Indirect investment: sign of the times

By Louis Nguyen*

The media often talks about Foreign Direct Investment (FDI) in Vietnam and depending on which source and statistic you view, this figure ranged from between $5 billion to $5.5 billion in 2004.

On the other hand, another form of investment which carries great importance and is often overlooked is the Foreign Indirect Investment (FII). FII operates through the establishment of foreign investment funds, with the most obvious example being VinaCapital, Dragon Capital, IndoChinaCapital, and IDG Ventures Vietnam. Between 1994 and the introduction of the Domestic Investment Law in 2004, foreign indirect investment in some 100 local companies topped the $400-million mark.

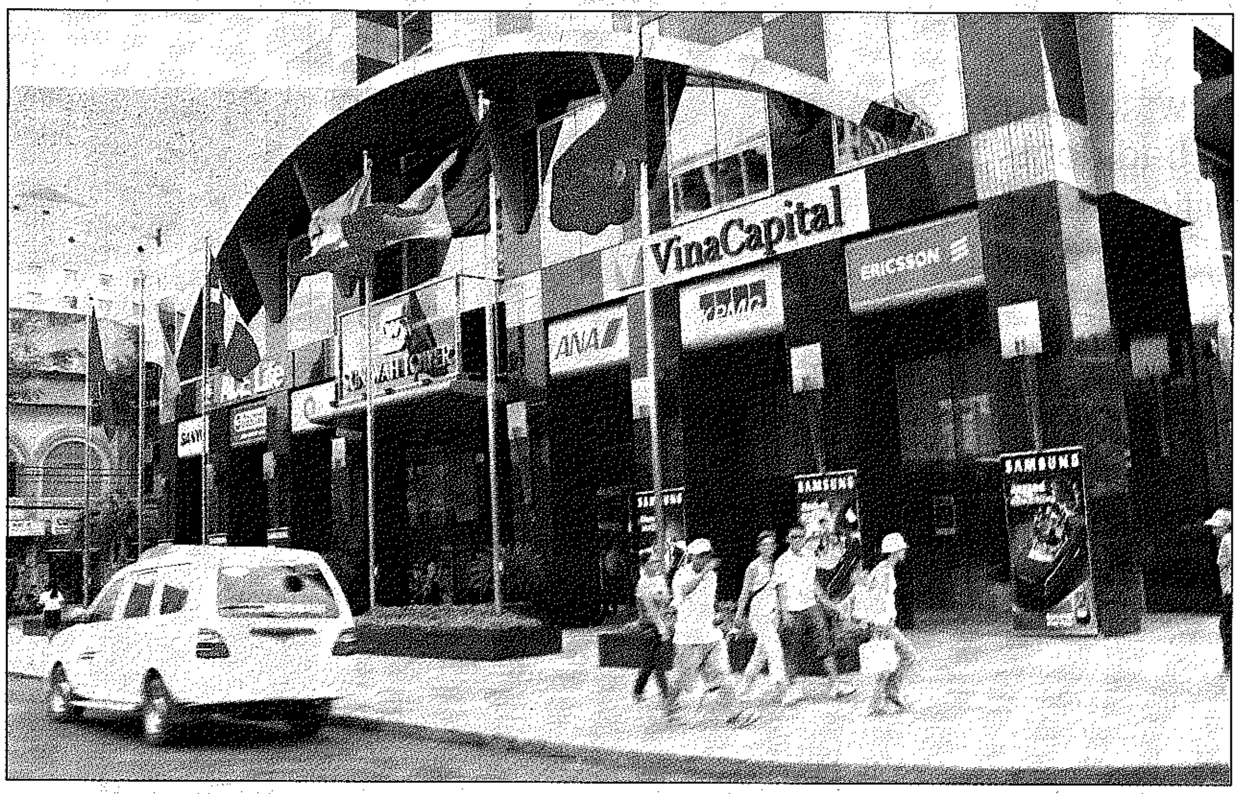

Photo: Trong Nam

Rising indirect investment is an advertisement for further foreign business interest in Vietnam

Operation of foreign investment funds could be divided into two periods, that being before and after the Asian financial crisis. The first foreign investment funds made their appearance in 1991, including large scale investments with Vietnam Enterprise Investment Ltd ($60 million), Beta Vietnam Fund ($70 million), The Vietnam Fund Ltd. ($60 million), Vietnam Frontier Fund ($60 million), etc. Some of them withdrew around $200 million in total after the Asian financial crisis hit. Starting in 2001, the operation of foreign investment funds recovered from the often termed, "second wave". At present, there are six investment funds capitalised at approximately $480 million. They started off as small but have been increasing in size and gained some tremendous experience and have successfully returned profits to their investors.

These funds provide great investment vehicles to attract foreign institutional and qualified investors into Vietnam as the investment managers of these funds are often English-speaking foreigners and *Viet Kieu* (overseas Vietnamese). In addition, the presence of these funds increases investment standards in Vietnam, improves financial transparency, and increases opportunities for exit strategies. After the financial crisis, the flow of foreign indirect investment began to rise again, but it represents only a small proportion of the total foreign investment: 1.2 per cent in 2002; 2.3 per cent in 2003 and 3.7 per cent in 2004, while this proportion in such neighboring countries as Thailand, Malaysia and China varies from 30 per cent to 40 per cent.

Foreign investment funds often invest in two categories: listed securities or private equity. Listed securities are traded via the main stock markets (Ho Chi Minh City and Hanoi) or the active over-the-counter (OTC) market. Private, non-listed companies and real estate projects also present great investment opportunities and can be invested through the form of private equity. Only the foreign investment funds with large capital and global managerial skills can invest in attractive local companies as they do not only provide capital, but also operational and strategic assistance to the senior management team. In Vietnam, private equity investment through foreign investment funds is much needed as most companies require global management skills, sales, marketing, and differentiations.

Although the stake in local companies held by foreign investors increased from 30 per cent to 49 per cent recently, it still fell short of their expectations. Of the 35 listed companies in the stock market, only 15 had shares held by foreign investors. In other companies, they held only small proportions because of poor performance and small scales. The total market value of the listed companies was only around $350 million. It is quite small in comparison with regional stock markets: 1,300 listed companies worth $480 billion in China; 250 listed companies and $80 billion in the Philippines; 430 companies and $110 billion in Thailand. In addition, the expected payback from small-scale companies through the stock market is not desirable.

Fund and Fees

The idea of fund investment is still new in Vietnam and many developing countries. Fund investment is suitable for an investor who wants to be able to choose to invest in a particular classification of assets (eg. London shares, Vietnam real estate or technology companies), without having to study the characteristics of the individual assets. Financial advisors often direct some or all of their clients' assets towards fund investments.

Fund investment spans the gamut of riskiness (and reward) from ultra-safe, low-yielding bond funds at one extreme, to highly-leveraged derivative hedge funds at the other. Another type of high risk investment fund is venture capital, which became popular in the late 90s due to the rise and fall of dot-com companies. Investors in venture capital funds are also often invited to participate, or funded by one company (IDG is the sole investor in IDG Ventures Vietnam, for instance).

Fund managers of investment funds normally charge investors in the fund a management fee, which is calculated as a fixed percentage of assets under management, and an incentive fee, which is calculated as a percentage of the fund's returns. Other "administrative" fees may also be charged. A fund might charge a 2 per cent management fee and a 0.4 per cent administrative fee in addition to a 20 per cent incentive fee. If a fund manages $100 million and earns $18 million in income and capital gains over a year, the combined fee for the year would be $6 million.

For ease of exposition, this example assumes fees are paid annually. In practice, they are charged monthly or quarterly. The incentive fee may be subject to a hurdle rate or high-water mark provision. With the former, the performance fee is paid on returns only in excess of some hurdle rate. If there were a 5 per cent hurdle rate in the above example, the total fee would be reduced to $5 million. A hurdle rate may also be set equal to some variable index, such as the Libor. About one in five investment funds employ a hurdle rate of some sort.

With a high water mark, a fund must recover any losses - return to the last high-water mark - before incentive fees can be charged. For example, if a fund loses $10 million one year but earns $12 million the next year, any performance fee for the second year will only be based on the $2 million gain in excess of the prior year's loss. Since investors may join the fund at different times, high water marks must be tracked individually for each investor. About four out of five investment funds employ a high-water mark provision.

Exit Strategies

An exit strategy is one of the key concerns for most investors in investment funds. Also known as a liquidity event, an exit strategy is the fund's intended method for liquidating its holdings while achieving the maximum possible return. These strategies depend on the exit climates including market conditions and industry trends. Exit strategies can include:

1. Selling or distributing the portfolio company's shares after an initial public offering (IPO),
2. Sale of a portfolio company or investment asset to another entity or through the mergers and acquisitions (M&A) process,
3. Recapitalisation or repurchase of shares from investors by the owner.

In simple terms, exit strategies are methods of how investors can get their money back, hopefully with healthy profit. In Vietnam, exit strategies are often in the form of an M&A since the stock markets are not yet mature. In order for investors to reap greater rewards and return multiples, the capital market will need to grow drastically or investment portfolio companies will need to be able to provide an IPO in international markets such as Singapore, Hong Kong, Tokyo, or even major markets such as NYSE and NASDAQ.

Currently, no Vietnamese company has ever IPO'ed in an international market but it is inevitable that this will happen in the next few years with the emergence of powerful Vietnamese companies preparing for international listings, including Vinamilk, VMS/Mobifone, Vietcombank, Bao Viet Securities and Kinh Do.

The Early Bird Gets the Worm

Through the Foreign Indirect Investment process (FII), investment funds currently in existence in Vietnam play a vital role in developing enterprises and capital markets. Funds such as VinaCapital and Mekong Capital, are leading the pack by placing heavy emphasis on working closely with their portfolio companies and entrepreneurs on global competitiveness, executive development, sales and marketing training, and efficiencies through technology implementation. In addition, most investment funds have influential relationships with their existing international investors and senior executives and can often help portfolio companies expand regionally and globally.

To generate excitable return on investments, the investment funds appear to understand the value of patience. With Vietnam entering WTO within the next few years, competition will be fierce for all parties and more multinationals will enter the Vietnam market. Those companies and investment funds with a competitive edge and market share all realise that the value of their investments will naturally increase due to incoming demand. That will be their moment in the sun as they bet on the growth of Vietnam and its ability to profit handsomely for their investors.

CURRENT FOREIGN INVESTMENT FUNDS IN VIETNAM
(estimated at the end of 2005)

Name	Fund Size	Number of Deals	Investment Focus
Dragon Capital	$200 million		Listed securities in broad industries
VinaCapital	$100 million	32	Private equity and listed securities in consumer goods, financial services, and real estate
IDG Ventures Vietnam	$100 million	2	Early state private equity in technology
IndoChina Capital	$50 million		Private equity in real estates
Mekong Capital	$20 million		Private equity in manufacturing
PXP	$10 million		Listed securities in broad industries

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Capitalising on a nation's rich promise

Through investment funds, foreign indirect investment (FII) capital is quickly flowing into Vietnam, opening up a host of opportunities for domestic companies in great need of capital. Nguyen Hong reports.

It's not easy to catch Don Lam, managing director of VinaCapital, these days.

He and his staff are engrossed in preparations for a major conference for international financial investors that will take place in Ho Chi Minh City later this week. Lam, also featured as Vietnam's Mr Wall Street in *Fortune* magazine, said the idea to hold the conference, the first-ever on foreign portfolio investment in Vietnam, came from what he learned during overseas fund-raising trips.

"During the trips, we have seen that many foreign investors seriously lack information about Vietnam. Some of them even still hold suspicions of Vietnam from the war, with the result that they cannot imagine that there are beautiful hotel properties in this country," said Lam.

"Vietnam is clearly misunderstood by many, so we want to organise this event to bring Vietnam closer to investors and help them overcome misconceptions, and also promote a better picture of Vietnam among fund managers, who hold billions of US dollars for investors," he said

"Our aim is to let investors understand Vietnam first, then think of investment," he said, adding that as part of the two-day event, his firm would organise fact-finding tours for fund managers to visit successful Vietnamese businesses where his fund has successfully invested.

The conference, in which *Vietnam Investment Review* is the major media sponsor, will attract nearly 100 representatives from prestigious financial institutions around the world. These institutions manage assets estimated at around $100 billion.

Both Lam and VinaCapital's executives said they would convince international financial investors to open their pockets to invest in Vietnam by showing how their fund have successfully performed in the last two years.

In early 2003 when VinaCapital invited investment in the Vietnam Opportunities Fund (VOF), financial investors still hesitated because most of them didn't know much about Vietnam. Those who knew Vietnam didn't believe in its opportunities because most of them had a painful experience during the 1994-97 period.

But the situation is now different. VinaCapital dispelled the worries of investors with its better-than-expected performance. According to the UK fund operation research agency LCF Rothschild, VOF was the best performing fund in Vietnam last year with a 25 per cent increase in net asset value (NAV) and a 38 per cent increase in share prices. Total assets under VOF have increased from the initial $10 million to $95 million.

Over the last two years, VOF has secured a number of investments in both local and foreign-invested enterprises (FIEs). Among them are Vietnam's largest confectionery maker Kinh Do, where VOF now owns a 10 per cent stake; the Ki Do Ice Cream transaction, in which VOF and the local Kinh Do Group acquired Wall Ice Cream assets from Unilever, and the International School of Ho Chi Minh City, where VOF together with the school's management bought out the previous shareholder.

The latest investments are the Indochina Building Supply (IBS) acquisition – the name behind American Home ceramic products – in which VOF purchased all outstanding shares from some 20 shareholders, and Indotel equity purchase, with VOF purchasing a majority control of Indotel, the foreign partner in the five-star Metropole Hotel joint venture.

These investments, according to Lam, represent one of the key investment strategies that VinaCapital believes will create long-term value for VOF. It is also vivid evidence to persuade international financial investors to invest in Vietnam.

"When raising capital, we have to persuade international investors of our professionalism and our long-term strategy so they will pour money in," Lam said. "They don't simply give us $100 million for playing. In financial operations, effectiveness is the most important answer."

VinaCapital plans to raise an additional $50 million abroad to push up investment in the country. It will sell more shares on the London Stock Exchange for $1.60 each to raise money for VOF's fifth capital increase since its establishment in November 2003, Lam said.

The offering will enable VOF to make the most of attractive opportunities in the country. More than 90 per cent of its fund ($95 million) has so far been invested in projects covering financial services, real estate and manufacturing sectors in Vietnam and is expected to fully utilise its capital by the year's end.

Photo: Duc Thanh

Ministry of Planning and Investment head Vo Hong Phuc (left) hands another foreign investor the chance to do business in Vietnam

Lam said Vietnam's expanding economy with its high GDP growth, rapidly developing financial systems, emerging stock market, accelerated equitisation of state-owned enterprises, the success of operating investors and dynamic private sector would offer abundant investment prospects.

"We've seen more and more opportunities in banking, consumer goods, education and real estate sectors. We will look for high-quality assets and enhance their value with investment and involvement," he said.

"More than 60 per cent of Vietnam's population is under 30, and young people spend a lot," he said. "So consumer goods makers are our most favourite," he added.

While the listed market remains small with capitalisation of $350 million, the over-the-counter (OTC) market is worth more than $3 billion with approximately 1,300 companies. Companies are still relatively starved of capital and hence available for the fund to invest in, he said.

The managers expect a number of high quality state-owned enterprises to be equitised in the next one or two years, including Vietnam's largest commercial bank, Vietcombank and Bao Viet Corporation. Other candidates include state-owned petroleum companies and state-owned mobile phone companies.

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Apart from VOF, many other foreign investment funds contacted by *VIR* expressed their optimism in their portfolios, and made plans to raise more funds to invest into businesses in Vietnam.

Mekong Capital, which manages the Mekong Enterprise Fund (MEF), plans to launch a second fund with a size of $40 million by early next year for further investment in Vietnam. It wants to take the plunge into new business opportunities as its first fund did, with a capital size of $18.5 million.

The MEF has already invested more than $13 million into nine Vietnamese companies since the fund was launched in April 2002. It is expected to fully utilise the capital by the year's end.

Its already-built portfolio investments include Tan Dai Hung Plastic Company, the AA Construction and Architecture Company, Lac Viet IT Company, Nam Hoa Wood Toy Company, Minh Phuc Plastic Packaging Company, Duc Thanh Wood Company and Saigon Gas Holdings. All are based in Ho Chi Minh City.

The second fund will have a very similar strategy to the first one, which focuses mainly on private enterprises in Vietnam, according to managing director Chris Freund.

MEF specialises in investment in private firms in Vietnam, Laos, and Cambodia to help them elevate management skills and competitiveness, and is contributed to by international organisations and banks such as the Asian Development Bank (ADB), the Nordic Development Fund (NDF), the State Secretariat for Economic Affairs (SECO), and the Finnish Fund for Industrial Cooperation Ltd (Finnfund).

Dragon Capital, which is currently managing two investment funds – Vietnam Enterprises Investment Limited (VEIL) and Vietnam Growth Fund (VGF) – also said it was currently looking to invest in eligible companies or projects worth up to $200 million.

Through Dragon Capital, the funds have so far invested about $100 million in nearly 40 Vietnamese enterprises, most of them are listed firms.

When receiving investment from funds, companies also gain something important besides money. They gain insight, experience and management know-how, observers said.

However, there is still a big gap between enterprises and investors. Foreign investment funds are trying hard to seek places to make investment, while enterprises keep complaining that they lack capital for operation.

Local enterprises, though needing capital, still hesitate to contact investment funds. They may fear that the fund would take over once it gained a stake.

The enterprises are not really aware of the concept "public companies", therefore, they do not want to allow investment funds to join the management board. This issue is considered one of the main points for the funds to decide whether to invest in the enterprises.

In several companies, the most problematic obstacles were their production planning and management or shortage of qualified personnel. Also, many companies are unable to increase their capital and sales and marketing capacity.

Management at small and medium enterprises still lack experience and professionalism to run their enterprises or negotiate with partners, said investment investors. Furthermore, they have limited capacity to work out investment plans, long-term vision, and human resources.