

June 8, 2015

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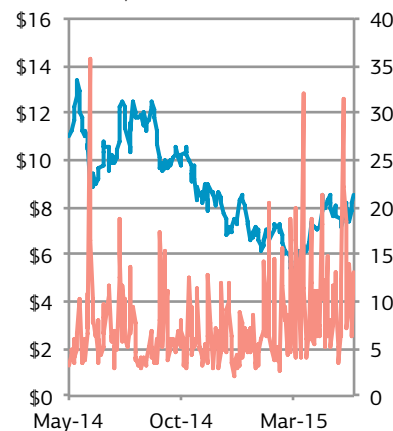
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## SouFun (SFUN US)

Price	USD 8.52
<b>Rating</b>	<b>SELL</b>
<b>Price Target</b>	<b>USD 4.28</b>
Market Cap	3.5 bln
Avg. Volume	12.2 mln
P/E	38.2x

SouFun (SFUN US) last share price in USD (blue) and volume (pink, in mln shares)



Source: Bloomberg June 5, 2015

## SouFun (SFUN US)

# Weak Shapeshifter

### ▶ **Brittle business model. Poor results**

SouFun's Q1 2015 net income was down a massive 85% YoY. Such poor results should draw into question the robustness of SouFun's business model. This is a company which has consistently morphed away from its initial strategy of being an online real-estate listing portal.

### ▶ **Losing out to Leju**

SouFun makes a big thing about its transition to an "O2O" business model. But the reality is that Leju has overtaken SouFun in e-commerce, despite starting from a smaller base.

### ▶ **Unsecured lending growth continues**

SouFun's unsecured lending has increased to USD 244 mln. SouFun's entrusted loans had interest rates ranging from 12% to 20%—what kind of borrowers are desperate enough to pay such throat-slitting interest rates?

### ▶ **Quasi-securitization, but still on the hook?**

SouFun is now engaged in a quasi form of securitization. But securitization SouFun-style means SouFun is still on the hook for credit risk.

### ▶ **Rich valuation. Target price: USD 4.28**

SouFun is currently trading at a very rich FY2015e PE multiple of 38.2x. This compares with an average historical forward PE multiple of 14.6x. Given how poor SouFun's recent results were, plus the lack of visibility over SouFun's future earnings, it's amazing that SouFun is trading at such a rich forward earnings multiple.

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## Brittle Business Model

SouFun's recent Q1 2015 unaudited results were even weaker than the previous poor quarter. Q1 2015 net income was USD 6 mln, down a massive 85% from USD 42 mln a year ago.

SouFun's poor results alone should draw into question the robustness of its business model. This is a company that has consistently morphed from its initial strategy of being an online real-estate listing portal. That should be a red flag for investors who were initially attracted by the high margins typical of listings businesses; even as SouFun has gained market share, it has shunned the model that so consistently delivers profits in other markets.

SouFun's latest contortions reveal a business struggling to generate revenue growth while bleeding profusely via large cost increases.

**Minimal revenue growth:** Q1 revenue was USD 124 mln, up 1.8% YoY. Marketing revenue fell 13.5%, to USD 41 mln, while e-commerce revenue was up 75% YoY, to USD 29 mln.

**Continue to ignore e-commerce hype:** We continue to ignore the hype over apparently strong e-commerce revenue growth because 1) we're skeptical of the quality and sustainability of these earnings and 2) there is likely to be a large overlap with marketing/advertising revenue.

**Bulging costs:** Costs are certainly a fast-growing area for SouFun. Q1 cost of revenue was USD 44 mln, up a huge 75% to USD 44 mln. Selling expenses also increased at a similar clip (up 74% to USD 48 mln) and G&A expenses also saw a 23% increase to 24 mln.

### Why SouFun Shouldn't Be Given the Benefit of the Doubt

Bulls would argue that SouFun is undergoing short-term pain for long-term gain and that the long-term goal is to run a successful "O2O" real-estate agency. If you strip away the fancy marketing spin and buzzwords, at its core, SouFun continues to take shareholder capital and act as a money lender to the property sector.

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

Q1 2015 net income was down 85%.

Costs are the only thing bulging—apart from Vincent's pockets.

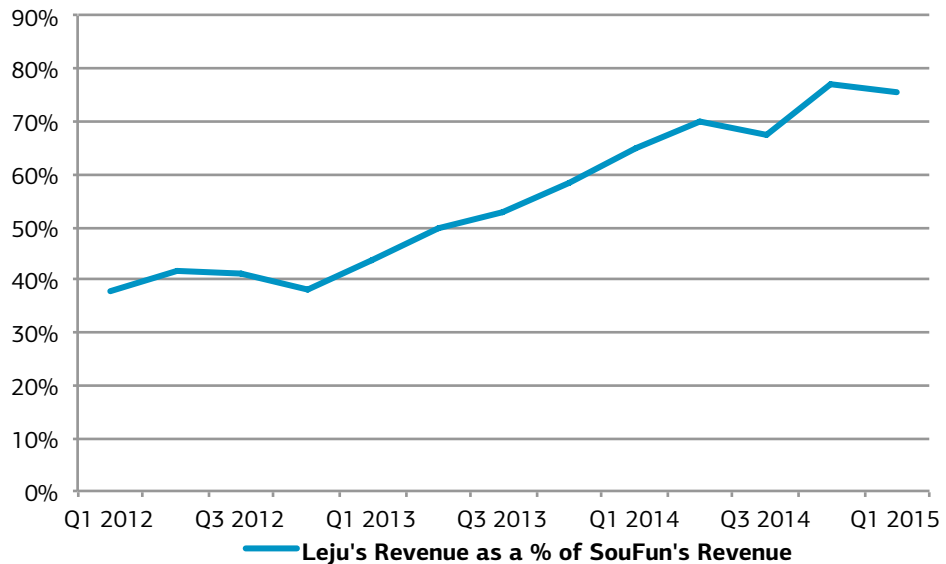
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## SouFun Is Fast Losing Out to Leju

SouFun's so-called dominance in online real estate is called into question when compared with Leju. While SouFun earns more revenue than Leju, Leju is catching up fast.

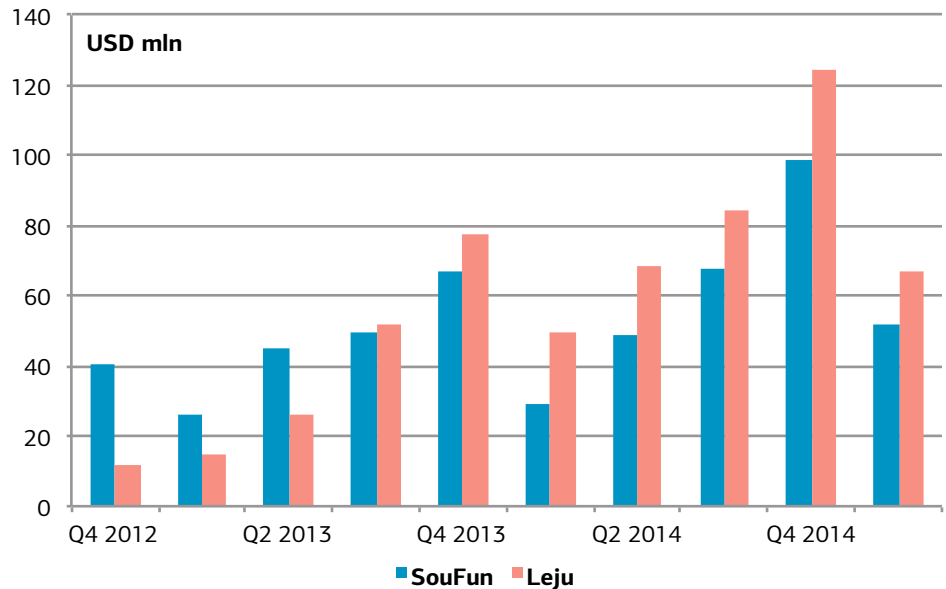
Leju has already overtaken SouFun in e-commerce, despite entering later, and is also threatening to overtake SouFun in advertising revenue.

**Chart 1. Leju's Total Revenue Is Catching Up to SouFun's**



Source: Company financials, J Capital Research

**Chart 2. Leju's E-Commerce Revenue Exceeds SouFun's**



Source: Company financials, J Capital Research

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## Unsecured Lending Growth Continues

In SouFun's recent 20F, SouFun finally acknowledged that it undertakes unsecured lending. Note 9 in the 20F contains the following disclosure:

“The Group provides secured loans in the form of entrusted loans, mortgage loans and unsecured loans, primarily to home buyers, real estate developers and other borrowers that meet its credit assessment requirements. The loans to home buyers and other borrowers are primarily originated through the Group's online financial service channel on its website.”

SouFun also notes that, while homebuyer loans are unsecured, loans to real estate developers are generally secured.

“**Most of the loans to home buyers are unsecured** as they generally also borrow mortgage loans from commercial banks. **The loans to real estate developers are generally secured loans...**the Group generally provides loans to real estate developers using an “entrusted loan” structure...The Group, as opposed to the commercial banks, bears the credit risk of the entrusted loans.”

While it's positive that SouFun has finally provided some color on its lending activities, we don't think SouFun is being entirely transparent. The above disclosures relate to “loan receivables” sitting in current and non-current assets.

However, as we've written previously, SouFun also has a range of other unsecured exposures and a large portion of these loan derivatives are made to property developers. This is despite SouFun's stating that “loans to real estate developers are generally secured loans.”

## The Various Loan Derivatives

SouFun's unsecured lending has increased from USD 214 mln in Q4 2014 to 244 mln in Q1 2015. SouFun provides this easy funding in order to win advertising accounts of property developers.

The exposures we've identified include:

- ▶ USD 107 mln for “loan receivable”.
- ▶ USD 87 mln “Deposits for non-current assets”.
- ▶ USD 50 mln for “customer deposits.”

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## Loan Receivables: 107 mln

These loans are made via SouFun’s P2P lending platform [Tianxiadai](#). SouFun makes loans to both individuals and property developers. As per previous reports, we have concerns over SouFun’s guarantees and how credit risk is being mitigated.

- ▶ SouFun’s 20F breaks down its loan receivable exposures and these are shown in the table below.
- ▶ The large majority of exposures are short-term and 63% of them are unsecured.
- ▶ 100% of the 2 mln non-current exposures are unsecured.
- ▶ Apparently no defaults so far.

**Table 1. The Large Majority of Loans Are Unsecured**

Loan Receivables (USD mln)	Dec 2014	Unsecured %
<b>Current Secured</b>		
- Entrusted loans	17.4	
- Mortgage loans	11.9	
<b>Total secured loans</b>	<b>29.4</b>	
<b>Unsecured</b>	<b>50.3</b>	
<b>Total current loans</b>	<b>79.6</b>	<b>63%</b>
<b>Non-current Secured</b>		
- Mortgage loans	0.04	
<b>Total secured loans</b>	<b>0.04</b>	
<b>Unsecured loans</b>	<b>2.0</b>	
<b>Total non-current loans</b>	<b>2.0</b>	<b>100%</b>

Source: Company financials, J Capital Research

### Loan Shark Interest Rates

SouFun notes that entrusted loans had interest rates ranging from 12% to 20%. Apparently entrusted loans are secured by collateral that had a “market value ranging from 103% to 174% of the entrusted loans...”

Of course, we can only take SouFun on its word that it has adequate collateral for these loans. “Market value” is a very subjective term and in a

What kind of borrowers are desperate enough to pay 12-20% interest?

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Securitization  
SouFun style =  
no offloading  
of credit risk.

stressed borrower situation the perceived “market value” of the underlying collateral (especially if it’s property), is likely to be a lot less than first assumed.

### Quasi-Securitization, But Still on the Hook?

Securitization normally involves selling mortgage loans receivable to investors in exchange for cash, with the investor assuming the credit risk of the underlying receivables. However SouFun has a different take on securitization.

Under SouFun’s “innovation”, SouFun sells the economic benefits of the mortgage loans receivable in exchange for cash on its website. SouFun’s 20F discloses that it will continue to provide:

“(i) limited administrative services in the form of collection and payment services to the borrowers and investors and (ii) a guarantee to the investors in the event of default by the borrowers. The nature of these continuing involvements does not constitute control over the transferred mortgage loans receivable.”

So in addition to running a repo business, SouFun is still on the hook if the underlying borrower defaults. SouFun states that USD 15.7 mln in mortgage loan receivables were shuffled via this process.

### Deposits for Non-Current Assets: 87 mln

SouFun disclosed in its 20-F that the 87 mln was entirely for the Greenland Window office development in Chengdu. Our previous reports detailed the nature of this loan to Greenland, as well our project site visit. In essence, SouFun lent money to Greenland on a one-year unsecured basis.

SouFun also disclosed that as of December 31, 2014 construction of the building has been completed and that quality testing is being done. SouFun plans to use the building as its regional office. Presumably then, in the next quarter or so, this deposit for non-current asset will turn into property, plant and equipment on balance sheet.

Nonetheless, SouFun’s willingness to lend 1-year unsecured to a property developer shows the risky way that SouFun manages capital.

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## Commitment Deposits / Customer Deposits: 50 mln

For whatever reason, SouFun termed this balance sheet item “Customer deposits” in its Q4 2014 and Q1 2015 filings, but “Commitment deposits” in its recent 20F.

In the 20F SouFun discloses that commitment deposits “...represent cash paid to real estate developers for the right to provide sales agency services for their real estate projects.”

That is, SouFun’s market position and bargaining power is so weak that in order to win business, SouFun has to pay deposits to developers. These “deposits” are most likely unsecured loans to risky property developers. While SouFun notes that as of December 31, 2014 “no commitment deposits were in default”, the existence of such an “asset” shows SouFun’s large credit risk to the property sector.

## Loose Capital Management

Given our concerns of SouFun’s loose capital management, the cash flow statement is arguably the most important financial disclosure to examine. Unfortunately, SouFun only discloses its cash flow statement once a year. What we find is that SouFun is on-lending the large majority of its net income.

The following items stand out:

- ▶ **Loans are 70% of net income:** Lending-related operating cash outflows total USD 129mln (commitment deposits of 47 mln and loan receivables of 82 mln). This is 51% of SouFun’s 253 mln net income. Add on 48 mln for “deposits for non-current assets”, which is effectively a loan, results in USD 177 mln or 70% of net income.
- ▶ **Other lending-like exposures are large:** Accounts receivable (USD 23 mln), funds receivable (25 mln) and customers’ refundable fees (11 mln) total USD 59 mln. Combined with 177 mln in loans gives a total of 236 mln, or 93% of SouFun’s 2014 net income.
- ▶ **Spending 119 mln to buy shares in real estate agencies and consultants:** USD 24 mln was spent buying shares of Color Life, a Hong Kong listed real estate consultancy, which is 50% owned by the highly-g geared developer Fantasia. 35 mln was spent on Hopefluent, a Hong Kong listed agency. SouFun now owns 16.76% of Hopefluent, a business that has seen its operating margin fall from 14.7% in FY 2013 to 11.8% in FY 2014.



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When SouFun grants credit, every third or fourth customer defaults.

- ▶ **Of the 119 mln, 62 mln was spent buying shares in Tospur Real Estate Consulting:** Tospur is a non-listed company, so you have to take Vincent's word that the 62 mln is actually money well spent and not a way for cash to be worked off the balance sheet. SouFun is currently setting up a JV with Tospur to provide real estate internet financing services. SouFun (USD 10 mln for 60% stake) and Tospur acquired stakes in Beijing RunZe Microfinance Co. Ltd. Runze is a microfinance company with a licence to make loans.
- ▶ **More cash to be spent on agencies in Q2.** SouFun disclosed that it is spending USD 121 mln for a 10% stake of World Union, another agency. This transaction is expected to close in Q2 2015.
- ▶ **Total cash decreased USD 226 mln in FY2014.** SouFun's venture into loan sharking means it has become an even more capital-intensive business. We are very skeptical that shareholders will ever receive a high return on this capital.

## How Can SouFun be a Successful Loan Shark?

We have previously pointed out that SouFun's counterparties have much larger credit risk compared with those of Leju and Sina.

SouFun's bad debts/accounts receivable are 30% in FY2014, much higher than Leju (9%) and Sina (6%). This has increased from 25% in FY2013. In effect, when SouFun grants credit, every third or fourth customer defaults. In addition, SouFun's write-offs are many multiples of Leju's and Sina's.

SouFun's poor history of managing a simple billing cycle with advertising clients does not bode well for SouFun's ability to make prudent unsecured lending decisions to high-risk credit-starved borrowers willing to pay up to 20% interest rates.

**Table 2. High Bad Debt %**

Bad Debts / Accounts Receivable	FY2011	FY2012	FY2013	FY2014
<b>SouFun</b>	25%	29%	25%	30%
<b>Leju</b>		8%	7%	9%
<b>Sina</b>	7%	8%	5%	6%

Source: Company financials, J Capital Research

**Table 3. When SouFun Sells on Credit, There Is a High Likelihood of a Write-Off**

Write-Offs % A/C Receivable	FY2011	FY2012	FY2013	FY2014
SouFun	53%	32%	25%	22%
Leju		6%	5%	5%
0%	0%	3%	3%	6%

Source: Company financials, J Capital Research

## Rich Valuation

SouFun is currently trading at a very rich FY2015 PE multiple of 38.2x (based on Bloomberg consensus). This compares with an average historical forward PE multiple of 14.6x.

Given how poor SouFun’s recent results were, plus the lack of visibility over SouFun’s future earnings, it’s quite amazing that SouFun is trading at such a high forward earnings multiple.

### USD 4.28 Target Price

We retain our price target of USD 4.28. This is 50% downside from SouFun’s price as at 5 June 2015 and even seems a little high at 19x FY2015 consensus EPS.

## Risks

- ▶ **Private equity buys in:** Vincent Mo is a wily operator and if SouFun’s price continues to fall, he could hatch an escape plan.
- ▶ **SouFun truly becomes a national property agent:** If SouFun 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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