China | Real estate and internet

SouFun Holdings (SFUN US)

February 19, 2015

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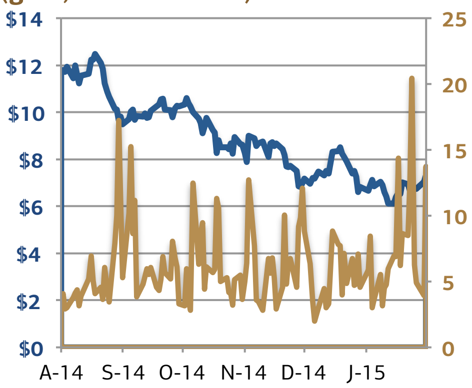
Not fun

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



Source: Bloomberg, Feb. 19, 2015

SouFun Holdings (SFUN US)

Price	USD 7.30
Rating	**SELL**
Price target	**USD 4.28**
Difference	**41%**
Market Cap	USD 2.9 bln
Simple Moving Avg.	6.81 mln shares
P/E	12.6x
Float	100%

Source: Bloomberg, Feb. 19, 2015

+ Poor FY2014 results

Net income of USD 254 mln was down 15% YoY. While e-commerce revenue was up 47% YoY. We're skeptical of the quality and sustainability of these earnings, given it's mostly from property derivatives.

+ Incestuous credit risk

SouFun has made a USD 38 mln unsecured loan to a Greenland property project. Greenland itself is looking to move into the hot sector of internet finance. So SouFun is lending to Greenland, which is then lending to another property developer, which may also be the receipient of SouFun financing. If a major credit event occurred, there is likely to be a daisy-chain impact throughout the various property funding channels.

+ The ever-morphing balance sheet

Every quarter, new exposures suddenly appear on SouFun's balance sheet like aggressive tumors. They typically have minimal disclosure, and Q4 2014 is no different. Why, for example, did "long-term investments" more than double, and what are the USD 47 mln of customer deposits, which appeared for the first time?

+ 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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Let Mo run your dough

Since our initiation report, SouFun has fallen as much as 31%. At it's current USD 7.30 price, just under USD 1 bln has been wiped off its market cap. The market has begun to price in SouFun's exposure to China's sick property sector. However, we think there is more to come.

When you buy SouFun, you are not buying an online real estate listing portal, but a money lender to the property sector.

In particular, you are investing in SouFun / Vincent Mo's ability to make prudent credit risk decisions and not in its ability to generate advertising revenue from real estate listings.

FY2014 results were poor, with NPAT down 15% YoY

SouFun recently announced poor Q4 2014 unaudited results, with FY 2014 net income of USD 253 mln, down 15% from 299 mln in FY 2013. Q4 2014 net income fell a large 26% YoY to 84 mln.

- **Flat revenue growth:** Q4 revenue was USD 223 mln, up 3% YoY. Marketing revenue fell 5% YoY to USD 92 mln, while e-commerce revenue was up 47% YoY to USD 99 mln. Listing revenue fell 50% YoY to USD 25 mln.

- **Ignore the e-commerce hype:** We don't buy into the hype of strong e-commerce revenue growth because 1) we're skeptical of the quality and sustainability of these earnings, given it's mostly from property derivatives and 2) there is likely to be a large overlap with marketing/advertising revenue. In other words, it's just advertising revenue under a different name.

- **Costs increased**. Q4 cost of revenue increased 54%, to USD 43 mln, while selling expenses were up 37%, to USD 48 mln. G&A expenses surprisingly fell 10% to 25 mln.

The bank of Mo

USD 214 mln of unsecured loans to developers

We have found a total of USD 214 mln of unsecured loans to developers on SouFun's balance sheet.

SouFun provides such loose funding in order to win the advertising accounts of property developers and is evidence of SouFun's weak market position. SouFun doesn't explicitly state they are unsecured loans, and two of the loans are booked as innocuous-sounding "deposits."

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- USD 86 mln for "deposits for non-current assets."
- USD 47 mln for "customer deposits."
- USD 81 mln for "loans receivable."

Deposits for non-current assets

SouFun's deposits for non-current assets doubled to USD 86 mln as at Q3 2014. As at Q4 2014, this has largely stayed the same, at USD 87 mln and like in Q3 2014, SouFun has not disclosed what constitutes the entire underlying exposure.

Greenland, a developer, is also getting into internet finance

We know that USD 38 mln is an unsecured loan to Greenland for its Greenland Window office development in Chengdu, but we still don't know what the remaining USD 49 mln loan is for. Hopefully SouFun's annual report will provide this disclosure.

Greenland Hong Kong has stated that it plans to "diversify" into internet finance in 2015. It seems that Greenland is looking to help other developers with financing.

This simply highlights the incestuous nature of exposures in the property industry, a "double/triple correlation risk" of sorts:

- SouFun has provided an unsecured loan to finance Greenland, while Greenland is looking to enter Internet finance.
- Greenland's intention to enter Internet finance and be a competitor to SouFun shows the low barriers to entry of this "business" and leads to questions over the sustainability of SouFun's P2P business.

The underlying credit risk is very incestuous

- Therefore, if a major credit event occurred, there is likely to be a daisy-chain impact throughout the various property funding channels.

Customer deposits – the latest unsecured exposure

"Customer deposits" of USD 47 mln appeared for the first time on SouFun's balance sheet under current assets.

In the Q4 earnings call, SouFun said:

> *"customer deposits of around $47.3 million paid to real estate developers…"*

Similar to "deposits for non-current assets" above, this is most

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likely an unsecured loan to a developer, presumably with a shorter tenor.

Loans receivable have doubled

Loans receivable are a controversial item on SouFun's balance sheet. They have more than doubled QoQ, to USD 81 mln in Q4 2014. In FY2011, the USD 26 mln of loans receivable were loans to property developers. They were the subject of reports by Glaucus and questions from the SEC.

In the earnings call, SouFun stated that Q4 had cash outflows of USD 5 mln, due to:

Dialing up loan shark business

> *". . .micro loans of around $45.3 million provided to developers and home buyers on our financial services platform, customer deposits of around $47.3 million paid to real estate developers..."*

The USD 45.3 mln of micro loans explains the USD 45 mln increase in total loans receivable to USD 81 mln.

SouFun also noted that its revenue for other value-added services was USD 6.8 mln in Q4 2014, which was more than double Q4 2013:

> *". . . mainly due to the rapid growth of our financial services...We began offering financial services on our financial platform, which mainly includes loans to developers and home buyers."*

The USD 6.8 mln was earned entirely in Q4, presumably from lending the incremental USD 45.3 mln of micro loans. This is an **interest rate of 15.9% over only 3 months** (6.8 mln/45.3 mln). One wonders about the creditworthiness of borrowers who are desperate enough for cash to pay loan shark interest rates. And how SouFun is mitigating the very high credit risk.

Given they are "micro loans", it's assumed that these are most likely the crowd funding and P2P loans that SouFun offers via its Tianxiadai platform. We wrote about Tianxiadai in our initiation report, and we have concerns over who is providing guarantees and how credit risk is being mitigated. In addition we note that SouFun is now also making loans to individuals, as well as property developers.

In the Q4 earnings call, Soufun maintained that the company is

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"*very careful to select the projects when we do our lending*" and that there is a separate guarantee company, which provides SouFun with a guarantee to the lender in the P2P platform.

SouFun also stated that it doesn't have "*any big bad debt. We think we have controlled the risk very well.*"

We are skeptical that SouFun is not on the hook for this lending and that SouFun is a competent manager of credit risk.

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."

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.

As at Q4 2014, funds receivable totaled USD 62 mln, up 67% YoY and 42% QoQ. Funds receivable are now larger than accounts receivable of USD 50 mln. It's also possible that funds receivable are downpayment loans – we need to do additional primary research to verify this.

In a previous annual report, SouFun states that it *"…carefully considers and monitors the credit worthiness of the third-party payment service provider used.*" SouFun doesn't disclose bad debts 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.

Home decoration lending a signal of higher LVR lending

In the Q4 earnings call SouFun stated that:

"Home decoration" loans = more unsecured lending

> *"…we are going to offer more loans to the home buyer and to our clients into home decoration and in the service home as well."*

It's possible that these are really construction loans, possibly down payment financing packaged as home decorations and as an alternative to lending directly to the developer.

This analyst recalls working in the Credit Risk department of an

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Australian investment bank in the middle of 2007. The mortgage business had submitted a proposal to launch a 105% LVR mortgage. The additional 5% LVR over 100% was for "home improvement / renovations".

What this showed was the peak of the credit bubble and the competitive pressure to loosen lending standards. While we don't expect SouFun to go massively into "home decoration loans", it is a sign to us that China's already loose lending environment is becoming even looser and riskier.

Loose capital management and falling cash levels

Taking shareholders cash and lending to property

SouFun's cash has fallen 39% YoY to USD 355 mln. This figure doesn't include USD 207 mln of restricted cash balances, which is used as security for USD 181 mln of short and long-term USD loans, or USD 455 mln of short-term investments, which are supposedly 90-day money-market instruments.

SouFun doesn't produce a quarterly cash flow statement, but in the earnings call stated that:

- Q4 2014 cash flow used in operating activities was USD 5 mln vs cash generated of USD 142 mln in Q4 2013.
- FY 2014 cash flow from operating activities was USD 214 mln, a 47.5% decrease from USD 408 mln in FY2013.

Q4 2014 operating cash outflows arose from SouFun lending money to property. SouFun stated that outflows came from:

> *". . . micro loans of around $45.3 million provided to developers and home buyers on our financial services platform, customer deposits of around $47.3 million paid to real estate developers..."*

Investments in off-line agencies too

In the earnings call, SouFun also stated that apart from using cash for lending, the fall in cash was due to investments in offline real-estate agencies. Of the initial three agencies, the agreement with Century 21 has been terminated.

As previously noted in our initiation report, the real estate agency acquisition spree is a poor strategy as agencies don't make money, they are high cost, low return businesses and the secondary property market is not healthy.

It's another example of Vincent Mo using SouFun's cash according to his whims.

No transparency on long-term investments

What are long-term investments?

Long-term investments more than doubled QoQ to USD 121 mln in Q4 2014. SouFun has not provided any disclosure on this increase. We suspect it's either a prepayment or loan for a property, most likely a commercial office building.

Back in FY2012, SouFun had USD 111 mln in long-term investments. This was a prepayment for a Shanghai building to use as its headquarters and training center. This was a very controversial deal known as the "Baoan transaction."

One of the most puzzling aspects of this transaction was that the seller, Shenzhen-listed China Baoan Group (000009), a real estate conglomerate based in Shenzhen, made five announcements about the sale, starting on May 30, 2012 and none of them mentioned SouFun.

Instead, Baoan announced that the sale was made to Shanghai Guiling Industrial Co. Ltd. This company, with no evident link to SouFun, is a copper trading company, and when a J Capital staff member visited Shanghai Guiling's office on January 3, 2013, we found four employees engaged in copper trading. They did not know who SouFun was.

Again, with the large increase in long-term investments and the lack of disclosure, we have serious questions over SouFun's capital management.

Kaisa links?

Given Sohu's exposure to Kaisa via its off-balance sheet P2P platform, Souyidai, we looked into whether SouFun also had exposure.

Sohu's problems stemmed from guaranteeing sales for developers and these sales were generated by offering discounts through VIP membership cards – a direct copy of SouFun's e-commerce business model (a business where Leju has overtaken SouFun).

J Capital's Matt Lowenstein wrote in his recent Sohu update that "we hypothesize that Sohu began offering straight-up financing in

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return for advertising contracts. In effect, Sohu is funding its own sales, but since it is doing so off balance sheet, there is no discernible growth in accounts receivable. Those off-balance sheet receivables have just gone bad."

We did press searches and found no information linking SouFun with Kaisa. We note that China Overseas Land, another developer who was caught up in the Shenzhen project cancellation mess is active on SouFun's P2P platform. However, we haven't yet found anything more concrete.

The Kaisa default brings risk in the property market to a new level and SouFun appears to have extended unsecured loans to developers. Therefore there are likely to be in-direct links which may be revealed in due course.

Insider selling

Insiders have been selling

IDG Capital Partners ("IDG") is one of the most active VC investors in tech in China. IDG held 12.6% of SouFun's pre-IPO shares. IDG sold 4.3% in the IPO to an ownership stake of 8.3%.

Quan Zhou, a general partner and director of IDG, is also a Director of SouFun's board.

In December 2014, IDG sold three lots of SouFun shares totaling 0.72%, or 2.09 mln shares. The total proceeds from the sale were around USD 14.5 mln.

IDG has progressively sold down its SFUN stake to less than half of its post-IPO shareholding. IDG now holds 4.05% of SFUN.

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.

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.

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USD 4.28 target price

We retain our price target of USD 4.28, This is 41% downside from SouFun's price as at 18 February 2015.

Based on Bloomberg consensus, SouFun is currently trading at 12.6x 2014 P/E and 14x FY2015 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 16x FY2015e consensus.

However, SouFun is a value trap. While consensus estimates have fallen, we think the market is not pricing in:

SouFun is a value trap

- SouFun's leverage to transactions and 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.
- 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 further ventures into "internet finance", we think its credit risk profile will increase.

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.
- **SouFun truly becomes a national property agent:** If SouFun really is able to morph into a national online and offline property agent, then we are wrong.
- **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.

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