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BLUEPRINT: Hong Kong's big fish

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For a dozen years, Phoenix Property Investors has exceeded performance targets, largely thanks to home runs on its home turf. Now, with Hong Kong values declining, founders Samuel Chu and Benjamin Lee explain how they intend to continue their success. PERE Magazine April 2014 issue.

When Phoenix Property Investors hit the fundraising hard cap for its latest Asian real estate opportunity fund in December, the Hong Kong-based firm had plenty to celebrate. At $750 million, Phoenix Asia Real Estate Investments V is the largest capital raising the firm has achieved since it was formed in 2002.

Besides exceeding its target by $150 million, it also was one of a limited number of funds raised last year to be oversubscribed – quite a feat considering that many rival fund managers in the region struggled to even reach a first closing.

Phoenix, led by Hong Kong entrepreneurs and long-time friends Samuel Chu and Benjamin Lee, has navigated through 48 transactions during its 12 years in existence, realizing more than 70 percent of them along the way. Apart from its 2007 fund, Phoenix Asia Real Estate Investments III, each of its investment vehicles should meet or exceed their 20 percent IRR and 2x multiple targets. Even Fund III would have performed as planned but for a handful of outlays in Japan made immediately before the collapse of Lehman Brothers. Still, with certain of its deals producing barnstorming 5x, 6x and even 7x equity multiples, it is little wonder that institutions around the globe have stampeded into Phoenix's funds whenever they have become available.

Today, as Phoenix surveys the view from the height of its success, there are some storm clouds gathering. Many of its most successful deals were struck in its home city of Hong Kong but, for the past year, opportunistic pickings in the former British colony have been slim. Consequently, much of Fund V's capital has sat on the sidelines, with a little less than 10 percent deployed into just two deals so far.

Compounding matters, the outlook for Hong Kong's luxury residential market – a property type that has been very profitable for Phoenix – looks grim in the short term at least, with property brokerage Savills predicting drops in value of up to 10 percent this year following a fall of more than 7 percent in 2013. In fact, its copious resources coupled with a declining domestic market have caused certain commentators to question whether investors have backed a fish that has grown too big for its pond at a time when there's little food for it to eat.

One advisor to institutional investors, who declined to be named, notes how Phoenix has a reputation for strong investment discipline. However, its growth has reached a scale that naturally brings with it scrutiny over whether such resolve can be maintained. "They are getting larger, and their carried interest and management fees must be significant now," he says. "The perennial question for a firm like this is 'Can it maintain its discipline?'"

Furthering that point, a rival Hong Kong-based manager, who also declined to be named, believes Phoenix is at a pivotal point in its evolution, given it has raised its largest fund at a time when Hong Kong property values are heading south after reaching record highs. "They've raised too much capital for a market as small as Hong Kong," she suggests.

Lesser of two evils

It is not long into PERE's almost two-hour conversation with Chu and Lee at their headquarters in Hong Kong's bustling Shun Tak Centre before the firm is responding to these concerns head on. Lee, Phoenix's 'point man' for its LPs, states for the record: "I would much prefer to suffer from LPs telling us we have not been able to invest their capital than us forcibly place their hard-earned money into investments."

Phoenix has never released capital commitments before, but Lee notes that committing to bad deals is the worse of two evils. "At the end of our investment period, if we find ourselves short – that has never happened before, but should that happen – we would gladly go back to the LPs and say 'Sorry, we couldn't find enough high-quality deals for you, so we will allow your commitment to lapse'."

Chu, a 30-year investment veteran with one of the strongest investment reputations in Asian private equity real estate, admits that this vintage's hunt for strong deals has been tough. "It is true that we are not very invested yet," he says. "I must have looked at 1,000 deals in the past 12 months and have done only two deals so far. I have been extremely cautious."

Nonetheless, if Chu has any concerns about the lack of activity for Fund V, it is not showing. "I'm still having lots of fun," he laughingly jokes (his laugh is a prominent feature throughout the interview). As if knowing something others don't, he adds that he is expecting greater activity soon. "The second half of this year will be a lot more interesting," he says. "In fact, we have a couple of deals in the pipeline. If I had paid for those last year, I'd have paid 10 percent to 15 percent more." Listening to Chu speak, it is easy to believe that, should his prediction prove correct, Fund V's investors might have called a countercyclical play perfectly.

Chu is very much Phoenix's 'deal guy' – so much so that, despite his ownership and leadership functions, he is deliberately shielded from much of the firm's managerial and administrative duties to ensure he is not distracted from sourcing great deals. He does not offer much detail about his investment style, but he repeats how it is important to buy cheap, something he consistently has been able to do at Phoenix – and even prior to that.

Indeed, Chu is recognized today for having honed an acute sense for value. As such, those tracking him doubtlessly would be interested to hear his market forecasts. “I can’t call market timing,” he says in an attempt at humility. It is not long, however, before he professes how investing is “all about anticipation. The market in Hong Kong will correct, and we should be patient and wait,” he adds. “Our LPs are happy with that.”

Many trick pony

In spite of its Hong Kong exploits, Phoenix is not as polarized in its strategy as perhaps the outside world has perceived. Besides Hong Kong, the firm has been investing in Japan since Fund II and Taiwan since Fund III. Furthermore, it is hugely invested in the 1.3 million-square-foot Crystal Galleria, a mixed-use development in Shanghai. That project has a valuation of more than $1 billion, capitalized in part by a number of Phoenix funds.

In addition, Phoenix hired Rai Katimansah last year as head of Southeast Asia investments, with a view to finding deals in Indonesia and the Philippines – the first of those slated to complete in just months. And Chu likes that few inter-national managers currently dare invest in these countries. “When we first invested in Taiwan in 2006, nobody wanted to go there. Today, we are probably the largest foreign investor there,” he adds, laughing once again.

Told how a Southeast Asia-focused panel at PERE’s annual Asia Summit the day before the interview was concerned about guns and terrorism in the Philippines, Chu says: “Talk about the impact of things like that is more emotional than rational.”

Lee tempers Chu’s enthusiasm, adding: “We are a SEC-registered advisor. We do extensive legal and tax due diligence before we even think to invest somewhere. We take that very seriously.” Nevertheless, he agrees with Chu. “We don’t bet on beta; we want to create alpha.”

Even so, Phoenix’s ambition to broaden its investment horizons has met with a degree of nay-saying from rivals. The aforementioned, unnamed Hong Kong manager cautions: “They are going to untested waters, and treading new waters is always risky.”

“We are going to do a deal in Jakarta too,” an unwavering Chu notes. By his reckoning, it is hard to ignore markets with such middle-class and consumer spending growth. “Indonesia has a population of 270 million people and a growing middle class that is spending money. As a result, they need upgraded property. In the Philippines, the [IT support] business is overtaking India and yet property prices are very cheap,” he says, offering a glimpse of the sort of property that Phoenix wants to buy.

That is not to say that Southeast Asian markets will siphon too much capital from Phoenix’s primary market,

maybe just 5 percent to 10 percent of Fund V's equity. And, in spite of Fund III's unfortunate Japanese deals, Phoenix remains open for business in that market as well, with Chu and Lee agreeing that the country could account for another 10 percent to 15 percent of the fund's total equity.
In Tokyo, Phoenix employs a team of four professionals led by Daisuke Hayashi, who recently joined the firm after 10 years at Aetos Capital. Insisting Hayashi's team can claim some of Fund V's equity, if the deal warrants it, Lee adds: "We are opportunistic about Japan if we can find good value."

According to Chu, onlookers should not forget that more than 40 percent of Fund II – a vehicle that met its return target – was deployed in Japan and, although Fund III's deals saw their equity written down by 50 percent, less than one-third of that fund actually was invested in the country. "I spoke with one consultant who told me those deals were still top quartile for that vintage. Not that the information did us any good," Chu comments. Even so, he feels such an endorsement vindicates Phoenix's activities in Japan at the time. "If there's an upside, it is that, comparatively speaking, our strategy was validated," he reasons.

Cream of the crop

It has been an entirely different story for Chu and for Phoenix in Hong Kong, where the firm has enjoyed most of its success. Ever since 2002, when the earliest iteration of the firm converted a restaurant in Kowloon into a retail property and turned a HK$86 million (€8 million; $11.1 million) investment into HK$385 million in less than 18 months, the firm has not wanted for backing. Deals like that one encouraged friends to back what would become Fund I. On day one, the vehicle contained $12.3 million in commitments. When wound up two years later, that equity had grown to more than $50 million in investments and the firm's growth trajectory was established.

At that nascent stage, Phoenix effectively comprised Chu finding local deals and Lee offering outside fund management support – he was running a private equity business called Strategic Capital Management, which had been ongoing since 1993. However, when his partner retired, Lee signed up to Phoenix on a full-time basis. Shortly after that, the firm launched Fund II, pulling in $73.5 million from high-net-worth families.

It was not until Fund III in 2007 when things got institutional. Indeed, the months leading up to the global financial crisis were ripe for investment managers with newly established track records, particularly those with Asian real estate offerings. Accordingly, the vehicle attracted $350 million from institutions that have since remained loyal, as evidenced by a $460 million closing in 2010 – the worst year for Asian private real estate funds in the last five years, according to PERE's Research & Analytics division – and last year's $750 million final closing for Fund V.

When hearing about some of the firm's home runs, it is not difficult to see why Phoenix has garnered such exponential support, why friends have become high-net-worth families and those families have given way to 'the gamut' of institutions that back it today.

Asked to describe Phoenix's strongest deal, Lee and Chu pick Gramercy, a 90,000-square-foot luxury residential tower in Hong Kong's Midlevels district. That deal is singled out not necessarily because of its total return but because the firm sees its approach to the development as one blueprint of what it does.

"Hong Kong law says, if you own 90 percent of a building that is 40 years old or more, you can buy the remaining 10 percent at market price," Chu explains. "So, we assembled these buildings bit-by-bit then forced a conditional sale agreement. You can do that with dilapidated buildings."

Phoenix proceeded to knock the buildings down before rebuilding with enlarged floor plates. Enlisting the help of architect Aedas and interior designer Peter Remedios (famed for his work on five-star hotels), the firm deployed $90 million, including $23 million of equity, creating a residential tower that was to sell very quickly. On its opening weekend of marketing, all 96 of the apartments offered for sale (out of a total of 106 in the building) sold and the tower become a reference for 'copycat' developers in the process, Chu claims. The fact that Gramercy has generated a return in excess of 5x has not gone unnoticed either, particularly by investors keen to benefit from similar deals.

"The deals that Phoenix has done in Hong Kong have been phenomenally successful," says a second neighboring investment manager, who regards accumulating a Hong Kong tower piece-meal as a risky strategy. "I give them credit for the way they collect compulsory sale projects," he comments. "I've always found that to be too unpredictable in terms of timing, as getting 85 percent to 90 percent ownership of an asset might take six months or it might take two years. When you are a fund, you don't necessarily have the luxury of time."

Love is the answer

Chu regards deals like Gramercy as the result of "thinking outside of the box" – something he and Lee say is a central characteristic they look for in staff. To have such mental dexterity when tackling real estate deals, these men believe you should love the asset class. They also think that ambition – or greed – is not enough.

To that last point, Lee recounts a recent interview involving an applicant who had previously just finished a prestigious investment banking analyst program. When asked what she wanted to be doing in five years time, she replied that she wanted to make a lot more money than she did today. Unsurprisingly, she failed to land the job. "We talk about having fun because you don't have a mission if your mind and soul aren't in it," he says. "Sam and I don't even really regard this as a job."
Chu chimes in: "We like complicated deals. We are entrepreneurs, and we like people who think outside of the box. Don't say no to us; say how."

Indeed, it was that sort of thinking that ushered Joey Chiang, Phoenix's managing director, into the ranks of top management just eight years after joining the firm as a mid-level deal assistant. "He worked extremely hard, never said no and took on the hardest tasks," Chu recalls. In fact, Chiang is the first new partner in the 12 years that Phoenix has existed, but both Chu and Lee want there to be more and regard that as evidence of a maturing business. "That's what I tell people at interview. We really hope that one day you will become a partner."

When asked whether succession is playing a part as well, Lee says it is to a degree. However, it also is about making the 'pie', as Chu puts it, bigger. "Give up some of your shares, and the pie gets bigger. You're better off anyway," he says.

Phoenix currently is in the midst of putting together an advisory board that involves an individual from one of the world's largest asset managers. "He was the 10th partner at a time when they had under $3 billion AUM. Now, they have more than $800 billion AUM and more than 100 partners."

Lee also insists he and Chu will continue to invest in Phoenix's people, partly to get more to a stage where they viably can make partner. "We want to surround ourselves with people that are smarter than we are," he says. To that end, the firm consistently has invested its management fees on improving the team. Although there has been some noticeable turnover among Phoenix's lower echelons, Lee refers to recent personnel changes as "upgrading our human resources." To that point, one of the unnamed managers notes: "They're not losing key people. Turnover can mean improving your staff."

Ultimately, Lee says it is all about ensuring the firm is best equipped to perform for its investors via the strongest strategy it can offer. In true investor relations-speak, he adds: "All of our people have been brought together to achieve one aim: perform consistently for our LPs."

Thus far, Phoenix has done just that. Whatever storm clouds might be gathering in the future, the firm's investors have been pleased with what they've experienced from the firm to date and have voted with their checkbooks. For Chu and Lee, that is what matters the most.

Phoenix Property Investors
Founded: 2002
Headquarters: Hong Kong
Other offices: Tokyo, Taipei and Singapore
Key personnel: Samuel Chu and Benjamin Lee, founding partners; Joey Chiang, managing director
Staff: 65
Assets under management: $4.1 billion
Equity raised since inception: $2 billion