JCAP

Finance
China

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Company Update

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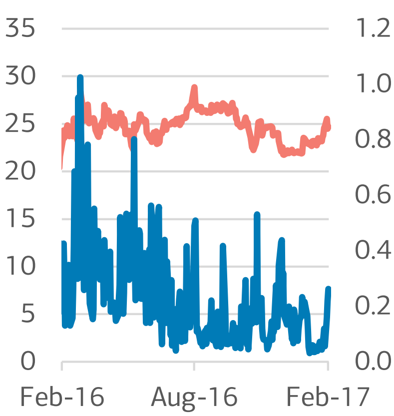
Noah Holdings Ltd.(NOAH US)

Price	USD 25.25
Market cap	USD 1.39 bln
Rating	**SELL**
Target Price	**USD 0.00**
P/E	15.25x
S/I	3.7 mln shares

Noah Holdings Ltd. (NOAH US) last share price in USD (left, pink) and volume in mln shares (right, blue)



Source: Bloomberg February 15, 2017

Noah Holdings Ltd. (NOAH US)

Messengers Always Get Killed

- **Good until it's not:**
  Noah may have another two to three quarters before defaults catch up. The growth in assets without a matching growth in income is a warning sign.

- **WMPs declining:**
  In January through September, Noah sold only 2.9% more WMPs while selling 49% more of the higher-yield, riskier private equity products. Most of those PE sales are for their own funds and higher inducements offered indicate that the P/E investments may be in trouble.

- **Q1 opportunity or risk?**
  Credit surged in January, sending housing prices and commodities markets up. Interest rates rose. While risks mount, returns are also higher.

- **Valuation:**
  We recommend that clients SELL Noah and we have a price target of 0. We choose this price target because we believe that in a financial crisis, Noah will share responsibility for defaults and be required to make good from its own balance sheet. The claims could wipe out equity. But the moment to short may not come until H2.

Yield has plummeted. It is likely that Noah is selling more money into the private equity funds to cover maturities that the underlying projects cannot pay.

Stalking Horse for a Financial Crisis

Noah Holdings will probably underperform expectations when it reports Q4 results on the evening of February 27 in the U.S. (February 28 9 am China time). Q1, given the surging credit we saw in January, may be better. But beware: despite the company's claim that, as a sales agent, it is merely the messenger, in a financial crisis, Noah will be shot.

The Q3 results contained some warning signs: while assets under management rose by 49%, net income was up by only 8.7% and recurring service fees—representing Noah's share of the profit from assets under management—rose by only 7.9% year-on-year. In other words, yield has plummeted. It is likely that Noah is selling more money into the private equity funds to cover maturities that the underlying projects cannot pay.

Furthermore, most of the income in Q3 came from one-time commissions. Performance-based income declined, as did Noah's sales of wealth-management products (WMPs), down 8.3% YoY. That is important, because, relative to private equity, WMPs are more liquid and secure. That means that the P/E funds are likely offering higher yields in order to attract money.

Most of Noah's RMB 114.8 bln in assets under management are invested, in one way or another, in highly illiquid real estate projects. Real estate in China continues to rise to heady and, indeed, completely unrealistic values related more to liquidity in the economy than to real demand or affordability. Real estate, being the collateral for the vast majority of the loans in China's financial system, is continually supported by monetary and banking authorities. The bubble has lasted far longer than almost anyone anticipated, But it will not last forever, and when it goes, so will Noah.

Although several mutual funds still hold positions in Noah, the sell side has more or less abandoned coverage and the company is almost completely un-shortable. Smaller, mostly Chinese funds joined the Q3 call. The analysts asked shrewd questions. For example, Bo Lun Tang of CICC:

> "Despite a strong growth in the AUM for the first three quarters … it seems like the average recurring service charge as AUM has decreased."

CFO Shang Chuang's response:

> "We have actively managed the acceleration maturity of many of our direct real estate funds ... And so on a blended weighted average rate, our management fees has actually come down."
>
> Seeking Alpha transcript

In other words, Noah is worried about real estate and has tried to secure early payment and probably accepted lower returns as a consequence.

In general, Noah's disclosures are confusing, changing, and incomplete. It is impossible to know what lies under the hood of the many affiliated private equity companies with similar names, the Gophers and the Gofers. The simplest and most reliable way to look at Noah is through a jaundiced eye, knowing that the chimerical values in China's real estate market will ultimately all come tumbling down.

Valuation

We believe that Noah has built a strong salesforce. But the notion that the company will bear no responsibility for the inevitable default of many of its own private equity products strikes us as a dream not unlike believing in the Tooth Fairy. China's financial authorities typically seek negotiated solutions to defaults that do not rest on strict legal responsibility, and Noah's connection with its bulging Gopher and Gofer affiliates will not go unnoticed. Additionally, angry investors will inevitably seek redress, and Noah, as a private company, is an easy target. If you believe that China faces a financial crisis, Noah is not investable.

Risks

Credit rose sharply in January, and China's financial economy is again overheating. Each such cycle only adds to the risk of a general financial crisis. But before that happens, sales by Noah and returns to the P/E investments could be good.

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