February 5, 2019

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February 5, 2019

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The Corruption Scandal Engulfing Fanhua

- **We believe that Fanhua has been implicated** in a corruption case in China that saw a close associate from PICC P&C sentenced to 11 years in jail. Fanhua has been specifically barred since 2017 from selling P&C insurance for the biggest insurer in China. We think reputable insurance companies are now very reluctant to work with FANH.
- **Fanhua has failed to disclose guarantees for trust plans** issued to finance subsidiary China Finance Holdings (CNF) and for other corporate purposes. CNF's prospectus shows $682 mln in funds raised from trust plans and a default rate of over 12%. Although it is unclear how much liability Fanhua, a minority shareholder, bears, the guarantees for loans underlying the trust are explicit.
- **Fanhua's core insurance business is generating** meager earnings. Investment income and Fanhua's share of sub-prime lending by subsidiary CNF provided 73% of 2017 profit and 109% of profit in 2016. Yet these income streams are highly vulnerable to China's teetering property market.
- **We believe the "521" share incentive plan violates SEC rules.** The plan has never been registered with the SEC, though it is a securities offering. The plan provides forward guidance on revenue and stock price in violation of SEC Regulation Full Disclosure (Reg FD). We have made a submission to the SEC pointing this out.

Pariah

Fanhua is being treated as a pariah agency by major Chinese insurers. According to our interviews with Chinese insurance regulators, FANH was dropped as a sales agent for the People's Insurance Company of China (PICC) because of a suspected corrupt relationship. PICC now lists 40 different sales agents through which it sells its product, but PICC explicitly bars Fanhua. PICC's importance in China's insurance industry can hardly be overstated. Before it dropped Fanhua, PICC represented 27% of FANH revenue. PICC works with dozens of third-party insurance vendors, including automobile dealerships throughout China. A regulator from the CIRC told us that Fanhua was the only legitimate third-party agent with which PICC refuses to do business.[1]

Fanhua still employs a family member of the former president of PICC's P&C division, Wang Yingcheng,[2] who was detained in February 2017, shortly before PICC unilaterally dropped Fanhua as a partner. Wang was sentenced last May to 11 years in jail on corruption charges. "I believe the relationship between Wang Yincheng and Fanhua Group is improper," said an official of the Chinese Insurance Regulatory Commission (CIRC) to J Capital on condition of anonymity. His comments were echoed by other regulators.

In China, top executives of state-owned companies like PICC are government officials. The relationship between Fanhua and Wang Yincheng could conceivably put the company at risk under the U.S. Foreign Corrupt Practices Act of 1977.

The relation, apparently an older brother, of the corrupt PICC executive stepped down from one position at Fanhua but continues to be an executive of at least two Fanhua subsidiaries. Public records show that Wang Jincheng[3] was chairman of the supervisory committee of Fanhua Insurance Surveyors & Loss Adjustors Holding Co., Ltd.

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[1] Within a week of Wang's arrest, PICC P&C had suspended all business with FANH. FANH disclosed the termination to investors on March 3, 2017. The company's 6-K reads as follows [our emphasis]:

> On March 1, 2017, Fanhua's subsidiaries were notified verbally by PICC P&C's local branches that PICC P&C was temporarily suspending its business cooperation with Fanhua on areas such as insurance agency, brokerage and claims adjustment because certain of PICC P&C's senior management members were being investigated by the government. As a decade-long business partner of PICC P&C, the Company was disappointed by this **unilateral notice**. However, the Company also understands that as a state-owned enterprise, it may be necessary for PICC P&C to take such precautionary measures as a result of internal or external investigation. At this stage, the Company is unable to predict when and whether the business cooperation with PICC P&C might resume. The Company plans to engage in ongoing dialogue with PICC P&C and urges it to resume their mutual business cooperation relationship as early as possible.

[2] The Chinese characters are 王银成

[3] The Chinese characters are 王金成

but resigned roughly two months after his detention. He remains an executive of Guangdong Fanhua Fangzhong Investment Management Co. Ltd. and Shenzhen Fanhua Huahong Zhengda Insurance Claims Adjustment Shanghai Branch.

Fanhua's entanglement with the disgraced Wang Yincheng is an open secret in China and has been reported in the Chinese press. An article in the respected financial magazine Caijing, published in February 2018, reported that a relative of Wang Yincheng worked for Fanhua. The text is as follows:

> 中纪委公告中提到，王银成利用职务上的便利为亲属经营活动谋取利益。业内传闻，王银成的一位直系亲属是泛华金控集团背后的实际控制人。去年3月1日，泛华各地机构即陆续接到人保财险当地机构的口头通知，称由于人保财险集团高层接受调查，暂时停止与泛华进行保险代理、经纪和公估业务的合作。
>
> Translation: *According to a public announcement from China's Central Commission for Discipline Inspection, Wang Yincheng managed to used the benefits of his position to generate a profit for his relatives' business activity.* ***Based on industry rumors, a relative within Wang Yincheng's immediate family is the actual controller of Fanhua Group.*** *On March 1 of last year, branches of Fanhua received oral notice from PICC stating that, due to an investigation of top management, [PICC] has suspended its agency, brokerage, and claims-adjustment businesses with Fanhua.*

Insurance regulators we interviewed told us that Wang Yincheng has been close to Fanhua founder Hu Yinan since Hu's early days in Shenzhen.

We know based on interviews with regulators and Fanhua staff as well as from county records from Shanxi Province that the two Wangs are closely related, probably brothers, born four years apart in 1956 and 1960. It is common in China for brothers to share a character in their names, in this case, "cheng," meaning "becoming." The older brother's "Jin" means "gold" and the younger brother's "Yin" means "silver." In Chinese, the surname comes first. A third close relation, Wang Baocheng,[4] is partnered with the Fanhua brother in at least three companies in Shenzhen that we believe may benefit the former PICC executive. The companies are Shenzhen Bishen Biotech, Shenzhen Yindong Investment, and Shenzhen Jingbao Investment.[5]

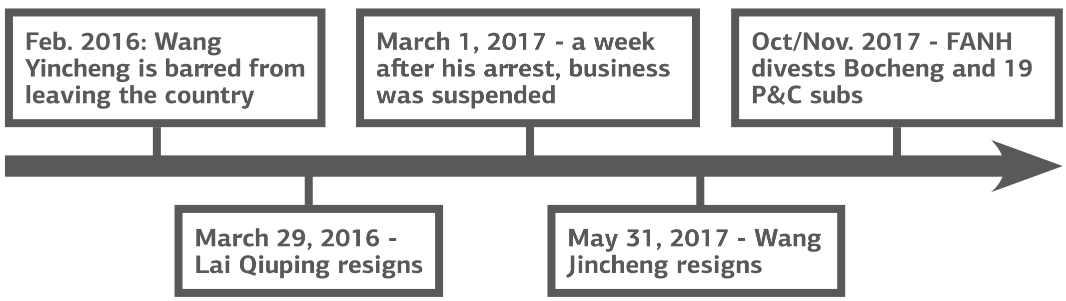
We think the corruption case may be the reason behind Fanhua's supposed divestiture of its P&C businesses, the Fanhua Times unit, to Beijing Cheche Technology. FANH also suddenly divested its insurance brokerage business, Bocheng, to a related

[4] The Chinese characters are 王保成

[5] The Chinese characters are 深圳市必神生物科技有限公司 , 深圳市银东投资发展有限公司 , 深圳市京宝投资发展有限公司

party, Liu Tingting, and divested 19 P&C insurance subsidiaries, most of them to another related party, Yang Lin. FANH then announced that it had made a "strategy change" from P&C insurance to life insurance, which we believe was done to avoid the potential disclosure requirement regarding Wang Yincheng's case. We note that Lai Qiuping, a co-founder of Fanhua, stepped down shortly after Wang Yincheng's detention.

From these events, we believe that FANH was involved in Wang Yincheng's corruption case. The timeline of these events looks like this:



In addition to these legal woes, the CIRC announced in December that Fanhua's claims adjustment company in Hainan Province had broken the law by inflating expenses. Fanhua was penalized in Yunnan, Shaanxi, and Hubei in 2018 for legal violations. These fines have not been reported to U.S. investors in apparent violation of SEC rules. Possibly Fanhua racks up so many fines that it doesn't remember to report them.

The Fanhua Times "divestiture"

In its response to our first report, Fanhua said that Yang Lin, currently the ultimate owner of 11 of the 19 companies that Fanhua claims to have sold to Cheche, and the Yang Lin who built Fanhua's business in Neijiang, Sichuan, are two different people with the same name. This does not change the fact that Fanhua divested companies to its own related party and not to a third party as claimed. The Yang Lin who received Fanhua's largesse is chief executive of Beijing Baoping Science and Technology Co., in which Fanhua is invested. He is a shareholder with Fanhua co-founder Lai Qiuping in a company called Xinzhiying Asset Management. He is owner of the shell company to which Fanhua transferred its Fanhua Times assets. And he has been intermediary for at least 15 Fanhua transactions.

Undisclosed guarantees

Fanhua is partially responsible for guarantees issued to large trust plans that its employees are asked to sell to benefit the company. Just one trust issued in summer 2017 raised ¥2.05 bln ($304 mln). Most of the funds come due before July this year.

Offering Document for the Foreign Trade Trust - Jinghua No.5 Collective Fund No. 29

The partner institution, Shenzhen Fanhua United Investment Group Co., Ltd. provides a joint liability guarantee for each claim of the borrower under Jinghua No. 5.

合作机构保证担保：合作机构深圳泛华联合投资集团有限公司为菁华5号项下借款人的每笔债权提供连带责任保证担保；

资金封闭流转：信托专户作为借款人还款的唯一账户，账户封闭处理，实现资金封闭流转，对现金流进行实时监控，并在必要时，对账户进行资金截流。

三、计划特点

项目设计具备优势：

设计等额分期还款方式降低借款人还款压力，监控借款人的还款能力变化；

设置借款人准入标准，严格执行审贷分离制度，实行后台集中审批，防范道德风险；

系统支持，使用行业内较为先进的贷款系统，并将通过系统开发实现向我司开放所需数据端口。

合作机构细分领域领先

深圳泛华联合投资集团有限公司（简称"深泛联"）股东泛华保险为亚洲保险中介行业第一家在全球主要资本市场（美国纳斯达克主板）上市的企业。

Shenzhen Fanhua United Investment Group Co., Ltd's shareholder, Fanhua Insurance, is the first company in the Asian insurance intermediary industry to be listed on a global exchange (the NASDAQ main board).

Source: http://www.fotic.com.cn/s/7238-18853-98748.html

Source: http"//www.fotic.com.cn/s/7238-18853-98748.htm.

We cannot estimate how much debt Fanhua has guaranteed, but several Fanhua-guaranteed trusts are listed on this website: [http://www.fotic.com.cn/6952.html.](http://www.fotic.com.cn/6952.html) CNF discloses that Fanhua is a "service institution" for its trusts but not that it has issued guarantees. The CNF prospectus provides translations of three trust plans. Buried deep down are these words: "In this trust project, subordinated trustor's related party Shenzhen Fanhua United Investment Group Co., Ltd. as a loan service institution cooperates with the trustee to handle loan marketing, loan acceptance, approval, post-loan management, overdue collection and other concrete pre-loan, in-loan and post-loan matters." (page 6/20, CNF prospectus)

Where the "profit" comes from

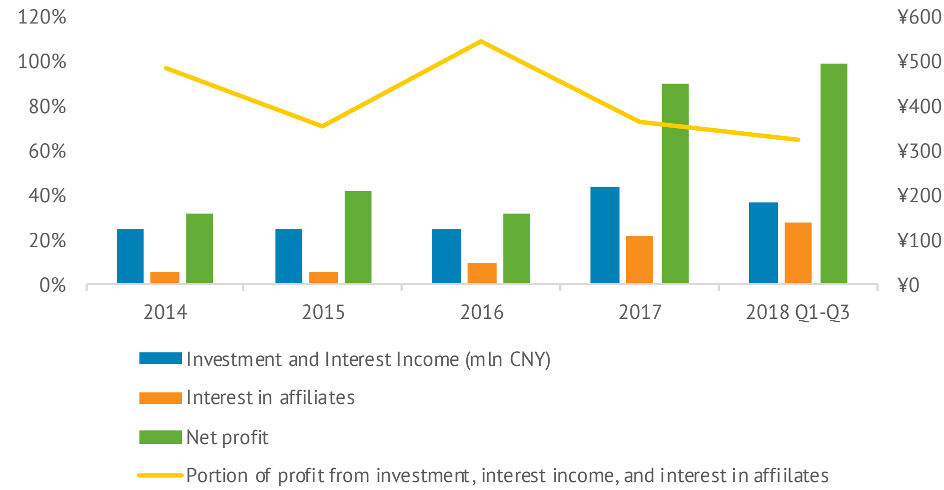
Fanhua's core insurance sales business delivers very little profit; in fact, all the profit comes from line items that have nothing to do with insurance. Interest income, investment income, and the company's 21% share in the CNF sub-prime lending business provided 73% of profit in 2017 and 109% of 2016 profit—meaning that the company would have lost money without these ancillary income streams.

But these items bear significant, under-appreciated risks.

Fanhua holds 20.58% of the newly listed subsidiary, CNFinance Holdings, which provides home equity loans to mostly sub-prime borrowers. "We typically facilitate home equity loans to MSE [Micro and Small Enterprise] owners in the form of installment loans with a monthly contractual interest rate typically ranging from 0.9% to 1.3," says the company in its prospectus. That means about 15% per year.

Fanhua's share in CNFinance provided the company with ¥108 mln in 2017, fully

Chart 1. Profit from Investment and Interest Income (in proportion of profit. LHS, and mln RMB, RHS)

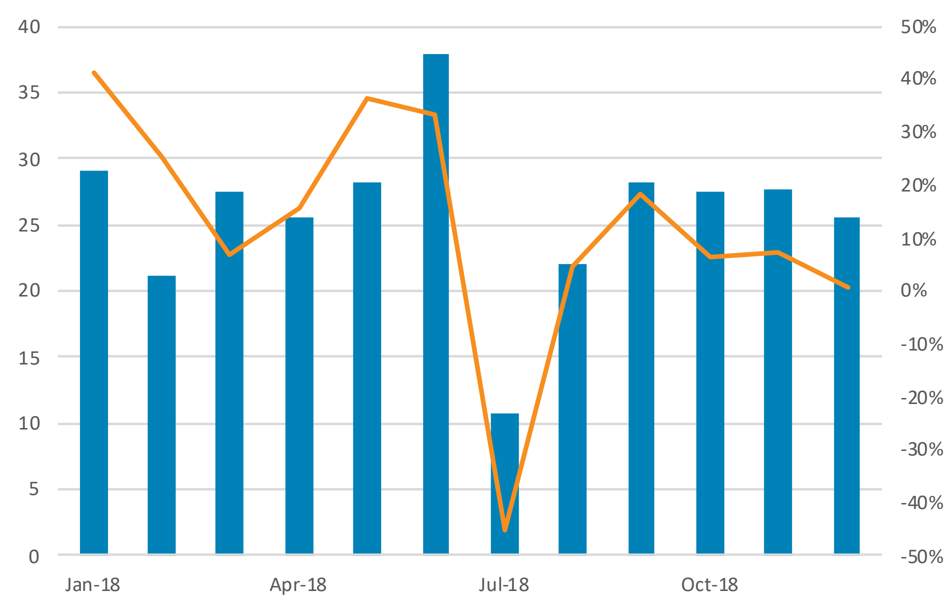


Source: Company disclosures, J Capital

24% of profit. But this income is highly vulnerable. Housing sales in China have slowed dramatically, and default rates on loans are rising. The types of second-lien loans that CNFinance issues and securitizes are at the bleeding edge of risk.

Partial reports for January 2019 indicate sharp sales declines; China's largest developer, Vanke, reported a 28% decline in sales in January by area. Growth at China's

Chart 2. Top 25 Listed Developers Sales Volume (mln sq m and YoY)



Source: Listed company reports

top 25 developers decelerated through 2018 from 41% growth in January to less than 1% in December.

CNF discloses a fast-rising delinquency ratio, which they said topped 12% in Q3 2018: “The delinquency ratio for loans originated by us increased from 5.38% as of December 31, 2016 to 7.17% as of December 31, 2017, 11.49% as of June 30, 2018 and further to 12.07% as of September 30, 2018.” (CNF prospectus, page 29)

Investment income

“Investment income” is the most concerning portion of Fanhua’s statements and yet provides the highest yield, contributing ¥191 mln to Fanhua’s profit in 2017, 43% of the total. The investment income represents a 7.7% return on Fanhua’s short-term investments, which are currently ¥2.5 bln. Assuming that these short-term investments are actually real and recoverable—dubious, in our view—the high return suggests that the company has put its money into risky private investments that do not have an implicit or explicit guarantee. Wealth management products sold by banks are at best returning 4% currently. Here is a sample:

Table 1. Bank Wealth Management Products

Product Name	Issuer	Term (Days)	Estimated Annual Yield
2019 Postal Savings Bank WMP No. 33 (VIP Tranche)	China Postal Savings Bank	180	4.05~4.05
2019 Qianyuan-Furun Xiaoxiang (Hunan Branch) No. 50 (Spring Festival exclusive) WMP	China Construction Bank	161	4.16~4.16
2019 Delibao Bank of Communications Benefit-Earning Welcoming the New WMP	China Communications Bank	109	~4.35
2019 Delibao II	China Communications Bank	191	~4.35
2019 Delibao No. 17	China Communications Bank	91	~4.60
2020 Delibao 91-Day Shanghai Exchange WMP	China Communications Bank	91	~4.15
2021 Delibao 63-Day Shanghai Exchange WMP	China Communications Bank	63	~4.10
2022 Delibao 364-Day Shanghai Exchange WMP	China Communications Bank	364	~4.20
2023 Delibao 30-Day Shanghai Exchange WMP	China Communications Bank	32	~4.05
2024 Delibao 182-Day Shanghai Exchange WMP	China Communications Bank	182	~4.15
2019 Yuntong Fortune 91-Day WMP	China Communications Bank	91	4.10~4.10

Product Name	Issuer	Term (Days)	Estimated Annual Yield
2020 Yuntong Fortune 7-Day WMP	China Communications Bank	7	3.40~3.40
2021 Yuntong Fortune 63-Day WMP	China Communications Bank	63	4.00~4.00
2022 Yuntong Fortune 28-Day WMP	China Communications Bank	28	3.90~3.90
2023 Yuntong Fortune 14-Day WMP	China Communications Bank	14	3.60~3.60
2019 Yuntong Fortune Longterm Pension 98-Day WMP	China Communications Bank	98	4.00~4.00
2020 Yuntong Fortune Longterm Pension 70-Day WMP	China Communications Bank	70	4.00~4.00
2021 Yuntong Fortune Longterm Pension 42-Day WMP	China Communications Bank	42	3.90~3.90
2022 Yuntong Fortune Longterm Pension 364-Day WMP	China Communications Bank	364	4.15~4.15
2023 Yuntong Fortune Longterm Pension 189-Day WMP	China Communications Bank	189	4.15~4.15

Source: Wind

Banks are currently offering 1,117 wealth-management products, according to the data company Wind. The highest-yielding product is expected to provide 4.2% in annual returns. In fact, the only products offering such a high return are products issued by related party Chengchuang. For example, the Chengchuang Yujin M&A Private Equity Trust No. 3[6] offers an expected "basic return" of 8.5%.

Chengchuang Fund Offering

Source: Fanhua sales

[6] Listed on this website: http://pof.people.com.cn/fund/info?name=%E6%89%BF%E5%88%9B%E8%A3%95%E9%94%A6%E5%B9%B6%E8%B4%AD3%E5%8F%B7%E7%A7%81%E5%8B%9F%E8%82%A1%E6%9D%83%E6%8A%95%E8%B5%84%E5%A5%91%E7%BA%A6%E5%9F%BA%E9%87%91

Fanhua would have investors believe that the investment income derives from high bank balances sitting in money market accounts. The 20-F disclosure from 2017 reads as follows:

> Investment income represents income received from short term investments in collective trust products and interbank deposits. Our investment income increased by 66.4% from RMB115.3 million in 2016 to RMB191.8 million (US$29.5 million) in 2017. The increase was primarily attributable to more high return short term investment products in 2017. (2017 20-F page 61)

But our interviews with Fanhua employees indicate that Fanhua may itself be managing customer funds. Employees described investment products that Fanhua offers for sale to its own employees. The company promises an annualized return of 7% on a six-month investment of ¥100,000 and 8% on ¥300,000.

“Fanhua definitely makes a return on its trusts,” said a Fanhua Insurance employee in Hebei Province, specifying that Fanhua earns a return, not just a sales commission. Companies acting strictly as sales agents do not receive a return; they are paid only a commission on sales. The returns are 6.3-8%, the employee said, depending on the type of trust product. The highest yield comes from a consumer receivables derivative trust.

Fanhua insurance agents are selling financial derivatives designed by company co-founder Lai Qiuping. We visited the offices of his Chengchuang Investment Company.[7]

The Guangzhou office tower where Chengchuang has its operations. Photo by J Capital December 7, 2018

[7] The Chinese characters are 承创（深圳）投资有 限公司

There, we obtained a list of 40 investment products that Chengchuang is selling to the public. Chengchuang staff emphasized that the whole Fanhua insurance sales network sells these products.

Chart 4. Chengchuang M&A Funds: Partial List

编号	基金名称	私募基金管理人名称	托管人名称	成立时间	备案时间
1	[illegible]	诚创（深圳）投资有限公司	国信证券股份有限公司	2017-01-18	2017-01-20
2	[illegible]	诚创（深圳）投资有限公司	国信证券股份有限公司	2017-02-23	2017-02-28
3	[illegible]	诚创（深圳）投资有限公司	国信证券股份有限公司	2017-03-09	2017-03-18
4	[illegible]	诚创（深圳）投资有限公司	中信证券股份有限公司	2017-04-17	2017-05-16
5	[illegible]	诚创（深圳）投资有限公司	中信证券股份有限公司	2017-04-28	2017-05-23
6	[illegible]	诚创（深圳）投资有限公司	中信证券股份有限公司	2017-05-17	2017-06-29
7	[illegible]	诚创（深圳）投资有限公司	中信证券股份有限公司	2012-08-06	2017-07-13
8	成都创佳瑞企业管理合伙企业（有限合伙）	诚创（深圳）投资有限公司	中信证券股份有限公司	2016-12-31	2017-09-01
9	[illegible]	诚创（深圳）投资有限公司	中信银行股份有限公司	2017-11-15	2017-12-18
10	[illegible]	诚创（深圳）投资有限公司	上海浦东发展银行股份有限公司	2018-01-10	2018-01-20
11	[illegible]	诚创（深圳）投资有限公司	上海浦东发展银行股份有限公司	2018-01-31	2018-02-08
12	[illegible]	诚创（深圳）投资有限公司	上海浦东发展银行股份有限公司	2018-02-28	2018-03-16
13	[illegible]	诚创（深圳）投资有限公司	上海浦东发展银行股份有限公司	2018-03-08	2018-03-16
14	[illegible]	诚创（深圳）投资有限公司	上海浦东发展银行股份有限公司	2018-03-22	2018-04-03
15	[illegible]	诚创（深圳）投资有限公司	上海浦东发展银行股份有限公司	2018-03-22	2018-04-03
16	[illegible]	诚创（深圳）投资有限公司	上海浦东发展银行股份有限公司	2018-05-07	2018-05-16
17	[illegible]	诚创（深圳）投资有限公司	上海浦东发展银行股份有限公司	2018-05-07	2018-05-17
18	[illegible]	诚创（深圳）投资有限公司	上海浦东发展银行股份有限公司	2018-05-23	2018-06-05
19	[illegible]	诚创（深圳）投资有限公司	上海浦东发展银行股份有限公司	2018-06-12	2018-06-25
20	[illegible]	诚创（深圳）投资有限公司	上海浦东发展银行股份有限公司	2018-06-12	2018-07-05

A screenshot showing some of the Chengchuang investment products for sale by Fanhua. The characters highlighted in yellow say "Chengchuang" and the middle column provides Chengchuang Shenzhen's full corporate name. | Source: Fanhua employee

Fanhua insurance company sales staff confirmed that they sell these products. They also sell funds designed by another Lai company called Chengdu Chuangjiarui.[8] A member of the sales team of Fanhua Lianxing told us that her team sells Chengchuang private equity and trust products, funds managed by Puyi Fund (55.5% owned by Lai Qiuping's Chengchuang and 31.1% owned by Yang Lin), and Puyi Investment products (Fanhua Puyi Investment Management Co. Ltd. is 83.78% owned by Fanhua executive Yu Haifeng and 15.4% owned by Fanhua).

Fanhua sales agents told us that these fund products represent a small portion of sales but a very high proportion of net income and sales agent commissions. The salespeople we interviewed commented that financial products generally require an investment of ¥1 mln, while insurance policies cost a few thousand, so even though the volume of insurance policy sales may be much greater, investment products represent a high proportion of sales in terms of value. The fund companies and insurance sales agents generally share offices, making it easy for the

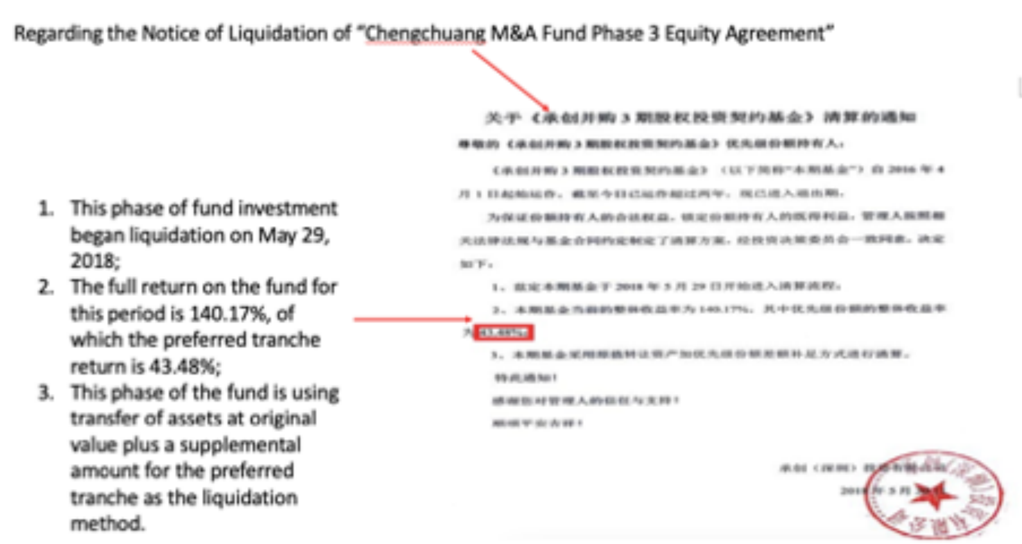
[8] The Chinese characters are 成都创佳瑞企业管理合 伙企业（有限合伙）

insurance agents to sell financial products. When an insurance client buys a financial product, a fund company staff member will open an account for him or her and book the sale for the fund company, although the insurance agents receives a commission. Co-location and inter-changeability of offices and staff mean that fund sales have become an integral portion of the Fanhua business. Sales of investment products are highly vulnerable to China's volatile business cycle. We think Fanhua's insurance sales business has shrunk, and the company is desperately trying to make up for the deficit with these investment products.

The product descriptions being offered to fund clients are vague in the extreme. Chinese readers can see the product list on the website of the Guangdong AMC; descriptions are limited to product names, such as "equity fund phase 1" or "M&A fund phase 10." Most of the products are short-term, and all are described as private equity funds. While this might look unremarkable to international investors, the impression is misleading: the bland descriptions hide bundles of very risky securities that, we believe, are mostly invested in Fanhua's own business. That amplifies the risk of investing in Fanhua.

Returns claimed for these investment products are as high as 145%.

Chart 5. Chengchuang's Outsized Returns



A notice from Chengchuang company confirming the return on one of its private equity products.
Source: A Fanhua investor

CC Investment Co., Ltd　　承创并购基金 1 期股权投资契约基金

关于《承创并购基金 1 期股权投资契约基金》清算的通知

尊敬的《承创并购基金 1 期股权投资契约基金》优先级份额持有人：

《承创并购基金 1 期股权投资契约基金》（以下简称"本期基金"）自 2016 年 2 月 4 日起始运作，截至今日已运作超过两年，现已进入退出期。

为保证份额持有人的合法权益，锁定份额持有人的既得利益，管理人按照相关法律法规与基金合同约定制定了清算方案，经投资决策委员会一致同意，决定如下：

1、兹定本期基金于 2018 年 4 月 23 日开始进入清算流程；

2、本期基金当前的整体收益率为 138.95%，其中优先级份额的整体收益率为 43.65%；

3、本期基金采用原值转让资产加优先级份额差额补足方式进行清算。

特此通知！

感谢您对管理人的信任与支持！

A liquidation notice for the Chengchuang Equity M&A Fund No. 1, claiming a return of 139% for ordinary investors and 43.7% on the preferred tranche. | Source: Fund investor

"Fanhua is the owner of these trust products," said a manager Puyi Wealth Management, in which Fanhua owns a stake and whose financial products Fanhua sells. "If there is a default, Fanhua will make the payment. But that won't happen."

Interest income

Fanhua's interest income computes to 6% of its cash and restricted cash balance, a return that is much higher than any bank could be providing. As shown above, banks at most are offering 4.2% on investments locked up for a year.

Fanhua is a weak player that has built the company by acquiring sales agencies all over China. But those agencies have no good reason to affiliate with Fanhua unless Fanhua provides superior payment. Payments to executives, whether for equity shares in companies or via share incentive plans, create incentive for sales agencies to remain part of the Fanhua network. But Fanhua, in an effort to improve share price by claiming high profitability, hides those transactions.

Now Fanhua, having lost the bulk of its business, is trying to make up for its weakness by wading into the riskiest portion of China's property market. We believe investors should flee this risky company.

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