E-House

Ziroom: Winning in China’s Housing Rental Services Market

The housing rentals market is projected to be a major growth engine in China’s real estate sector over the next 10 years. Prohibitively expensive housing prices, shifting millennial mindsets, and population increases have boosted demand for rentals, especially in China’s major cities. Ziroom, a leader in branded apartment rentals, now holds the lead position in China for rental services. To stay there, Ziroom needs to maintain its scale advantage while carefully managing capital expansion. But wealthy real estate Goliaths with cost advantages are entering the market, posing strategic challenges for Ziroom’s management to overcome.

Brewing in-house innovation: A Brief History of Ziroom

Ziroom’s parent company, Lianjia (Homelink), is a familiar name to many Chinese tenants and landlords. Established in 2010, Lianjia quickly grew to become one of China’s largest rental platforms through a series of acquisitions, claiming to own more than 50% of the real estate rental market in Beijing and Chengdu, and now operates in 25 cities in China.¹

When he joined Lianjia in 2010, Xiong Lin, a former Lenovo systems engineer and IBM strategy consultant, had no expectation that he would eventually be leading a high-profile startup within the company. Within a year, however, Lianjia put him in charge of a new business unit it launched. Xiong Lin chose the name Ziroom or “自如” in Chinese — meaning carefree — to reflect his vision of a blissful rental experience for millennials.

Ziroom sources its units from property owners, renovates these apartments through standardized template styles, and then rents out the properties at a premium while providing other add-on services. With access to Lianjia’s rental platform and its customer and property listing data, Ziroom was set up for success and has grown at a staggering rate. Within 18 months of its 2011 launch, Ziroom has identified and served 30,000 tenants. By late 2015, that number jumped to 400,000 tenants. The latest available data depicts an even brighter picture: It shows Ziroom serving more than 1.2 million tenants across 500,000 listing units.²

In 2016, Ziroom was spun off from Lianjia.³ The move differentiated Ziroom more clearly as an apartment rental services company and enabled it to raise its own funding. As announced in January 2018, Ziroom attracted USD $621 million in Series A financing. Led by Warburg Pincus, other investors included Sequoia Capital, Tencent and Sunac. With a USD $3 billion valuation, Ziroom is China’s first rental housing tech ‘unicorn.’

Reflecting on the deal, Julian Cheng, co-head of Warburg Pincus China, said this: “We decided to invest into Ziroom not only for its innovative business model, leading scale, and brand premium, but also for its strong commitment to service and the management team’s operational capabilities.”⁴ Strong words of praise for a company where the average age of its employees is 25 years old.

New Generation, New Lifestyle: China’s Urban Renters

Helen is a young high-earning management consultant in Shanghai. She is also part of China’s new ‘do not buy’ generation. But make no mistake — homeownership remains a mark of success for most working millennials and often a critical precursor to marriage. Nonetheless, expensive housing prices, shifting cultural mindsets, and demand for higher housing standards have delayed this and other milestones for many. Today, millennials comprise over 95% of China’s urban tenant population.⁵ Alongside them are recent urban arrivals in search of housing.

According to the National Bureau of Statistics and CRIC, the mortgage payment of the average 100-square-meter property in Beijing, Shanghai, or Shenzhen would cost 180% of the average working millennial’s income.⁶ In contrast, renting a similarly valued property would take up about 58% of a renter’s income. It’s even lower for a shared rental — it would cost a fourth of income (Exhibit 1). No wonder millennials without significant financial resources will choose to rent instead of buy property. Indeed, more than two-thirds of millennial property owners admit that they were only able to purchase their properties as a result of significant parental financial support.⁷

Exhibit 1: Increasing Purchase Cost Drives Rental Demand in Shanghai⁸

In Shanghai, increases in property prices outpaced rental growth in the last two years

Source: Centaline data

The millennial generation also finds the flexibility of renting more appealing than owning, which is a notably different attitude than their elders. They also are more likely to switch jobs, transfer to another neighborhood and even change cities and in search of better

opportunities and lifestyles. Changes in demographics and perceptions about marriage have also pushed some millennials towards renting apartments. Indeed, owing to the overall smaller population base of millennials as a result of the one-child policy, aggregate marriage registrations have been declining year-on-year. Moreover, many young Chinese women are choosing to marry later, citing career aspirations, and are less concerned about being branded “sheng nu” (leftover women) as older singles.

As the generation born during the reform era, Chinese millennials generally demand higher quality in housing as well, even if it comes at the expense of property ownership. A Chinese Academy of Social Sciences study surveyed 1,400 recent college graduates and found that 55% of them would rather rent long-term to maintain a desired standard of living than face the responsibility of mortgage payments. In fact, only 33% of respondents were willing to forgo a better lifestyle for property ownership.

Taken together, the above factors only serve to extend the rent cycle of Chinese millennials. Overall population mobility and favorable government policy further support growth in the rental and rental services market.

**Population mobility fuels the rental market**

Chinese people are relocating like never before. As of 2015, 18% of the country’s population — about equal to the population of Indonesia — are mobile citizens who move to or between urban centers, according to government estimates. Between 2005 and 2015, China’s 10 largest cities saw their share of this mobile population increase, going from 24% to 36%. Beijing, Shanghai, and Shenzhen have seen an increase from 34% to 45% over the same period. China’s Bureau of Health and Family Planning also found that 60% of mobile citizens intend to reside permanently in urban areas, with expectations of residence in a given metropolis to be five years, before seeking opportunities elsewhere. Transient or not, the implication for the rental market is clear: Ongoing population mobility is closely connected to the growth of the rental market.

Based on the growing mobile population and the number of people graduating each year, E-House estimates that total rent payments will grow at an annual rate of 9% to $4 trillion RMB (USD $600 billion) in 2027. Estimates by PingAn Securities and Lianjia call for the same market to reach approximately $3.7 trillion RMB by 2027.

**Government incentivizes growth in rental market**

In mid-2016, China’s State Council announced a series of policy changes and incentives to support growth in this sector. For example, tenants are now explicitly protected against unwarranted rent raises, losses in deposits, and eviction. They may also apply to draw funds from their pension accounts against

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rental payments. In certain cities, mobile citizens may receive a temporary residency status to qualify for free education and health care. Electronic contracts, even those signed via mobile devices, are now also fully enforceable.

In an attempt to boost supply of rental properties, the State Council has also offered financial incentives and relaxed financial regulations to property owners. Landlords with annual rental income below 360,000 RMB (USD $54,000) now receive tax deductions. Commercial properties, notwithstanding certain requirements, may now be converted into residential rental units, and in certain cities, local governments will grant REIT status to certain rental unit developers.

Moving from Market Demand to Market Supply: The Rise of the Branded Apartment in China

In China and elsewhere, traditional methods for finding rental housing can be time-consuming and unpleasant. The process starts with a face-to-face meeting in a rental agency, followed by site visits, and long, at times difficult, negotiations over lease terms, including rental cost and services. Moreover, Chinese apartments often have only a bare bones interior and no furniture, making move-ins more costly and troublesome.

Given this, the rental market and rental services sector in China have been ripe for disruptive innovation. With rising disposable income, Chinese customers want a more stress-free experience as well as sophisticated products. The first offerings came in the form of online, no-cost services. For example, public listing sites such as Ganji and Yoher provide free apartment listings, similar to Craigslist in the U.S. In parallel, specialized and commission-based rental agencies, such as Lianjia, provide a searchable database of property listings. These online listings immediately lowered search costs, but they did little to improve a customer’s experience beyond the search stage.

To capture the entire value chain, branded rental players such as Ziroom entered the space in the early 2010s to offer renovated, standardized, and furnished units to customers. Customers get to pick from a variety of interior styles (Exhibit 2). In some cases, tenants may also purchase ancillary services, if not already provided as part of a premium-level rental.

Ancillary services might include door-to-door moving services, scheduled cleanings, free wifi, and/or renter’s insurance. While branded apartment tenants pay a premium of 30% to 60% more than those renting bare-bones units, the reward is freedom from the usual hassles of home maintenance and housing search costs.


Moreover, much of the hard work of apartment selection, interior design, verification of financial resources, and contract signing can all be done online. For example, rather than leaving large security deposits, users instantly share their online credit profile via Ant Financial, Alipay’s credit profile subsidiary, to prove that they are in good financial standing. This removes the red tape of having to gather proof of employment and bank account verification letters.

Once formalities are completed, branded apartment tenants can make use of proprietary mobile applications to pay rent, make repair requests, or otherwise interact with a rental services company. Branded housing tenants, in other words, never need to reach out directly to a property owner to request maintenance, and property owners are free from any hassles from tenants.

The Ziroom Experience: Service, Community, and Quality

Anyone who rents a Ziroom branded apartment is called a “Ziroomer,” which signifies their status as not just a tenant, but a member of a community. Ziroom deepens this connection through its online platform and offline group activities that it organizes for residents.

To start, all “Ziroomers” have access to the Ziroom mobile platform and webpage, where they can schedule services, learn about other residents and discounts available through Ziroom partners, as well as view the Ziroom event calendar. The range of services and housing styles available vary. As illustrated in Exhibit 3, Ziroom has four major housing products. Each is distinguished by its level of services offered, location, and type of housing.

The earliest of Ziroom’s product offerings was the direct rental. The shared branded rentals, marketed as “Friendly Home,” are a hugely popular product, and immediately distinguished Ziroom in the branded rentals market. Its appeal was strongest with recent college graduates eager for an urban lifestyle without an urban price tag. The “Friendly Home” branded rental allows renters to select furnishings for the bedroom, and includes a locking door for added security, with a shared kitchen, as well as living, and bathroom space. A third product, the “Full House,” refers to a fully rented apartment, which is offered in different sizes, ranging from studio to several bedrooms.

Exhibit 3: Ziroom’s core products in its branded rental segment

Ziroom’s latest product is a co-living apartment building, a design that reflects growing interest among upwardly mobile young people around the world. Perhaps most famous of these models is the “WeLive” co-living housing model in New York, which is a spinoff of the WeWork co-working space model. In addition to the services provided in Ziroom’s other products, the Ziroom branded apartment building includes several types of common use areas that are designed to deepen social relationships with other residents. These include a gym,

in-house café or snack bar, game room, and a big common room where social events are organized.

Ziroom works directly with developers to obtain its co-living apartment buildings, and only makes an agreement based on several factors. The developer must be willing to provide a long-term lease of approximately 10 years long. The location should be in an area with heavy foot traffic as that is most likely to attract young people. Thus far, these apartments are all located near train stations, in areas where inexpensive restaurants and other shopping options are nearby. In contrast, Ziroom’s other product offerings are made possible through 2- to 4-year leases from property owners and can be found in different types of neighborhoods and building types.

The Ziroom Model: Benefitting from Scale Effects

At its core, the success of the Ziroom model has been its ability to generate and benefit from increasing scale. Part of this growth came quickly through access to Lianjia’s database. More significantly have been efforts to attract both renters and property owners, which is closely linked to the abilities of the Ziroom team’s leadership and its employees. Providing tenants with a quality experience, after all, requires attention to the smallest of details to ensure that each Ziroomer finds value in paying a premium price for housing. They are buying more than just a place to sleep. They are buying an experience. Property owners are no less eager to have a worry-free experience.

Satisfying the demands of both, while reducing margin pressure through increasing scale has been the key to Ziroom’s success. Market fluctuation in vacancies, after all, can quickly wipe out the already thin margins upon which most branded rental players rely for earnings. A one-month vacancy per year, for example, translates into an 8.3% direct loss in revenue, which forces players such as Ziroom to increase average rental prices as a means to create some buffer. Put differently, sensitivity tests indicate that every percentage increase in vacancy is a 1% direct reduction in gross margin.20

Given this, it is important to understand what factors aided Ziroom’s effort to scale its product offerings without sacrificing margins. These factors are described below.

Have the Right Kind of Parent: The Lianjia Connection

With access to Lianjia’s database of rental properties, Ziroom was in a unique position to source and pitch its rental services offerings without the search costs that many branded apartment competitors face. While Lianjia and Ziroom function today as separate companies, transparent and instant data flow between them remains an important competitive advantage supporting Ziroom’s growth.

Find the Right Customers: Targeted Marketing

From the start, the Ziroom team knew that it needed to achieve regional scale to reduce renovation and service costs within major cities. They also had strong awareness of Ziroom’s target market: the young, financially upward, educated renter and the property owner with neither time nor interest in property management. By providing a matching service, Ziroom was an attractive option for both groups. Its ancillary offerings additionally allowed Ziroom to distinguish itself as more than just a broker for rental properties.

Most property owners who partner with Ziroom are those who purchased one to two additional apartments as a means of investment, but perhaps lack the time and experience to serve as property managers. To attract this group, Ziroom makes several promises: (a) to cover 15-days’ worth of rent in the event of vacancy; (b) to verify the quality of renters; (c) to maintain the property in clean condition; and (d) to assume responsibility for basic maintenance of the property. For direct rentals, Ziroom will market these units with reduced Ziroom services and charge the property owners 5% to 10% of monthly rent.

as the management fee. For branded rentals, Ziroom includes a host of ancillary services, and rents out these units at a market premium of 30% to 60%, with greater margins resulting.\textsuperscript{21}

To attract renters, Ziroom runs various promotions. For example, new Ziroomers may get as much as one month of free rent.\textsuperscript{22} In addition, Ziroom has partnered with many service providers to offer exclusive discounted benefits to Ziroom users. Ziroom’s targeted renters largely include recent college graduates, starting with outreach on college campuses. In addition, Ziroom reaches out to corporations eager for one-stop solutions to procure housing for employees. Its ‘Ziroom Enterprise Rewards’ program allows corporate-affiliated renters additional benefits, such as zero deposit requirements and a dedicated (instead of rotating) cleaning and maintenance service team.

**Own Your Designs: Ziroom as Furniture Maker and Branded Interior Stylist**

Ziroom initially purchased furniture from IKEA, but quickly realized that considerable savings and market advantage were to be found by taking the work of furniture design and construction in-house. Today, Ziroom not only produces the majority of its own furniture and styling effects, but also sells them these branded products on its webpage. This is similar to the marketing strategy of major hotel chains, and perhaps

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most famously the Westin Hotel store and its “Heavenly Bed” branded product.

In addition, Ziroom contracts with appliance providers at scale, which allows for a lower purchasing price. The company also keeps labor costs under control by way of service contracts, instead of direct hires, for its maintenance and cleaning staff.

The scale of Ziroom’s housing stock, in other words, is an important element of its competitive advantage, as it allows Ziroom to mitigate the industry-wide issue of rising renovation costs. Assuming a conservative estimate of 500 RMB per square meter in construction and appliance costs, Ping An Securities noted that the average unit, even at a 50% price premium, may require at least three years to reach profitability. Rising labor costs will also contribute to potentially higher construction costs in the future.

Taken together, these factors imply that rental units return only a few percent in profit, before back-office costs kick in, and despite a high capital investment upfront. As such, should the price premium fall below 40%, only the largest players can remain profitable in the long term. After all, much like retail store concepts, branded interior designs also require a new wave of renovations every several years to remain competitive.

Ziroom has already renovated tens of thousands of units within several major Chinese cities, and it remains best positioned for lower construction costs thanks to its centrally procured materials and construction vendors. Based on available comparative data, its largest competitor, Xiangyu — a subsidiary of 5i5j, one of China’s largest house sales and rental platforms — trails behind Ziroom (Exhibit 5). Other competitors remain far behind.

### Exhibit 5: Properties under Management by Branded Rentals in China

| Property | Management
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Only Ziroom and Xiangyu have significant scale

Source: PingAn Securities, company websites

### Have the Right Team: Ziroom Partners and Staff

Ziroom is a young company not only in terms of its years of operation, but also by way of the age of its employees. Serving in sales, marketing, and other functions, Ziroom’s young team is an in-house barometer of market demand. Indeed, its latest branded housing product, the co-living space, has succeeded in no small part owing to the ability of in-house employees to correctly identify what kinds of ancillary services were in demand.

### Access to Finance

Even prior to its successful Series A financing round, which yielded a USD $3 billion valuation, Ziroom benefitted from a more favorable policy environment. Specifically, China relaxed its securities and REIT requirements to aid the expansion of the rental market. In early 2017, Mofang issued 350 million RMB (USD $52 million) in asset-backed securities (ABS). Given that branded rentals do not hold significant property assets, the securities were backed by future rental income from tenants. While some analysts argue that the deal was relatively small and its cost of capital still exceeded initial expectations, Mofang’s issuance was the first ABS case for branded rentals in China. Some months later, in August 2017, Ziroom, in partnership with China Foreign Economy and Trade Trust Company, Ltd. (FOTIC) issued its own ABS, with a AAA rating in the amount of 500 million RMB.

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Depending on the market’s perception of the underlying assets, ABS may help branded rentals obtain less expensive capital. In parallel, the growing popularity of REITs in China can enable branded rentals to potentially acquire buildings at a lower financing cost.

Looking Ahead: Ziroom’s Opportunities and Risks

Though Ziroom does not own properties under management, its current management model cannot grow without significant capital expenditures. This is an industry-wide problem, but Ziroom’s leadership position in major cities means that it is in a riskier position to overexpand its network. With rising “bare-bones” rental costs in major cities, branded players are incentivized to sign long-term rental contracts with property owners to secure well-located units, despite the risk of higher vacancies. To protect margins, players are also moving to more expensive areas, which require more capital investment to acquire. With increased competition amongst branded rental players over similar properties, players will likely find fewer arbitrage opportunities.

More importantly, fluctuation in vacancies can quickly wipe out the thin margins for most branded rental players. As noted earlier, even short vacancies will lead to a material loss in revenue and diminished gross margins, forcing rental companies to act defensively by raising average rents.27

What this means for Ziroom and its competitors is greater margin pressure. Given this, Ziroom needs to pursue three avenues aggressively to maintain profitability off rent premiums. These avenues include (a) reductions in the cost of capital and expenses to challenge new competitors; (b) optimization of core products, and (c) the promotion of ancillary services.

The Rise of New Cost-Competitive Players

While Ziroom may have secured its market position for the next few years, traditional real estate giants are on the horizon to tap into the growing rental market. In response to increased cooling measures on housing sales, real estate developers have begun pivoting into standardized rental markets. Vanke launched and rebranded its rental division, Port Apartments, in 2015 and 2016. In September 2017, major Chinese real estate firm Longfor launched its first GuanYu rental property in Beijing.28 Most recently, Port Apartments began to offer over 100,000 properties for listings across 18 major Chinese cities.29

Traditional real estate entrants can be particularly troublesome for Ziroom. Given their volume and expertise, real estate developers will enjoy substantially lower construction costs. To put it in perspective, Vanke built at least 250,000 units and made them available for sale in 2015 alone.30 That is equivalent to the entire rental housing stock of some players in the branded rental market. Real estate developers’ asset-heavy balance sheets and revenues also beget lower cost of capital to fund rental market expansions. Finally, real estate developers are well funded by their much larger and profitable housing sales segment. In some cases, developers may be willing to sustain multiple losses in the rental market to weed out competition.

Avoid Market Conflict: Optimize Ziroom’s Core Product

Though it is tempting to expand laterally to new segments, Ziroom should focus on building scale on its core products. Specifically, Ziroom would be better off investing heavily on its core rental business over its lodging products, which may be diverting its capital and management into a different industry.

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The lodging industry competes against new players and requires a separate team with different expertise. While there may be some hedging benefits against vacancies through its short-term lodging segment, Ziroom would be better helped through active reductions on the volatility of vacancy in the core business. For example, Ziroom could expand its company housing segment to allow for a more stable and predictable revenue stream. The U.S. co-working company, WeWork, took this strategy in 2017. Now the majority of its members are no longer start-up entrepreneurs, but employees of Fortune 500 companies housed in WeWork spaces around the world. Given that Ziroom now holds the industry-leading position with higher bargaining power, its management could also consider adjusting rental terms to shift vacancy risks to property owners.

Expand Ancillary Products to Drive Profitability in Core Products

Since long-term rental products may struggle to become significantly profitable in the short term, branded rental players rely heavily on ancillary services for overall profitability. Naturally, branded rental players are marketing ancillary services heavily to their customer base. Ziroom prices its daily cleaning at 35 RMB an hour; assuming a 75% utilization rate and a 3,000 RMB full-compensation package per cleaner, Ziroom earns at least a 50% margin on even conservative estimates.

Nonetheless, there are very few recurring ancillary services that solicit a significant interest from tenants. While moving services may also be profitable, an average tenant is unlikely to utilize the service more than once every year. Childcare services are not common in China, as working parents often rely on grandparents to share the burden of childcare, if at all possible. Even cleaning may not be a sustainable service, as tenants may opt for other cheaper, private cleaners on the market.

In favor of long-term financial viability, Ziroom may want to consider rolling out premium features on top of its complimentary facilities. For example, Ziroom may charge a small premium on faster wifi plans, where the marginal costs for Ziroom are negligible. Additionally, it may look to develop tiered membership programs for Ziroomers that provide additional discounted partner benefits or invitation to exclusive events based on the membership tier, both with a focus on drawing tighter the link between Ziroom rental housing and the membership experience.

Conclusion

Thanks to Lianjia’s data and expertise, Ziroom has captured the growing rental market in the last several years. While the market share they captured is impressive, industry profitability is coming under pressure. Even with the projected uptake in the rental population in China, Ziroom needs to be wary of entrants from the traditional real estate sector, some of which may hold a substantial cost advantage over it. Leveraging its Lianjia data, Ziroom management will need to carefully balance network growth against vacancy and cost risks. At present, Ziroom is in a prime position to systematically optimize its operational costs, explore new avenues for lower costs of capital, and develop relevant and profitable ancillary services to remain the market leader in branded rentals. Failure to pursue these channels may threaten its long-term position.