Private Equity in Vietnam

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The Deals

One of the first deals by a global private equity firm in Vietnam was in 2006, when TPG and Intel Capital invested in FPT, a local IT firm. Now FPT has grown to the point where it is purchasing companies outside Vietnam.

Another notable foreign transaction recently was the acquisition by a fund managed by Warburg Pincus of an interest in all of the retail assets of Vingroup, one of the largest private sector property developers. This was the largest initial private equity investment ever in Vietnam and has since been scaled up.

In between these two bookends there have been:

- Private equity investments by large international names such as KKR, further deals by TPG, Goldman Sachs, Mount Kellett, CVC and GIC, among others. These investments have tended to be in the US$100 million range and up, but there are typically not a lot of investments in this size range.
- Investments by smaller offshore funds managed by the likes of Navis, TAEL and Gaw Capital. These have tended to be in the US$15 to US$50 million range.
- Numerous investments by Vietnam specific private equity funds such as funds managed by Mekong Capital, Vietnam Investment Group and Private Equity New Markets (f.k.a. BankInvest). These investments are typically in the US$6-20 million range and are much larger in volume than the first two categories.

A constant challenge facing private equity firms of all sizes is that the investment opportunities in Vietnam tend to be smaller than their funds are targeting. This can sometimes force funds to be creative. It also reduces the number of deals.

Private equity investments have been made in both equitised State-owned enterprises (***SOEs***) and in private sector companies, with the latter predominating. Most investments into equitised companies occurred between 2005-2008 when many funds followed a pre-IPO investment strategy, following some successful investments in the auctions of Vinamilk shares in 2003 and 2005. Most pre-IPO opportunities at the time were equitised SOEs. But with the collapse of the stock market starting in mid-2007, the IPO market dried up. Since then, capital has increasingly flowed to emerging private companies such as Masan Group, VinGroup, MobileWorld, Golden Gate, etc.

Operational Challenges

Corporate governance and management standards in Vietnam remain low in many sectors, which is both a challenge and an opportunity for private equity in Vietnam. Equitised companies often retain many bad habits from the state owned days, such as managers receiving under-the-table commissions on purchases and sub-contracting to related parties of senior executives. Private companies may not face such issues, but they typically under-invest in developing their management teams and are often a "one-man show" with no clear path to long-term sustainability.

Hence successful private equity investors in Vietnam are actively involved in improving their investee companies. Mekong Capital recently conducted an analysis of its past 30 investments and found a strong correlation between the degree to which those companies had implemented Mekong's Vision Driving Investing approach and their Net Profit CAGR, with less than 10% being outliers.

Regulatory Trends

There are various drivers of all the interest in Vietnam. The political backdrop is stable (even more so when compared with other countries more normally regarded as beacons of stability). GDP growth hovers around 6%. There are now more companies of investable size. Warburg Pincus' investment into Vincom Retail involved around US$300 million. The Government has recently announced it would sell its 90% stake in the Saigon Beer Company in two lots, each of which could fetch US$1 billion. Depending on the sector and the circumstances, valuations are often not unreasonable given the growth possibilities.

Part of this has been driven by liberalization of the Investment Law and the Enterprise Law. The changes make it easier for funds to structure their investments and to invest in more sectors with greater certainty. For example, for the first time the definition of a foreign-invested company is clear. This makes it easier to set up a structure that enables foreign money to be invested into a domestic company if such is necessary in light of foreign ownership limitations.

At the same time foreign ownership limitations are gradually being eliminated either sectorally – as phase-in periods for full foreign ownership contained in the 2007 WTO accession become effective – or for listed companies such as Vinamilk that, under new regulations, pass the appropriate shareholder resolutions allowing for foreign shareholders to own more than 49%.

The real estate sector, which has attracted several funds, has benefitted from the lifting of the prior ban on foreign ownership of housing in Vietnam.

The Government has been moving forward with its equitisation (privatization) program. While investments in privatized companies are difficult for offshore funds given their complexities, those who understand the process have been able to profit.

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Common Structures and Instruments

PE funds normally invest through convertible or exchangeable bonds, convertible or exchangeable loans or preference shares directly in the Vietnamese investee company. The investor cannot set up a pure holding company in Vietnam. Even if the investee is owned by a local quasi-holding company, the investor tends to invest as close to its money as possible for greater control and visibility.

There are various considerations in determining the appropriate structure for an investment:

- Convertible/exchangeable loans with a term of more than 1 year have to be registered with the State Bank of Vietnam (***SBV***). The SBV may raise questions if the interest rate (or IRR) is too high (there is no interest rate cap but the SBV has complete discretion as to what it will permit).
- Convertible/exchangeable bonds can only be issued by companies that have been profitable on an operating basis for the previous year.
- Preference shares, though contemplated in the law, have a limited legal foundation and there are many unanswered questions. Dividend and liquidation preference shares do not carry voting rights. Voting preference shares exist but only in specific circumstances that do not apply in this context. The legality or enforceability of hybrid preference shares is debatable. As a result, preferred share investors often acquire ordinary shares as well (and possibly debt too).

As a result of uncertainties, investors tend to try to back up their structures with put options either to the company or to the ultimate owners, if that is feasible. These are sometimes supported by security interests.

Common Risk Factors

The fundamental question with many investments is that of the enforceability of the documents as agreed. For the larger deals, there is a split on the use of English law or Vietnamese law (English law can be used so it is only if the PE investor has insufficient leverage that Vietnamese law is accepted). But nearly all deals stipulate that disputes will be heard in an offshore arbitral forum (usually Singapore). An award can theoretically be enforced in Vietnam, but in this context the difficulties suggest that enforcement against offshore assets will be easier if they exist.

PE funds (including the Vietnam-specific ones) are all foreign entities and so invest dollars through their Vietnam capital accounts. The investments (except for a loan) are in Vietnamese Dong, so the PE fund is taking the foreign exchange risk. For some years now this has proved to be a reasonable risk to take, especially compared to the currency turmoil in other parts of the world. The Vietnamese Dong has not devalued at all from Sept 2015 – Sept 2016. Returns have to be expressed in VND but some investors attempt to

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use exchange rate adjustments. These are of questionable legality and would be relatively straightforward to challenge. They should therefore be backed up by alternative provisions if the primary ones are found wanting.

If the investment capital is brought into Vietnam through the correct accounts, it (and any dividends) can be repatriated through such accounts without undue difficulty though with a reasonable amount of paperwork. On rare occasions and for short periods, the banks have been short of foreign currency and in such circumstances there is no guarantee that money can be remitted or converted at any particular rate.

Exits

There have been numerous successful exits by PE funds in Vietnam. Mekong has exited many of the investments in its first two funds through sales to trade buyers and share sales after local IPOs. The latter can take time as liquidity is not huge, so a plan for such sales has to be drawn up that will not disrupt the market. Typically listed companies with strong corporate governance and attractive growth rates quickly reach the foreign ownership cap (usually 49%), resulting in most transactions happening in large block transactions at a premium to the public equity price – and most disposals of listed shares by PE funds have occurred via these "off market transactions".

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There are some theoretical problems in converting into ordinary shares prior to a sale. Various regulatory approvals may be needed in respect of the issuance of new shares and in respect of the non-cash consideration that will be needed for them. There is also an issue about whether such shares will be subject to a lock-up period. Again, proper planning can avoid a lot of the pitfalls. In practice, the conversions have generally been implemented as expected. But the risks are such that investors normally build in fall-back rights (either against existing "founder" shareholders if they exist, or against company cash) in case they are less fortunate.

A specific problem has arisen in respect of the conversion of preference shares into ordinaries. In a recent preference share deal, the local Department of Planning and Investment argued that because the par value of an ordinary share and a preference share is both VND 10,000, the conversion ratio had to be 1:1. The redemption preference therefore has to be considered carefully in case there needs to be a sale followed by a new investment into ordinary shares.

Conclusion

Vietnam is changing rapidly. The economy has been growing consistently by impressive, and possibly sustainable, amounts of between 5 – 7% a year. There are plenty of opportunities (though often small ones) for investors who are familiar with the market. But as in any emerging market, potential pitfalls abound for those who do not spend the time to develop a real understanding.

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