺亚财富理财顾问有限公司第一分公司
http://www.tjftz.gov.cn/APPS/entwindow/companyinfo.jsp?companyconfine=1&id=23432

Shanghai Noah Yuanzheng Investment Consulting Co., Ltd.
上海诺亚远征投资咨询有限公司

http://zs.job001.cn/company/6617983.html

Gopher Asset Management Co., Ltd.
歌斐资产管理有限公司

http://www.gopherasset.com/gsgl.html

Shanghai Noah Investment Management Co., Ltd.
**上海诺亚投资管理有限公司**
http://www.alljobsearch.cn/comp_50/c504638/

Shanghai Noah Rongyao Insurance Brokerage Co., Ltd.
上海诺亚荣耀保险经纪有限公司

http://www.circ.gov.cn/web/site0/tab230/i77897.htm

Shanghai Noah Investment Consulting Co., Ltd.

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According to the Prospectus, "This entity is currently inactive. We may use this entity to conduct a portion of our future fund of funds business if any future PRC law imposes license requirements for any part of that business."

This site discloses two additional subsidiaries.
http://storage.secwatch.com/filings/962fef0cacf387bfad52da81284c10a2/dex81.htm

Noah Private Wealth Management (Hong Kong) Limited

- Jurisdiction of incorporation: Hong Kong

- Wholly-owned subsidiary

Shanghai Rongyao Information Technology Co., Ltd.

- Jurisdiction of incorporation: China

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