MIKE SELL
December 2017

OUR OUTLOOK FOR VIETNAM

ASIA FUND

FUND MANAGER DIARY: VIETNAM

Mike Sell, Alquity's Head of Asian Investments, voyaged to Vietnam in November.

During his trip Mike visited existing and prospective fund holdings to gain insight into Vietnam's market, the macro economic outlook, the implication of long-term themes and the companies best placed to benefit from them. His trip report is below:

VIETNAM: QUICK FACTS	
Population:	96.2 MILLION*
Age:	54% UNDER 30**
GDP per Capita:	$6,400 (as reference Thailand's is $16900, Indonesia's is $11700)
Government Debt to GDP:	61.6%*
Urbanisation Rate:	34.9%*
Foreign Exchange Reserves:	$47 BILLION***

*CIA Factbook 2016
**2009 census
*** Vietnam government, Oct 2017

DELIVERING PERFORMANCE

Vietnam has outperformed regional peers during 2017 as you can see from **Graph 1.** Interestingly, the stock market average daily trading volume, see **Graph 2**, is now larger than that of the Philippines, which is classified as an 'emerging' market. Vietnam has also seen a rapid increase in new listings on the stock exchange over the last 3 years as **Graph 3** demonstrates, which should see the country's daily trading liquidity increase further. Additional catalyst to this growth has been provided by the Vietnamese government's recent announcement of reforms in the listing process of state owned entities.

The Alquity Asia Fund is advantageously equipped as, free from artificial constraints relating to 'frontier' or 'emerging' labels, our investment process focuses solely on discovering the best companies throughout the region. If trends continue, Vietnam may well follow in the footsteps of Pakistan, and generate its best returns before attaining its 'emerging' market classification upgrade.

Over the course of my time in Vietnam I met with 16 companies in both Hanoi and Ho Chi Minh (Saigon) and local brokers, to quiz them on local trends, the impact of macroeconomic factors and uncover whether future prospects remain exciting.

VIETNAMESE BANKS

Vietnam's banking sector is comprised of over 100 financial institutions, of which 10 are listed. They range from unreformed state-owned establishments, well-run government owned banks with strategic shareholders, and private sector banks. In recent months, a consumer finance company has listed, and another is expected to in early 2018.

I met with our sole holding in this sector, Vietcombank (VCB), which has delivered a 40%+ return in US

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Dollar terms during 2017, helped by a rising market share, currently 8.4%, and rising net interest margin. I also met with two other well-run Vietnamese banks, but in my view VCB's superior management and outlook make them a firm preference. VCB navigated the last credit cycle much more effectively than many peers, due to their focus on risk control in conjunction with their Japanese partner Mizuho. Thanks to this careful management, their non-performing loans peaked at 2.7% in 2013 and the bank's loan loss coverage provisions exceed 100%. Within this context, the Vietnamese government have repeatedly stated that VCB should become a regional example of Governance best practice. To help support this, I continually engage with the bank to increase the independence of the Board and greater disclosure on proposed votes at the Annual General Meeting.

ANALYSIS OF MACROECONOMIC ENVIRONMENT

Effective management aside, the banking sector requires a supportive macroeconomic environment to deliver attractive risk-adjusted returns.

- CREDIT AND INTEREST RATES

Controlled by the central bank, the level of overall credit rose in 2017 to support the Vietnamese economy and, combined with easing drought conditions, has been successful in accelerating GDP growth from 5.1% in Q1 2017 to 7.4% in Q3. Moody's encouragingly upgraded the sector's outlook to positive in October, and credit growth is expected to continue at a similar pace of 18-20% in 2018.

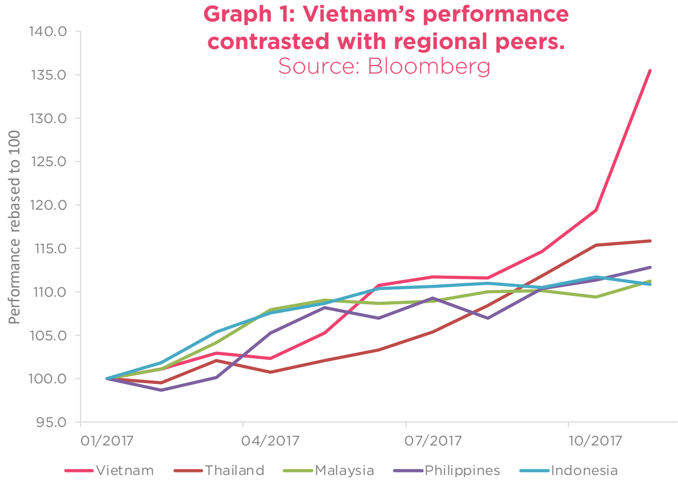
In their first move for over three years, the Central Bank cut interest rates by 25bp to 6.25% in July, representing a significant decline from the peak of 15% in 2011. However, as **Graph 4** indicates, with headline inflation rising just 2.98% in October year on year, and core inflation rising just 1.32%, real rates remain high and there is no current pressure for Vietnam to start following the U.S. Federal Reserve with rate hikes.

- EXPORTS AND IMPORTS

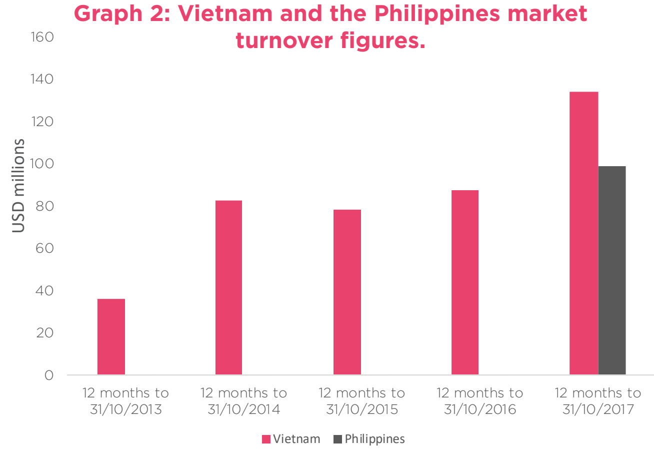
Although exports have seen a 20.7% increase in 2017 equating to $173.7bn in total, this has resulted in a trade surplus of just $1.2bn. This is due to the fact that approximately one third of exports are electronics and require Vietnam to import a significant amount, see **Graph 5 & 6**, due to the country's relatively undeveloped supply chains.

Foreign exchange reserves have risen to a record high of $45bn, but as this represents just over 2 months of import cover, there is valid concern this could lead to a repeat of what we have recently seen in Pakistan and ultimately a significant currency devaluation. However, as 70% of imports are for processing and re-export, rather than domestic consumption, a similar scenario in Vietnam is unlikely. The continued attraction of the country to foreign investment bodes well for Vietnam's future growth potential, with a jump of 14 positions to number 68 in the World Bank's Ease of Doing Business Report and disbursed foreign direct investment growing 11.8% to $14.2bn so far this year. Additionally, international tourist arrivals rose 28.1% to 10.5mn in the first ten months of the year, which is a further boost to the current account.

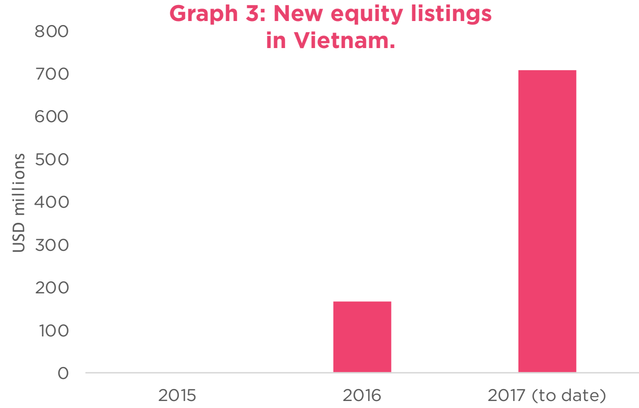
Graph 1: Vietnam's performance contrasted with regional peers.
Source: Bloomberg



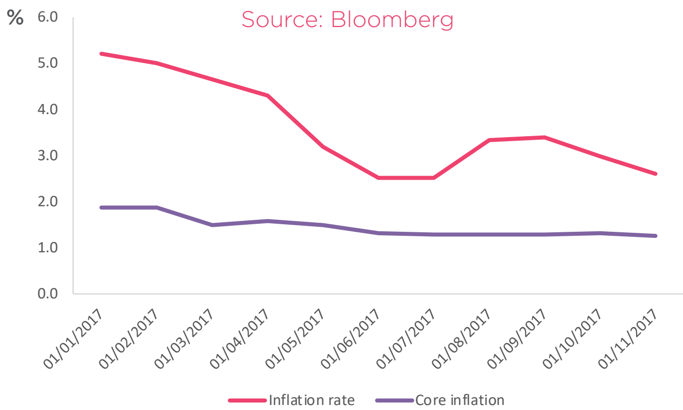
Graph 2: Vietnam and the Philippines market turnover figures.



Graph 3: New equity listings in Vietnam.



Graph 4: Vietnam inflation rates over this year.
Source: Bloomberg



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Picture 1: Vietnam loves Vinamilk!

Picture 2: Masan dominating Vietnam's sauce selection.

Picture 3: Cities are expanding rapidly.

• DEBT

Public debt reached 63.6% of GDP in 2016, near the government's self-imposed safety limit of 65%. However, the National Assembly reported in October that this is likely to decline in 2017, helped by the lowest fiscal deficit in 10 years of 3.5%.

It is also noteworthy that the duration of government debt has risen from 1.8 years in 2011 to 8.7 years in 2016. The government's significant privatisation programme provides further potential upside, for example the recent stake sale in Vinamilk which raised $400mn.

LONG TERM THEMES URBANISATION AND DEMOGRAPHICS:

Our focus in Vietnam, as elsewhere, is on companies that are beneficiaries of the long-term themes of urbanisation and demographics. Vietnam's urbanisation level is 34.9%, and 54% of the population are below 30 years old, which provides structural growth drivers for many years. Our attention is further drawn to the consumer sector, as the latest consumer confidence survey recorded a high of 117 and retail sales have grown 10.7% so far in 2017.

• CONSUMER GOODS:

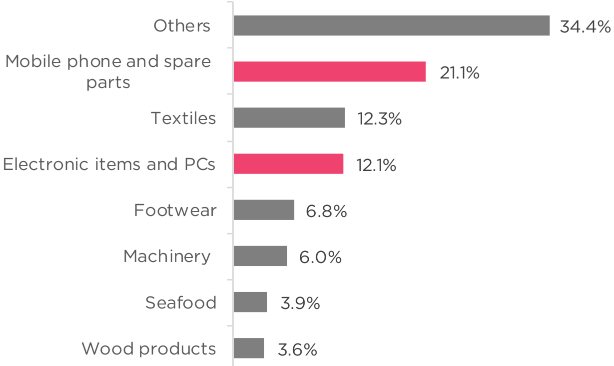
I had a meeting with Vinamilk, the leading dairy company in Vietnam, see **Picture 1 above**, with 54.5% drinking milk and 84.7% yoghurt market share. I've been concerned this year about margin pressure from rising global milk prices and the government's privatisation programme creating an equity overhang. Although less concerned about margins after the meeting and impressed by further market share gains, the possibility of further equity sales remains. Therefore, I shall be undertaking further analysis to ascertain whether valuations discount this and whether there is an attractive entry point now or at some point in the next 12 months.

I visited our preferred consumer goods holding Masan for the fourth time in 2017. I am continually impressed by their restructuring programme which highlights the hidden value in the business, and can also report that their core consumer business is recovering. I undertook channel checks in a leading supermarket in Hanoi and, as you can see from **Picture 2 above**, it's clear Masan continues to dominate the core sauce category.

• ENVIRONMENTAL, SOCIAL AND GOVERNANCE:

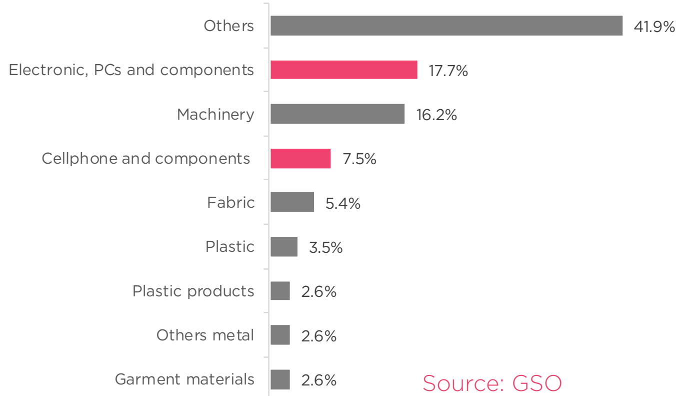
A key area of my engagement with Masan focused on desired further improvements to their corporate governance and transparency. The company has been making significant headway, with the publication of detailed ESG data for part of their operations and the formation of a Corporate Governance Enhancement Consulting Group, but has a way to go. Vinamilk attains an A grade in our ESG investment process, and in my view is the benchmark that companies need to aspire to. Compared to regional peers, Vinamilk's disclosure of environmental data, see **Figure 1 overleaf**, is exemplary, alongside 2018 plans to restructure their Board of Directors more akin to international standards, with the

Graph 5: Major export items in 10M 2017



Source: GSO

Graph 6: Major import items in 10M 2017



Source: GSO

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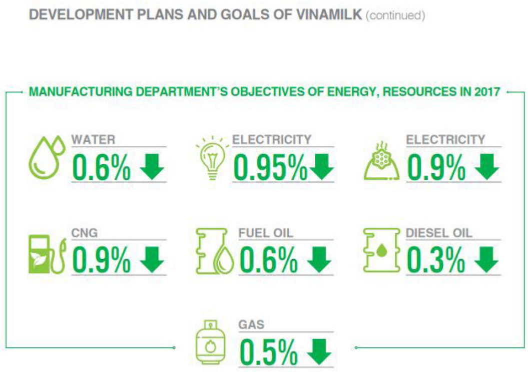
Figure 1 - an extract from Vinamilk's Sustainable Development Report 2016.



OVERVIEW ON THE ENVIRONMENT AND ENERGY MANAGEMENT SYSTEM AT VINAMILK

»	**100%** employees are trained to be aware of environment protection as well as economical and efficient use of energy
»	**13/13** factories are certified with the energy management system following ISO 50001, the environment management system following ISO 14001
»	**9/13** factories are in use of Biomass energy
»	**5/13** factories are in use of CNG
»	**13/13** factories are performing energy audit as regulated
»	No complaints and no sanctions about the environmental violations in 2016
»	**8/9** farms achieved Global Gap certification
»	**100%** of farms invest in waste treatment system using Biogas technology

formation of an audit committee and increasing the number of independent directors.

Elsewhere I met with several companies in a variety of consumer sectors, ranging from detergents to ice cream. Many of these had governance structures that were either insufficiently aligned with the interests of minority shareholders, or were embarking on significant acquisitions and subsequent restructuring, and therefore were not yet suitable for inclusion. However, a food company has made great strides in both these areas and, subject to further analysis, could be potentially interesting, as was a restaurant chain which we have been tracking for over two years and is looking to list in the next 18 months.

• INFRASTRUCTURE COMPANIES:

Vietnam's cities are expanding rapidly, with 300,000 people moving to Ho Chi Minh City every year creating huge demand for housing and infrastructure. I met with a number of businesses capitalising on this trend during my visit.

Among these companies was Fecon, a leading construction company that focuses on pilings for skyscrapers and tunnelling for subway systems. Given the company's similarities with our holding in Acset in Indonesia, this was particularly interesting. At this point, however, insufficient disclosure results in an inadequate risk-reward trade-off.

Our holding in Nam Long Properties continued to impress in terms of growth potential, project level disclosure and governance. Nam Long build affordable housing ranging from 50-75,000 USD in Ho Chi Minh and have the Singaporean group Keppel Land as a shareholder, also historically once having the IFC. The company focuses on environmental factors, has three independent directors, and is a company we intend to continue to own. This positive conclusion was starkly contrasted by a disappointing meeting I had with a leading retail landlord, which I believe is managed in the interests of the parent company rather than minority shareholders.

Casting my net wider, I also met with Petrolimex, the leading government-backed chain of petrol stations with a 50% market share. Alquity has made very successful investments in this sector in Latin America, and there is huge opportunity to upgrade the forecourt's retail environment.

However, I am concerned about government intervention, aggressive competition and market saturation, exemplified during a 3-hour road trip to Ha Long, where petrol stations appeared every few miles.

CONCLUDING THOUGHTS:

Overall, I returned from Vietnam with our conviction in the macro outlook and core positions reaffirmed. Although we will remain alert for risks of overheating and stress in the fiscal or external accounts, these certainly do not appear to be on the horizon at the moment. While the market has risen over 40% this year, I believe valuations are proportionate given the growth outlook and the risk-reward trade-off remains favourable.

The major challenge lies in discovering attractive new ideas, in companies where the values of management align with values of minority shareholders. Over the course of my trip, I have identified some candidates with this potential, either now or in the medium term, and fully expect upcoming listings to create additional opportunities.

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