VIETNAM COUNTRY REPORT

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Vice Chairman
VIETNAM BOND MARKET ASSOCIATION
1. THE ECONOMY
After two years of painful monetary and fiscal discipline, Vietnam has broken the boom/bust cycle and put its economy on a sound footing for “growth with stability”

- Inflation has been whipped, external accounts rationalized and the currency restored – and there has also been progress on reining in SEOs
- The Government deserves full credit, but policy discipline has also brought decelerating growth, and this is a challenge because reform has two phases
  - *Phase I*, sorting out macro indicators, may have been the easier part
  - *Phase II*, curbing the vested interests and the bank / SOE nexus, has proven more difficult – but recent events mark a beginning, albeit a hard-fought one
- The deeper reform campaign is underway, and its ongoing progress will help the economy push through its growth slump, with a bottom seen in 1Q13
- Meanwhile the market is by far Asia’s cheapest, at 8.5x PER on +14% EPS growth, and it is primed to motor at the first sign of renewed reform momentum
PHASE I REFORM: LEAD INDICATORS

Monetary/fiscal tightness has seen key macro numbers all move the right way in past year

**MONETARY: CAUTIOUS RATE CUTS**

**FISCAL: DOWNTREND BEGINS**

**INFLATION: PEAKED AND FALLING**

**TRADE DEFICIT: DOUBLY DECLINING**

**FX RESERVES: REBUILDING**

**CURRENCY: CA 21000 SINCE 2011**
Government has moved from forced high growth to “growth with stability”, and has made good progress in implementing the new strategy.

<table>
<thead>
<tr>
<th>ITEM</th>
<th>2006-10</th>
<th>NOW</th>
</tr>
</thead>
<tbody>
<tr>
<td>Macro Strategy</td>
<td>Growth via aggressive fiscal / monetary stimulus, channeled thru SOEs that are designated as chaebol-type growth drivers, with license to do anything</td>
<td>“Growth with stability”: fiscal / monetary restraint, prioritization of inflation and currency management, roll-back of SOEs to core businesses</td>
</tr>
<tr>
<td>Loan Policy</td>
<td>No targets for credit, with result of 31% average growth</td>
<td>Target of 15% pa for credit growth</td>
</tr>
<tr>
<td>Monetary Policy</td>
<td>No targets for M2, with result of 35% average growth</td>
<td>Target of 15% pa for M2 growth</td>
</tr>
<tr>
<td>Fiscal Policy</td>
<td>Official deficit &gt; 5%, and unrestricted SOE investment creates off-budget spending that adds massively to final shortfall</td>
<td>Official deficit targeted at 3% for 2015, while strict limits on SOE investment greatly reduce final budget gap</td>
</tr>
</tbody>
</table>
Since Vinashin, Government has halted the expansion of SOEs, and many former high-ranking executives have been dismissed, jailed or investigated.

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<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Economic Role</td>
<td>Enthroned as all-powerful growth champions, with control of strategic industries and mandate to lead development</td>
<td>Recognized as Frankensteins, with exec’s from Vinashin, Vinalines, EVN and Agribank removed from their posts and disgraced</td>
</tr>
<tr>
<td>Corporate Status</td>
<td>Implicit Gov’t guarantee for all loans and losses</td>
<td>Demoted to limited-liability companies, with no more automatic subsidies</td>
</tr>
<tr>
<td>Borrowing Terms</td>
<td>Better than Triple-A as market priced in nil risk</td>
<td>Cost of funds is 200-300bps above private sector and 300-500 bps above VGBs</td>
</tr>
<tr>
<td>Investments</td>
<td>19.5% of GDP in 2010</td>
<td>11.2% of GDP in 1H12</td>
</tr>
<tr>
<td>Non-Core Businesses</td>
<td>No restriction, with result of massive debt-funded expansion into speculative ventures, led by property and financial enterprises</td>
<td>Target of maximum 15% of paid-in cap and anecdotally there is ample evidence that divestment has started</td>
</tr>
<tr>
<td>Transparency</td>
<td>All data a “State secret”</td>
<td>Plans to publish key financial results</td>
</tr>
</tbody>
</table>
PHASE I REFORM: BANK CONTAINMENT

Much tougher prudential regulation is being imposed on banks with Vietnam’s own Basel III, raising risk-management standards while controlling quantity and quality of loan growth.

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<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>General Status</td>
<td>Pell-mell expansion of banks is officially encouraged to fuel growth, but with no serious regulation or oversight</td>
<td>Government has greatly expanded regulations, while evolving plans to break State Bank / SOE nexus</td>
</tr>
<tr>
<td>Loan Growth</td>
<td>No restrictions; State and crony banks lend indiscriminately to SOEs for their get-rich diversification schemes</td>
<td>New credit targets, high rates and risk aversion see loans at just +3.5% yoy as of Aug: part over-kill, but also part shake-out</td>
</tr>
<tr>
<td>NPLs</td>
<td>Fiction of 2-3%</td>
<td>Recent SBV estimate of 8-10%</td>
</tr>
<tr>
<td>Paid-In Capital</td>
<td>No requirement</td>
<td>$150m now; proposed $500m by 2015</td>
</tr>
<tr>
<td>CAR Calculation</td>
<td>8% - cum general provision, ex RPLs</td>
<td>9% - ex general provision, cum RPLs</td>
</tr>
<tr>
<td>Branch Expansion</td>
<td>No rules</td>
<td>$10m capital per branch</td>
</tr>
</tbody>
</table>
As loan growth slows, loans/GDP have plunged, putting Vietnam in deleveraging mode.

But NPLs still loom large at a consensus 8-12% of loans – say $13bn on the current book of $125bn.

With collateral at about 1.35x, and discounts calculated at 50%, uncovered NPLs may be $4bn.

That is 30-35% of banks’ net equity, and a couple years of earnings - but it’s not Thailand 1997.

The SBV has a good work-out program involving consolidations, re-caps, bad banks or AMCs, etc.

Over a two- or three-year period, with good admin and timely asset sales, the SBV could probably find the funds to make its program work.

The SBV tried to merge a few small banks in 2011-12, with limited success, but it showed it had a plan.

And ability to resist its plan may be dwindling.
PHASE II REFORM

• The Government has made significant headway in containing banks and SOEs, but that is not enough - the former must be fully restructured, and the latter privatized.

• The extraordinary resolve the Government showed in Phase I reform is still there for Phase II, but it first needs to clear away opposition from the vested interests.

• Earlier this year the Communist Party issued Resolution Three, to upgrade and accelerate the anti-corruption effort.

• This was followed by Resolution Four, requiring self-criticism by all members – the first such procedure since 1968 – and prompting internal realignments.

• Recent actions against bankers show Vietnam’s reform elements going actively on the offensive – and they are likely to increase their momentum.

• In the end, bank overhauls may simply be unavoidable: low growth from non-lending banks is politically unacceptable, but scope for fiscal / monetary stimulus is limited.

• Progress on banks would pave the way for a re-start of SOE privatization.
• Lax fiscal /monetary policy has historically been main inflation motor, but not the only one

• In the past 18 months, numerous other forces have imposed themselves: subsidy cuts on public goods, the agri-commodity boom, Chinese pork-buying, floods – and devaluation itself

• But inflation has been trending rapidly lower as fiscal / monetary looseness is corrected and one-offs price hikes drop out of the base

• 2012 CPI is likely to be 6%, with subsidies on petrol, water and other key staples terminated

• 2013 CPI is expected at 7-8%, on a view that food and foodstuff prices may tick up
MONETARY POLICY

- Government put policy rates up to a peak of 15% by early 2012, but has cut them to 8-9% now.

- Unhappily, the decline in lending rates, from 21% to 16%, has been much less, while loan growth remains moribund at +3% yoy.

- This is despite a resurgence of M2, and reflecting several factors - banks’ risk aversion, their upper hand with businesses and their effort to bolster NIMs while raising NPL provisions.

- Lending will pick up as NPLs are sorted out and bank restructuring accelerates, but the process is likely to be a slow one – loan growth may not be much more than +10% in 2013.
FISCAL POLICY

- Official budget deficit fell sharply in 2010-11 as investment spending was controlled
- The gap is ticking up in 2012 as wage hikes become unavoidable, while revenue is under pressure
- But expenditures are under careful management – public investment has plunged from 43% of GDP in 2010 to 34% in 1H12, with SOEs moving from 19% to 12%
- Off-budget spending on SOEs is also known to have contracted dramatically – this is significant, and if it were added to the official deficit, the combined total would show a healthy decline
- Meanwhile the Government is working hard on revenue enhancements, per the development of PIT

DEFICIT / GDP

GOV’T AND SOE INVESTMENT

PERSONAL INCOME TAX
As a percentage of GDP, the trade deficit (c.i.f.) peaked in 2008 and has rapidly declined.

Core trade deficit (eliminating oil and gold) has plunged after topping out in Jun 2010, with exports have consistently outpacing imports.

At present there is substantial export growth coming from FDI projects launched in 2009-10, and generally, Vietnam’s lower-end goods are expected to hold up well in a recession.

Credit contraction helped to tame the trade deficit, but with a huge structural decline in non-essential imports, normalized lending will not blow the gap back out.
Despite its oft-proclaimed demise, FDI has remained steady at $7-8bn pa throughout 2009-12

This is a bigger number vs GDP than for virtually all peers

Wages remain competitive, even with inflationary pressures, thanks to well-known demographic trends

Property FDI heavily contributed to trade deficit up in 2009-10

But FDI is now back to focusing on productive sectors, i.e., utilities and manufacturing

FDI players confirm they are bringing in or attracting support industries, particularly in electronics
• BOP risk has never really been about the trade deficit – this has always been well offset by net capital flows

• BOP risk does not come from hot money (long gone) or from sovereign debt (40% of GDP and mostly concessional)

• Historically, the BOP has been in surplus

• Problem is internal capital flight, via “errors and omissions” that eat reserves

• This blows out when locals lose faith in currency and dump VND for USD / gold

• Ending inflationary policies ends internal capital flight – as is now happening

• Hence reserves are rapidly rebuilding

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### BALANCE OF PAYMENTS

<table>
<thead>
<tr>
<th>($bn)</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011E</th>
<th>2012F</th>
<th>2013F</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade Account (fob)</td>
<td>(12.8)</td>
<td>(8.3)</td>
<td>(5.1)</td>
<td>(0.5)</td>
<td>8.2</td>
<td>10.4</td>
</tr>
<tr>
<td>Net Services</td>
<td>(0.9)</td>
<td>(1.2)</td>
<td>(2.5)</td>
<td>(3.0)</td>
<td>(4.2)</td>
<td>(5.3)</td>
</tr>
<tr>
<td>Net Investment Income</td>
<td>(4.4)</td>
<td>(3.0)</td>
<td>(4.5)</td>
<td>(5.1)</td>
<td>(5.6)</td>
<td>(6.5)</td>
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<tr>
<td>Remittances</td>
<td>7.3</td>
<td>6.4</td>
<td>7.9</td>
<td>7.9</td>
<td>7.3</td>
<td>7.3</td>
</tr>
<tr>
<td>Current Account</td>
<td>(10.8)</td>
<td>(6.1)</td>
<td>(4.3)</td>
<td>(0.7)</td>
<td>5.8</td>
<td>5.9</td>
</tr>
<tr>
<td>ODA Loans</td>
<td>1.7</td>
<td>5.2</td>
<td>4.2</td>
<td>3.3</td>
<td>3.3</td>
<td>3.1</td>
</tr>
<tr>
<td>Other Net Loans</td>
<td>(0.7)</td>
<td>(0.7)</td>
<td>(0.8)</td>
<td>(1.4)</td>
<td>(1.9)</td>
<td>(1.9)</td>
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<tr>
<td>Net Financial</td>
<td>2.0</td>
<td>(0.1)</td>
<td>(3.6)</td>
<td>(3.8)</td>
<td>(4.4)</td>
<td>(4.2)</td>
</tr>
<tr>
<td>Net FDI</td>
<td>9.3</td>
<td>6.9</td>
<td>7.1</td>
<td>7.3</td>
<td>6.9</td>
<td>6.6</td>
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<tr>
<td>Capital Account</td>
<td>12.4</td>
<td>11.3</td>
<td>6.9</td>
<td>5.4</td>
<td>3.9</td>
<td>3.6</td>
</tr>
<tr>
<td>Sub-Total</td>
<td>1.6</td>
<td>5.2</td>
<td>2.6</td>
<td>4.7</td>
<td>9.7</td>
<td>9.5</td>
</tr>
<tr>
<td>Errors &amp; Omissions</td>
<td>(1.1)</td>
<td>(14.1)</td>
<td>(4.3)</td>
<td>(3.6)</td>
<td>(2.8)</td>
<td>(3.0)</td>
</tr>
<tr>
<td>Ch in Reserves = BOP</td>
<td>0.5</td>
<td>(8.9)</td>
<td>(1.7)</td>
<td>1.1</td>
<td>6.9</td>
<td>6.5</td>
</tr>
<tr>
<td>RESERVES</td>
<td>23.0</td>
<td>14.1</td>
<td>12.4</td>
<td>13.5</td>
<td>20.4</td>
<td>26.9</td>
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<tr>
<td>Months of Imports</td>
<td>3.7</td>
<td>2.6</td>
<td>1.9</td>
<td>1.7</td>
<td>2.3</td>
<td>2.7</td>
</tr>
<tr>
<td>Debt/GDP - %</td>
<td>29.8</td>
<td>39.0</td>
<td>39.0</td>
<td>42.4</td>
<td>45.0</td>
<td>44.0</td>
</tr>
</tbody>
</table>

Sources: World Bank for historic, Dragon Capital for forecasts
- Currency is the acid test of reform
- VND has been stable near 21,000 since Feb 2011 devaluation
- Official and interbank rates (and black-market rates) have long since converged
- The gold-US$-VND nexus has been broken
- If policy discipline is maintained, downward adjustments in VND can remain minimal
- Macro reforms will make it possible to continue rate cuts without undermining the currency

VND/$ RATES, 2008-12

After several years of steady depreciation, VND is finding a level near 21,000
GROWTH

- Policy discipline is heroic but it has put Vietnam in a classic post-bubble deleveraging slump.
- The +4.4% GDP estimate for 1H12 is widely viewed as high, given no loan growth, but there was a push from public investment at ca +5% and resilient retail sales at +7%.
- A recent McKinsey study of 45 countries in 1930-2010 suggests that the low-growth phase of deleveraging typically lasts 2-3 years; if so, Vietnam has put in some good time at 18 months.
- This model might see the economy bottoming in 2013 given underlying plus factors that do exist.
- These are falling rates, the beginnings of renewed lending, residual consumer spending, low household debt, minimal foreign debt, a recent upturn in 3Q12 PMI, the ongoing FDI/export story.
- Phase II reform, if it happens, would be a powerful catalyst for the growth re-start.

MCKINSEY DELEVERAGING STUDY, 1930-2010

- **Recession**
- **Deleveraging**

10 years

10-years historic trend

10 years

1-2 years

Economic downturn starts as economy still leverages up

2-3 years

Downturn continues during the first years of deleveraging

4-5 years

Economic “bounce back” while deleveraging continues

10 years

10-year trend post deleveraging
Government now fully understands that pumping GDP is more trouble that it’s worth
It will stick to the new program of “growth with stability” and the fiscal / monetary discipline it entails
Trade deficit will stay at a modest level of GDP, reinforcing hidden BOP surplus
CPI and VND will stabilize as more professional macro management is institutionalized
2012-13 growth prospects are underwhelming, but performance from 2014 should be more exciting
Meanwhile the Government is likely to be stepping up bank and SOE reforms
VIETNAM’S ECONOMIC REFORMS: WILL HISTORY REPEAT ITSELF?

- **1986 Economic Reform**
  - Focusing on Agriculture
  - Barely have enough food to avoid famine

- **1999 Economic Reform**
  - Enterprise Law
  - Private Sector Industrial Production

- **2011 Economic Reform**
  - SOEs, Financial Sector
  - ???

- **Rice Export** (LHS)

- **Industrial Production**

- **Trillion VND** (trn VND)

- **0, 500, 1000, 1500, 2000, 2500 '000 tons**

2. THE EQUITY MARKET
MARKET PERFORMANCE: LONG TERM

Not a pretty long-term historical chart but…
...thanks to the macro policy turnaround, comparative performance YTD has been quite encouraging, even with the correction for recent political events.
Market is cheap – admittedly for a reason, but the Government is working on the reason.
After a tough 2011, earnings will surge in 2012 on margin gains, even as the top line decelerates and in 2013 NPAT will follow sales.

<table>
<thead>
<tr>
<th>31 Aug - VNI 396</th>
<th>2010</th>
<th>2011</th>
<th>2012F</th>
<th>2013F</th>
</tr>
</thead>
<tbody>
<tr>
<td>P/E (x)</td>
<td>9.8</td>
<td>10.8</td>
<td>9.2</td>
<td>8.4</td>
</tr>
<tr>
<td>EPS Growth (%)</td>
<td>17.7</td>
<td>-9.4</td>
<td>13.7</td>
<td>13.7</td>
</tr>
<tr>
<td>PEG (x)</td>
<td>0.6</td>
<td>neg</td>
<td>0.7</td>
<td>0.6</td>
</tr>
<tr>
<td>Sales Growth (%)</td>
<td>34.5</td>
<td>19.5</td>
<td>9.7</td>
<td>13.4</td>
</tr>
<tr>
<td>EBIT Growth (%)</td>
<td>20.5</td>
<td>7.5</td>
<td>27.5</td>
<td>12.7</td>
</tr>
<tr>
<td>PBT Growth (%)</td>
<td>29.6</td>
<td>-3.3</td>
<td>24.3</td>
<td>11.0</td>
</tr>
<tr>
<td>NPAT Growth (%)</td>
<td>25.9</td>
<td>-3.5</td>
<td>20.1</td>
<td>14.5</td>
</tr>
<tr>
<td>Net DER (x)</td>
<td>0.4</td>
<td>0.4</td>
<td>0.4</td>
<td>0.3</td>
</tr>
<tr>
<td>ROE (%)</td>
<td>20.2</td>
<td>15.6</td>
<td>18.5</td>
<td>18.1</td>
</tr>
<tr>
<td>Yield (%)</td>
<td>5.0</td>
<td>4.0</td>
<td>4.6</td>
<td>4.5</td>
</tr>
<tr>
<td>PBV (x)</td>
<td>1.69</td>
<td>1.61</td>
<td>1.54</td>
<td>1.45</td>
</tr>
</tbody>
</table>
FORECASTS AND VALUATIONS

2012

• **Sales:** Will slow sharply on the downturn in GDP growth

• **EBIT:** Lower cost inputs, especially from raw materials and marketing expenses (after big jumps in 2011) will see EBIT margins motor

• **PBT:** Rate cuts may have a negative effect by constraining non-interest income at banks, and financial income at net-cash companies – and these players are 60% of market earnings

• **NPAT:** The winding-down of tax breaks from earlier years will be a further hit, but ultimately bottom-line gains will still be very healthy

• **EPS:** Hit by dilution from late 2011, early 2012

2013

• Sales growth will pick up a bit but another round of margin gains is not foreseen, and certainly large companies that had explosive growth in 2012 will not repeat the experience

• Hence the bottom line will be more inclined to follow the top line
PLAN FOR 2013-1015

• Tighten regulations on securities companies
• Merge Hochiminh City Stock Exchange and Hanoi Securities Exchange
• Launch ETFs
• Allow local open-ended funds
• Launch the new trading platform
• Have a central counterparty system
• Have securities lending and borrowing system and allow short-selling
• Have stock index futures
3. THE BOND MARKET
**VIETNAM BOND MARKET – HISTORY**

**Milestones:**

- **Before 2006:** Very small issuance, limited transaction.

- **From 2006-2008:**
  - The Vietnamese market in reality born when Vietnam entered WTO.
  - Bonds as % of nominal GDP now about the same as Thailand and Philippines in mid-90’s.
  - New issuance was 2x-3x the outstanding before, in all kind of bonds.
  - Secondary market activities: clearly picked up to some U$80-100m per day at the end of 2008. Yield was bottom out at 6.5% and peaked at 20+% mid-2008.

- **2008 - today:**
  - is primarily Vietnamese.
  - Trading volume has been around US$20-30m per day for both repo and outright transactions.
  - Yields is at 9.5-10% for 5yrs.
VIETNAM BOND MARKET – INFRASTRUCTURES

- **Investor base:** In the absence of mutual funds/pension funds, the domestic banks make up one giant investor. Very few institutions (if any) do mark-to-market.

- **Product range:** extremely narrow, basically only straight bonds.

  - **Government bonds:** US$10.5bn; 90% will matured within the next 5 years.
  
  - **Government guaranteed bonds:** From 2007, total more than US$ 5bn.
  
  - **Municipal bonds:** extremely small. No new issuance since 2010.
  
  - **Corporate bonds:** Issuers are SOE’s and property companies.
  
  - **Derivative and hybrid products:** in reality doesn’t exist. Equity linked notes have been issued in 2009-2011 as convertible bonds, bonds with warrants, exchangeable bonds, mandatory to convert debt.
VIETNAM BOND MARKET – INFRASTRUCTURES

- **Market Regulation Improvements:**
  - State Treasury issuance policies:
    - From 2011, has used the reopening method to enlarge the size of new bonds and testing the buying-back program. The size of each bond is now 2.5 times comparing to 2007 ($37m vs $14m).
  - The electronic auction and trading system from Aug-2012.
  - Coupon tax on foreign investors: 5% from March-2012 (before:10%), transaction tax 10bps.
  - Changes in related laws

- **Rating agencies:** No domestic rating agency contributes to opaque corporate pricing. Although:
  - SBV has the credit information center which rates listed companies but too generous results.
  - Private Credit Bureau JSC (PCB ), has just submitted application for license to the State Bank of Vietnam.
  - Credit Rating Vietnam Joint Stock Company (CRV) has rated listed companies and commercial banks.

- **Market participants:** The VBMA (Vietnam Bond Market Association) officially operated from May-2009, now has around 60 members(banks, fund managers and insurers)
VIETNAM BOND MARKET – Challenges

Illiquidity and very limited product range
- Limited transaction: Government bond turnover is USD 10-30m per day.
- Practically, no market makers.
- Market is very binary
- Not possible to shorten the curve.
→ Exit strategy is essential.

Limited market access and taxes for offshore institutions
- They do not have access to interbank market
- They pay 10 bps transaction tax and 5% coupon tax.
→ Major focus is on minimizing tax costs.

Frequent discrepancy (at times >100 bps) between screen rates and true market rates
- Screen rates tend to be too high when rates are falling and vice versa.
- Performance can be distorted.
- Distorts strategy.

3yrs Screen rates vs Secondary market

- Secondary market _ Ask
- Bloomberg (3yr)
PLAN FOR 2013-2016

- Improving legal system,
  - Improve issuing government bonds, municipal bonds, and corporate bonds
  - Allow fixed-income derivatives
  - Allow pension funds
  - Establish credit rating agency

- Developing market
  - Building the primary dealer system
  - Building government bond yield curve
  - Developing inter-dealer market

- Improving infrastructure
  - Adopting custody standards by IOSCO
  - Aiming to unify the custody houses, the clearing and settlement systems
THANK YOU!

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