The Art of Saying No: The Investments We Rejected
Part III

July 28, 2026

This is the third installment in our series analyzing investments we researched extensively but ultimately passed on. As we noted in Parts I and II, studying the companies we did *not* ultimately buy offers a unique window into our investment approach — one that's absent if we only examine the companies we did buy.

The Setup — A Unique Business Model

This example actually predates the Fund, going all the way back to 2010. I was researching a Chinese real estate development company with a unique business model. As I've mentioned before, I am often attracted to unique business models. Different and new business models often come with strong moats and above-average profitability, and they can make for under-the-radar investing opportunities as the market often underestimates them. Often, the company is placed in a "box" together with other, very different companies that are only superficially in the same line of business, with all of this specific company's unique strengths lost in the clutter. They often screen poorly as well, especially as the metrics naturally used are taken from and compared to peer companies that are not really peers.

This particular company developed wholesale malls (mostly for apparel) in major Chinese city centers (mostly Tier 2 cities, which are still massive cities by global standards). The twist was that the malls they developed were exclusively underground — and they received the land for free. In exchange for developing the malls with reinforced concrete ceilings suitable to serve as public bomb shelters in case of need, the Chinese government granted the company underground rights in the heart of downtown for free, no lease required. This gave them access to highly coveted areas with major foot traffic, in areas where there was generally no remaining space for above-ground development at all, for free. They would develop the malls at Chinese warp speed, spending under one month on all the above-ground work disrupting traffic, and only 6–12 months total from groundbreaking to being open for business. Given that they didn't own the land (and the malls were designated as civil air defense shelters in times of war), they were not able to get mortgages on the properties. Instead, they would sell ~25% of the square footage to recoup the cost of construction and provide cash for the next project, retaining ~75% to lease out for long-term recurring revenue. It was a sweet business model, with the potential for steady, long-term growth. The company was … Renhe Commercial Holdings.

Background

Renhe was expanding fast, both through acquisitions of developed underground malls that were pre-operational as well as by building new projects under the civil air defense shelter programs. They had a little more than 2 million square feet fully leased out across seven projects and four cities (after having sold about 1 million square feet of space to recover development costs), and were projecting another 11 million square feet coming online over the next year spread over 14 projects and an additional seven cities (about 8 million square feet net, after selling the 25% allocated to cost recovery).

Although the rental revenue was still relatively small compared to their market cap (about $25 million USD in 2008, compared to a market cap of $1.7 billion USD), that was set to massively explode (from ~1.25 million leasable square feet in 2008 to ~10 million leasable square feet entering 2010). Between that, the cash on the balance sheet (~$500 million USD), and the incoming funds from selling 25% of each new project as it was completed, the valuation looked quite cheap.

Their capital-light business model delivered tremendous margins. Renhe achieved gross margins of around 75% on their sales, far in excess of the 30–50% typically found in Chinese real estate development of the time, simply because Renhe did not have to pay any land costs. And after selling part of every project to cover the development costs, they were essentially building a substantial real-estate portfolio with a highly profitable recurring revenue stream and an effectively zero-cost basis.

Why We Rejected

Given that Renhe was a Chinese company, my antennas were specifically attuned to any whiff of fraud or impropriety. Three things struck me. First, they had a dream business model. There was no need to financially engineer or take on extra risk. They should just develop malls, recoup their costs by selling rights to a quarter of the square footage, and start over again. Wash, rinse, repeat. Yet the company did not act that way, constantly seeking to break out of their tried-and-true formula, which led me to wonder what the company saw about their business model that I wasn't seeing.

Second, the balance sheet was weaker than it should have been for such a capital-light model. The reason was that their sales of a portion of each project to finance development were not paid up-front in cash. Now, seller financing is a thing, but it definitely raised concerns over whether these sales were fully real and if the cash would eventually appear. In the meantime, the company was not as capital-light as it liked to appear. On an accounting basis, they were capital-light, but on a cash basis, they were still hungry for cash to finance the next development.

Third, and this was the red flag that firmly knocked Renhe out of consideration for investment, in December 2009, the company announced a full sale of one of their malls. This was against the official business model of selling a quarter to recoup development costs and retaining the rest for long-term recurring lease revenue. But the crucial point was that the sale was again not really real. The buyer was not putting up 100% of the cash, and the only collateral for ongoing payments was the underground mall itself. If the underground mall spaces had trouble being leased out, then ultimately the buyer would default and the mall would revert to Renhe. Which meant that *economically* not much had really taken place. Renhe was still set to get future payments based on leases of the space. They were going to do that before the "sale", and they were in the same position after the "sale". The transaction was seemingly done simply to window-dress the quarterly numbers, with no underlying substance. This was a major red flag both as to management integrity and competence and as to the underlying business. This turned us off from investing in the company at all, despite the seemingly unique business model and attractive financials and valuation.

The Rest of the Story

Spoiler alert: the buyer ended up defaulting and the mall reverted to Renhe. Renhe tried to aggressively expand multiple development projects at once, which ended somewhat predictably. Rapid over-expansion led to distressed malls with high vacancy rates, as well as cost overruns and delays. Selling 25% of the malls no longer covered development costs and they started being reliant on debt and on cash injections from selling the next project to cover the cost of the previous project, somewhat Ponzi-like. In 2013, Renhe booked massive impairment losses on their seller-financed receivables and took back possession of empty, distressed properties. In 2015, they defaulted on their debt, forcing a negotiated restructuring. Eventually they "pivoted" to a wholly different model before becoming fully worthless and being delisted in 2022. All the while, the stock was in a consistent downtrend, having lost 90% of its value by the end of 2013.

Interestingly, in July 2011, Moody's released a report listing numerous Chinese companies with red and yellow flags for accounting fraud risk. Renhe was indeed on the list, but we had seen the signs and avoided it long in advance.

Postmortem and Lessons

We definitely made the right call with Renhe.

Some might say that the lesson is to avoid China at all costs. We believe that such a lesson is too broad and excludes many good companies that would have made investors many multiples of their investment. China definitely needs more care than many more developed and liberalized market environments, but that does not mean it should necessarily be entirely avoided.

The real lesson, in our opinion, is that careful analysis of the accounting statements and the real-world underpinnings behind the accounting statements can reveal whether a bright, new business model or product is truly fulfilling its destiny or if there is rot at the core. When the business model and the accounting point in one direction, but the cash flow does not quite match up, that is the time to probe deeper to understand why the divergence. And when management takes business actions that seem to have been taken purely or mostly for accounting reasons and not for legitimate business reasons, that is the time to run in the other direction as fast as you can. Most frauds have warning signs visible in advance. Not all frauds, but most. Your job as an investor is to make it your business to look for the signs and pay heed.

Moral of the story: Pay attention to the accounting and do not ignore red flags.