

E-House

Greentown China Holdings: Moving toward an Asset-light Business Model



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Rising land prices and tighter macro-level policy controls over housing purchases are putting pressure on real estate developers in China. Many have sought alternative solutions to the industry's traditional asset-heavy business model to cope with an increasingly challenging development environment. One strategy growing in popularity has been the asset-light business model. Greentown, one of China's largest real estate companies, has been a market leader in making this transition. Drawing on its construction management business especially, the company has leveraged this competitive advantage to provide third-party construction and project management services in exchange for development fees. Greentown's case provides valuable lessons in corporate strategy and positioning under changing market conditions.

Greentown: Past to Present

Established in 1995, Greentown China Holdings is a vertically integrated real estate enterprise with headquarters in Hangzhou, China. The company has five unique, yet complementary business units. These include "Greentown Real Estate," which focuses on investment projects; "Greentown Project Management," which focuses on non-investment project management, and includes sale of its expertise in branding, management and resource strategy; "Greentown Town Development," which focuses on developing master-planned communities; "Greentown Asset Management,"

the non-real estate investment arm of Greentown; and finally "Greentown Ideal Life," the company's living services platform.

Greentown went public on the Hong Kong Stock Exchange in July 2006 with an IPO price of 8.22 Hong Kong dollars per share. As of June 30, 2017, Greentown has a premium land inventory of more than 30.57 million square meters, with approximately 45% in China's coastal Zhejiang province. During the first half of 2017, Greentown China realized a net profit of 1.3 billion RMB, an impressive 56% increase from the same period last year.¹

¹ "Greentown 2017 Interim Report" June 30, 2017. Accessed March 18, 2018. <http://www.irasia.com/listco/hk/greentownchina/interim/2017/intrep.pdf>

Exhibit 1: Greentown land bank summary – June 2017

REGION	# OF PROJECTS	TOTAL GFA	% OF GFA
Hangzhou	19	4.59	15.0%
Zhejiang (excl. Hangzhou)	31	9.02	29.5%
The Yangtze River Delta Area (excl. Zhejiang)	6	1.50	4.9%
The Bohai Rim Area	19	9.81	32.1%
The Pearl River Delta Area	3	0.73	2.4%
Others	13	4.16	13.6%
Overseas	1	0.76	2.5%
Total	92	30.57	100.0%

Source: "Greentown 2017 Interim Report" June 30, 2017. Accessed March 18, 2018. <http://www.irasia.com/listco/hk/greentownchina/interim/2017/intrep.pdf>

The company is known for its high-end residential projects, unique architectural aesthetics and customer-focused services. Different from competitors, Greentown targets only premium projects and signals its commitment to this segment with the slogan, "No. 1 integrated service provider for an ideal life." For the past 14 years, Greentown has been consistently ranked among the top 10 Chinese real estate company brands with a brand value of 29 billion RMB.²

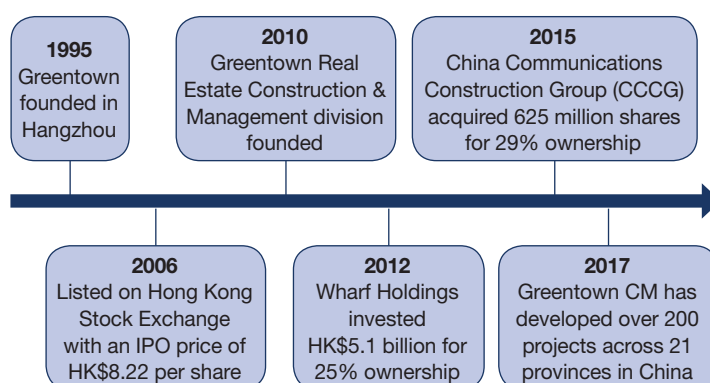
The success of the company and its brand recognition has everything to do with the company's now-famous founder Song Weiping, who has a rather unique and somewhat artistic view of real estate development. From the start, he claimed that "product equals personality," meaning a developer's personality manifests itself in the types of projects created.³ This perspective has served as a guidepost for Greentown from its inception.

Song's obsession about quality and aesthetics is what ultimately distinguishes Greentown as a top-notch brand. Even so, continual innovation and upgrading of Greentown projects also led to a shrinking pool of buyers with the financial capacity to afford its products. This has made the firm quite vulnerable at key moments,

most notably during 2009 when large land acquisitions, combined with tightening government regulations, resulted in a financial crisis at the firm. Unable to react quickly to mounting pressure, Greentown had to take on additional partners.

In June 2012, Wharf Holdings invested approximately HK\$5.1 billion (4.2 billion RMB) in Greentown as a strategic partner in exchange for a 25% stake. In March 2015, China Communications Construction Group (CCCC) acquired approximately 525 million shares for HK\$6 billion, and subsequently acquired an additional 100 million shares. Today, CCCC holds 29% of total issued shares in Greentown, making it the company's single largest shareholder.⁴

Driven by the need to recover from financial turmoil, Song and his management team reassessed Greentown's existing business model, and ultimately decided to transition toward an asset-light business model. The result was the creation of Greentown Real Estate Construction & Management Group (Greentown CM).

Exhibit 2: Timeline of key events in Greentown's corporate history

Not every developer is willing to focus on construction management. Not only is it a tough sector to enter, but without the benefit of earnings from the land premium, construction management has a much lower profit margin compared to traditional development. Moreover,

² "Greentown 2017 Interim Report" June 30, 2017. Accessed March 18, 2018. <http://www.irasia.com/listco/hk/greentownchina/interim/2017/intrep.pdf>

³ "The Tragedy of Greentown" June 18 2014. Accessed March 18, 2018. <http://finance.sina.com.cn/chanjing/gsnews/20140618/092219446701.shtml>

⁴ "Greentown 2017 Interim Report" June 30, 2017. Accessed March 18, 2018. <http://www.irasia.com/listco/hk/greentownchina/interim/2017/intrep.pdf>

the complexity of project management increases significantly for advisors since they lack control over key decisions but still must satisfy customer demands. In addition, the work of construction management has high barriers to entry. It requires a company with sufficient resources, strong brand equity, and management capability.

At the start, Greentown’s strongest competitive advantage was its premium quality product and strong brand image. Financing scarcities and excess capacity constrained the company’s capability for further growth. As a result, Greentown’s production cycle was sub-optimal. In September 2010, Greentown CM was established as a wholly owned subsidiary and the first asset-light real estate development platform in China.

In September 2015, Greentown CM transitioned from being a platform to a distinct enterprise, offering its services across China. As of December 2017, Greentown CM has developed more than 200 projects across 21 provinces. In 2017 alone, the company signed on 38 new projects in cities such as Shanghai, Xi’an, Chengdu and Sanya, reaffirming its leadership position in the construction management industry.⁵

Industry Backdrop

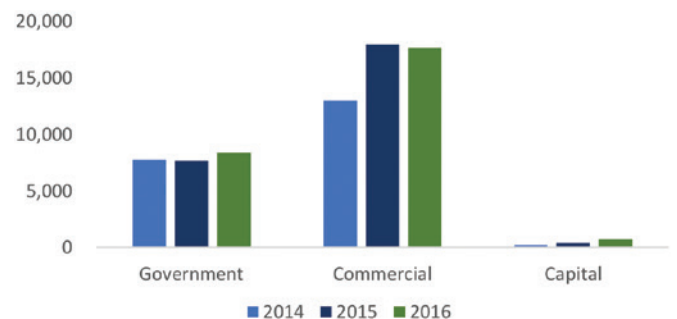
China’s real estate industry has changed rapidly over the past 20 years. With an increasing number of players, industry concentration, and tightening government regulations, the traditional asset-heavy development model is no longer as lucrative, and in some aspects, more risky than in the past. As a result, many of China’s largest, long-standing real estate developers are restructuring their businesses from an asset-heavy model toward one that is asset-light, and by way of emphasis on such intangibles as brand value, management capacity, and advisory services.

In contrast, traditional real estate development is largely “construction-centered,” meaning that a construction

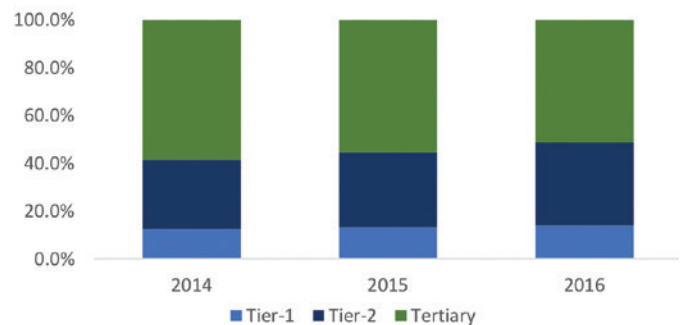
company takes charge of every stage of a project development process, starting from land acquisition, to construction, sales, and ultimately property management. This has resulted in repetitive designs and lack of innovation, which supports rapid scaling, but not market differentiation. To remain competitive, the real estate industry has begun to specialize in new ways, and most notably through the separation of real estate

Exhibit 3: Construction management landscape

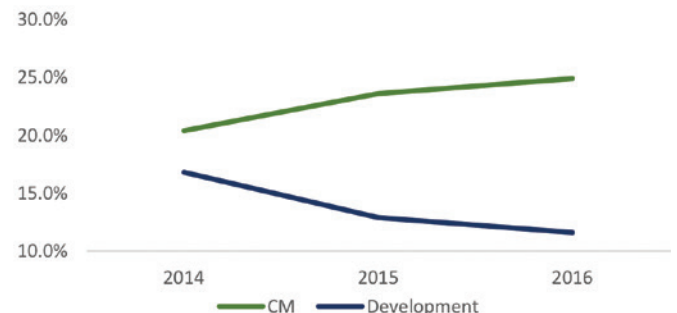
CONSTRUCTION MANAGEMENT BY SOURCE ('000 SQM)



CONSTRUCTION MANAGEMENT BY CITY TYPE



CONSTRUCTION MANAGEMENT VS. DEVELOPMENT PROFITABILITY



Source: E-House Internal Research: Page 18-19. Accessed March 18, 2018.

⁵ “Greentown Construction and Management Ltd. targets certain key cities for its strategic initiatives”. January 26, 2018. Accessed March 18, 2018. <http://stock.jrj.com.cn/2018/01/26122224011889.shtml>

investment and real estate development functions, similar to what exists in the U.S. today.

With an influx of institutional capital from insurance companies and other investment funds, the real estate market also has had to evolve to service these new investor types. Given fiduciary responsibilities, these investors want to have a more active role in how their capital is utilized, but they often lack industry expertise. For this reason, institutional investors have sought partnerships with experienced developers, a dynamic that has fueled growing divisions of labor between those in the land acquisition, property development, and the property management businesses.

All to say that broad macro-level changes in terms of land prices, cost of capital, greater policy restrictions, and investor types have created growth opportunities in the construction management industry.

Leveraging Competitive Advantage

Even before Greentown's construction management platform was established, the company had tested its abilities in this segment. In 2005, for example, Greentown had partnered with the Hangzhou city government on a large-scale redevelopment project, called the "Village-within-the City." That experience inspired Song to reconsider the value of the Greentown brand, and in 2008, he launched Greentown's construction management platform.⁶

Although rooted in Greentown's existing reputation as a top-notch builder, the construction management platform set the stage for the company to scale in a new, less risky way. Specifically, by focusing solely on the development process and project management, Greentown was able to work around its capital constraints. To put this in context, in 2009 Greentown's

total asset base was only half of China's other large developer, Vanke.⁷ Given this, trying to compete against firms that had bigger balance sheets, cheaper cost of capital, or greater land banks was a losing proposition. Greentown instead increasingly looked to generate revenue from what it does especially well, which is design, development and service.

This shift in strategic focus has created meaningful growth in Greentown's operations. As of December 2017, the total number of projects managed by Greentown CM reached 190 with a planned total GFA of approximately 44.53 million square meters and estimated sales value of approximately 300 billion RMB.⁸

Greentown's Asset-light Model

In some ways, Greentown's construction management business model is similar to a franchise model. Specifically, a client hires Greentown to bring its brand and management team to a given project. The Greentown brand attracts retail consumers of high-end housing. The company's project management capabilities simultaneously allow it to commercialize its services by making them available to a developer for a fee. In exchange, Greentown typically assumes responsibility for initial planning and design, construction, budget control, sales and property management services. The client is responsible for providing capital for the entire project, has sole decision rights on the investments and also takes full responsibility for market and non-market risks.

During a project's initial stage, which is often the most substantive part of an entire project, Greentown analyzes the client's needs, and selects and designs products that meet Greentown's brand standards. Thus, Greentown initially serves as a consulting firm that bridges the gaps among a client's needs, market demand, and industry

⁶ E-House Internal Research: Page 2. Accessed March 18, 2018.

⁷ "Greentown 2009 Annual Report" December 31, 2009. Accessed March 18, 2018. <http://www.greentownchina.com/eng/ir/report/ar2009.pdf>; "Vanke 2009 Annual Report" December 31, 2009. Accessed March 18, 2018. <http://www.vanke.com/en/UploadFile/2012-03/60b7263f-a4d9-41a0-840d-17d230529eb5.pdf>

⁸ "Greentown 2017 Interim Report" June 30, 2017. Accessed March 18, 2018. <http://www.irasia.com/listco/hk/greentownchina/interim/2017/intrep.pdf>; Greentown company website, "About Us." Accessed May 1, 2018. <http://www.greentownchina.com/eng/about/company.php>

knowledge. Greentown also has its own standards when it comes to project selection, including city location, market fundamentals and a client's needs. For example, to maintain brand quality, Greentown will not accept projects in cities with an average property sales price of less than 6,000 RMB per square meter.⁹

Greentown has also benefitted from good timing. Urbanization in China has increased dramatically over the past 20 years, accompanied by growing incomes and interest in high-quality housing. The decision to move to an asset light model of scaling has enabled Greentown to expand its reach nationally in response to these market drivers.

Three Main Business Lines

Greentown's full-service construction management business now includes three main customer segments -- small and medium-sized developers, government, and institutional real estate investors. These clients have increasingly turned to Greentown to boost the brand value of their projects.¹⁰

Small and medium-sized developers especially have limitations when it comes to their brand, product and management platform. One of their biggest challenges is a cash drag on their land inventory, which is inevitable if their projects cannot compete with larger developers and project completion timelines are too slow. Greentown's construction management offers a solution, and results in a premium product that typically yields higher profits.

Another major customer group are those institutional real estate investors who leverage their strong balance sheets to acquire land, but then need help developing projects. Here again the issue of good timing matters. Institutional investors have become a dominant force in China's real estate industry, and with this a need for developers to service the capital markets, as opposed to just acquiring equity investors. Some of these investors

hope to better control development risk through collaboration with Greentown and to turn around sub-performing assets. Others hope to improve the skills of their internal teams through partnership with Greentown.

Also, government agencies have become a customer group for Greentown's construction management arm. These government agencies have abundant land resources, but few view real estate as their main line of business or core competence. Outsourcing the development function of land assets is the natural solution.

In addition to offering its client base full-service construction management services, Greentown also offers project development consulting services. Customers have engaged Greentown on a wide variety of projects, from senior living facilities, to master-planned communities, product positioning, and architecture and design. Finally, Greentown does offer a line of specialized development services, that include not only project management, but also sales and project financing.

In effect, prospective customers can partner with Greentown on any part of their development project where professional expertise is needed.

Fee Revenue Business Model

Different from Vanke, whose construction management takes the form of minority ownership, Greentown CM charges only development fees. Greentown's management believes that minority ownership is an interim approach to help mitigate issues such as lack of trust or standardized service contracts, but is not a sustainable business model. Greentown instead operates under a pure development fee model.

Under this structure, Greentown CM charges three types of development fees. They are 1) base salaries and compensation; 2) development fee based on project scale and process; and 3) sales incentive fees. The

⁹ E-House Internal Research: Page 7. Accessed March 18, 2018.

¹⁰ "Greentown's house building unit plans overseas IPO" March 19, 2017. Accessed March 18, 2018. <http://www.scmp.com/property/hong-kong-china/article/2080282/greentowns-house-building-unit-plans-overseas-ipo>

first fee includes primarily the team's base salary, social security and other benefits. Development fee accounts for the majority of the revenue, and is linked to the scale of the project. Lastly, there are sales incentive fees. Greentown will negotiate a pricing mechanism through which Greentown earns a percentage on any excess profit created.

Focusing on Top-tier Cities

Greentown's construction management business far exceeded expectations, achieving considerable scale in a short period of time. With it came the challenge of maintaining quality control and proper management oversight. After all, real estate development is a labor-intensive business and the quality of subcontractors can vary drastically from market to market.

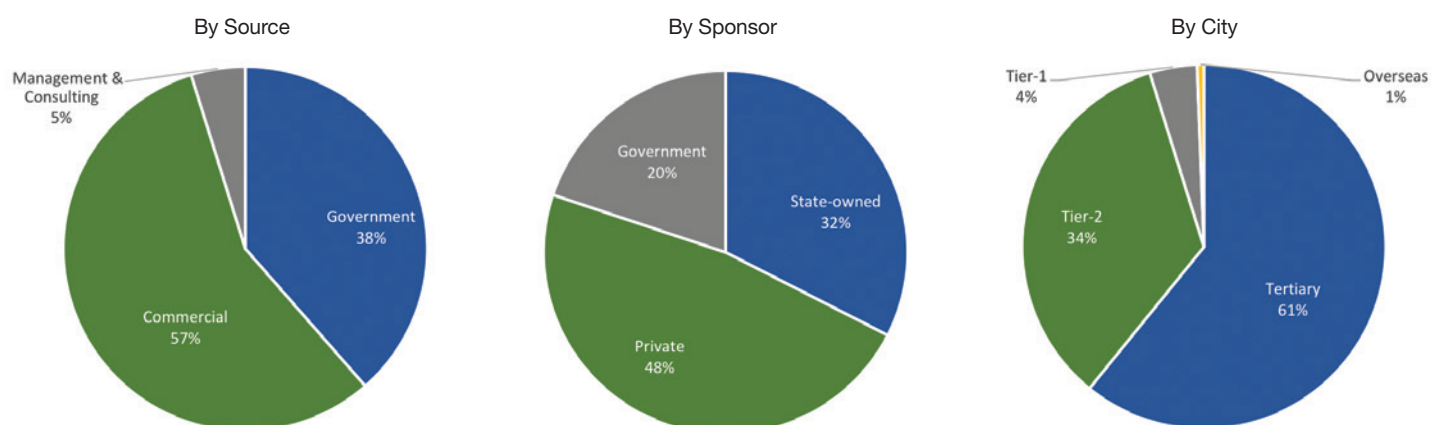
To maintain brand quality and ensure sustainable growth, Greentown has begun to implement a plan to prune its portfolio. Specifically, Greentown plans to shift its project focus to Tier-1 and Tier-2 cities, and will increasingly focus on clients with stronger financial backing such as

state-owned enterprises and government agencies. In addition, Greentown will selectively participate in certain city redevelopment projects.

Currently, Greentown's construction management projects are spread across Tier-3 and Tier-4 cities on the East Coast of China, and comprising around 60% of Greentown CM projects.¹¹ Due to the capacity constraints in these cities, Greentown CM is unable to contribute more meaningfully to the growth of its overall platform. The company plans to focus future construction projects on 15 major cities such as Beijing, Shanghai, Guangzhou and Shenzhen and organically exit its existing projects in tertiary cities to "upgrade" its portfolio.¹²

The other "upgrade" initiative will focus on the financial capacity of the clients. Greentown aims to transition from servicing mostly private companies to, as mentioned, state-owned enterprises and government agencies, which account for around 52% of Greentown CM's total projects.¹³ In an increasingly challenging market environment, companies with sufficient capital and

Exhibit 4: Greentown project composition



Source: E-House Internal Research: Page 28. Accessed March 18, 2018.

¹¹ E-House Internal Research: Page 28. Accessed March 18, 2018.

¹² "Greentown bids farewell to the simple housing sales model". September 1, 2016. Accessed March 18, 2018. <http://news.fang.com/2016-09-01/22683043.htm>

¹³ E-House Internal Research: Page 28. Accessed March 18, 2018.

strong government connections will be able to weather the storm and provide continued deal flows.

An Overseas IPO?

Another key initiative for Greentown's management is to access permanent capital sources through the public markets to accelerate the growth of Greentown CM. According to Greentown General Manager Li Jun, Greentown CM is seeking an IPO overseas in the near future. Management believes that the "builder" sector, while currently small in China, has huge potential for growth. In the U.S., this sector accounts for 30% of the real estate market while in China it is less than 2%.¹⁴ As the first dedicated construction management company in this space, Greentown CM has strong growth potential to further scale the business once the company gains access to permanent capital. From a capital markets perspective, asset-light real estate businesses are also valued much more favorably compared to the traditional asset-heavy firms, which bodes well for Greentown.¹⁵

Potential Challenges for Future Growth

While Greentown is well positioned for the future by way of its asset-light business model, it does face certain challenges in the near term. The company's competitive advantage has been its brand value and product quality. This brand value, however, was accumulated through its initial investment projects wherein Greentown had total control over every step of the development process. By shifting toward an asset-light model, Greentown now lacks control over major decisions, which can create a quality control issue on the final product delivery and could slowly dilute Greentown's brand. If the company is unable to enforce tight quality control mechanisms to ensure consistent project delivery, Greentown would lose the one advantage that sets it apart from its competitors.

¹⁴ "Greentown's house building unit plans overseas IPO" March 19, 2017. Accessed March 18, 2018. <http://www.scmp.com/property/hong-kong-china/article/2080282/greentowns-house-building-unit-plans-overseas-ipo>

¹⁵ E-House Internal Research: Page 29. Accessed March 18, 2018.