Driving Vietnam's economic growth– the role of private equity and venture capital

REDDAL

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Key messages

Despite rapid growth and foreign investment, Vietnam's economy (like many of its peers in SEA) remains vulnerable due to weak local supporting industries

Vietnam's private equity sector is still small and volatile but a vibrant ecosystem is starting to shape up, partially due to government support

Finding good deals and driving systematic value creation continue to be challenging for private equity players – it is still about finding the "right opportunistic deal", and there is room for more active HR, process, top- and bottom-line performance improvement

Vietnam has promise but requires transparent policy – consumer- and technology-driven sectors have potential, and private equity could have a big economic impact if actively and transparently engaged in SOE reforms

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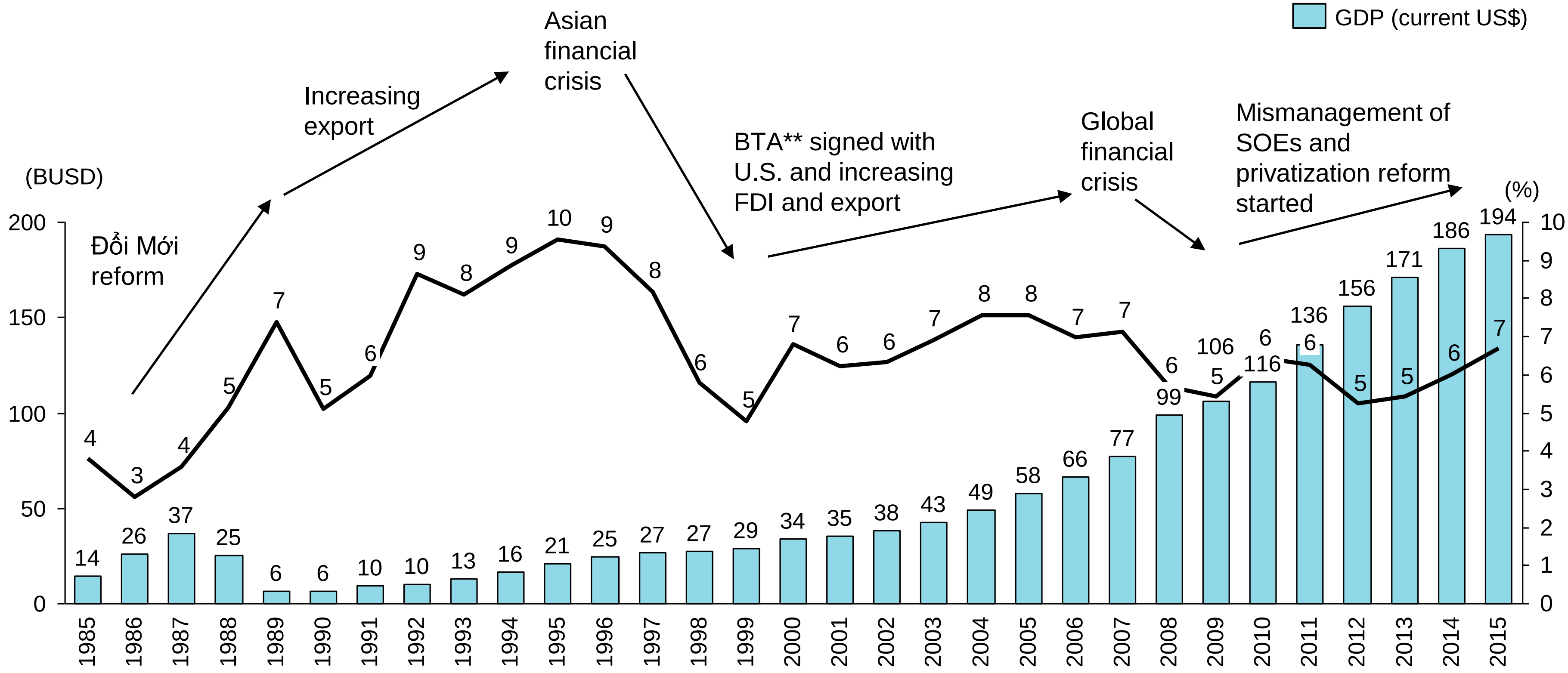
After Đổi Mới* reform, Vietnam experienced rapid growth, peaking at double digit GDP growth in 1995

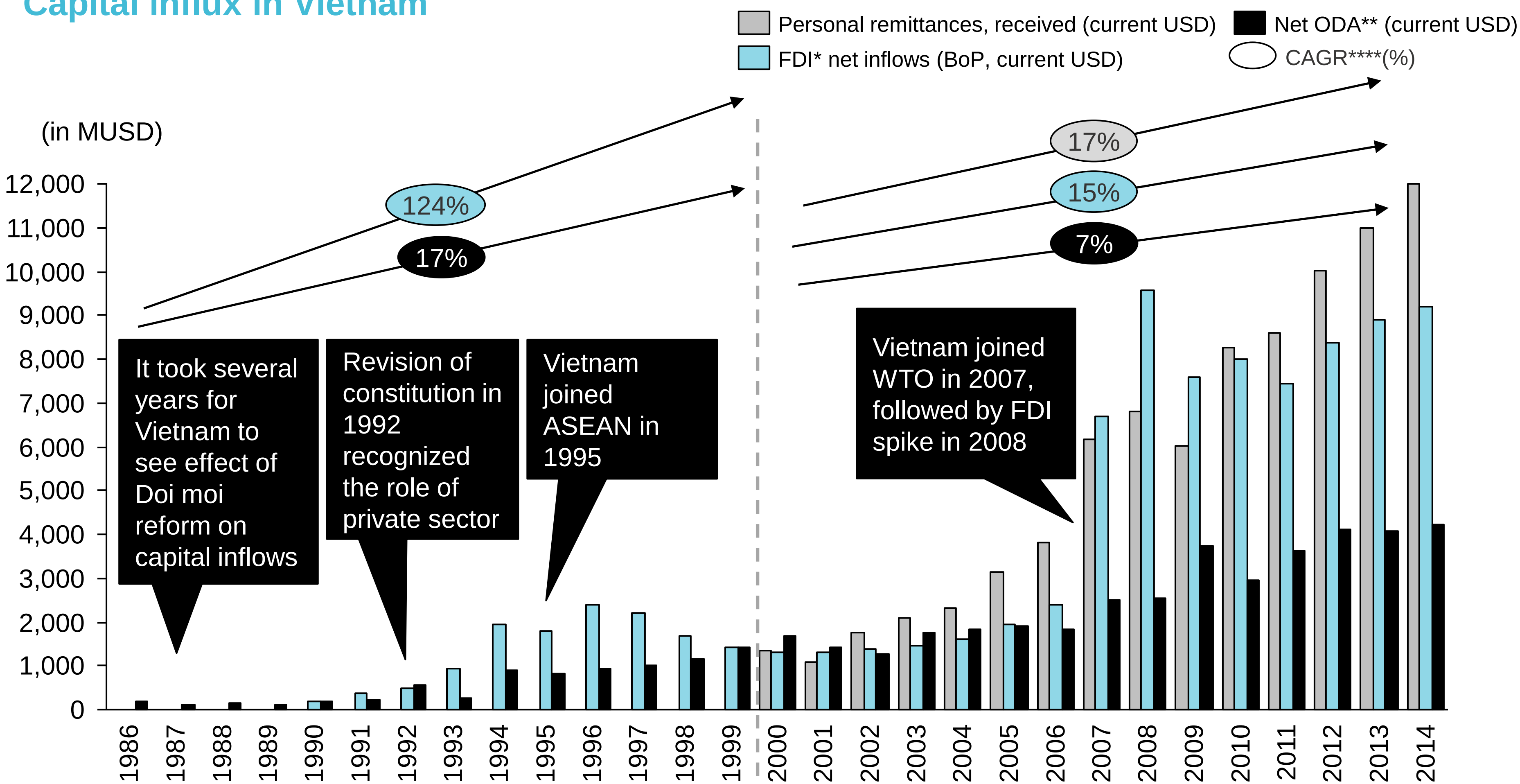
GDP and GDP growth in Vietnam



*:Đổi Mới is the name of the major economic reforms started in Vietnam in 1986 to create a socialist-oriented market economy. **Bilateral Trade Agreement
Source: World Bank (www.worldbank.com)

FDI* and ODA** have been important sources of capital influx for Vietnam, remittances*** taking an increasingly dominant role

Capital influx in Vietnam



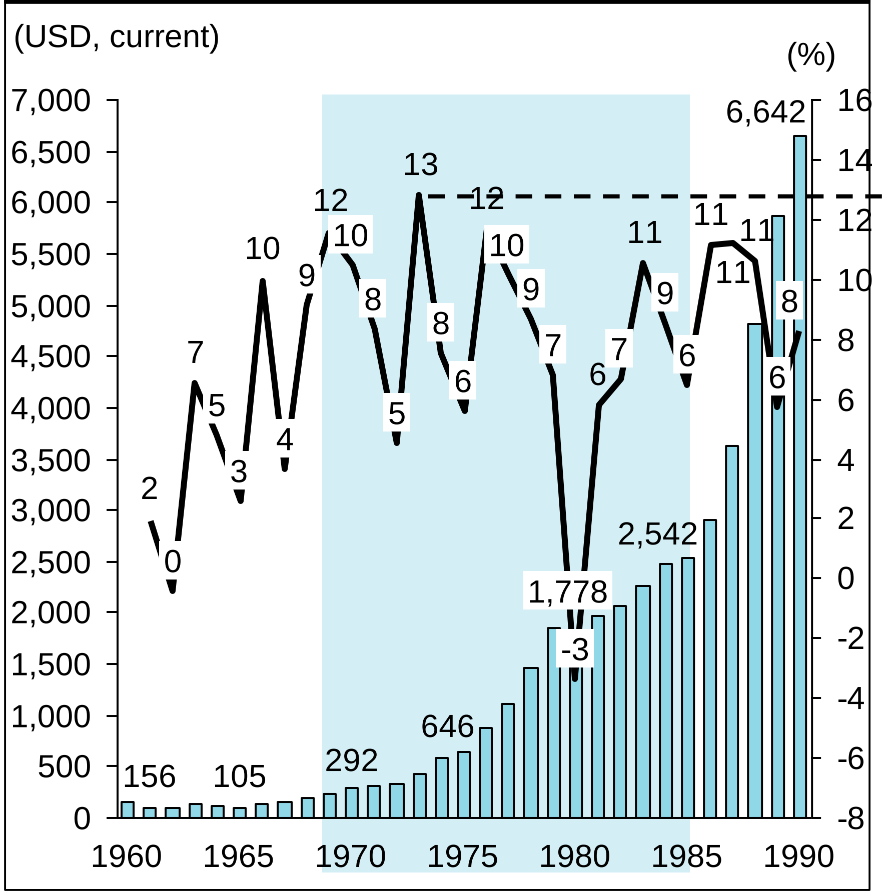
*Foreign direct investments (FDI); **Official development assistant (ODA); ***Data available after 2000, ****Compounded annual growth rate (CAGR)
Source: World Bank (www.worldbank.com)

Vietnam's recent growth has similarities to Korea in the 70s, but with markedly lower growth rate in GDP per capita

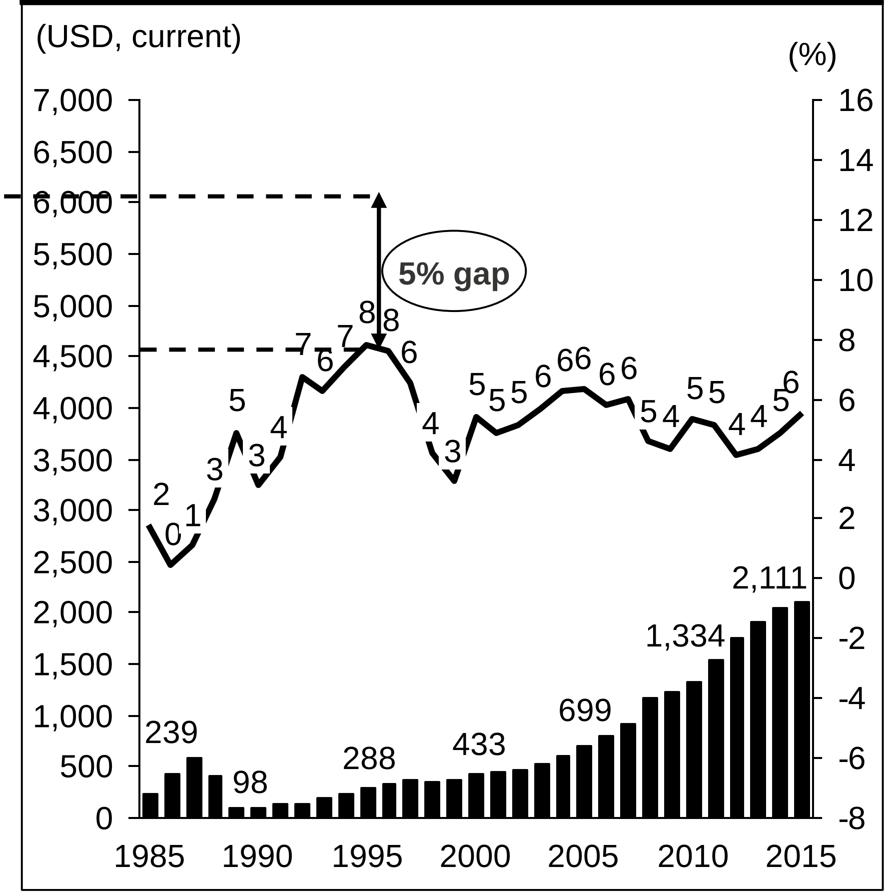
GDP per capita and GDP per capita growth rate

Growth rate - Korea
Growth rate - Vietnam
GDP per capita - Korea
GDP per capita - Vietnam

Korea (1960 – 1990)



Vietnam (1985 – 2015)



Source: World Bank (www.worldbank.com)

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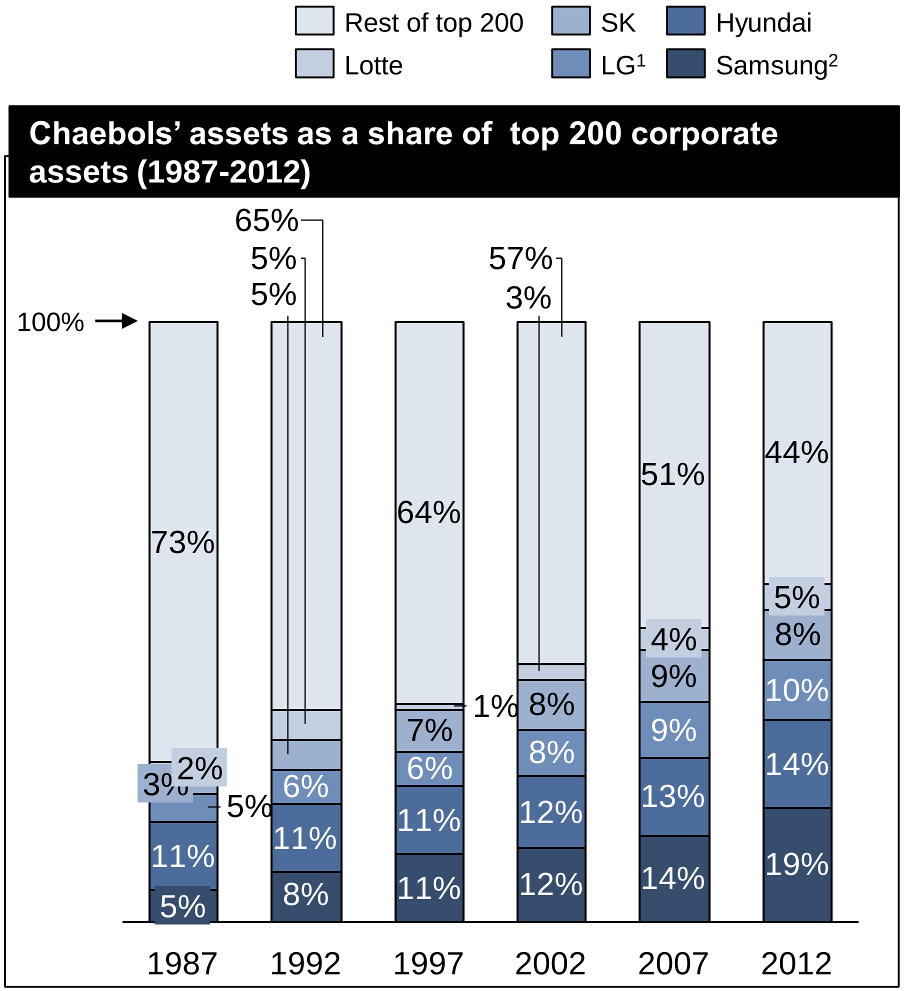
Korea used interventionist/protectionist strategy to drive manufactured goods exports, while subsidizing target industries and related chaebols

Korean growth and industrial policy

Guided capitalism model

Period	Main policy direction
1950s	• Import substitution • Price stability
1962-1971	• Policy shift to export promotion (EP) • Expanding SOC[3]
1972-1981	• Heavy and Chemical Industrialization under EP • Administered credit allocation • Import substitution of parts and components
1982-1991	• Industrial rationalization • Initial liberalization and opening • Shift to private sector initiatives
1993-1998	• Deregulation • Globalization (capital and foreign exchange liberalization) • Fairness and transparency in industrial and trade policy • Technology based industrial policy

Chaebols' assets as a share of top 200 corporate assets (1987-2012)



[1] Includes LG, GS, LS and their affiliates; [2] includes Samsung, Shinsegae, CJ and Hansol; [3]Social overhead capital such as roads, schools and hospitals
Source: ERRI, 재벌 및 대기업으로의 경제력집중과 동태적 변화분석; Ahn, The outward-looking trade policy and the industrial development of South Korea

Most now developed countries (NDCs) used interventionist policies to promote their infant industries

Tariff rates on manufactured products by NDCs in early stages

(in weighted average percentage value)

Period of interventionist trade and industrial policies

	1820*	1875*	1913	1925	1931	1950	Interventionist trade and industrial policies
U.K	45-55	0	0	5	N.A.	23	• Prime minister Walpole introduced industrial reform in 1971, which was intended to promote manufacturing industries • In addition, following policies lowered import duties on raw materials, abolished export duties on most manufactured goods and raised duties on imported foreign manufactured goods
U.S.	35-45	40-50	44	37	48	14	• From 1816 to end of the Second World War U.S. had one of the highest average tariff rates on manufacturing imports
Japan	R**	5	30	N.A.	N.A.	N.A.	• Until 1911, Japan was not able to use tariff protection due to treaties that barred tariffs rates over 5% • Instead, Japan introduced state-owned pilot plants in selected industries including shipbuilding, mining, textile and military industries • After 1911, Japan started introducing high tariff rates to protect domestic infant industries and make imported raw materials more affordable

*Approximate figures; **Import of manufactured goods were highly restricted that tariff was not meaningful

Source: Bairoch (1993); Chang (2005)

However, today's developing nations are endorsed to pursue neoliberal policies – which is not always to their advantage…

Economic growth policy guidelines

Policy related conditions attached to financial aids

- Organizations such as International Monetary Fund and World Bank attach policy related clauses to receive financial assistance
- Donor governments also impose similar market liberalism conditions when providing financial support

Trade agreements forbid tools to promote infant industry growth

- Multilateral trade agreements, including WTO rules, considerably restrict developing nations to leverage active tools to protect infant industry growth

"Based on our experience the real driver of economic development comes from actions that makes doing business easy – this is not necessarily the same as opening the markets."
- Emerging market investor

Reflections

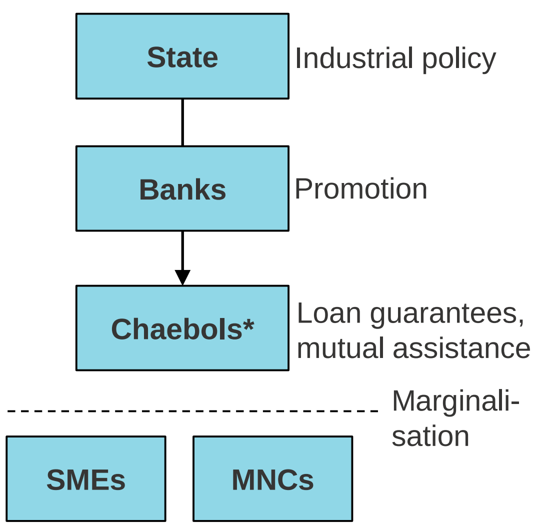
- Today's developing nations must realize that there is no proven "best practice" to catch-up with frontier economies – each country must consider solutions from its specific circumstances
- The chosen growth model needs to be suitable to the country's stage of development and current external environment
- Actions must include efforts to strengthen the domestic industry and ensure its competitiveness
- Attracting FDI or driving a strong industrial policy are not by themselves sufficient policies

Source: Reddal analysis

Korea pursued substitution, while Malaysia and Taiwan pursued complementary strategy

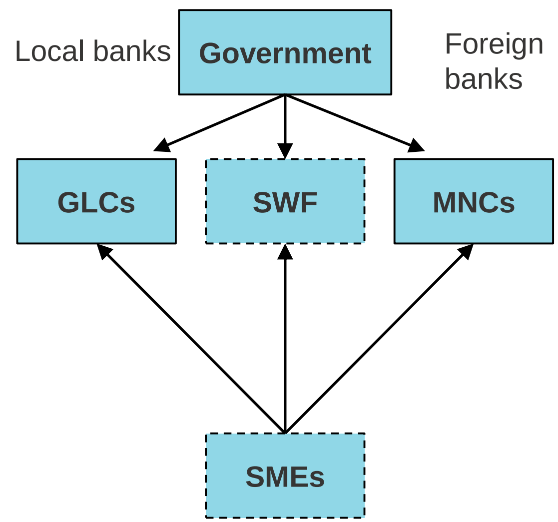
Comparison on national growth models

Korea (also Japan, China)
(substitution strategy)



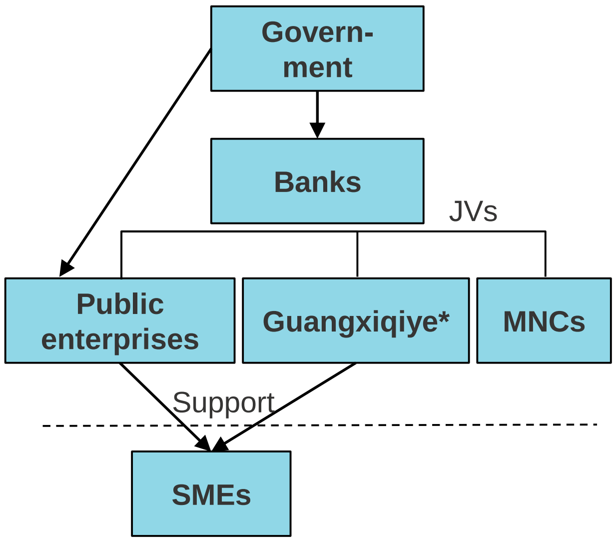
Focus on developing local companies that will "substitute" MNCs, also developing own value chain). This gave rise to Korean chaebols and strong local industries

Singapore and Malaysia
(compl. strat. – int'l model)



Focus on developing supporting SMEs that complement MNCs by participating in their value chains. This made Malaysia vulnerable to MNCs leaving to other countries

Taiwan
(compl. strat. – semi-int'l model)



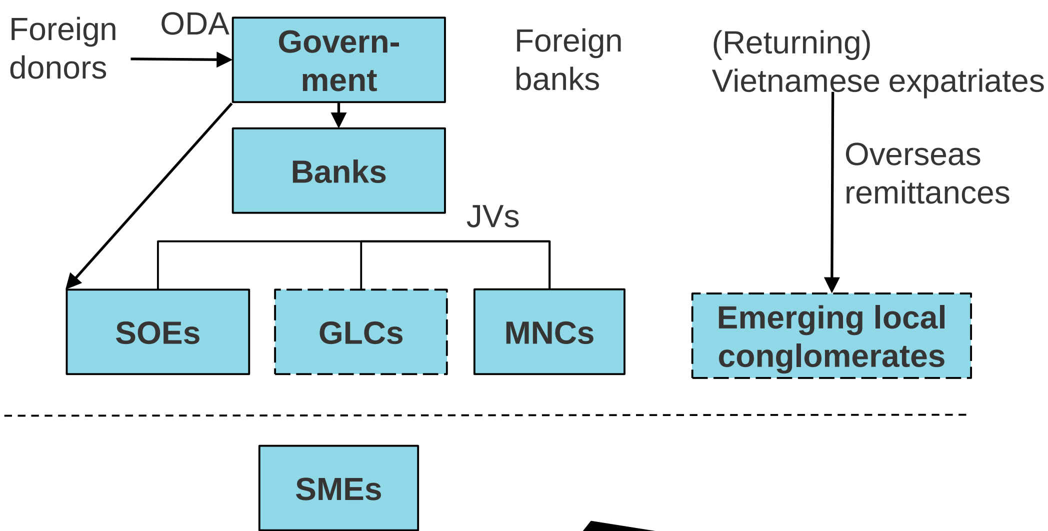
A mix approach combining Korea's substitution and Malaysia's complementary strategy, that gave rise to both local business groups and supporting SMEs

Note: MNC = multinational company, SME = small and medium sized enterprise, GLC = government linked company, SWF = sovereign wealth fund, SOE = 100% state owned enterprise: *Chaebols,keiretsu and guangxiqiye all refer to family controlled conglomerates, but with some distinctions.
Source: Shin, Chang, *Restructuring Korea Inc*., pp. 11-22; Reddal analysis

Vietnamese growth model does not emphasize building strong local companies to substitute MNCs nor strong SMEs to complement

Comparison on national growth models

Vietnam (compl. strat. – semi-int'l model)



Both SOEs and MNCs play a significant role in the Vietnamese economy, typical of a semi-international model. Linkages with SMEs are weak as their capabilities are not strong enough to participate in the value chains.

Comments

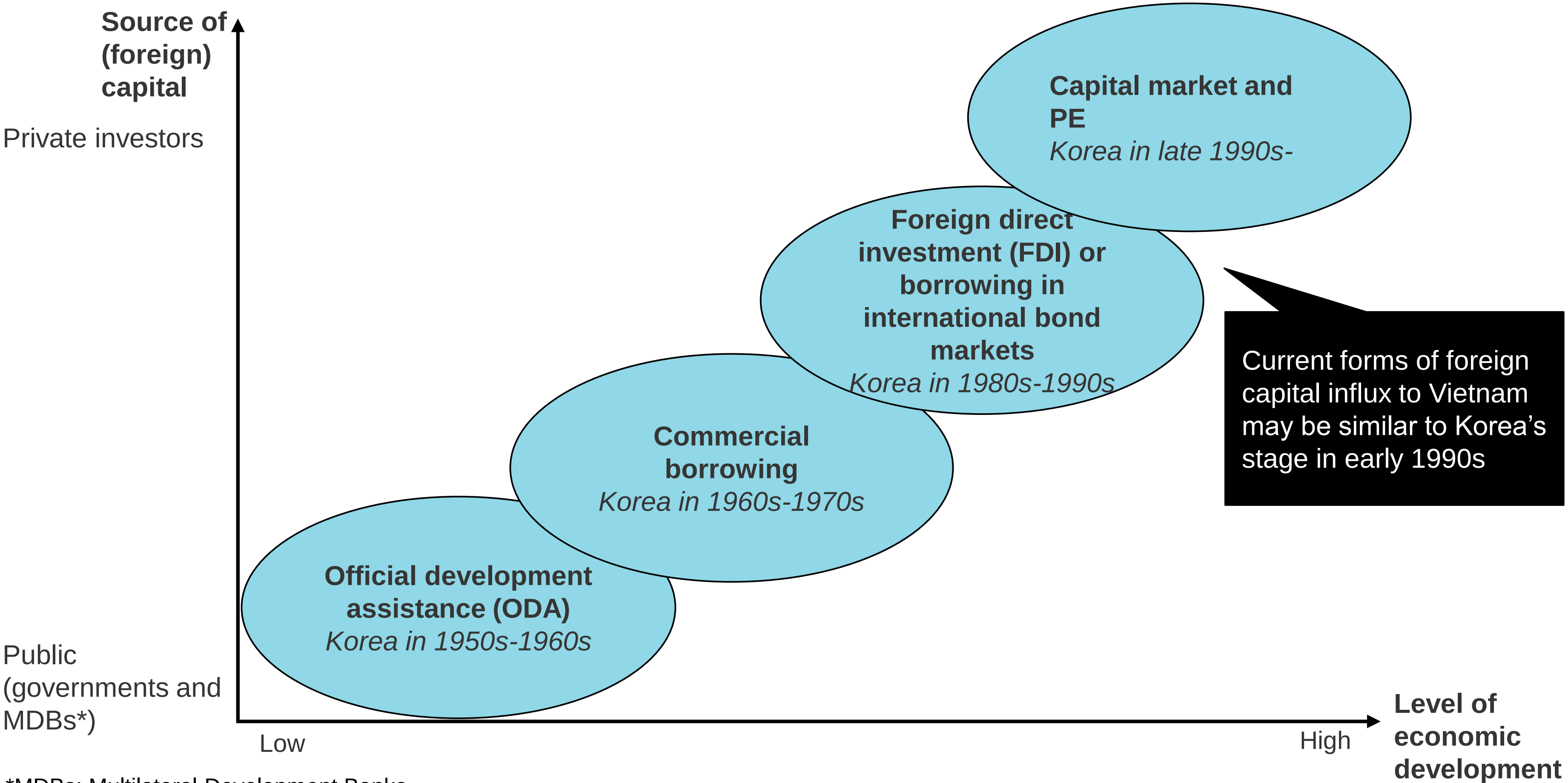
- The Vietnam model is closer to Taiwan, with JV between SOEs and MNCs a common practice because of government equity/license requirements in sensitive sectors and unique access to local knowledge and natural resources
- Vietnamese SOEs are not only owned but also managed by respective line industries/local governments with strong political patronage
- Recent privitization and restructuring efforts of SOEs are slowly turning them to GLCs, which are closer to the Singapore model
- Recent reforms since 1986 "Doi moi" and influx of overseas remittances from Vietnamese expatriates have also encouraged the emergence of a few local conglomerates

Note: MNC = multinational company, SME = small and medium sized enterprise, SOE = 100% state owned enterprise managed by respective line ministries or local governments, GLC = government linked company as result of SOE privatization

Source: Shin, Chang, *Restructuring Korea Inc*., pp. 11-22; Ha Thanh, Nguyen & Klaus Meyer (2004); Van Chung, Vu (2015); Reddal analysis

Compared to the evolution in Korea from 1950 to today, Vietnam is entering the stage where private equity could play a larger role

Evolution of investment drivers – Korea



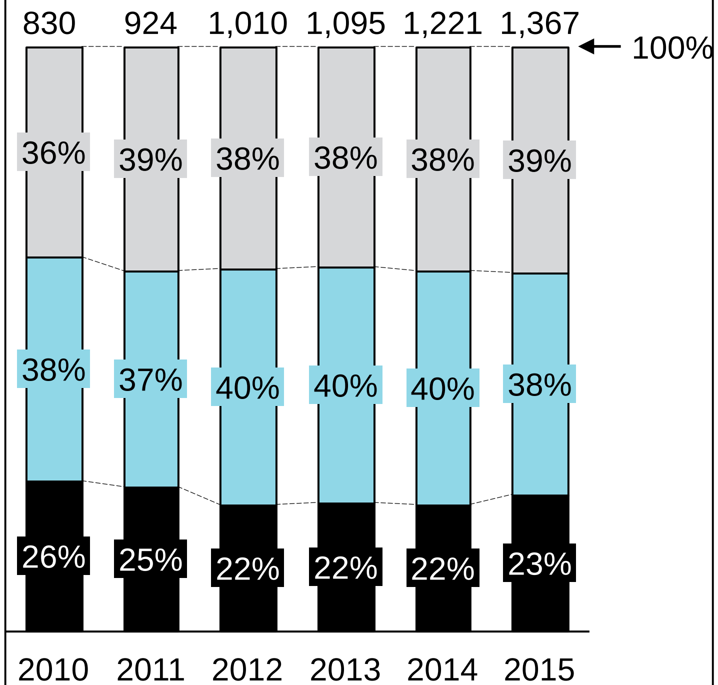
*MDBs: Multilateral Development Banks
Source: Lee, *"Economic catch-up and technological leapfrogging"* (2016)

FDI has been a major contributor to Vietnamese economic development but its spill over effect to the rest of economy has been small

FDI investments and spillover effects

Non-state State FDI

Investments by types of ownership
(total in trillion VND)*



FDI contribution to Vietnamese economy (based on 2015 data)

FDI companies contribution to GDP: 18%

FDI companies contribution to export: 70.5%

FDI companies contribution to state budget revenues**: 14.1%

FDI companies contribution to overall employment: 4.2%

Reflections

- FDI has been focused on industrial manufacturing sector
- It has contributed significant amount to GDP development
- However, its contribution to employment has been very limited
- IMF assumes that most employments have been made through subcontractors and suppliers to the FDI companies; however, the competitiveness of these companies have much room for improvement

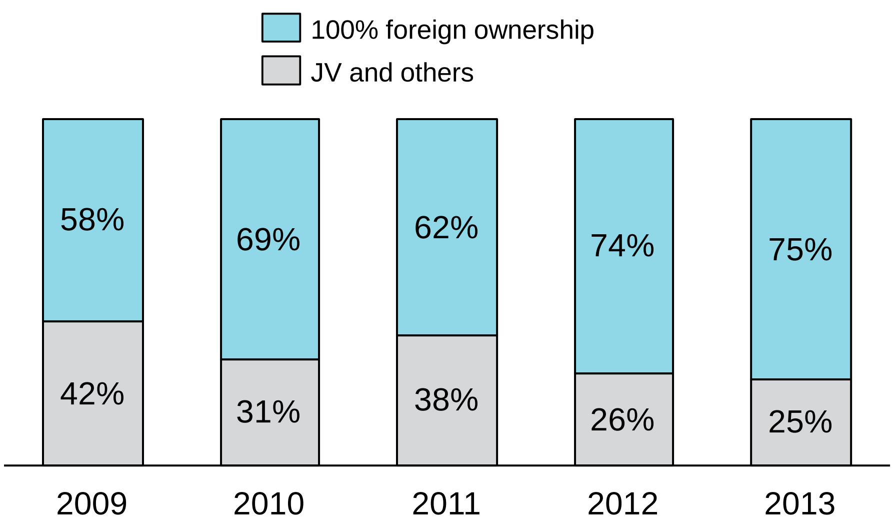
*As of 12/31/2015; **As of 2014

Source: Vietnamese General Statistics Office, Ernst and Young, *Private equity briefing: SEA* (2016); OECD, *Investment Policy Review of Vietnam* (2016); IMF (2002)

Majority of FDI come in the form of green-field investments; Korea has overtaken Japan to be the largest investor

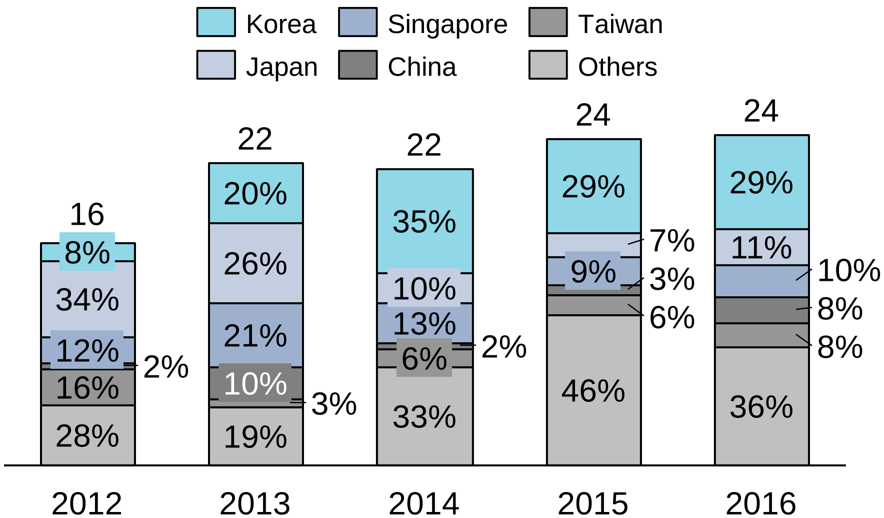
Form and source of FDI investments

Share of annually operation capital from FDI
Percent



- JVs with SOEs were popular but have gradually declined due to bureucracy, inefficiency and corruption scrutiny
- 100% foreign own companies account for the majority of projects as well as operation capital; legal reforms have leveled playing fields between domestic and foreign companies in many sectors
- M&A (brown-field) investments, while popular in East Asia, is still rather limited in Vietnam with much room for growth

Key FDI investors by country of origins, 2012 – 2016
BUSD



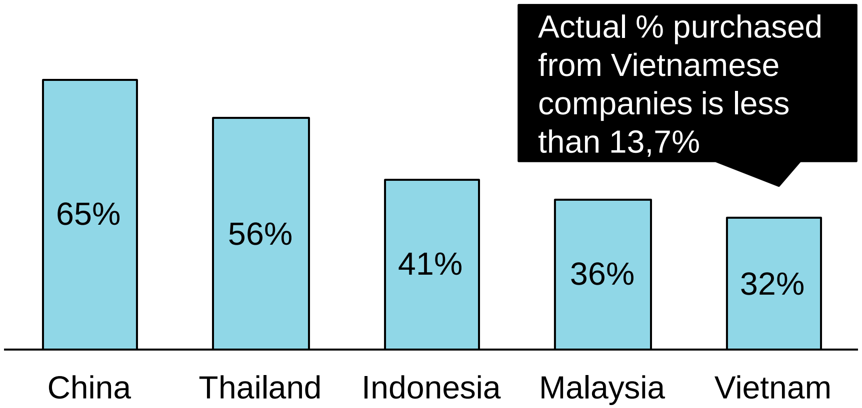
Japan's decrease in FDI activities in Vietnam may be attributed to depreciation of JPY and reported lower profitability in Vietnam compared to Japanese' investments in other countries in the region; China not very visible

Source: Vu (2013), General Statistics of Vietnam

Localization rate and local (Vietnamese) supplier quality assessments highlight the competitiveness issue of Vietnamese players

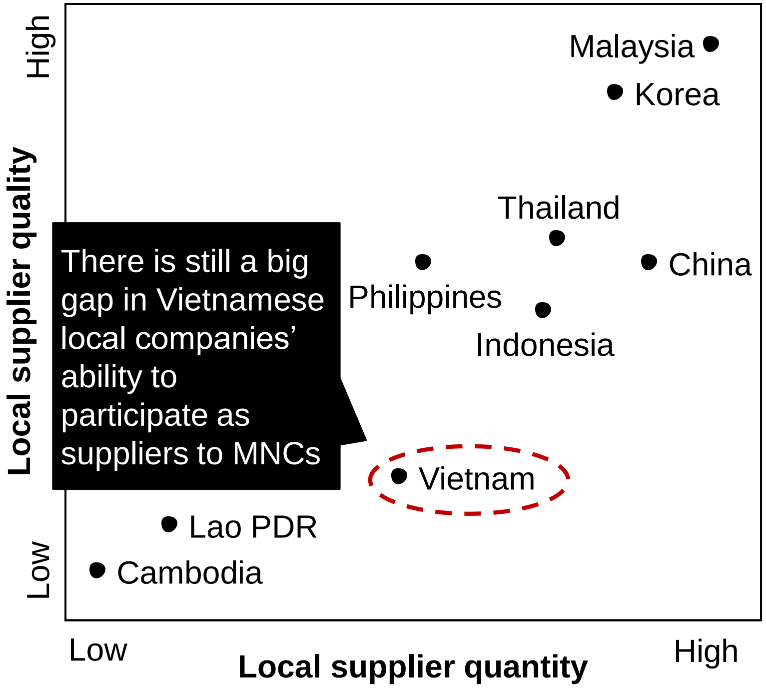
Competitiveness of Vietnamese suppliers

Localization rate* of Japanese-invested manufacturers by country, 2015



- Out of 32% Japanese local sourcing in Vietnam, 45% was sourced from Japanese companies operating in Vietnam and 14% from Taiwanese companies operating in Vietnam
- Low localization rate has directly affected Japanese invested companies' profitability in Vietnam
- Vietnam has been cooperating with Japan since 2000s to build supporting industries but have failed to realize two planned supporting industrial parks after 14 years

Local supplier quantity and quality, 2015**

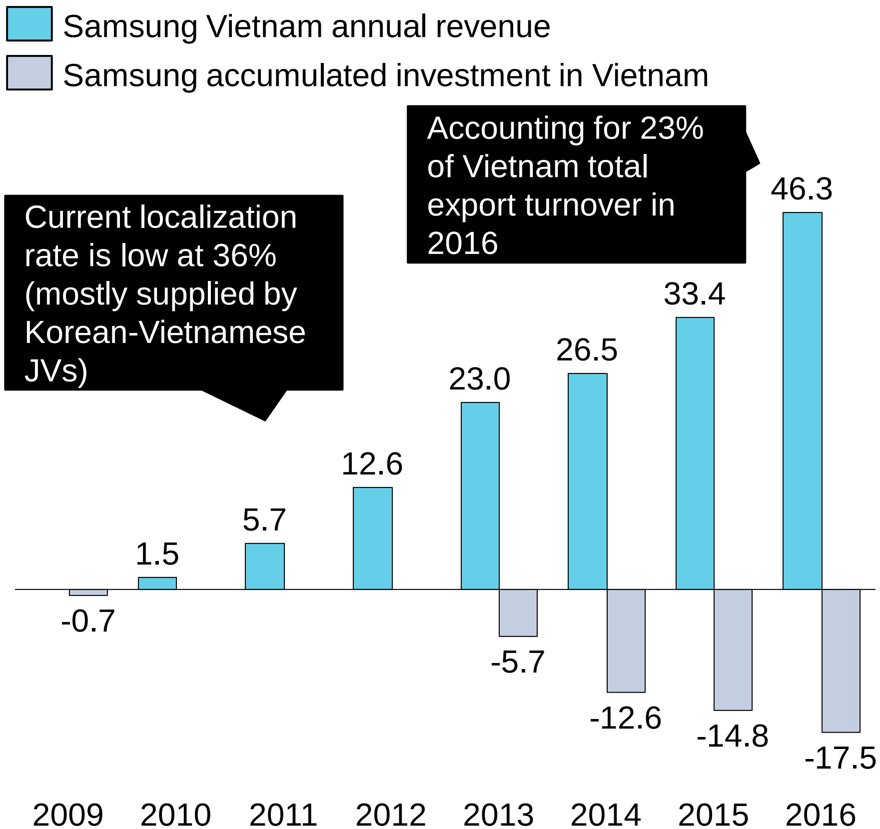


*Localization rate is defined as % of raw material and intermediary goods sourced locally, **Based on OECD ranking of 140 countries
Source: JETRO annual survey, OECD, press articles

In addition to phenomenal revenue growth, Samsung is taking an active role in developing Vietnamese supporting industry

Samsung annual revenue and accumulated investments in Vietnam

BUSD



Source: press articles, Reddal analysis

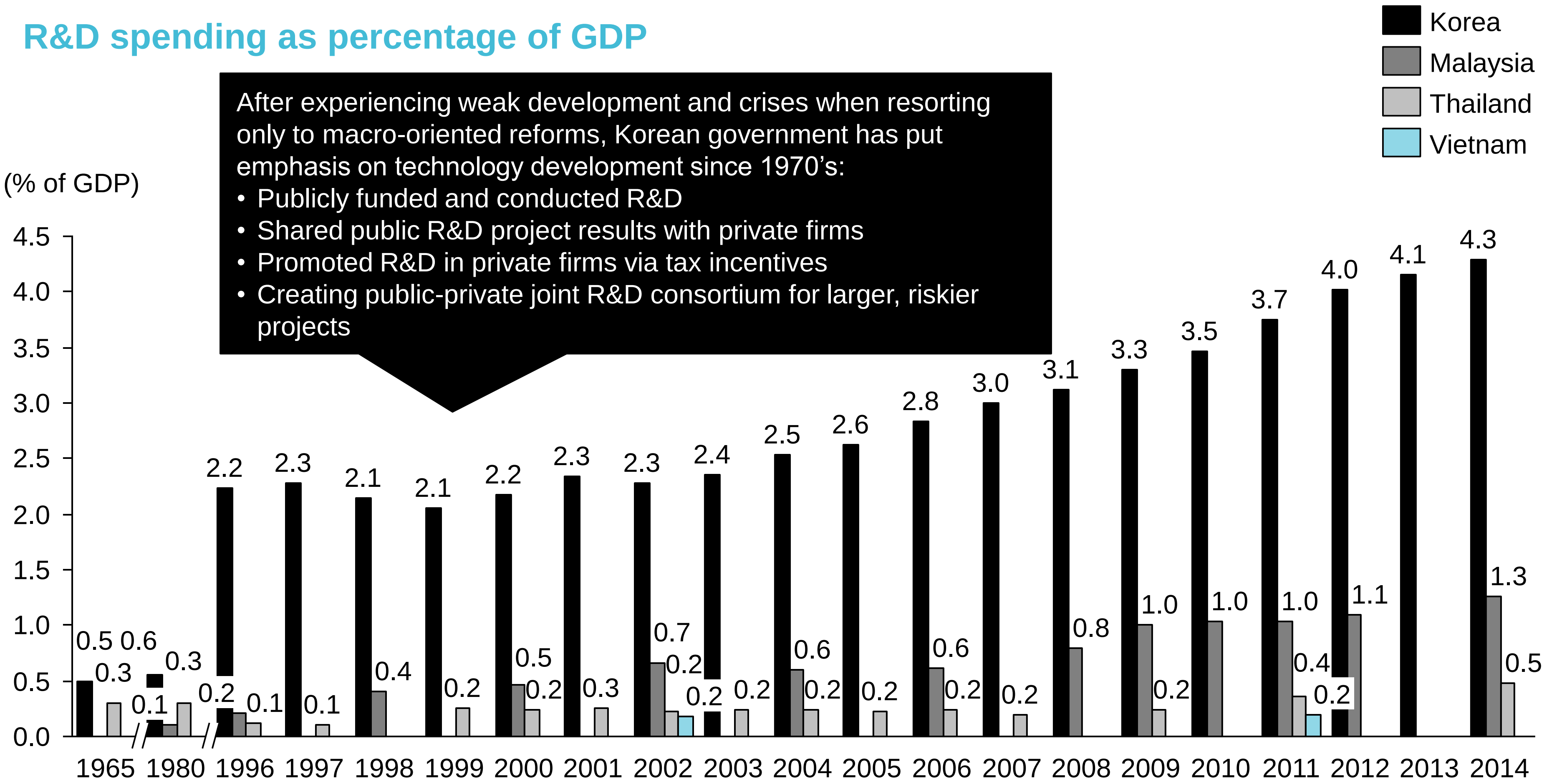
Samsung role in developing supporting industries in Vietnam

- Samsung Vietnam expects to increase the localization rate of products to 57% in 2017 from the current 36%
- Number of Vietnamese companies (though mostly JV with Korean companies) involved in Samsung supply chain reached 190 in 2016
- Samsung announced in 2017 that it aimed to fill 90% of jobs in manufacturing operations with Vietnamese workforce; currently 50% of management positions are Vietnamese
- Samsung is organizing conferences to find new local suppliers for more than 200 components and measures to increase competitiveness of local players in supporting industries together with Vietnamese Ministry of Industry and Trade

Experts from Samsung work directly with local suppliers to improve both quality and operational efficiency. For example, Goldsun reduced inventory level by 60%, faulty rate by 72% and increased ability to supply correct requested quantity from 0% to 94%

Vietnam (like its peers in SEA) lags behind in R&D spending, when compared to Korea

R&D spending as percentage of GDP

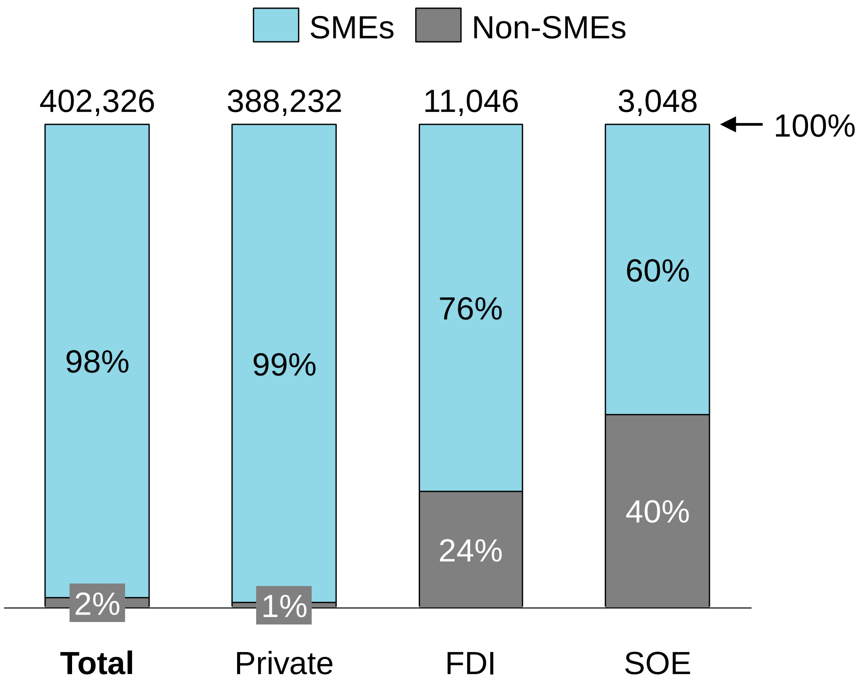


Note: data for 1965 and 1980 based on Reddal estimation from *"Economic catch-up and technological leapfrogging"*
Source: World Bank (www.worldbank.com); Lee, *"Economic catch-up and technological leapfrogging"* (2016)

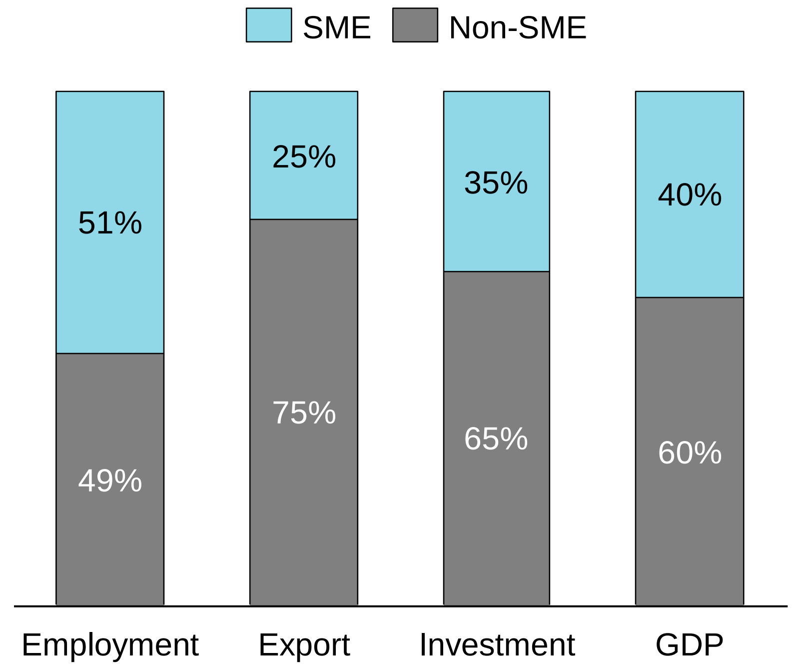
Economic contribution of the numerous local SMEs to Vietnamese economy has been limited

Distribution and economic contribution of Vietnamese SMEs*

Share of number of companies by size and sector, 2014



Contribution of SMEs in different economic indicators, %

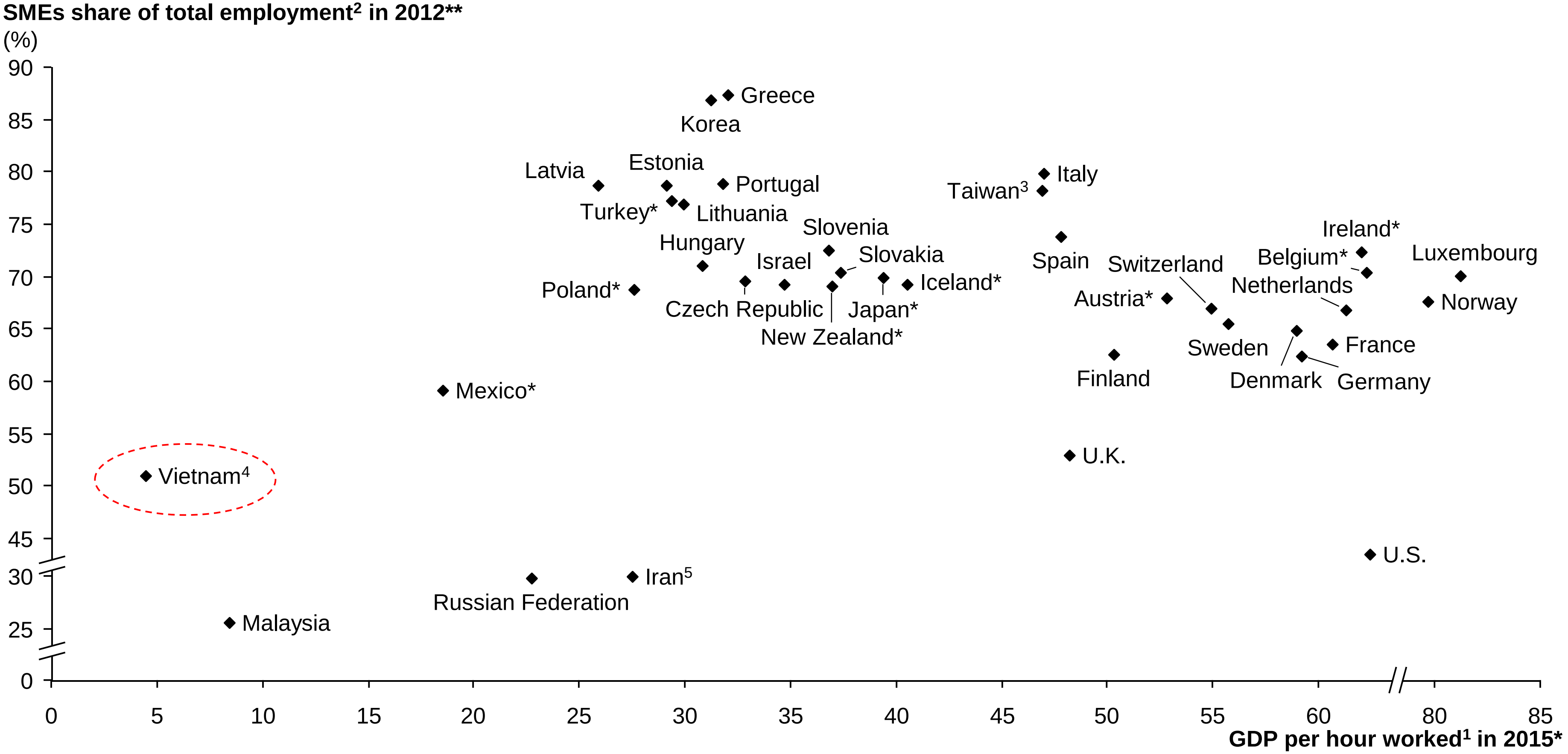


*SMEs are categorized into small and micro (below 50 persons), medium (50 – 199 persons) and large (above 200 persons)

Source: General Statistics Office of Vietnam

In global terms, Vietnamese SMEs' limited role in employment and their very low productivity stands out

SMEs contribution to overall economy by country (full list of countries)

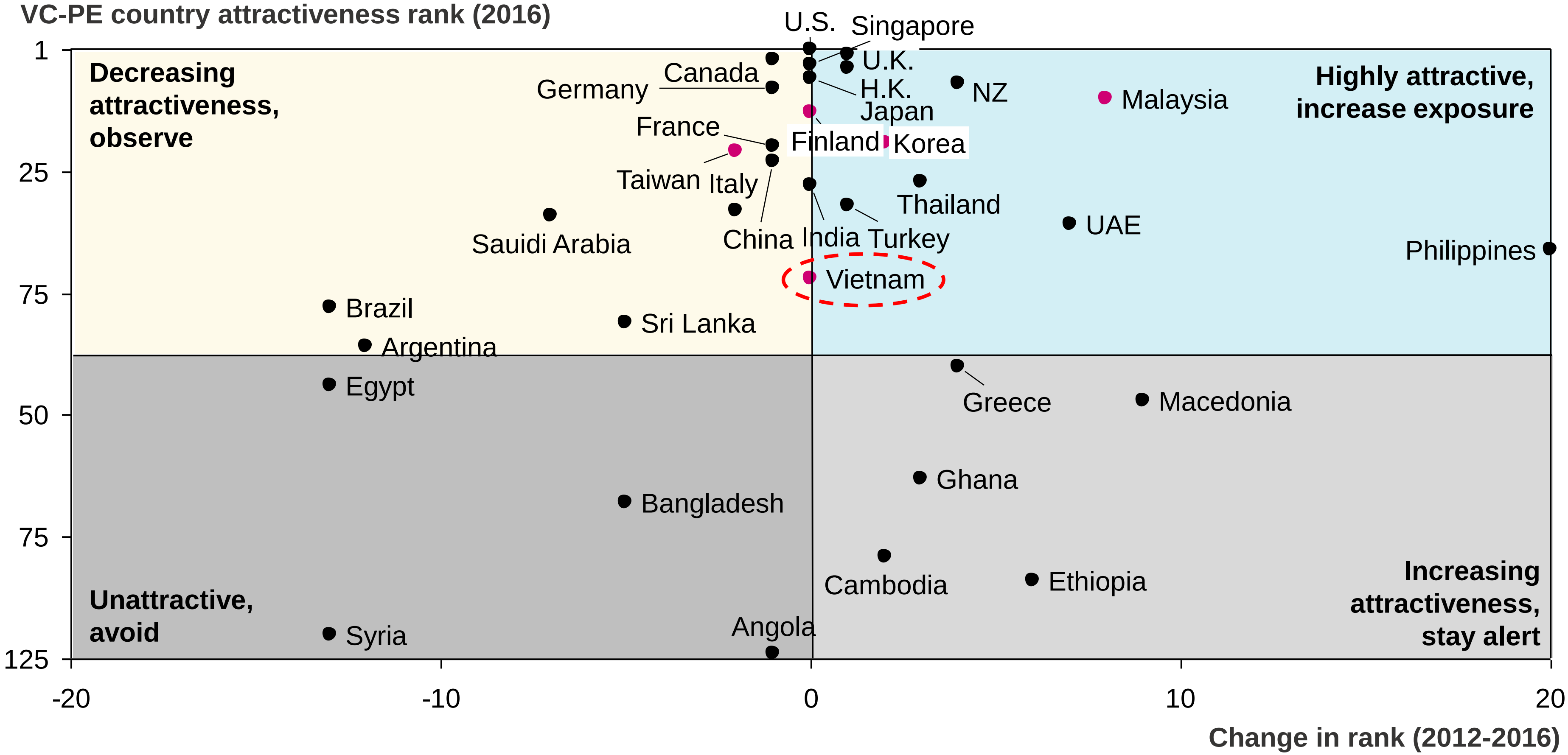


*Used 2013 number of labor forces and 2016 GDP for Iran and 2014 data for Korea and the U.S.; **Used 2013 data for Korea

Source: [1]OECD, *Compendium of Productivity Indicators* (2016); [2]OECD, *Entrepreneurship at a Glance* (2015); [3]Ministry of economic affairs of the R.O.C and The conference board total economy database; [4]General Statistics Office of Vietnam; [5] Statistical Center of Iran (www.amar.org.ir)

In international comparison Vietnam does not yet rank very highly in PE attractiveness, nor is its ranking on the rise

Comparison of attractiveness of VC-PE sector by country (IESE), 2016



Source: IESE Business School, University of Navarra, *Venture Capital and Private Equity Country Attractiveness Index* (2016)

Both macro-economic and societal factors as well as sector specific indicators contribute to measuring VC-PE attractiveness

Six key drivers for VC-PE attractiveness index

Drivers	Proxy	Sub-category
1. Economy	Total economy size (GDP), expected real GDP growth and unemployment	
2. Depth of capital market*	Size of stock market	Market cap of listed companies and number of listed domestic companies
	IPOs and public issuing activity	Market volume and number of issues
	M&A market activity	Market volume and number of deals
	Debt and credit market	Ease of access to loans, credit information index and lending rate
	SM liquidity (trading and volume), bank non-performance loans and financial market sophistication	
3. Taxation	Tax and administrative burdens	Entrepreneurship incentive, number of tax payments and time spent on tax issue
4. Investor protection and corporate governance	Quality of corporate governance	Disclosure index, director liability index, shareholder suits index, legal rights index and efficacy of corporate boards
	Security of property rights	Legal enforcement of contracts, property rights and intellectual property protocols
	Quality of legal enforcement	Judicial independence, impartial courts, integrity of the legal system, rule of law and regulatory quality
5. Human and social environment	Education and human capital	Quality of educational system and quality of science research institutes
	Labor market rigidities	Difficulty of hiring index, rigidity of hours index, difficulty of firing index and firing costs
	Bribing and corruption	Bribing and corruption index, control of corruption and extra payments and bribes
6. Entrepren-eurial culture and deal opportunities	Innovation	Innovativeness index and capacity for innovation
	Science and technology journal articles	
	Ease of starting and running a business	Number of procedures to start a business, time needed to start a business and costs of business start-up
	Simplicity of closing a business	Time for closing a business and costs for closing a business
	Recovery rate	Corporate R&D and R&D spending and utility patents

Source: IESE Business School, University of Navarra, *Venture Capital and Private Equity Country Attractiveness Index* (2016)

Key messages

Despite rapid growth and foreign investment, Vietnam's economy (like many of its peers in SEA) remains vulnerable due to weak local supporting industries

Vietnam's private equity sector is still small and volatile but a vibrant ecosystem is starting to shape up, partially due to government support

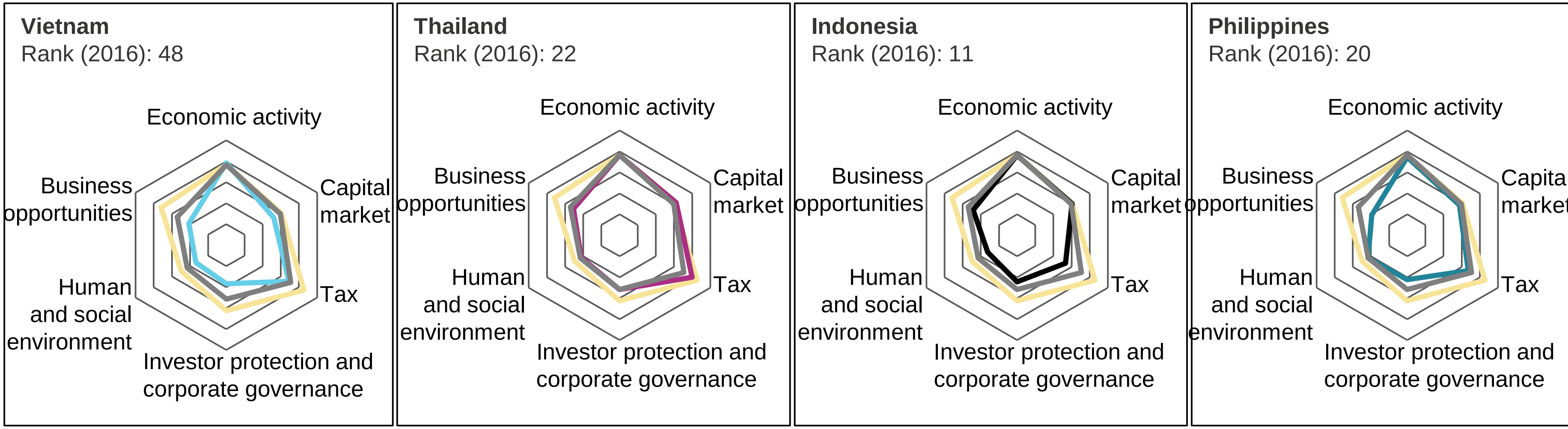
Finding good deals and driving systematic value creation continue to be challenging for private equity players – it is still about finding the "right opportunistic deal", and there is room for more active HR, process, top- and bottom-line performance improvement

Vietnam has promise but requires transparent policy – consumer- and technology-driven sectors have potential, and private equity could have a big economic impact if actively and transparently engaged in SOE reforms

The Vietnamese VC-PE market lags behind in terms of entrepreneurial, human and legal factors

IESE VCPE country attractiveness index

ASEAN* average — Vietnam — Thailand — Indonesia — Philippines — Korea



- Similar to other ASEAN peers, Vietnam represents attractive economic activity and its capital market infrastructure continues to develop
- However, "investor protection and corporate governance", "human and social environment" and "business (entrepreneurial culture and deal) opportunities" are still poorly developed

*Average of ASEAN countries (Malaysia, Indonesia, Philippines, Vietnam, Cambodia and Thailand), excluding Myanmar, Laos and Brunei
Note: chart using scores for each driver; Asia average is weighted average of individual country data (Armenia, Azerbaijan, Bangladesh, Cambodia, China, Hong Kong, India, Indonesia, Japan, Kazakhstan, South Korea, Kyrgyzstan, Malaysia, Mongolia, Pakistan, Philippines, Russia, Singapore, Sri Lanka, Taiwan, Thailand and Vietnam) by GDP or population
Source: IESE Business School, University of Navarra, *Venture Capital and Private Equity Country Attractiveness Index* (2016)

Private equity market was initiated with committed capital from MDBs*, followed by activities from global PEs seeking higher returns

Vietnamese PE industry history and key milestones

Phase 1: Real-estate focused | **Phase 2: More classic PE deals and profitable exits** | **Phase 3: Higher value deals from global PEFs**

1997 … 2001 … 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016

- 2001: First PEF established (Mekong Capital) in collaboration with WB and ADB
- 2006: PENM and VIGroup established, invested by World Bank and sovereign wealth funds
- 2007: Peak year of secondary sales and SOE privatization
- 2011: KKR invested 159MUSD in Masan
- 2013: Warburg Pincus invested 200MUSD in Vincom
- 2015: Warburg Pincus invested 100MUSD in Vincom

Phase 1

- During the early stages of Vietnam's stock market from 2000 to 2005, stocks were thinly traded; similarly, PE market activities were quiet
- PE funds mainly attracted capital from foreign investors to invest in real estate
- World Bank's IFC made a seed investment in Mekong Capital, the first PE firm in Vietnam

Phase 2

- During 2005-2011, more PE-focused funds raising funds from foreign investors were established locally; this also made secondary sales a more viable exit path
- Transactions were most vibrant in 2007-2008; the peak year was 2007; most of transactions were secondary sales (PE funds exiting an investment by selling it to another PE fund or funds)
- Notable exit deals in this period: Dragon Capital and VPBank in 2010 (IRR 21%); Mekong Capital and Saigon Gas (2005 – 2009, IRR 26%); VinaCapital and Hilton Hotel (2006 – 2009, IRR 26%); VinaCapital and Masan (2006 – 2009, IRR 83%)

Phase 3

- The market attracted more large global PE firms, such as Warburg Pincus, KKR, and Navis Capital
- Most funds with local presence are in the exit stage with investments from previous boom period, with some notably profitable exits; KKR divested 52% of Masan in 2015, Mekong Capital sold shares in Golden Gate to SCPE in 2014 with 45% IRR
- The government has started to recognize the importance of equity based financing in supporting Vietnam's nascent start-up scene (especially in the ICT sector), which has resulted in drafting VC specific regulation

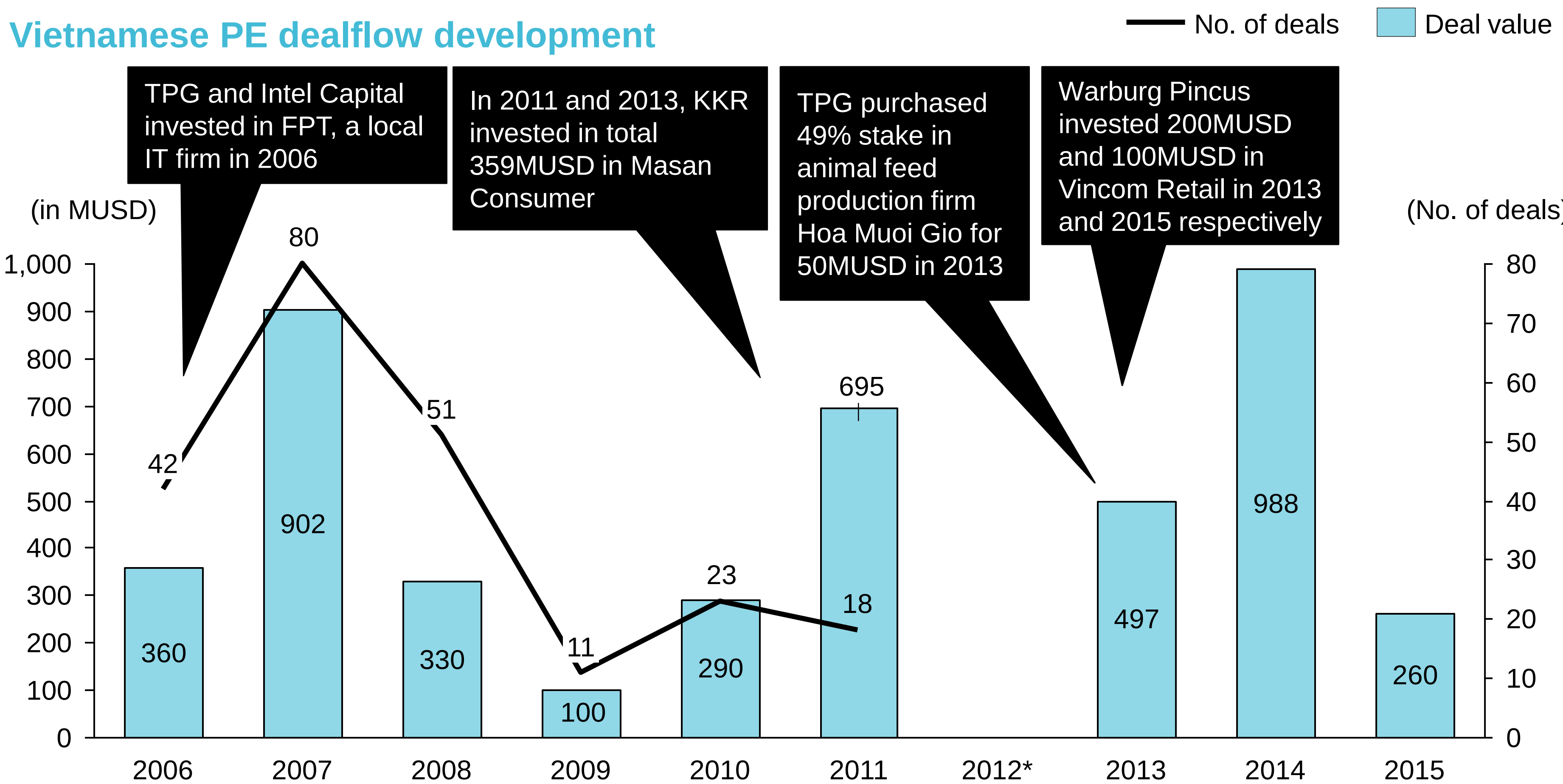
There is a lack of local LPs that invest into PE funds; local investors prefer to make investments themselves based on their own networks/connections

*Multilateral Development Banks

Source: press articles, fund websites, Reddal interviews

Vietnamese PE market development has been volatile, with few large deals by global PE funds skewing the annual deal value

Vietnamese PE dealflow development



*Reliable data not available

Source: BCG (2012), Deal Street Asia (2015), Financial Times (2016), Kroll (2015)

The Vietnamese government started to encourage private investment with reforms in investment laws and upcoming VC legislation

Regulatory framework for private investment in Vietnam

Draft
Valid

U.S. and European framework

- **Private equity**
  - **Venture capital fund**
  - **Buyout fund**
  - **Mezzanine fund**
  - **Vulture fund**
- **Hedge fund**

Vietnamese framework

- Circular to regulate VCs activities for innovation
- **Law on Securities (2006), updated in 2010**
- **Law on Enterprise (2014)**
- **Law on Investment (2014)**
- **Circular to regulate fund activities (2012)**

VC fund licenses have been separately arranged with government on special terms

Private invesetment is loosely regulated under the same umbrella of private funds and foreign investments

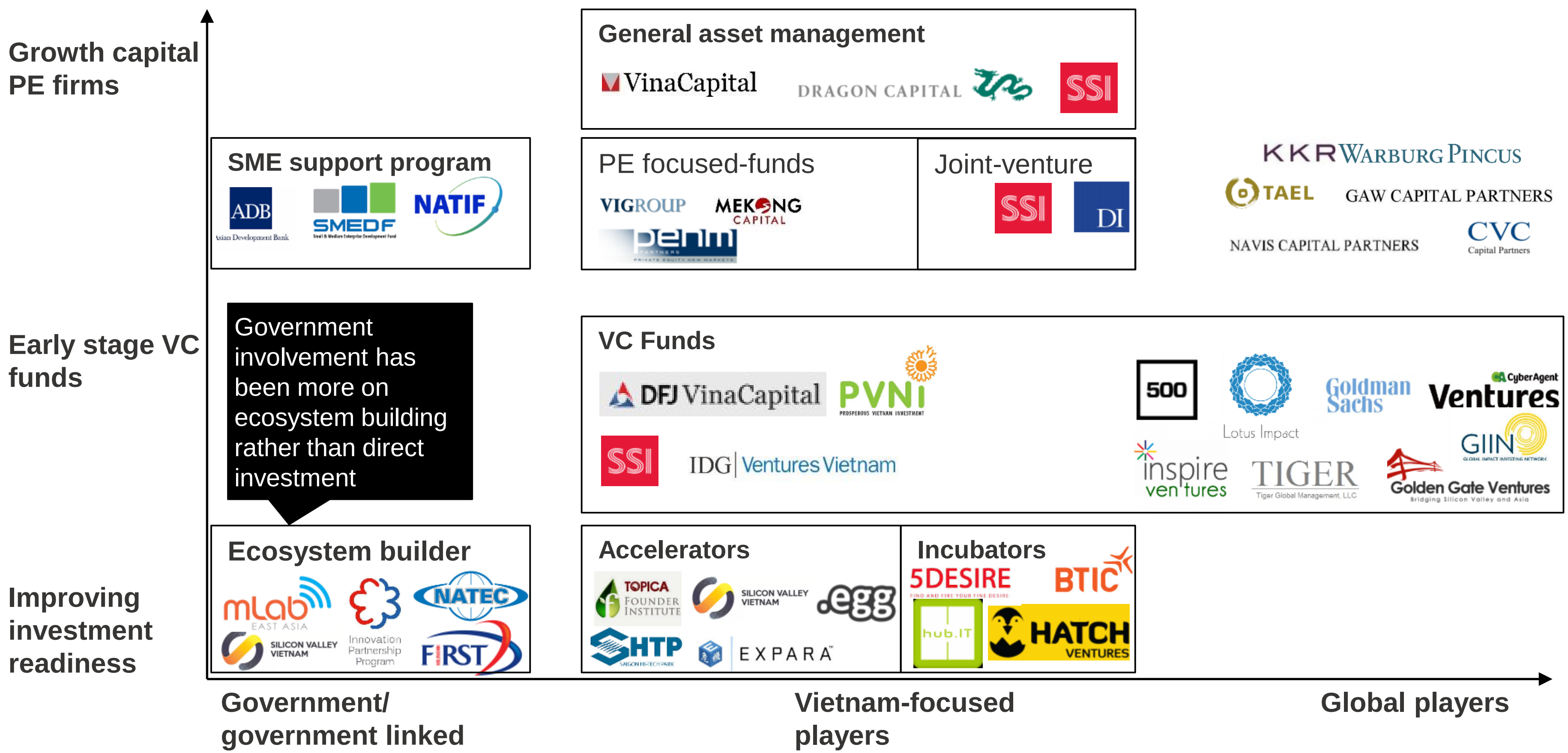
Remarks and latest developments

- Current lack of seperate legal framework and relevant incentives deters potential investors and increases uncertainty
- Driven by political initiatives to transform Vietnam into a start-up nation, a legislative draft is under development to regulate VC activities to fuel start-up activities
- New updates in the Investment Law and the Enterprise Law in 2014 aim to create more favorable conditions for investment and M&A activities, facilitating private equity activities in Vietnam
- In 2015, Decree No. 60/2015/ND-CP lifts the 49% cap on foreign ownership in Vietnam's listed companies in sectors not specifically regulated, which opens up exit paths for PE investments to some extent

Source: Practical Law (http://uk.practicallaw.com); press articles, Reddal analysis

Government explicit support translates to a vibrant ecosystem for early stage while growth stage has received slightly less attention

Vietnam VCPE ecosystem

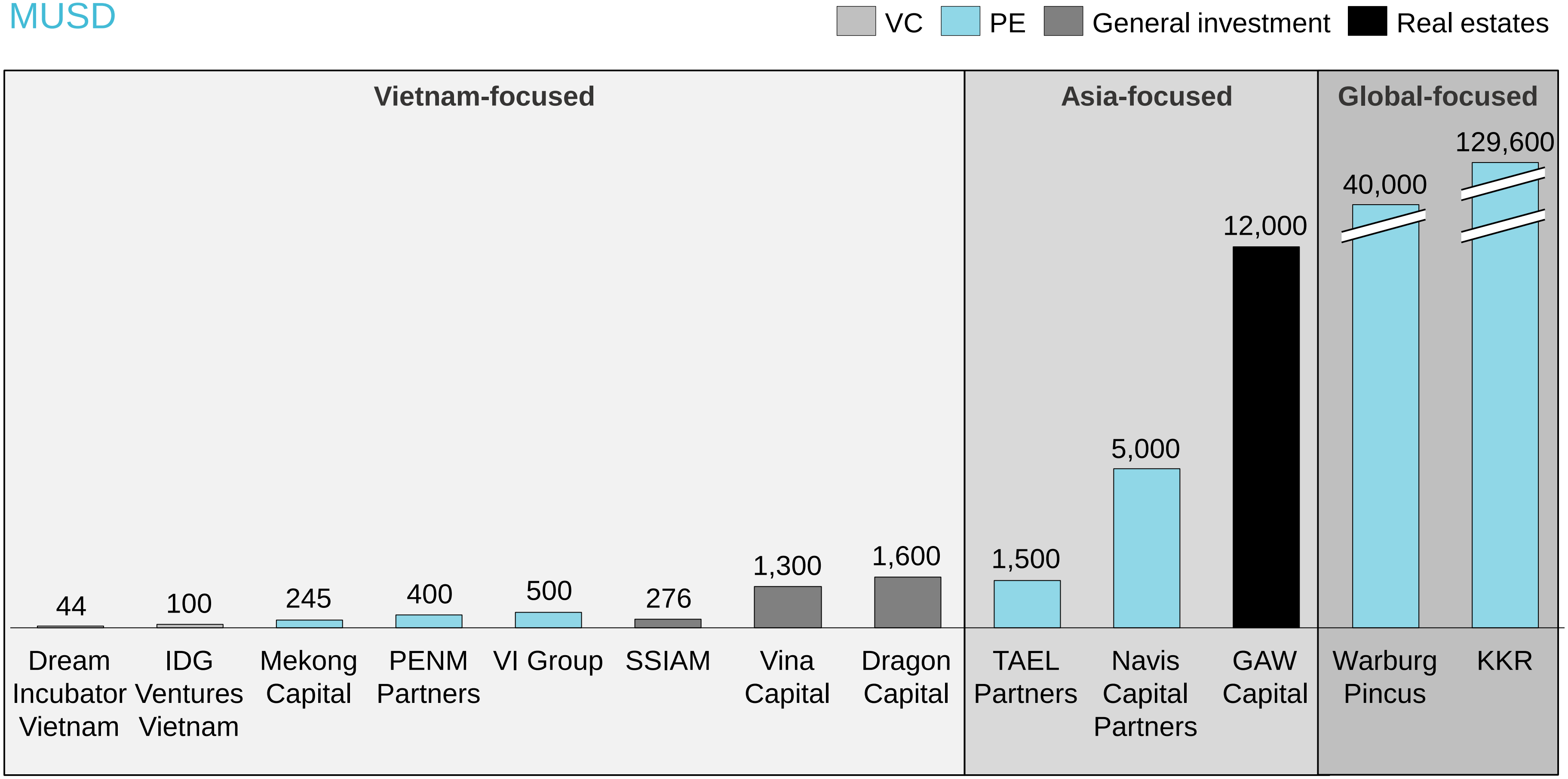


Source: Topica Founders Institute 2015, Reddal analysis

Locally based VCPE firms are still small in size compared to more senior regional/global PE houses

Local VCPE firms by AUM (as of December 2016)

MUSD



Source: funds' websites, press articles

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Vietnam has typical characteristics of an emerging market, which creates a mixed investment strategy of both buyout and growth capital

Unique characteristic of PE in emerging markets

Deal sourcing characteristics result in minority positions

Smaller transaction size due to limited use of leverage
- Lower leverage found is found in emerging markets due to a set of factors including regulation and culture

Difficulty in acquiring majority stake in targets
- Due to family ownership of majority of firms, the owner/founder is often reluctant to give up majority shareholder position

Smaller pool of suitable targets
- Mix of above two factors on top of weak contract enforcement and legislative infrastructure make it difficult for PE funds to find attractive targets

Value creation characteristics put more emphasis on operational efficiency improvement

Multiple expansion (financial arbitrage) potential limited
- Financial arbitrage/multiple expansion requires a coherent stock market, Vietnamese stock markets are still in development stage lacking efficiency and liquidity
- Due to lack of transparency and poor corporate governance, it is difficult for PE funds to leverage information asymmetry
- While volatility provides value creation opportunities by multiple expansion, this is driven by exogenous factors and highly risky

Lower emphasis on financial leverage
- While GPs do leverage debt, it is often seen as a means to achieve operational improvement
- To deal with decreased incentives to management due to lower leverage, GPs offer management packages that include earn-out and other ratchet mechanisms

Conclusion
- Minority share acquisition predominant, yet with negotiation on shareholders' agreement, GPs effectively obtain a similar level of control as the one found in western LBOs
- Same standard definitions of buyout and growth capital do not apply in emerging markets (including Vietnam)

Source: Fontaine, *Value generation in emerging markets PE* (2014)

Local PE tend to be flexible and patient in choosing targets while global PE are willing to pay premiums for top quality assets

Characteristics of PE investors in Vietnam

Global PE investors

While local junior PE firms often invest in SMEs with proven business models, more senior global PE firms or foreign strategic buyers often target bigger companies, top in their industries, to quickly gain market share.

Global PE or foreign buyers are willing to pay for premium to acquire top quality assets in their field, sometimes resulting in distortion of valuation in lower cap segments.

Local PE investors

Many of our LPs are government related funds. We had an agreement early on with our LPs that finding really good targets in the midst of information intransparency is more important than quick disbursement of committed capital at all costs. We have a long-term investment horizon.

We are generally not too picky in choosing investment targets in terms of sizes and ownership control as long as targets have strong fundamentals. Minority investment is prevalent because of a strong preference for control from business owners.

Low information transparency leads to the use of different risk mitigation methods, such as convertible bonds and performance-linked conditional purchase prices.

We are opportunistic. The market is too small for focus. We are flexible on how we work with owner/management. But it is critical to find the right kind of target and owner, with the right fundamentals/ core advantage.

Source: Reddal interviews with PE firms in Vietnam

While struggling to find investment ready targets, PE firms add value through management/networks and prefer exits through trade sales

Key characteristics of PE value creation in Vietnam

PE find it difficult to find sizable deals

- Attractive target sizes for PE firms in Vietnam are companies with at least 10 – 20 MUSD revenues, but only 7% of private companies have revenues above 2,2 MUSD
- Lack of sizeable targets force local PE firms to look outside of Vietnam for targets and use roll-up strategy with an anchor investment to boost investment size

Minority stakes and regulation affect value add options

- Even without majority stake, a common approach for value creation is board representation to influence strategy; many investors also bring a network of connections to relevant business and distribution partners
- Operational improvements are low-hanging fruit but less of a focus; leveraging PE brand name is another ”by-product” that can boost value creation by improving credibility of portfolio company
- Legal restrictions in certain sectors restrict deeper involvement into actions that drive top-line and margin improvements

Sales to foreign strategic buyers are most common

- Trade sales and secondary sales to foreign strategic investors are preferred as an exit route; IPO is difficult as liquidity in the capital market is limited
- Regionalization trend in ASEAN has a positive effect; foreign companies are interested in buying Vietnamese targets to gain market share

Source: Reddal interviews and analysis

ILLUSTRATIVE

Challenges include expectation mismatch due to inflated prices paid by foreign buyers and lack of information transparency

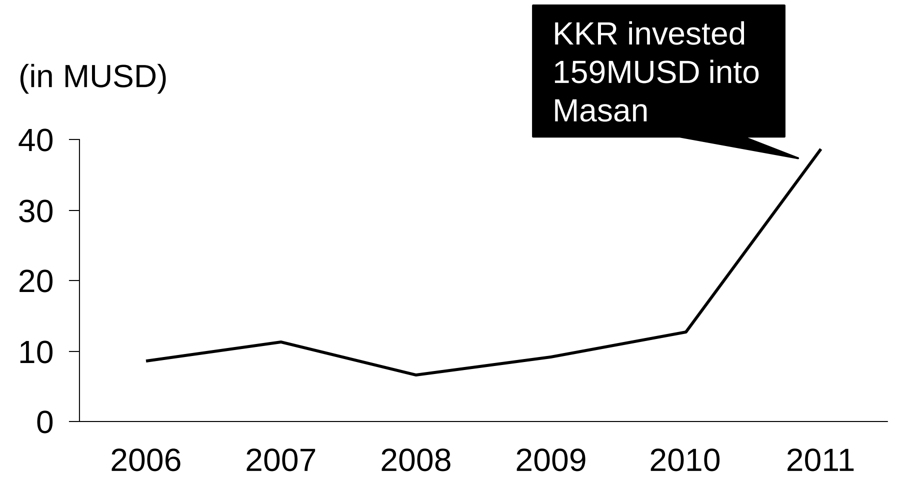
PE valuation expectation mismatch

> *Following a successful M&A deal with foreign buyers, usually purchased at a high premium, it is common that business owners in that sector start to have unrealistic expectation of their company's value, causing difficulties in deal sourcing*

> *It is generally challenging to acquire accurate financial information due to common tax avoidance practices, especially in family businesses*

> *Deal valuation, especialy in SOE valuation, can be highly volatile because of complications in treating land use rights and uncertainty of certain regulations/de-regulation affecting the whole industry coming into effect*

Global investors are driving larger deal size

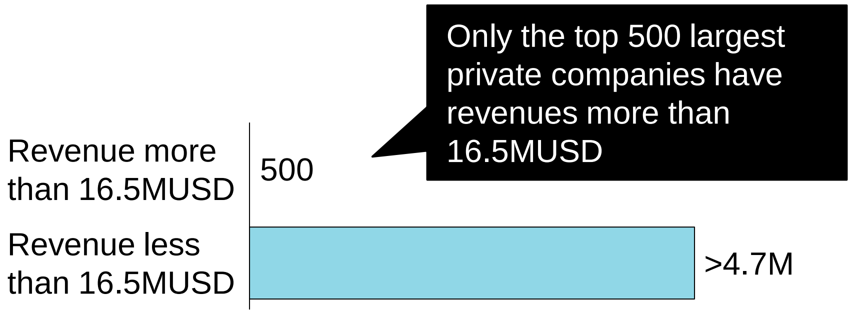


Source: BCG (2012), Reddal interviews

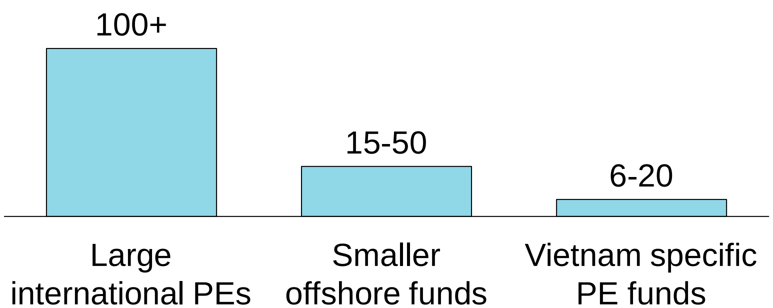
There is a general lack of companies with sufficient size, coupled with owners not willing to sell majority stakes – consolidation necessary

PE deal sizes and key influencing factors

Number of private companies by revenue



Common deal sizes by different PE funds
MUSD



Considerations

- With a usual minimum stakes of 20%, minimum size of companies suitable for investment is at least 10 – 20 MUSD; these are hard to find as this size of companies are often already listed
- In addition, family business owners tend not to give away control of their business, making it more difficult for PE funds to close good deals
- As a result, some Vietnam specific funds have to accept investing in smaller deals, look for deals outside of Vietnam or launch venture funds to invest in companies with good fundamentals but are still in a very early stage
- One common strategy is to purchase a leading company in a field, then expand its business by buying majority stakes of smaller companies (sometimes microcompanies) and merge them into the anchor company

Source: EMPEA, *Private Equity in Vietnam* (2017), General Statistics Office, *Business results of Vietnamese enterprises in the period 2010-2014* (2016)
http://vnr500.com.vn/

ILLUSTRATIVE

Each source of deals have different considerations and issues to address; family businesses are still the best match for PE in Vietnam

Key considerations in deal sourcing

Typical PE cases

Alternative

Traditional PE

Real estate

- It is difficult to invest in good real estate deals in attractive locations as high net worth individuals / influential bankers with strong social and political connections usually have an upper hand

Infrastructure and utilities

- It is not attractive due to a prolonged and highly political bidding processes and lack of legal framework to guarantee returns
- PE who want to be exposed to infrastructure usually invest in companies doing business in infrastructure in Vietnam and rarely invest directly in infrastructure projects

Family businesses

- Attractive to PE are those with good fundamentals and strong drive to expand, looking for funding, best practices and connections
- Founders open to PE funding are those in need of professional management support in the transition to second-generation of managers-owners
- Key challenge is owner resistance to PE investment in favor of more control and less pressure to disclose information

State-owned enterprises (SOEs)

- Key employees or influential bankers have upper hands in investing in SOE privatization
- Valuation is complicated with land use right issues, less driven by P&L but rather management attitude and brand name
- It is not so attractive for PE due to prolonged and non-transparent process, also policy uncertainty

Increasing state influence/control

Source: Reddal interviews with PE firms in Vietnam

Most local PE consider management and network support as key value adding levers, operational involvement is less common

Common value creation methods and investment strategies

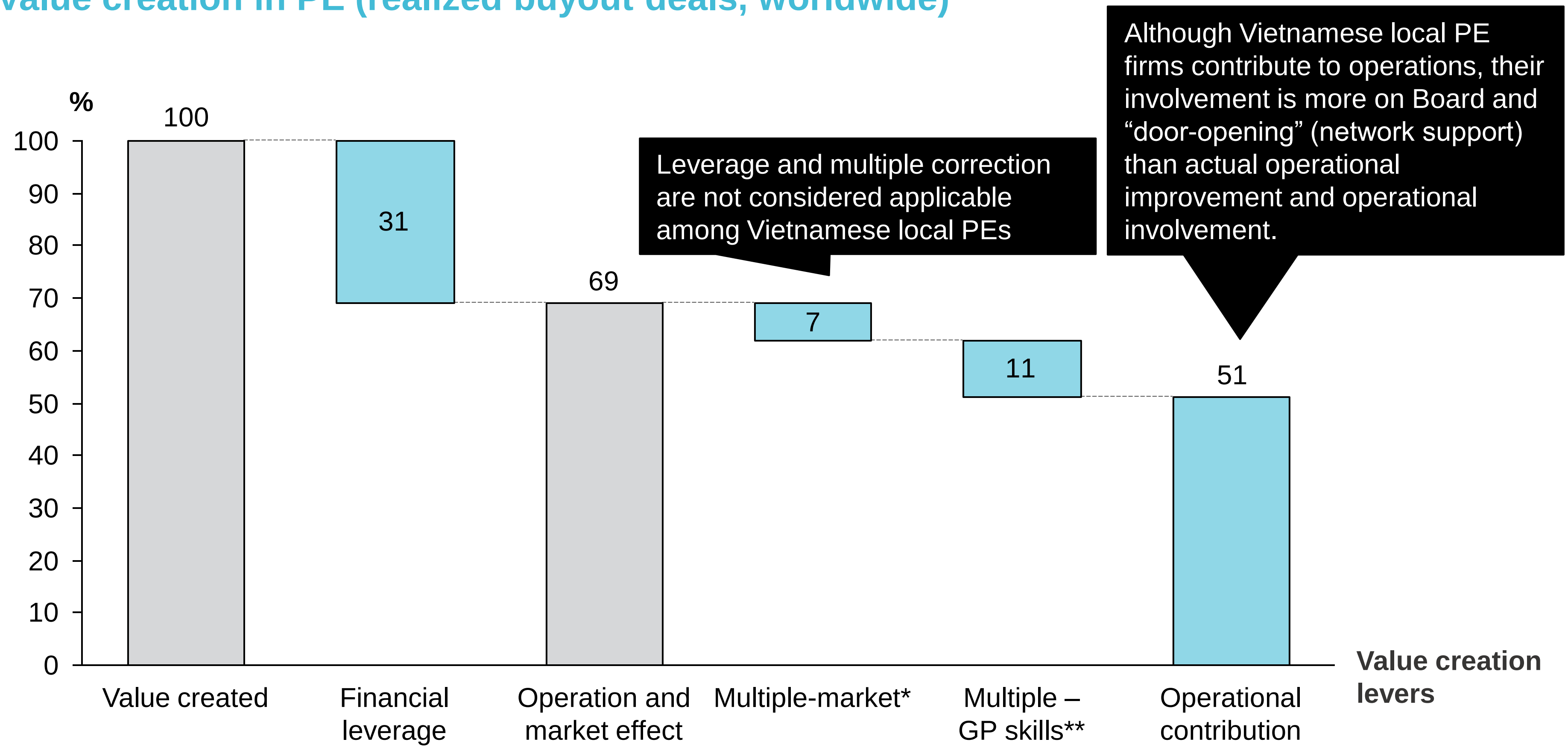
Commonly applied levers

Managerial and strategic planning support	• Encourage transparent and professional corporate governance by representing as independent board members • Help align business strategy and operations to optimize growth • Support portfolio companies to improve management capabilities through recruiting (for example, in 2014, Mekong Capital was directly involved with recruiting 11 executive management positions for portfolio companies)
Synergies among portfolio companies and partners	• Connect companies with business partners in PE funds' network (for example, VinaCapital helped connect Novaland with partners for business collaboration) • Leverage distribution networks of current portfolio companies to expand sales of new companies in portfolio • Facilitate strategic partnership for export-oriented companies through PE funds' own networks
Functional support	• Standardize processes, set up KPIs and implementation plans, including follow-up processes • Ad-hoc marketing and sales functional support: marketing, overseas roadshow preparation, data modeling to better understand customers • Enterprise information and technology system implementation, process improvement, lean/six sigma • Organize events to share best practices in for example supply chain management, customer satisfaction enhancement, and employee satisfaction measurement across portfolio companies

Source: Press articles, Reddal interviews with PE firms in Vietnam

Operational contribution by Vietnam focused PE are often not quantifiable as it is more at strategic than P&L level

Value creation in PE (realized buyout deals, worldwide)



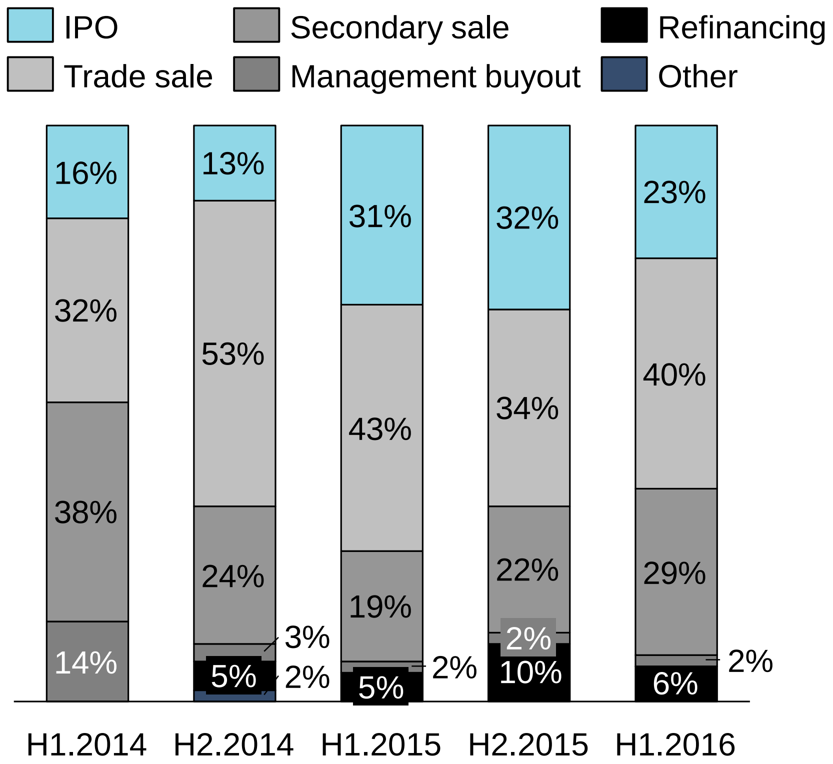
*Multiple effect due to an uplift in public market valuation; ** Multiple effect due to deal-specific multiple expansion, attributable to GP multiple expansion skills linked with qualitative operational improvements

Source: Analysis of 701 exits completed between 1990-2013 in North America, Europe and Asia-Pacific, Value Creation in Private Equity, Capital Dynamics and the Technische Universität München (June 2014), Reddal interviews with local PE firms (2017)

Trade sales and secondary sales to foreign investors are common exit strategies

View of major fund managers in Vietnam regarding most achievable exit strategy

Preferred exit strategy over last two years
Share of respondents, percent



Remarks

- In recent years, trade sale has been a common exit routes for major PE firms, especially for foreign buyers who usually are more willing to pay premiums
- In many cases, trade buyers are the foreign companies operating in the same industry as the target company (M&A)
- Secondary sale has been increasing in popularity recently; usually buyers are foreign venture capital funds which just started investing in Vietnam, in 2013 Mekong capital sold stakes of MWG to CDH Electric Bee – a VC registered in British Virgin Islands; in 2014, Mekong Capital sold stakes of Golden Gate to Standard Charter Private Equity (SCPE)
- IPO is another possible exit route, yet IPO is generally tough for some sectors, for example tech companies as the tech market is not very mature in Vietnam

Source: Grant Thornton's survey: Look out for investment growth (2016), Reddal interviews

For example, Mekong Capital's primary exit method has been trade sale to a strategic buyer

Meckong Capital states it typically acquires "significant minority" share in target companies

Exited portfolio companies of Mekong Capital

Investment	Industry	Description	Ownership (%)	Fund	Acquired	Exit	Exit method
Vietnam Australia International School	Education	Leading private bilingual dual-curriculum K-12 education service provider	Not available	MEF II	2010	2017	
Phu Nhuan Jewelry	Retail	Jewelry manufacturer and retailer		VAF	2007	2016	
Golden Gate	Food and beverage	Restaurant chain operator		MEF II	2008	2014	Trade sale (block sale)
Venture International	Industrial	Industrial workwear manufacturer		MEF II	2007	2014	Trade sale
Saigon Gas	Energy			MEF		2008	Trade sale to Total Group
International Consumer Products (ICP)	Consumer product	Household, personal care and food brands		MEF II	2006	2011	Trade sale to Marico Ltd.
Minh Phuc	Industrial	Printing and packaging company		MEF	2004	2011	Trade sale
Ngo Han	Industrial	Magnet wire producter		MEF II	2004	2013	
Duc Thanh						2009	Trade sale (block sale)
Masan Food	Food and beverage	Leading maker of branded sauce and seasoning products and a major player in the large instant noodles market,		VAF	2009	2010	Block sale
FPT Corporation	IT/Telecom	IT and telecom conglomerate		VAF	2011	2016	
AA Corporation	Retail	Furniture manufacturer		MEF	2003	2011	
Nam Long	Real estate	Housing developer		VAF	2010	2016	
Tan Dai Hung Plastics	Industrial	Plastics manufacturer		MEF	2007	2009	Trade sale (after IPO)
Maison	Retail	High-end fashion brand chain		MEF II	2008	2010	

Note: this is not a comprehensive list of all the exited companies of Mekong Capital
Source: Mekong Capital (www.mekongcapital.com)

Key messages

Despite rapid growth and foreign investment, Vietnam's economy (like many of its peers in SEA) remains vulnerable due to weak local supporting industries

Vietnam's private equity sector is still small and volatile but a vibrant ecosystem is starting to shape up, partially due to government support

Finding good deals and driving systematic value creation continue to be challenging for private equity players – it is still about finding the "right opportunistic deal", and there is room for more active HR, process, top- and bottom-line performance improvement

Vietnam has promise but requires transparent policy – consumer- and technology-driven sectors have potential, and private equity could have a big economic impact if actively and transparently engaged in SOE reforms

Beside existing opportunities in consumer and technology, it is important to address the supporting industry and SOE challenges

Investment opportunities in Vietnam and key underlying drivers

Existing opportunities

- Vietnam's attractive demographics and economic growth will continue to drive investments into consumer-driven sectors

- Government commitment to build Vietnam as a start-up nation and availability of affordable technical skill pool will drive digital and internet based sectors

Untapped and challenging opportunities

Supporting industrial SMEs to complement MNCs

- It is now or never for Vietnam to concentrate efforts on building strong supporting industries to sustain Vietnam position as an attractive manufacturing base and expand economic growth through FDI
- PE can play a role in steering the consolidation of the largely fragmented and under-qualified domestic manufacturing SMEs

Transform local SOEs into strong regional players

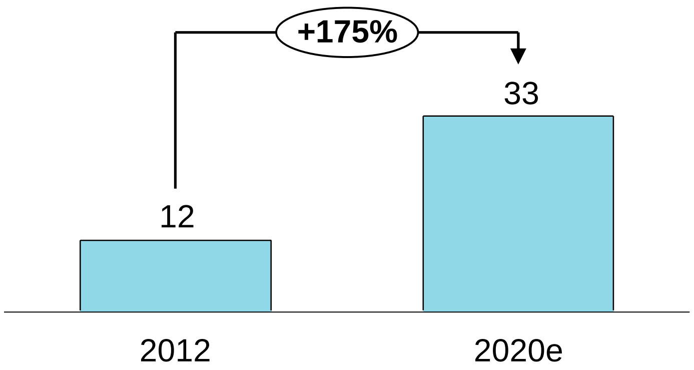
- Vietnam needs to build selected strong "back-bone" local industries that are competitive regionally by transforming current leading SOEs to avoid becoming too dependent on MNCs
- A transparent and competitive SOE privatization process is necessary to encourage private investors and PE to participate in this transformation journey

Source: Reddal analysis

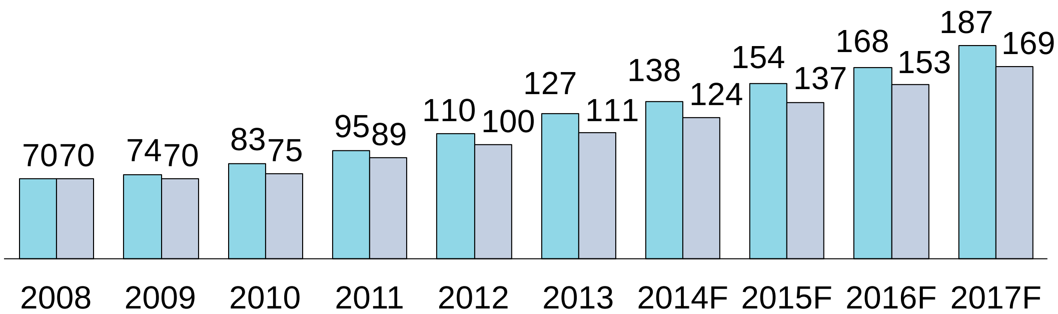
Vietnam consumer and retail sectors benefit from a young population and a growing middle class with increasing disposable incomes

Vietnam consumption growth

Size of affluent population, millions



Total personal disposable income and household consumption
BUSD



More spread-out affluent population

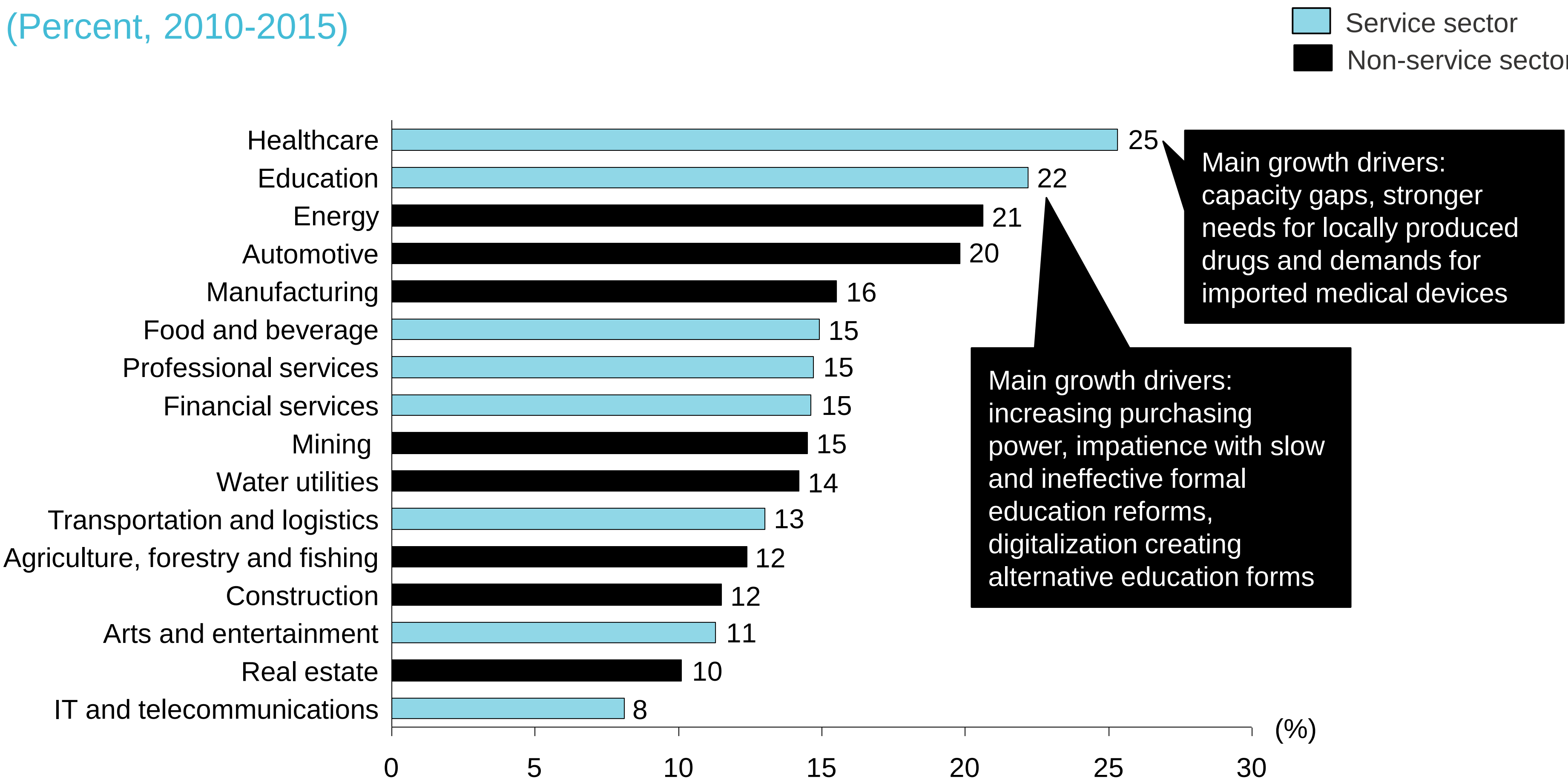
- Affluent segment is defined as people with monthly income above 190USD
- Share of affluent population will rise from 12,4% to 22,7% by 2020
- Not only growing in size, this segment will also be more spread out across the country, requiring presence in 73 locations to service half of this segment compared to 39 in 2012
- About 70% population is between 15 and 64 years old
- Household consumption has kept up closely with personal disposable income growth

Source: World Bank (2016), BCG (2013), Grant Thornton survey (2016), Economist Intelligence Unit (2015)

Service industry such as healthcare, education and food and beverage have seen strong growth in the past 5 years

Historical GDP growth rate by industry

(Percent, 2010-2015)



Source: Ernst and Young, *Private equity briefing: SEA* (2016)

ICT, education technology and green agriculture are among emerging sectors where new businesses can grow into strong SMEs

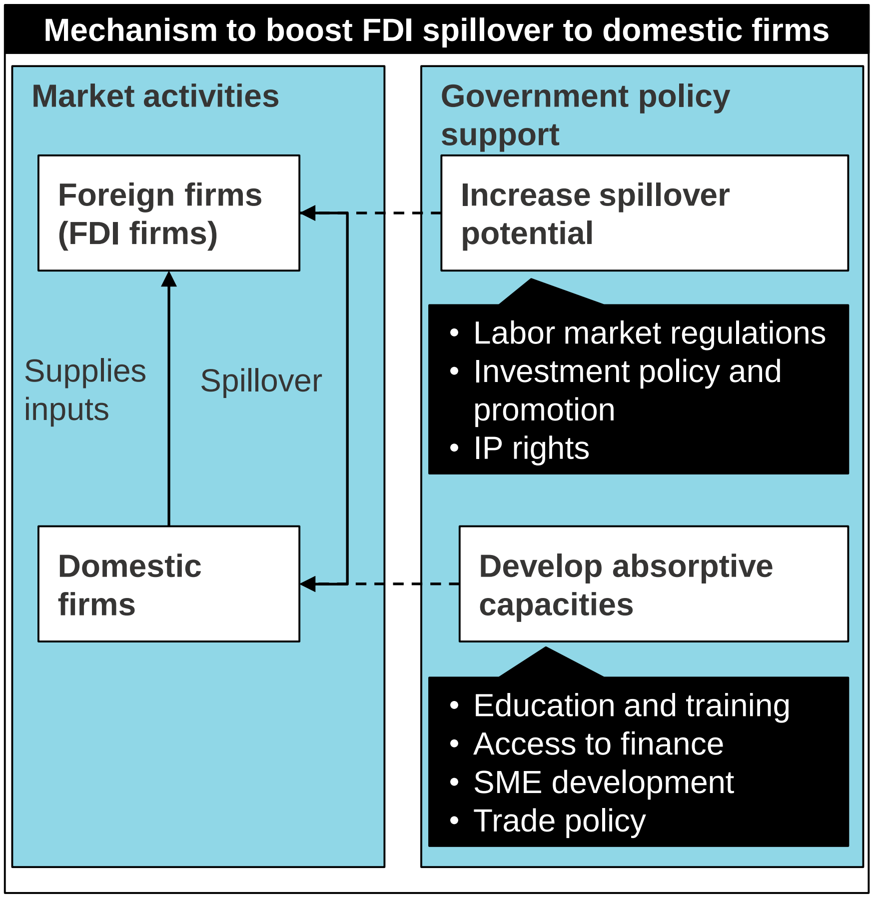
Opportunities in emerging sectors

	Internet based technology	Alternative education/ "edtech"	Green agriculture
	"Vietnam has the right ingredients to groom some of the region's best tech start-ups, also attracting founders from overseas and Silicon Valley"	*"This is a sector where innovative solutions developed in Vietnam can be scaled up to other markets in the region. Topica is a leading example."*	*"Potential but might be restrictive to players with large funding and extensive distribution network."*
Market drivers	• A large online population (51% of total population in 2016 (Internet World Stats) • Local availability of high-skilled and affordable IT skill pool	• Current infrastructure is significantly lagging behind demands, calling for innovation to solve the capacity gap • More willingness to pay for alternative forms of education	• Locally, consumers are increasingly aware of food safety, pushing for higher standard in agriculture practices
Regulatory drivers	• Recently approved tax breaks for IT professionals • Decision 844 detailed concrete plan to build ecosystem to support innovative high-tech start-ups	• Regulatory restriction for education sector is expected to be loosened in the next year, which makes it easier to attract foreign investment	• Vietnam's participation in comprehensive FTAs pose challenges to improve production standards to meet stringent technical barriers of export markets

Source: Reddal interviews with local and Vietnam-focused PE and VC firms (2017)

To improve local SMEs capabilities as suppliers to MNCs, Vietnam should further its efforts in developing absorptive capacities

FDI spillover framework and policy implications



Policy implications

- Stronger legal enforcement to ensure and incentivize MNCs to honour their commitment to technology transfer and increased localization rate when receiving foreign investment licenses
- Targeted financial assistance such as preferential loans, corporate tax breaks, income tax reduction for highly skilled professionals to support technology transfer for supporting industry manufacturers
- Larger government investment in R&D will be needed to improve local companies' capabilities

Source: Newman et al., *European Economic Review 76* (2015), Reddal analysis

Domestic manufacturers have a lot of development areas in internationalization context

Insights from Vietnam Manufacturing Expo 2017

Quotes from participants

I saw many foreign exhibitors here, and the domestic companies I saw mostly are distributors of imported products

- Visitor

Sorry we do not have any company introduction material. We only have these product brochures

- Vietnamese exhibitor

There are not many booths of Vietnamese manufacturers because they mostly come as visitors due to cost concern

- Visitor

Implications

- There is a clear gap between domestic manufacturers and international manufacturers in sales and marketing capabilities
- Domestic companies can benefit from effective investment in sales and marketing activities, as well as building sales and marketing assets
- As the regionalization trend intensifies, and trade barriers gradually become eliminated in ASEAN, staff training to build sales and marketing skill have become more critical for Vietnamese companies to compete even in domestic market

Higher-value deals are expected from upcoming SOE privatization in critical industries but PE significant participation remains uncertain

Large cap opportunities

Industry	Upcoming deals	Capital (MUSD)	Notes
Telecommunication	mobifone	600	Vietnam's second largest telecommunication operator
Energy	PETROVIETNAM PV Power	653	The second largest electricity provider in Vietnam
	PETROVIETNAM PV OIL	205	The second largest oil import-export and distribution company in Vietnam
Retail	SATRA	180	Owner of the biggest retail distribution system in southern Vietnam
Industrial goods	Vietnam Rubber Group	1,189	Vietnam's largest rubber manufacturer

Comments from local GPs

> *SOEs are not very attractive to local PE funds as "good" SOEs are most likely landed on a few interest groups/individuals who have good relationships with companies and government. So it is very difficult for PE firms to get to these deals.*

> *SOE privatization is often not a transparent process.*

> *We have participated in past waves as minority investors without much operational impacts. The upcoming waves will be more important as they are in more critical industries but it is unclear how we can be involved.*

Source: press articles, Reddal interviews, Allens, *Vietnamese SOE equitization An opportunity to break into the Vietnam market* (2017)

REDDAL

Transparency and clear-cut regulations are crucial in ensuring privatization benefits long-term economic prospects

Lesson learnt from Russia and China privatization

Massive but disorganized privatization in Russia resulted in opportunistic looting and capital flight

- SOE privatization in Russia after Soviet Union disintegration was massive and executed without a strong legal framework and guidance
- Without a well-thought execution plan, many SOEs ended up in the hands of a few well connected individuals and insiders, who were more interested in short-term gain and quickly liquidated these assets and took proceeds overseas

China's gradual approach showed advantages

- SOE privatization in China has been more gradual through both macro and micro reforms that gradually change SOE's incentives and behaviors
- Seperation of ownership and control by first redistributing control without giving up ownership created less shock and grants SOEs more autonomy to improve productivity

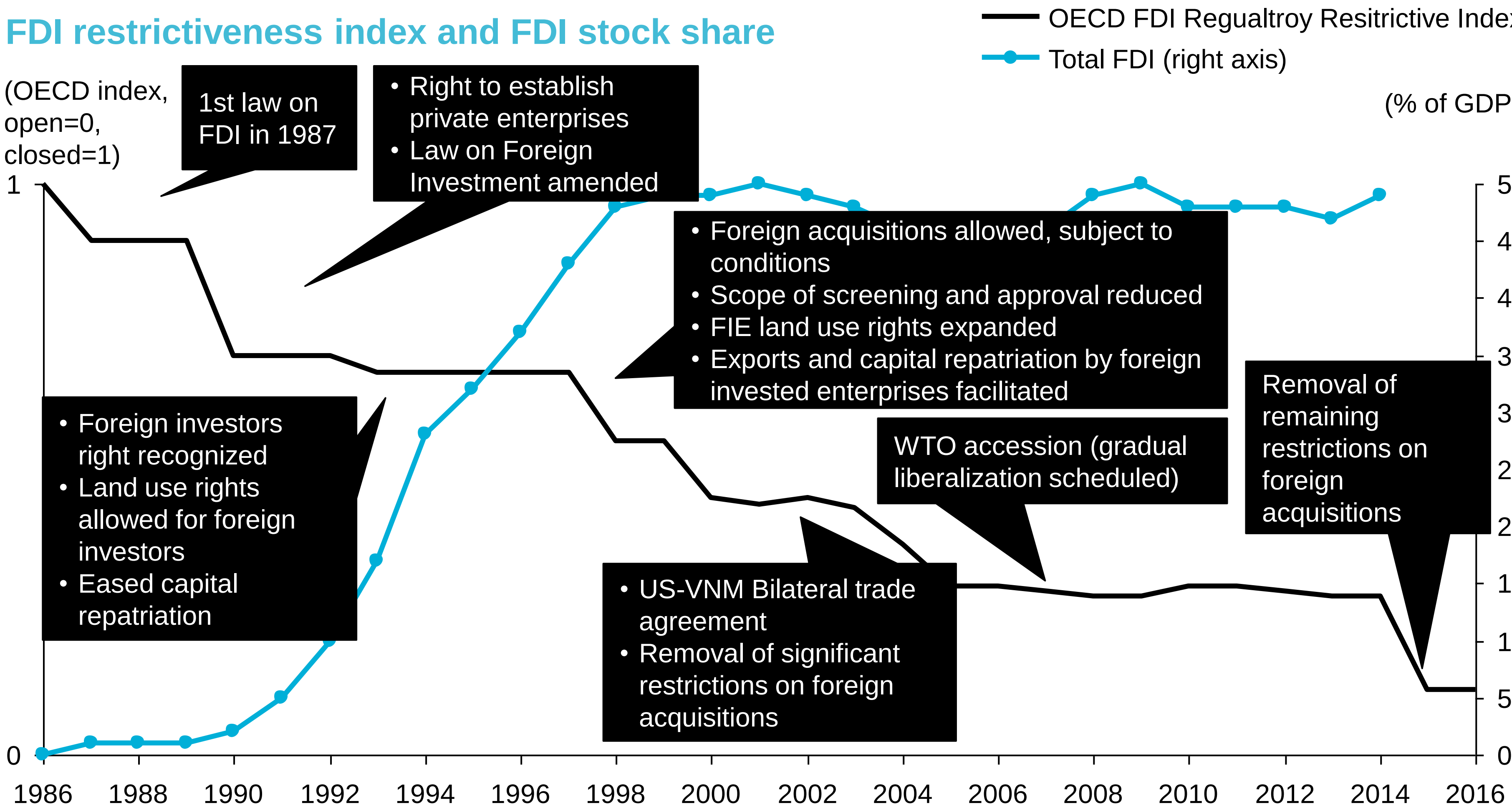
Implications

- Privatization should not be done in haste without a well-thought implementation plan (regardless of political pressure)
- A transparent privatization procedure is important to ensure equitable participation from the private sector and PEs
- Giving SOE more autonomy (and management incentive) to improve productivity and market competitiveness is more important than superficial privatization without changing actual control or performance
- Clear private property right is critically important to ensure a smooth transition from central state ownership to distributed private ownership

Source: Prokopenko (1998) *Privatization: Lessons from Russia and China,* Association for the Study of the Cuban Economy (2010)

FDI restrictions have been removed gradually over time and the 2014 FDI reform further removed constraints placed on foreign capital

FDI restrictiveness index and FDI stock share



Note: Figures for 1985 – 1997 are approximate figures based on OECD report
Source: OECD, *Investment policy review of Vietnam* (2016); OECD Stat (www.stats.oecd.org)

REDDAL

Restrictions on foreign capital, however, still remain in critical sectors where upcoming SOEs privatization takes place

Lower than OECD average
Lower than peer average
Higher than peer average

OECD FDI restrictiveness by sector (2016)

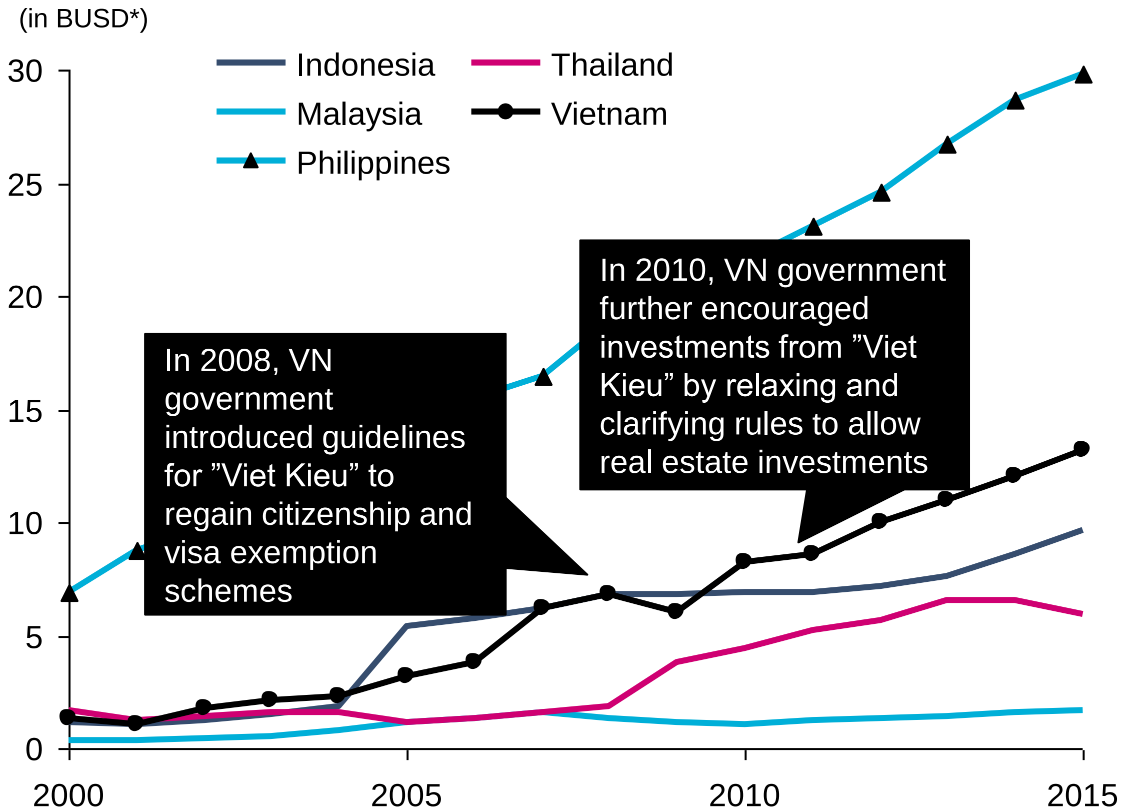
Industry	United Kingdom	United States	OECD average	Peer average*	Malaysia	Indonesia	Philippines	Cambodia	Vietnam
Manufacturing	0.000	0.000	0.019	0.037	0.000	0.065	0.074	0.022	0.025
Food and other	0.000	0.000	0.019	0.051	0.000	0.060	0.080	0.070	0.045
Oil ref. & Chemicals	0.000	0.000	0.019	0.037	0.000	0.087	0.070	0.010	0.020
Metals, machinery and other minerals	0.000	0.000	0.019	0.034	0.000	0.060	0.080	0.010	0.020
Electric, Electronics and other instruments	0.000	0.000	0.019	0.032	0.000	0.060	0.070	0.010	0.020
Transport equipment	0.000	0.000	0.019	0.032	0.000	0.060	0.070	0.010	0.020
Transport	0.092	0.550	0.213	0.338	0.100	0.384	0.670	0.043	0.495
Maritime	0.050	1.000	0.254	0.404	0.300	0.470	0.670	0.010	0.570
Air	0.225	0.650	0.348	0.357	0.000	0.485	0.670	0.110	0.520
Hotels & restaurants	0.000	0.000	0.020	0.110	0.050	0.110	0.320	0.010	0.058
Communications	0.000	0.110	0.085	0.355	0.250	0.260	0.670	0.010	0.583
Fixed telecoms	0.000	0.020	0.092	0.355	0.250	0.260	0.670	0.010	0.583
Mobile telecoms	0.000	0.200	0.079	0.355	0.250	0.260	0.670	0.010	0.583
All sectors	**0.040**	**0.089**	**0.067**	**0.218**	**0.211**	**0.315**	**0.398**	**0.052**	**0.114**

*Average of Malaysia, Indonesia, Philippines, Cambodia and Vietnam
Source: OECD Stat (www.stats.oecd.org)

REDDAL

Following government reforms towards Vietnamese diaspora, Vietnam has been the second highest receiver of personal remittances in ASEAN

Received personal remittances



Reflections

- 70% of remittances are estimated to be from Vietnamese expatriates which plays a bigger role in economic development compared to the rest 30% contributed by labor exporters, whose funds mostly used to reduce poverty and boost household consumption
- More than half of inward remittances come from Vietnamese expatriates in the US
- Ministry of Foreign Affairs estimated that up to 50% of inward remittances have been saved for investments, the rest used for household consumptions
- Because of the popularity of unofficial money sending networks, actual contributions of remittances are expected to be much higher than official records

(*) Current USD
Source: World Bank (www.worldbank.com), Vu (2015), Pham (2010)

Growing ties with the diaspora networks foster not only financial contribution but also human capital and knowledge sharing

Multiple impacts of the Vietnamese diaspora network

Major host countries are US, Russia and Eastern Europe, France, Australia, Canada

Host country

- Venture capitalist
- Service providers
- Consultants
- Suppliers

Diaspora network
- Business contact networks
- Professional associations
- Independent research institutes

Case example
- Association of Overseas Vietnamese Business Owners,
- Vietabroader (US-focused),
- Vietnam2020 (Singapore-based)

Vietnam

Financial funding → **Emerging conglomerates**

Case example
- Vingroup
- Masan

Technical and managerial support → **Family-run businesses**

Case example
- My Lan Group
- Highland Coffee

Access to exclusive ”highly-skilled” pool → **Entrepreneurial start-ups**

Case example:
- Misfit

First wave of returnees after Doi Moi mainly focused on leveraging local connections to capture local opportunities while current waves act more as a bridge between Vietnam and regional/global markets

Source: Pham (2010), Reddal interviews (2017), Reddal analysis

Key messages

Summary

- FDI and GDP growth has not created a solid economic base for Vietnam – domestically owned globally strong companies, and competitive supportive industries are missing
- While the PE ecosystem is growing, it is still small and volatile; government focus on VC may not solve the underlying issues (shallowness of entrepreneurship and innovation)
- Foreign PEs drive up deal size and valuations, but in reality number of suitable targets is still small and PE firms must adapt to this in their investment decision process and in how they create value (a bit of catch-22 – market is not yet mature for value creation as done in Western economies, but active value creation is badly needed)
- Vietnam has potential and there are good deals available (and solid fundamentals driving growth) – but to build a sustainable economic platform for the future, must address both large company performance, and ensure a strong SME supplier ecosystem exists; SOE privatizations may play a critical role, and have positive impact if done right


Working together for
successful growth!

