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SPECIAL REPORT: Sweet then sour

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When international investors were presented with plans for China's biggest private real estate fund by entrepreneurs Kenneth Hung and Vincent Lo, they flocked to the vehicle in droves. Some haven't touched Asian real estate since. PERE Magazine June 2013 issue.

A commonly uttered piece of advice is 'never mix business and family'. Unfortunately for two Hong Kong entrepreneurs and more than 140 investors that backed their real estate joint venture, that advice was not heeded. Today, all of those involved are suffering the consequences.

This is the story of Winnington Capital, a hedge fund manager that in 2008 raised $1 billion for its Trophy Property Development Fund, once the largest commingled pool of private capital corralled for Chinese real estate. It also is the story of a feud between Winnington founder Kenneth Hung and Vincent Lo, his brother-in-law and the chairman of development partner Shui On Land, which started with disagreements about how to develop the fund's assets and escalated when these developments hit snags and required further capital.

Although a resolution is close at hand, what is happening with the Trophy Property fund will resonate for years with the country's real estate investment managers and, importantly, with institutional investors looking at China for private real estate investments. For both groups, it is the antithesis of a blueprint to follow.

The Trophy Property fund has touched a wide spectrum of investors. Committed to the seven-year vehicle are US institutions like TIAA-CREF, the San Diego County Employees Retirement Association and the University of Texas Investment Management. There also are multi-managers like Franklin Templeton Real Estate Advisors and advisors like The Townsend Group in there. Even individuals from Goldman Sachs are invested.

For some of these investors, it could be some time before they engage with Chinese real estate strategies again. "For many LPs, this is their only allocation to Asia," says one of the fund's investors. "Those people have never come back, and I'm talking about some big investors."

One investment manager currently seeking capital for his firm's first pan-Asia property fund notes that what happened to the Trophy Property fund actually is hampering his own fund-raising. "That fund has hurt all of us in Asia," he says. As a result, his firm is deliberately steering clear of Trophy Property's investors in its fundraising push.

Hung and Lo, as well as their respective firms, declined to comment for this article. However, over recent months, *PERE* has spoken to some of the fund's investors, former Winnington employees and other informed parties to piece together the story of the failed Trophy Property fund – a giant pool of international capital, among the first of its kind, designed to take on Chinese developments of scale.

A simple strategy

The Trophy Property fund's original strategy was simple: the vehicle would take stakes in five developments by Hong Kong-listed Shui On Land across Shanghai, Wuhan and Chongqing. "It was quite the unique fund, given that all of its assets are with one operating partner," recalls one former Winnington executive.

For a relatively opaque property market, here was an opportunity for international investors to invest in a pre-determined set of developments by the same people behind the world-famous and successful Shanghai Xintiandi shopping district. For many of the fund's investors, this was unchartered territory.

It also was a first for the fund sponsor, as Winnington's Hung was not known for his property acumen but rather his hedge fund track record. In 2009, Asian Investor magazine included him in a list of the 25 most influential people in Asian hedge funds after two of his firm's long-short funds punched the lights out, returning 289 percent in 2003 and 366 percent in 2006.

However, it was Hung's family connection with Shui On founder Lo – and not his prowess in long-short strategies – that was marketed as a strong reason to back the venture. Hung is married to the sister of Lo's wife, Loletta Chu, the 1977 Miss Hong Kong winner who married Lo in 2008.

"The opportunity for the partnership is the result of a long-standing professional and personal relationship between Vincent Lo, the founder and majority shareholder of Shui On, and Kenneth Hung," states Trophy Property marketing material from placement agent CP Eaton Partners, subsequently obtained by *PERE.*

To guide Winnington as it piled its equity into the five developments, including a site immediately next to Shanghai Xintiandi, was Hung's friend and company chief executive Eddie Wong, who had joined the firm in 2005. A former chairman of HypoVereinsbank's Asia debt and cash-flow securitization operations, Wong's real estate background was largely on the financing side. Still, that didn't put off more than 25 large institutions and a range of smaller investors from committing capital by the tens of millions and, in a few cases, hundreds of millions of dollars.

The capital was deployed into developments that were colossal in scale and included multiple, smaller land parcels. According to the marketing materials, one of the developments in Chongqing spanned 30 million square feet, for example. Another in Wuhan extended to 15 million square feet.

Honeymoon over

Exactly how long after the Trophy Property fund closed before problems started to surface is a question still debated, and there are varying opinions. Widely agreed, however, is what the problems were – and there were many of them.

Observers say the fund had two "honeymoon" years before there was friction between Winnington and Shui On. One source points to Winnington's growing development team as an instigator of trouble. Despite its position as a passive investor, the firm is understood to have employed approximately 80 development professionals at one stage to work on the assets – a situation that was badly received by Shui On.

Matters were compounded by "timing issues." Construction delays, largely stemming from problems in relocating families from the development sites, put pressure on the vehicle's limited lifespan. It had been expected to wind up within seven years (nine at the outside given two options for one-year extensions), but it soon became clear things would take longer. In addition, the cost of these relocations increased beyond the fund's original underwriting, meaning more equity would be required.

As these realizations became apparent, tensions inevitably rose between Shui On, Winnington and its investors, and a blame-game ensued, particularly as Shui On continued financing the developments entirely from its own resources. The firm is understood to have covered Winnington's capital requirements from the point at which the fund's equity had been called in its entirety.

One source connected to the matter told *PERE* that Winnington's debt to Shui On grew to more than RMB2 billion (€244 million; $326 million) by 2012. That is because the Trophy Property fund is understood to have not held capital reserves. When calls came for further capital, the vehicle's coffers were empty.

Things were little better within Winnington itself and, in October 2011, Wong left the firm in a state of acrimony. Described by one investor as a "messy divorce between two friends," the nature of Wong's departure has been scrutinized since, with certain parties claiming Hung forced him out. Although Wong was the fund's key man, no 'key-man event' was evoked as all the capital already was deployed at the point of his departure.

Loss of control

Winnington and its investors, meanwhile, have been criticized for committing so much equity to stakes that were, in fact, minority and non-controlling. With Shui On as the majority shareholder for each development, their capital was trapped and at the mercy of a developer accustomed to taking a decade or more to see projects through to fruition.

That investors would have little authority after consigning their capital was clear from the onset. The marketing materials stated: "Shui On will be the builder and majority owner of the projects, and it is intended that the economic interests of the partnership will be fully aligned with Shui On."

One investor notes that minority stakes offered by local partners were commonplace at the time. "We know better now, but still it's rarely possible to get majority positions in China," he says.

The investor also admits that the Trophy Property fund's very introduction was ill-timed, coming immediately prior to the start of the global financial crisis. Chunks of the sites, which had large residential components, were intended to have been sold to smaller developers, enabling the firm to realize distributions for the fund's investors along the way. However, he notes that this tactic was obstructed by three years of restrictive policies introduced by the Chinese government in a bid to stem housing bubbles. "That basically killed the fund," he says.

By 2012, communication between Winnington and Hung, Shui On and Lo and the fund's investors was at best fractious and at worst dysfunctional. According to multiple parties familiar with the situation, there were long periods of silence between the three sides.

Anticipating trouble to come, each side hired lawyers. Winnington appointed Hogan Lovells to represent the fund, Shui On brought aboard Paul Hastings and the investors – now led by an advisory board that included Franklin Templeton and Townsend – hired Akin Gump Strauss Hauer & Feld.

In a further effort to better deal with its private equity partner, Shui On also hired Hong Kong-based private equity real estate firm TAN-EU Capital to help negotiate on its behalf. In so doing, Lo again looked close to home for services as he has family ties with TAN-EU's founder Rachel Tan.

Brokering a resolution

Tan is said to have played an instrumental part in brokering a solution designed to provide the Trophy Property fund's investors with as clean and profitable an exit as possible. That solution is understood to have been tabled last September and, at press time, is believed to be just weeks from being approved.

The solution centers around the exchange of four of the portfolio's minority stakes for a majority stake in the one development that stands the greatest chance of a clean exit – Shui On's development close to Shanghai Xintiandi.

Whether the $1 billion originally raised for the Trophy Property fund can be recovered from this arrangement, however, is debatable. With the equity of the fund written down by approximately 55 percent to no more than $450 million at the end of last year, certain investors believe the most they will see back is 70 cents on the dollar.

"We have our fingers crossed for that," says one investor. "I'm hoping for more than that," adds another, who emphasizes the potential of the Shanghai site.

Perhaps fittingly, the resolution of the Trophy Property fund rests with its key protagonists. While the stake swap carries broad favor with all parties, ultimately its future lies in the hands of Hung and Lo. A major stipulation for the swap to happen is the relinquishing of control of the fund's management by Hung.

Proposed instead is a spun-out entity that would manage the single-asset vehicle. It would be led by a 10-strong team that includes Philip Mintz, the former head of Warburg Pincus' China real estate platform, who would run the fund on a day-to-day basis, and Mehmet Dalman, the former chairman of the embattled London-listed miner Eurasian Natural Resources. Both joined Winnington after Wong left in 2012.

At press time, Hung was thought to have just withdrawn his involvement from the Trophy Property fund. With that step complete, the fund's investors can vote for the asset swap and change in stewardship, which they are expected to do. Simultaneously, Shui On's executive board is expected to approve its engagement with the new-look management team and decide whether it will continue to develop the Shanghai development on the fund's behalf.

Lessons learned

Anyone attending *PERE's* Asia Summit in February, at which Lo was a keynote speaker, might be forgiven for concluding that the Trophy Property fund would be the last collaboration between Shui On and private equity. His address at the two-day conference included a thinly-veiled attack on Winnington's real estate credentials and was a damning assessment of their partnership.

"For the past few years, we have worked with private equity fund managers and encouraged them to learn to be a developer, hoping we can work together better," Lo told delegates. "I must confess it hasn't worked. I understand fund managers have to work within their time limits and their IRRs. At least if they know the [development] business, they will be able to make more sensible decisions about which projects to invest in."

At a private gathering of investors and investment managers shortly thereafter, Lo confirmed he was referring to Winnington, but he clarified how the firm does have an appetite to work with private capital over longer terms, according to one source in attendance.

Indeed, the developer has engaged with private equity partners again, albeit via a different structure. In 2011, its subsidiary, SOCAM Development, partnered with TAN-EU Capital as joint general partners for a club-style investment fund, also focused on mainland China developments. Both sides injected $200 million into the vehicle, called SOTAN China Real Estate I, and all decisions are made on a 50:50 basis.

Nevertheless, those investors embroiled with the Trophy Property fund almost certainly will think twice before committing capital to a partnership with such an emphasis on the relationship between individuals. "It was not a positive, and we really did try getting our minds around it," says one investor. "For us and others, our investment was made despite it. You should never mix family and business."