Spotlight Asia

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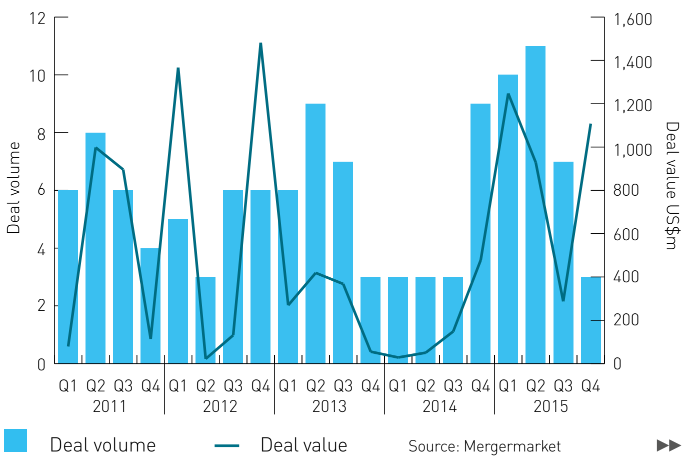
Investing in Vietnam: Open for business

Foreign direct investment (FDI) in Vietnam continues to gain ground, encouraged by positive economic prospects, political stability compared to neighboring countries, and government commitments to liberalize the economy. In 2015, FDI totaled US$13bn, a decline of 13% from 2014 but a significant uptick from investment barely reaching the US$2bn mark in the early 2000s. The removal of investment caps for overseas investors in certain sectors is likely to see such figures increase in the year ahead.

Inbound M&A as a component of FDI has likewise posted strong growth over the past year. Inbound acquisition values totaled US$3.5bn in 2015, increasing 406% from US$706m in deal value the prior year and accounting for 94% of deal activity in the country. Even as slower growth in China has sent shockwaves throughout neighboring markets, sentiment remains strong that inward FDI in Vietnam will continue unabated as investors set their sights on Southeast Asia's next emerging market. However, an appropriate degree of caution must be assumed, as the risks inherent in frontier markets – including weak financial structures, instances of corruption and graft, lack of transparency in business practices and questionable judiciary proceedings – are equally present in Vietnam.

Vietnam inbound M&A (2011-2015)



Source: Mergermarket

We are pleased to present the latest edition of Spotlight Asia, Kroll's quarterly M&A newsletter, produced in association with Mergermarket.

Contents include:

- An overview of FDI and M&A into Vietnam
- A close look at the strengths and weaknesses of Vietnam as a target investment jurisdiction
- Analyses of activity and trends in the manufacturing, consumer, and business and IT services sectors
- An interview with Ramon Ghosh, Associate Managing Director at Kroll, on the country-specific risks and attractions of investing in Vietnam, as well as the methods of mitigating transactional and operational risks in pre-transactional due diligence programs

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Vietnam

Economic and demographic advantages

Since 2008, Vietnam has maintained economic growth in the band of 5-7%, even when global markets were bottoming out during the global financial crisis in 2009. For 2015, Vietnam achieved GDP growth of around 6.6%, better than the global average of 3.3% and higher than several of its neighbors, such as Indonesia (4.9%) and Thailand (2.7%). Forecasts from the World Bank and Asian Development Bank anticipate growth to hover around 6.5% over the next two years, with optimistic estimates hinting at the possibility of growth hitting 7% in 2016.

Demographics also play to Vietnam's advantage. A growing and increasingly affluent middle class is giving rise to greater consumer demand, particularly for international goods and services imported from the United States. Equally, a young, well-educated, and low-cost workforce is providing a draw for international companies looking to relocate operations from an increasingly expensive China. Vietnam's labor pool of over 54.5 million people is expected to increase by 1.5 percent annually in the years ahead, according to the US Department of State.

VIETNAM: INVESTMENT CONSIDERATIONS	
STRENGTHS	**WEAKNESSES**
• Positive economic growth • Geographic proximity to global supply chains • Social-political stability • Government commitment to liberalizing economy • Participation in Trans-Pacific Partnership (TPP) • Demographics: young, rapidly growing low-cost workforce • Growing middle class with diverse consumer needs	• Weak financial structure and lack of regulatory oversight • High levels of corruption • Unclear/ambiguous regulations and lack of legal guarantees • Lack of transparency

Changing regulation: The end of investment limits

Another significant catalyst for foreign investment is revisions to limits on foreign ownership in Vietnamese companies. Previously, international investors were limited to minority stake acquisitions and investments of no greater than 49% in some sectors, with stringent application and approval processes on acquisitions of even 1%. Since September 2015, FDI caps in numerous industries have been lifted, allowing overseas investors to take up majority ownership or full ownership (100% acquisition) in publicly listed Vietnamese firms.

The long-awaited removal of controls is part of a broader push by the Vietnamese government to boost its national privatization program, which has struggled to attract investors willing to assist with restructuring the nation's companies. The government also aims to use the new rules to reinvigorate the economy with international trade deals with the US and Europe.

Foreign investment in several industries regarded as sensitive or strategic to national security will remain strictly controlled. These include certain investments in the financial services (30% stake limit) and telecommunications (49% stake limit) sectors, as well as the nation's airline industry (30% stake limit).

Overseas interest

As government efforts to attract foreign capital take root, inbound M&A in Vietnam remains dominated by Asian acquirers. Regional bidders completed 77% of inbound deals in 2015, accounting for 94% of deal values. Vietnam is also gaining ground on its neighboring countries, recording the second-highest number of cross-border transactions into Southeast Asia and the third-largest by deal value for inbound deals, with significant year-on-year improvements in both areas.

Japan-based acquirers completed eight transactions worth US$259m in 2015, in an outbound trend with Japanese corporates searching for new market opportunities amid an increasingly crowded and competitive home market. Likewise, Japan's aging and shrinking population means Japanese firms must capture new consumer bases, a problem that has seen increasing investment into emerging Southeast Asia.

While investment from North America was sparse, Vietnam's participation in the landmark Trans-Pacific Partnership (TPP) could usher in further interest from regional and global investors. While boosting exports, the TPP will also help attract investment amid government efforts to prioritize investments into the high-tech, consumer and advanced manufacturing sectors over the traditionally targeted light industry space.

Investment sectors

Inbound M&A in Vietnam has focused predominantly on opportunities benefiting from the country's able-bodied, low cost labor force and its burgeoning middle class. Of the approximate US$3.5bn in inbound deals, the manufacturing/industrials and consumer sectors accounted for a combined 47% of deals and 85% of M&A values. Business services and financial services also accounted for noticeable percentages of deal activity.

Manufacturing

In 2015, manufacturing M&A totaled US$1.3bn (46% of deal value) from eight transactions (27% of deal volume) as rising wages in China positioned Vietnam to receive manufacturers looking for cheaper places to manage their operations. Already the country is home to production facilities for international manufacturers, including assembly facilities for automakers Ford Motors (United States) and Toyota Motors (Japan). US electronics maker Intel has operated a US$1bn testing and assembling plant in Ho Chi Minh City since 2010, and Korea's Samsung plans to spend US$3bn upgrading a panel display plant near Hanoi through 2020. Investors keen on entering the manufacturing space must be mindful of the often complicated employment laws and ownership structures in the country.

A foot in the door: Risks and potential in frontier Vietnam

As Vietnam ranks amongst those billed to be the fastest-growing economies in 2016, Ramon Ghosh, Associate Managing Director at Kroll, highlights the jurisdiction-specific risks for potential investors and shares insights on mitigating risks en route to completing rewarding investments in Vietnam.

Is Vietnam's development far enough along to be considered an "emerging" market or is it still very much "frontier" in status?
Vietnam is slowly transforming from a frontier to an emerging market. The country has the human capital and working demographic to make developmental leaps with the economy maintaining healthy growth rates, but caps on foreign investment and relatively low levels of domestic investment have slowed this transition. This is changing and a reclassification should occur within the next five years.

The removal of caps for overseas investors in various industries since September 2015, with Free Trade Agreements (FTAs) and the ongoing state-owned enterprise equitization program, signals the government's commitment to open the economy further and create a more progressive environment for foreign investment.

Classification as a frontier economy, in some respects, has been beneficial for Vietnam, representing a country under-penetrated by foreign capital and so abundant in opportunities. With such opportunities come associated risks that may be less prevalent in more developed markets, but this need not be a stumbling block - properly mitigating risks and addressing factors specific to Vietnam can decrease exposure and boost potentially positive returns.

What are some of the risks Kroll has seen trending in Vietnam, and how can investors limit or reduce their exposure to these issues?
The key transactional risks we have seen relate to high corruption levels coupled with a lack of transparency. During a due diligence process, you may gain less information than in more sophisticated markets, making it difficult to know who you are dealing with, their relationships to the business, or if hidden agendas, including conflicts of interest and proxy relationships, are in play. A lack of information and transparency can also have an impact on valuations. Limited financial disclosures and questionable or different accounting practices can make it difficult to reach an agreeable and reliable valuation on an asset.

Operationally, business risks typically center on supply chain, distribution and vendor management issues, permeating industries from manufacturing and consumer to IT and business services. For example, a procurement manager with a high level of autonomy may be abusing his/her position for personal financial gain. Given the prevalence of cash based transactions in Vietnam, fraud or kick-backs could also be involved. A factory or company may not operate efficiently if investors do not fully grasp the layers of complexity involving employees, shareholders, and other interested parties. Investors therefore need to ensure, if expanding or acquiring inorganically, that they do not inherit legacy issues which do not meet their global compliance standards.

Corruption generally remains a major issue at a local, regional and national level, with Vietnam ranked 119 out of 174 countries in the 2014 Corruption Perceptions Index published by Transparency International, behind the Philippines, Thailand and China. Patronage networks and relationships with public officials are generally considered necessary for doing business in Vietnam, and many major companies are partially state-owned with opaque holding structures. Transparency regarding beneficial ownership is also limited as the use of nominee directors is widespread and public records are not always available or current.

Our advice is to have a cultural understanding of how business is done. Speak to the right people, undertake detailed inquiries and unravel the complex network of relationships. Having boots on the ground and a ground-level perspective is key, as higher level observations may overlook many of these considerations. All this takes time and leads to more questions, but is a necessary part of doing business, reducing risk, and limiting reputational damage.

What areas need to be tackled by the Vietnamese government to further build investor confidence?
Improving business conditions for overseas investors come down to three main objectives: addressing macro level concerns; fighting corruption; and maintaining commitment to economic reform.

To maintain stable monetary and fiscal policies, the Vietnamese government has implemented tighter monetary controls to reduce credit growth and contract inflation. However, Vietnam's relatively high debt levels need close monitoring as they may affect the country's stability or lead to a banking crisis should they persist.

In anti-corruption, business processes need to be made more transparent via fundamental improvements to Vietnam's legal system, such as the redrafting of ambiguous legislation and the active enforcement of existing frameworks. International legal commitments, especially FTAs like the Trans-Pacific Partnership (TPP), should be honored.

Vietnam should also maintain its commitment to further economic reforms towards a fully market-based economy, thereby leveling the playing field for all economic parties. With the recent leadership transition, this will help to consolidate investor confidence in Vietnam's long-term prospects.

Case study: Pre-transactional due diligence

An international investor retained Kroll to review the ownership and operations of a mid-sized manufacturing company in Vietnam. Our due diligence enquiries, which involved detailed discreet intelligence work, uncovered a number of issues. The target company was found to have unethical relationships in its procurement function which involved the practice of over-invoicing together with a number of environmental and safety violations in its operations. Kroll was also able to map the promoter's relationships within political and bureaucratic circles, and third party relationships within the company so the investor could consider this in the light of its own global compliance program.

Vietnam

▸ Consumer

Vietnam's middle class is expected to double in size from 12 million to 33 million by 2020. Vietnam's average per capita income is also set to increase over that time from US$1,400 to US$3,400, according to the American Chamber of Commerce in Vietnam. The noticeable growth in demand for consumer goods and services has already piqued overseas interest, with a consortium led by Warburg Pincus, the US private equity firm, announcing in June 2015 its plan to invest US$100m in Vietnam's largest shopping mall operator, Vincom Retail, following US$200m in 2013 to build the retailer's operations. In 2015, six deals in the consumer space (20% of deal volume) worth a total of US$1.1bn (39% of deal value) were completed.

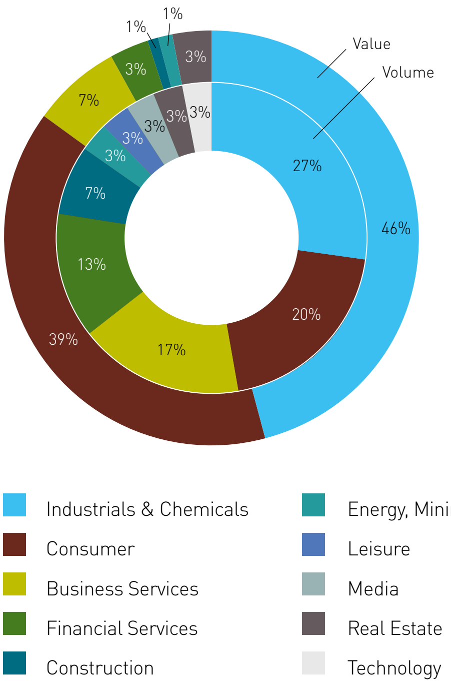
Similar investments among Vietnamese retailers will be needed in the years ahead as Vietnam's middle class not only grows, but spreads out. Today, retailer and consumer goods companies can reach half of the country's population by having business operations in Hanoi and Ho Chi Minh City. By 2020, these two urban centers will account for only one-third of the populace.

Business and IT services

Vietnam's business and IT services industry has been a hotbed for investment in recent years. Previously viewed as a base for low-skilled cheap labor, international companies, such as Intel, are now scrambling to capitalize on the country's low-cost, high-value tech talent. Comparatively smaller than India and China, Vietnam has carved out a portion of the business services market and continues to grow as a provider of talent for complex IT development tasks, such as software development, data analytics, and to some extent indigenous innovation.

However promising, Vietnam's IT services industry still faces significant hurdles. The pool of adequate talent is small – and drying up as international investors continue to employ the limited talent that exists. At the same time, outdated higher education curricula are failing to prepare graduates for modern IT and tech jobs. Despite government promises to address the education gap, doubt remains as many wonder whether authorities will prioritize education over economic development.

Inbound target sectors by volume and value (2015)



Source: Mergermarket

Private equity: Cautious optimism

Private equity (PE) remained active in Vietnam in 2015, albeit at decreased levels of investment. Total investment dropped 74% from US$988m in 2014 to US$260m last year – almost US$1bn short of totals in 2013. However, PE is expected to rebound in the year ahead on the heels of the loosened foreign ownership controls and fund managers increasing allocations to frontier markets. Overall, PE practitioners agree Vietnam has all the right fundamentals, and as a relatively underpenetrated market it is ripe for investment.

Aside from the Warburg Pincus investment in Vingroup, TPG Capital has also made forays into Vietnam. The US-based PE firm purchased a 49% stake in food animal feed production company Hoa Muoi Gio in 2013 for US$50m. KKR has likewise been acquisitive, making two transactions in 2011 and 2013 for stakes in Masan Consumer Corporations for a total of US$359m. More recently, Hong Kong-based Welkin Capital completed a minority stake acquisition of food-chain operator Huy Vietnam for an undisclosed amount, and Singaporean firm CVC Capital Partners has expressed its interest in the country by hiring a former partner at Ho Chi Minh-based Vietnam Investment Group to their own management.

PE investment since 2011 has leaned toward injections of growth capital to help Vietnamese firms expand. In 2015, venture capital saw some of the largest number of investments, accounting for 53% of all PE activity. This is happening as start-ups and early stage investments take center stage amid increasing competition and a limited target base of mid-market Vietnamese firms with proven track records.

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