E-House

Beating the Giants: Zhongliang's Strategy for Growth

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Stories of success in China's real estate market invariably come from the country's largest firms. But not always. The stunning rise of China's Zhongliang Group Limited is one such exception. Its triumph is a reminder that strategy, not scale, anchors a firm's competitiveness. Perhaps nowhere is this belief more evident than in China's heated real estate sector. Zhongliang, founded in China's entrepreneurial heartland of Wenzhou, experienced rapid national expansion driven by a novel business model, as it also strategically benefited from the central government's interest in improving the quality of homes in China's small- to mid-sized cities.

CHINA'S REAL ESTATE BOOM

During the 18th Party Congress in 2012, the government passed regulations that helped developers clear their housing inventory, and fuel urbanization.[1] Policy makers lowered interest rates, reduced down-payment requirements, and loosened residency criteria so more eligible buyers in major cities could acquire property. While buyers' eligibility generally was tied to their place of legal residency (*hukou*), local governments were allowed to reform their own residency requirements in a bid to open up their respective real estate markets. As a result, Chinese real estate developers experienced a growth frenzy in the mid-2010s.

However, China's excess housing inventory has remained an issue. Local governments were encouraged to buy up inventory for their own use, perhaps to create affordable urban housing.[2] But with home prices staying high, local governments came under fire. After all, the absence of affordable housing meant that the urban poor have to live in sub-par housing.

1 Dominic Chiu, "Housing Bubble, Politics and Trouble: Problems and Policies for China's Real Estate Market."
2 Ciemniak, Robert. "How Oversupplied Is China Housing Market Really?" Forbes. January 13, 2016. Accessed February 11, 2019. https://www.forbes.com/sites/robertciemniak/2016/01/12/how-oversupplied-is-china-housing-market-really/#59b76f127a74.

In 2015, the government launched its 'slum area reconstruction' policies, specifically targeted at Tier 3, Tier 4 and other lower-tier cities. This initiative provided two growth levers for the real estate industry. First, it created a demand for real estate construction, much of which was met by private developers. The government announced a plan to construct 18 million units of urban slum housing and 10.6 million units of rural housing. In 2017, Premier Li Keqiang set a target to develop 15 million units of urban slum housing units from 2018 to 2021, lifting close to 100 million Chinese out of the slums.[3] Second, when the government expropriated land areas for reconstruction, the slum residents who were affected received compensation. These former residents then deployed much of their compensation into private housing, further boosting the demand for residential units, and therefore helping the excess inventory problem.

To get a sense of the initiative's impact, consider that in 2014, only 9% of real estate purchases were tied to expropriation compensation. In 2016, the proportion grew to more than 48%,[4] covering in excess of 250 million square meters (2.7 billion square feet).[5]

After taking off in 2015, home prices in China have grown an average of 7% every month.[6] In 2016 alone, Shanghai's housing price index rose by 40%.[7] And after 2016, home prices in Tier 3 and 4 cities that are near megacities have risen by 54.6%.[8]

DEVELOPERS PIVOT, ESPECIALLY SMALLER PLAYERS

The massive surge in housing prices and developments in Tier 1 cities led to aggressive market-cooling governmental measures for these areas. In President Xi's address at the 19th Party Congress in 2017, he stressed that "houses are for living in, not for speculation."[9]

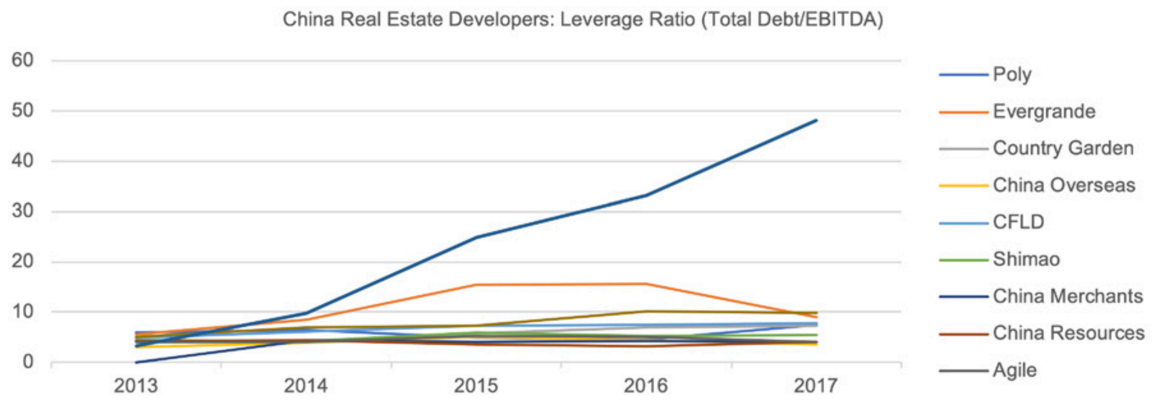
Following the guidelines of China's central authority, municipal governments passed city-specific rules to tighten the real estate market. For instance, Beijing raised its down payment requirement to 35% and 50% for first and second properties, respectively.

After such cooling measures were implemented, home price increases in the National Bureau of Statistics' 70-city average slowed dramatically. Shanghai's home prices fell by 8% in the last quarter of 2017 alone.[10] Since late 2017, Tier 1 home prices have stayed largely flat, with Tier 2 and Tier 3 cities growing at an average of 4% and 6% a year, respectively.[11]

Since most of China's top real estate companies are publicly traded, they were pressured to keep growing. They aggressively expanded into Tier 2 and 3 cities, where cooling measures were relatively mild. But these developers had to substantially increase their volume compared to what they built during their heydays in Tier 1 cities, to compensate for the lower sales prices in these newer areas. In turn, smaller developers, which previously focused on Tier 2 and 3 cities because these towns were less expensive to develop, found themselves competing against some of China's real estate behemoths. As a result, many of them moved down the ladder even more — taking on riskier projects as they suffered from new bidding wars and the threat of consolidation from the giants. However, practically all developers, having operated under a land-grab mentality, found themselves constrained by high leverage in a cooling, regulated market.

In 2017, the top 500 real estate developers accounted for 63% of the investment in the market, compared to 53% in 2016.[12] As such, the success of Zhongliang in such an environment is a striking example of how mid-sized players can triumph despite financial pressures, regulatory constraints, and intense competition.

3 E-house, 中梁地产——苦练内功在前，爆发增长在后.
4 珞珈投资，“深度解读！棚改货币化安置是怎么回事？，” 百家号, October 9, 2018, Accessed February 11, 2019, https://baijiahao.baidu.com/s?id=1613829483962123300&wfr=spider&for=pc.
5 姜超，“为什么棚改货币化安置成为众矢之的？，” 凤凰财经，June 28, 2018, Accessed February 11, 2019, https://finance.ifeng.com/a/20180628/16357025_0.shtml.
6 CEIC, "China House Prices Growth," Global Economic Data, Indicators, Charts & Forecasts, Accessed February 11, 2019, https://www.ceicdata.com/en/indicator/china/house-prices-growth.
7 "2016年上海房,." 安居客, Accessed February 11, 2019, https://www.anjuke.com/fangjia/shanghai2016/.
8 Songcheng Sheng, "6 Keys to Understanding China's Rising Real Estate Prices."
9 "Housing Should Be for Living In, Not for Speculation, Xi Says." Bloomberg News. Accessed February 11, 2019. https://www.bloomberg.com/news/articles/2017-10-18/xi-renews-call-housing-should-be-for-living-in-not-speculation.
10 Dominique Fong, "China's Hot Housing Market Begins to Cool," The Wall Street Journal, January 16, 2018, Accessed February 11, 2019, https://www.wsj.com/articles/chinas-hot-housing-market-begins-to-cool-1516098600.
11 华夏时报房地产，“中国房地产大数据报告,” Fang.com, December 5, 2018, Accessed February 11, 2019, https://news.fang.com/open/30477285.html?src=client.
12 E-house, 中梁地产——苦练内功在前，爆发增长在后.



Source: Bloomberg, Capital IQ, CEIC, JLL

ZHONGLIANG'S HISTORY AND CULTURE

Like many real estate veterans, Zhongliang's founder, Yang Jian, is no stranger to risk. Trained in architectural engineering, Yang spent decades building his Wenzhou-based real estate portfolio before moving into the national spotlight. When Yang relocated Zhongliang, formerly known as Huacheng, to Shanghai in 2009, he arrive with two decades of local property development experience in the Yangtze River Delta.[13]

Yang's resilience and appetite for risk were apparent long before China's real estate boom in the 2010s. From 2012 to 2015, when Wenzhou's average real estate price plummeted from 17,610 RMB (US $2,555) per square meter to 12,633 RMB (US $1,833) per square meter, Yang was able to maintain revenue of more than 10 billion RMB (US $1.6 billion), showcasing his decision to aggressively expand in the midst of a real estate market downturn.

After 2015, as the market improved and with the help of regulatory tailwinds, Zhongliang's business soared. Between 2016 and 2017, the developer more than doubled its revenue from 33 billion RMB (US $4.8 billion) to 75.8 billion RMB (US $11.3 billion).[14] Zhongliang's astounding growth was largely fueled by debt, with its debt-to-asset ratio reaching a peak of 17x in 2016 (and then falling to 0.44x in mid-2018).

Back then though, its high leverage had a substantial impact on the company's cost of debt, with lenders imposing an average 13.4% interest rate at the peak. Nonetheless, as Zhongliang was private during its expansion, it was able to operate with high leverage without facing the same level of scrutiny and pressure experienced by publicly traded developers.

During its rapid growth in the mid-2010s, Zhongliang also relied upon a decentralized, nimble culture to be successful. Yang had adopted a management style called 'Amoeba,' in which individual managers were made responsible for the profitability of their own unit, or 'amoeba.' Such decentralized accountability gave managers the power to expand aggressively and take steps to increase profits. These actions were largely in line with Zhongliang's overall strategy, as the macroeconomic and competitive environment forced it into developing smaller, higher-risk projects.

AGGRESSIVE EXPANSION WITH FINANCIAL DISCIPLINE

The Amoeba management style has been adopted by many major companies, including Japan Airlines. Its creator is Kazuo Inamori, who founded Kyoto Ceramic Co. Ltd. (Kyocera), a Japanese ceramic components and telecom equipment manufacturer, in 1959. By 2013, the company had grown to 71,600 employees with sales of $13.1 billion.[15] Inamori was inspired by the amoeba, a unicellular organism that can expand, divide and disband as needed. He divided his organization into 229 'amoeba' units; each unit was directly responsible for its profit and loss. At the same time, each amoeba must conform to the company's mission objective.[16]

Similarly, Zhongliang formed different regional groups, and divided these groups into smaller sub-regional project teams with profit and loss responsibility. By June

13 楼讯，“中梁杨剑如何带领中梁地产走进房地产百强企业？，” Sohu.com, June 19, 2018, Accessed February 11, 2019, http://www.sohu.com/a/236552767_100183544.

14 L木子李，“中梁地产销售业绩逆市飘红，其背后的”分算奖经营模式”带给你什么启示，” Sohu.com, May 28, 2018, Accessed February 11, 2019, https://www.sohu.com/a/233133038_100149890.

15 Simon, “Learning from Nature: Kyocera's Amoeba Management System,” Transition Consciousness, April 10, 2018, Accessed February 12, 2019, https://transitionconsciousness.wordpress.com/2018/04/10/kyoceras-amoeba-management-system/.

16 Simon, “Learning from Nature: Kyocera's Amoeba Management System.”

2018, Zhongliang had 12 regional groups and 66 regional companies, and every company had its own CEO.[17]

Under this system, employees' bonuses were heavily dependent on each amoeba's profitability, encouraging them to drive for value creation. Each project would require that the core members of the project invest in it while each regional company was responsible for its own management and marketing costs.[18] Additionally, employees' compensation was directly tied to gains in the bottom line.[19]

Organizationally, amoeba brought two main benefits. First, it reduced the need for a lengthy and often bureaucratic, decision-making process.[20] Under an amoeba model, Zhongliang companies can directly contact subcontractors instead of first going through group departments. These departments, in turn, are empowered to execute with little supervision. (In contrast, a centralized management model puts the responsibility for profits on those higher up in the company, who tend to choose safer, guaranteed projects.[21]) Second, the amoeba formation increases the firm's market sensitivity.[22] Decisions are left to local, nimbler project teams, who are much more knowledgeable about their area's market trends.

Supporting these efforts was Yang's commitment towards top talent development and employee training. By 2018, more than 80% of its managerial staff had prior experience, some at a senior level, with China's top 25 real estate companies.[23] In addition, Yang introduced the Zhongliang Institute, where lower-level staff are trained for more senior managerial roles and have access to programs in such areas as finance, marketing, and operations.[24]

SMALLER PROJECTS, FOCUS ON VALUE

Zhongliang mitigates the financial risks it faces in several ways. When it comes to designing products, the company keeps in mind its customer base profiles within given geographies. As such, amoebas would not be operating blindly but have a metric against which to select building design components. For example, the Laolishi housing model was designed for less transient markets in which residents tend to stay in the area, while the Longqin model was better suited for more mobile populations. These two models differ in apartment sizes, amount of public spaces, quality of the amenities, among others.[25] However, interior designs are similar.

Starting in 2016, Zhongliang also began requiring all regional groups to bring in external partners in every project to share the risk.[26] By doing so, Zhongliang gets to develop more projects while the external partner provides brand credibility and capital, in newer cities.

Geographically, Zhongliang has expanded beyond its Yangtze River Delta home base to actively diversify into China's less developed provinces. The company focused on potential hot markets in the Tier 3 and 4 cities, where large developers were uncomfortable with the market risk but capital requirements were too high for local players. As of 2015, Zhongliang only had projects in three cities. In 2018, they had projects in 110 cities in 22 provinces.[27] While China's largest developers engaged in bidding wars over the country's rising Tier 2 cities, Zhongliang's amoebas discreetly parachuted into even smaller cities to build partnerships with local players and thereby reap financial rewards.

More importantly, Zhongliang also instilled a culture with a laser-focus on value creation in its expansion. Knowing that it could not directly compete against the country's largest players, the company selectively targeted cities too small for real estate conglomerates. In 2017, more than 80% of its lands under development were acquired for less than 500 million RMB (US $72 million).[28] Yang once described this form of positioning as pitting '50 Mini Coopers' against '10 Mercedes Benzes,' meaning that Zhongliang's core business success lies in the volume of its smaller projects.[29] Through its Amoeba management style, Zhongliang created nimble, value-driven teams.

17 E-house, 中梁地产——苦练内功在前，爆发增长在后.
18 每日经济新闻. "半年销售首破350亿"黑马" 中梁地产如何大逆袭." 凤凰财经. July 13, 2017. Accessed February 12, 2019. https://finance.ifeng.com/a/20170713/15529260_0.shtml.
19 E-house, 中梁地产——苦练内功在前，爆发增长在后.
20 亿翰智库, "2017年，冲刺600亿！揭秘中梁地产四门内功兼修后的价值爆发."
21 Adler, Ralph W., and Toshiro Hiromoto. "Amoeba Management: Lessons From Japan's Kyocera." MIT Sloan Management Review. September 18, 2012. Accessed February 12, 2019. https://sloanreview.mit.edu/article/amoeba-management-lessons-from-japans-kyocera/.
22 亿翰智,. "2017年，冲刺600亿！揭秘中梁地产四门内功兼修后的价值爆发," Sohu.com, June 28, 2017, Accessed February 11, 2019. https://www.sohu.com/a/152777405_179625.
23 亿翰智库, "2017年，冲刺600亿！揭秘中梁地产四门内功兼修后的价值爆发."
24 中梁地产, "走进中梁学院 | 人才体系与培养," Sohu.com, July 10, 2018. Accessed February 12, 2019. http://www.sohu.com/a/240431791_662806.
25 亿翰智库, "2017年，冲刺600亿！揭秘中梁地产四门内功兼修后的价值爆发."
26 E-house, 中梁地产——苦练内功在前，爆发增长在后.
27 观点指数研究院, "原报道 | IPO与杨剑的中梁路线图"
28 E-house, 中梁地产——苦练内功在前，爆发增长在后.
29 运营商财经网, "开50辆宝马追10辆大奔 看中梁地产董事长杨剑如何打造房企黑马_mini," Sohu.com, September 13, 2018, Accessed February 12, 2019, https://www.sohu.com/a/253649815_452858.

This combination helped to establish the company as one of the more operationally disciplined developers, rather than one that haphazardly piled on debt to grow at all costs.

ROCKY ROAD TO AN IPO

In 2018, Zhongliang applied to go public in the Hong Kong Stock Exchange; the market expected the proceeds to go towards debt payment.[30] The latest S-1 filing revealed that Zhongliang became profitable in 2017, with a low net profit margin of 3.6%. In 2018, when its revenue more than doubled year-on-year, the company's net profit margin only increased to 8.4% — way below some of China's largest real estate players.

Zhongliang's decision to go public is likely the most viable way to actively reduce leverage without substantially sacrificing growth. With its cost of debt hovering in the low double-digits, Zhongliang needs to substantially reduce leverage to avoid high interest expenses. Given that creditors are higher on the pecking order than shareholders, Zhongliang's pitch will very likely depend on how quickly it can reduce its debt-to-asset ratio to the industry benchmark.

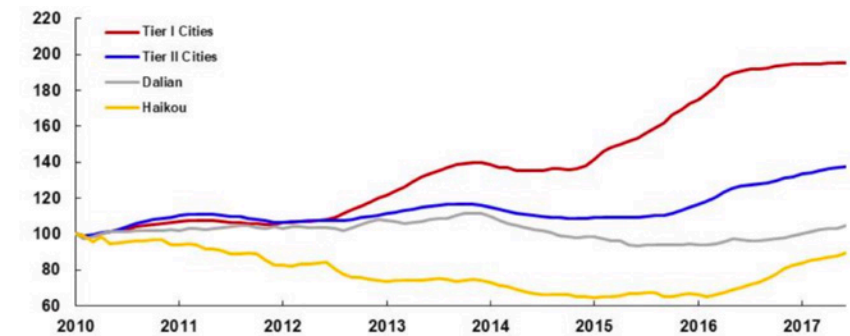
However, its IPO path was paved with delays and difficulties. In May 2019, Zhongliang announced that its IPO application had "expired," leaving investors wondering why the process took longer than that of other companies. Investors also raised questions about its revenue revisions, noting that its accrued revenue and accounted (contractual) revenue had a significant discrepancy of more than 15%.[31]

Overall, Zhongliang's success in the lower-tier markets has propelled it into China's top 20 real estate developers. Its strategy of developing horizontal, relatively inexpensive projects will likely attract investors seeking to diversify growth into lower-tier cities in China, where traditional real estate developers remain largely unseen. In May of 2018, shortly after Zhongliang announced its plans for an IPO in Hong Kong, its CFO Luo Jun stepped down, the second financial chief to resign within one year.[32] With no official explanation from Zhongliang, investors worry that the company would encounter more hurdles on the road to its IPO.

SLOWER GROWTH AHEAD

As growth weakens in Tier 3 and 4 cities, Zhongliang is invariably exposed to the slowdown. With China's national 'slum reconstruction' program largely complete, regulatory tailwinds also are beginning to subside.[33] Meanwhile, the surge in housing prices in lower-tier cities has pushed local governments to roll out similar cooling measures to stabilize the market.[34] While analysts still expect sizable growth from Zhongliang's portfolio of cities, these challenges could mean that future gains in these markets will be more muffled than years past.[35]

Exhibit 1: China House Price Index (June 2010 = 100)



Sources: China Real Estate Index System (CREIS) and author's calculations

Tier I Cities: Beijing, Shanghai, Guangzhou, Shenzhen

Tier II Cities: Tianjin, Hangzhou, Wuhan, Dalian, Suzhou, Xiamen, Chengdu, Nanjing, Sanya, Guizhou, Wenzhou, Harbin, Haikou, Changchun, Hefei, Qingdao, Fuzhou, Xi'an, Nanning, Zhengzhou, Shengyang, Wuxi, Changsha, Nanchang

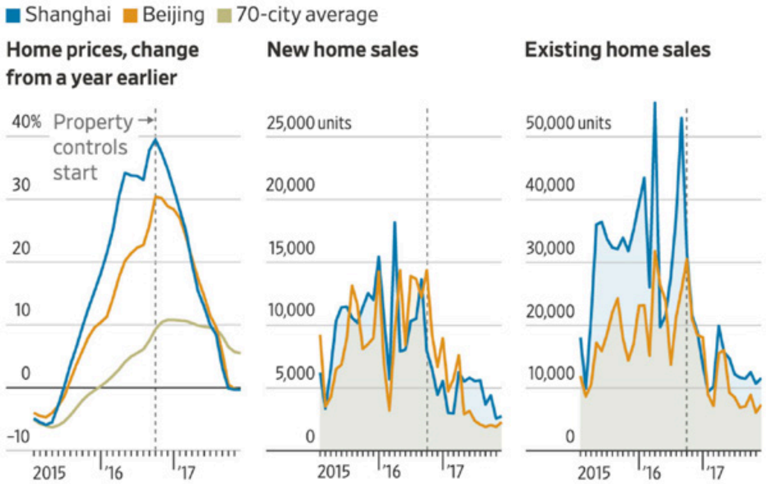
Source: Richard Koss, and Xinrui Shi, Stabilizing China's Housing Market, International Monetary Fund, Accessed February 12, 2019, https://www.imf.org/en/Publications/WP/.../Stabilizing-Chinas-Housing-Market-45749.

30 "中梁控股再战港股，重仓三四线城市风险累积" https://xueqiu.com/3542179334/127487631. May 30, 2018. Accessed May 28, 2019.
31 "中梁控股再战港股，重仓三四线城市风险累积" https://xueqiu.com/3542179334/127487631. May 30, 2018. Accessed May 28, 2019.
32 新京报，"中梁地产一年两换CFO," Sohu.com, May 18, 2018, Accessed February 12, 2019, https://www.sohu.com/a/231997754_114988.
33 李阿冰，"三四线城市的棚改货币化安置结束之后，现在的高房价何去何从?," Sohu.com, June 28, 2018, Accessed February 12, 2019. http://www.sohu.com/a/238186871_100192411.
34 Dominic Chiu, "Housing Bubble, Politics and Trouble: Problems and Policies for China's Real Estate Market."
35 李阿冰，"三四线城市的棚改货币化安置结束之后，现在的高房价何去何从？."

Exhibit 2: China Newly Built House Prices (% year-over-year change)

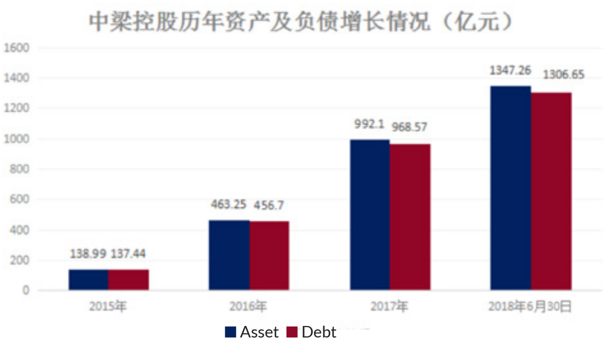
Source: TRADING ECONOMICS, "China Newly Built House Prices YoY Change," China Newly Built House Prices YoY Change, Accessed February 12, 2019, https://tradingeconomics.com/china/housing-index.

Exhibit 3: Impact of Housing-market Restrictions on Home Prices



Source: "China's Housing Market Is Cooling," Financial Information for Residential Property Buyers, April 4, 2018, Accessed February 10, 2019, https://www.globalpropertyguide.com/Asia/china/Price-History.

Exhibit 4: Zhongliang's Assets vs. Debt (in 100 million yuan)



Source: 观点指数研究院, "原报道丨IPO与杨剑的中梁路线图," 观点, December 3, 2018, Accessed February 11, 2019, http://www.guandian.cn/article/20181203/211106.html.

Exhibit 5: No. of Cities Zhongliang Invested In From 2015 to August 2018

Source: 观点指数研究院, "原报道丨IPO与杨剑的中梁路线图."