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SOWING SEEDS OF PROGRESS

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Sowing seeds of progress

An economic evolution is gathering steam in Vietnam, where new factories, manufacturing plants and private enterprises are changing the landscape forever. Being rich is no longer a crime, but foreign investors remain wary of an environment in which solid returns are hard to come by. Chris Cockerill reports on a private equity firm in Ho Chi Minh City that's immersing itself in the nascent market.

Two hours out of Ho Chi Minh City (HCMC), in the depths of the Mekong Delta, a new industrial estate is, like Vietnam's economy, beginning to emerge. A road – far from finished and for now occupied by a lone steam roller - leads into a park where a few small but new factories puncture the scrubland.

On the surface the environment is far from impressive, but the estate symbolizes something much more than the sum of its unfinished parts. It is here, and in similar half-built manufacturing zones scattered across the country, that successful private enterprises – for so long discouraged by Marxist ardour and a mass of red tape – are emerging. They are finally graduating from the small, cluttered open-front shops that colonise the roadsides into factories and manufacturing plants that in turn are laying the foundations of Vietnam's economic evolution.

For Mekong Capital, a small private equity fund based in HCMC, this area is significant for a more specific reason. At the end of the gravel track, within a new 100,000 square foot factory stands the estate's newest tenant, Tan Dai Hung, a poly-propylene woven bags manufacturer and the first of 10 private equity investments made by Mekong Capital.

The investment is, by anyone's standards, not sexy. The factory floor is raw and hot, the air pungent, and hundreds of young women sit bent double over sewing machines, churning out an array of coloured plastic bags for the likes of Carrefour, Europe's largest retailer, and express mail courier DHL. Also, a US$1.6 million investment for a 25% stake in a plastic bag-maker isn't likely to ripple the regional waters, when other private equity funds have executed billion dollar deals across Asia.

It's important, however, to put these numbers into context. Vietnam's GDP, while growing very quickly – 8.4% last year – still stands at just over US$50 billion. And with the country's private sector only just beginning to appear above the parapet, private equity players will struggle to find sizeable investments in any companies other than those in the former state-owned sector that have listed or are about to do so. As one observer notes: "As a generic form of

MANUFACTURING is helping to drive Vietnam's economic future.

investment, private equity is a bloody tough thing to do in Vietnam because it's so hard to find the companies to invest in and therefore hard to find the returns. The only other option is to look at the large companies, which means public companies and public markets."

MAKING PRIVATE EQUITY WORK

But for Chris Freund, founder and managing partner of Mekong Capital, investing in companies like Tan Dai Hung when they are at the very start of their journeys toward a public listing is the best and only place to be in Vietnam.

"We are early-stage investors, investing in companies four to five years before they list. We take a significant stake, and then get very involved with that investment," says Freund, explaining the basis of Mekong's active investment strategy.

Tan Dai Hung is one such example where Mekong's influence is clearly having a positive affect.

Following the latest round of expansion, involving the relocation of its business from just 13,000 square feet of space to its present 100,000 square feet, Tan Dai Hung is now one of the largest private plastic makers in Vietnam. It employs about 1,000 workers and runs 24 hours a day, six days a week. And while the financials are small in US dollar and global terms, they are growing at an enviable rate: the company's revenue was up 43% year-on-year at the end of 2005 to stand at just over US$10 million, while the company's net profit has risen by an average of more than 20% per annum over the three years that Mekong Capital has been invested.

According to Freund, all these figures mean that the original investment made by Mekong Capital has already doubled, an achievement that he describes as "not too bad".

And if the plans of Pham Trung Cang, the founder and owner of Tan Dai Hung, come to fruition, the investment will only keep gaining in value. "I want to see the company continue to grow into the largest plastics company in Vietnam, and listing is part of this process," says Cang, touring his new factory floor and pointing out the newly built canteen installed for his workers.

He certainly appears happy with what his foreign partner has brought to the business since it made the investment.

"Many funds are just passive; they wait for the profits of the company to improve, and then sell. But most companies here are constrained by their capacity and their capabilities. We didn't just need capital, we needed a partner that could help us bring in greater efficiencies and help us find the necessary people," says Cang. "And for the past three years Mekong has been very active in these two areas."

Cang has a black Mercedes parked outside, wears a belt that screams Versace in gold lettering and sports a more subtle, but still clearly expensive watch on his wrist. It's a far cry from when he set up the business 20 years ago. "Being rich was a crime," Cang says, admitting he hid his wealth from the authorities because if he had flaunted it he would have had to confess how he got it.

But following the introduction of *doi moi* – or renewal – by the government in the late 1980s, regulations were loosened and Cang, and others like him, began to be actively encouraged to succeed in business. And that's what Mekong Capital is attempting to tap into.

A TURBULENT HISTORY

Mekong Capital was established in 2001, following Freund's return to Vietnam. He had been based in the country during the early 1990s with Franklin Templeton when, under the guidance of Mark Mobius, the global asset manager decided, like other funds around it, on an ill-fated gambit into Vietnam.

Very quickly it became apparent to the investment community, which had raised US$400 million for potential investments, that it had misread the market and was years too early. When promised economic reforms failed to substantially materialize, many fund managers left the country with tails firmly between legs. Those left behind soon joined the exodus when the country was soundly smacked by the Asian Financial Crisis of 1997-1998.

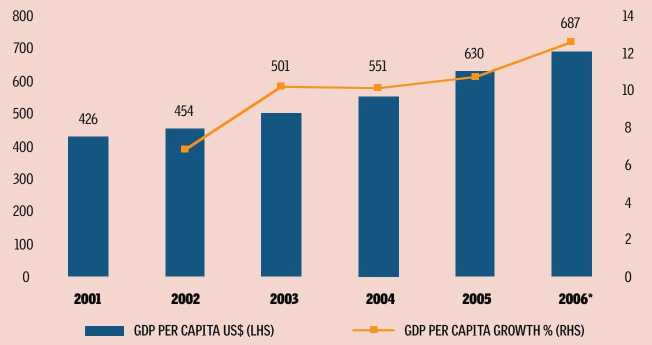
This final event proved too much even for the emerging market investment veteran Mobius, who wisely transformed his US$117 million Vietnam Opportunities Fund into a pan-Asian fund. Freund moved down to Singapore.

Freund admits that when he returned five years ago, or four years after the financial crisis tore through the country, it was tough getting people interested in Vietnam again. "In 2001, it was a hard sell. Asia was in the doldrums, and Vietnam was off the radar screen," he says.

However, Freund's determination eventually convinced the Asian Development Bank (ADB) to become an anchor investor in Mekong. "Supporting private sector development in Vietnam was a strategic priority for the ADB so it took a position with Mekong Capital," explains Freund. "It was a public statement that really helped in attracting others to the fund."

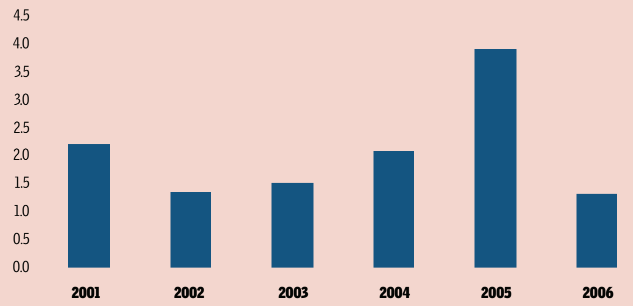
Following the ADB's commitment, Freund then went on to pull in another name. While he categorically refuses to say who this is, other investors based around Vietnam's economic capital say it's Gary Brinson, the former head of

GDP PER CAPITA (US$)

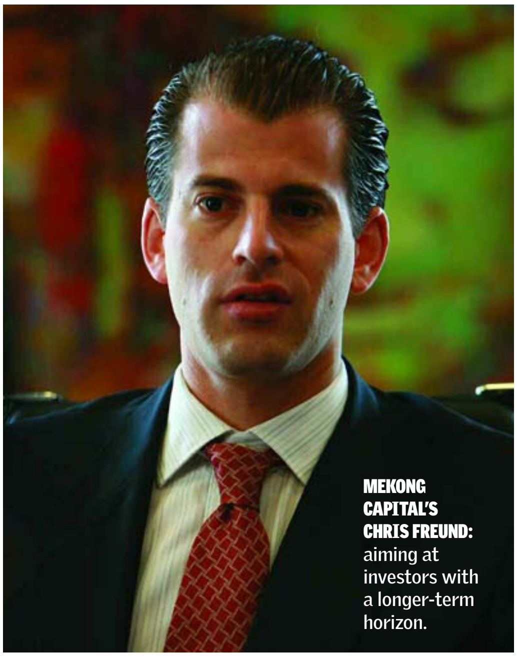


SOURCE: MINISTRY OF FINANCE, * – PROVISIONAL

NEW FOREIGN DIRECT INVESTMENT COMMITMENTS (US$bn)



NOTE: 2006 DATA REFERS TO DATA SINCE THE START OF 2006 TO 15 FEBRUARY.
SOURCE: GENERAL STATISTICS OFFICE OF VIETNAM, CEIC, CITIGROUP ESTIMATES.



MEKONG CAPITAL'S CHRIS FREUND: aiming at investors with a longer-term horizon.

UBS's US asset management business and a man whose name was often mentioned in the same breath as the US-based investor Warren Buffett in the early 1990s.

BUILDING FOR THE FUTURE

Landing these two brought much-needed kudos to the fund, and Mekong Capital was soon on a roll. Swiss investment funds, emerging market funds and family offices all came in with between US$250,000 and US$1 million in investments. The fund was closed in April 2002 with US$18.5 million in commitments, which was fully invested over the next few years into 10 companies, ranging from clothes manufacturers, a gas supplier and a magnetic wire producer. The average size of each investment amounted to about US$1.5 million.

In the years since Freund's return, the investment attitude towards Vietnam has changed markedly, with an estimated US$1.4 billion worth of money either invested or looking for potential investments. Mekong has been able to take advantage of this resurgence in interest. In June of this year, the private equity firm closed its second, more chunky US$50 million fund.

The new fund will, says Freund, look towards companies involved in branding and distribution with a focus on the growing domestic retail market as opposed to just export orientated companies. "US$50 million is the perfect size because our deals will be between US$3 million and US$5 million," he says, adding that the optimum number of investments for Mekong Capital's funds will be 20 to 25, each held for about five years.

While Freund accepts that his investments are several years away from reaping the rewards of potentially lucrative, but not guaranteed, public listings, he points out: "We are aiming at investors with a longer-term horizon."

This may be true, but even long-term investors will want to see returns at some point. And the returns on Mekong's investments to date are, because of the unlisted nature of the fund's investments, difficult to gauge. But Freund believes that average net growth for the investments has been about 44%, while the average annual revenue growth for the 10 investments has been 34%.

Says Freund: "Overall we estimate the gross internal rate of return (IRR) will be around 30% since our companies are growing at more than 30% a year and we would normally expect to exit at the same multiples as we entered. That means the net IRR would be around 22% according to our estimates."

Despite such strong numbers being bandied around, it seems other foreign investors in the country remain unconvinced about making private equity investments into Vietnam's private sector. Many large private equity funds cannot justify a presence in the country because the size of the available investments would not warrant the costs needed to establish themselves. In addition, drawing returns from the private sector investments will take too long for impatient shareholders. Freund admits that he is willing to accept less compensation than other foreigners, as is his team of 20.

THE NEED FOR TRUST

With the majority of Mekong Capital's members still in their 20s, Freund seems distinctly old at 35. All of his colleagues are Vietnamese returnees or of Vietnamese descent, coming back to the country their parents were forced to abandon during the late 1970s, following the collapse of the American-sponsored South Vietnamese government.

This strong Vietnamese culture running though Mekong Capital's new American investment-banking-styled offices, with their dark wood furniture and large meeting rooms, is something that Freund believes gives Mekong Capital an important advantage in this line of work. With each of his investment managers spending about two or three days a week with each company, a trusting relationship between investor and investee is highly important. This is never more so than when both sides enter negotiations about potential investments.

The understanding of what Mekong Capital does is often lost on clients unfamiliar with the workings of private equity. "We are often viewed at first as a bank and they ask how much our interest rates are," says Freund. "We have to explain our investment strategy and define ourselves as strategic investors. While we are interested in dividends, we are more interested in long-term capital gains brought about by building the company together so we can list it." With price-to-earnings ratios now standing at between 18 and 20 for those companies already on the Vietnamese stock exchange, it's an enticing proposition for many businessmen.

Once the companies and their upper management are clear about Mekong Capital's mandate, the next issue to surface is one of transparency. It's a concept that is something of an enigma throughout the country. Corruption is both rife and disparate, running through all strata of society, adding another, challenging layer to potential investments.

SHADY BOOKKEEPING

With this in mind, the most common problem faced by Mekong Capital is persuading the owners of investment targets to reveal the real company financials. Two or three sets of books are very common as Vietnam's companies attempt to hide as much of their profit as they can from the tax man. In addition – and giving an even clearer picture of how malfeasance pervades the country – a number of companies pay some tax officials, who are meant to assess them, for advice on how to hide their profits. These auditors in turn then fudge their figures so that the scam isn't uncovered during their own internal audit. And so it goes round.

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"In order for these companies to list they have to bite the bullet and go from non-transparent to transparent and they need our help," says Freund. "We need to get a match between the real numbers and the numbers that go to the tax man. If they don't want that, then the deal will fall apart." He adds: "But we know the right questions to ask to get the right books, and we spend a lot of time working with the companies helping them prepare the right books."

Freund makes sure that when a deal is signed, the contract contains options that allow for redress to be taken if targets are deliberately missed or companies go back on their agreements at the time of the initial investment. It sounds like a good idea, but the contracts remain untested in a Vietnamese court of law and Freund admits he would rather resort to other means of "pressure" than resorting to the law. He claims that progress is being made across virtually his entire portfolio, with only one of his investments behind in bringing its audited figures up to the necessary standard.

Many companies fail at the evaluation hurdle when it becomes apparent that the gap between the real figures and the reported figures are too big to breech. However, there are still potential landmines in this area even after an investment has been made. "Most private companies are coming from a situation of poor tax compliance before we invest. Although we work closely with them to rapidly improve tax compliance and most have had their past tax liability confirmed by the tax department, there's always a risk that the tax department does another audit and assesses a significantly different amount of tax liability than what we believed to be the case," says Freund.

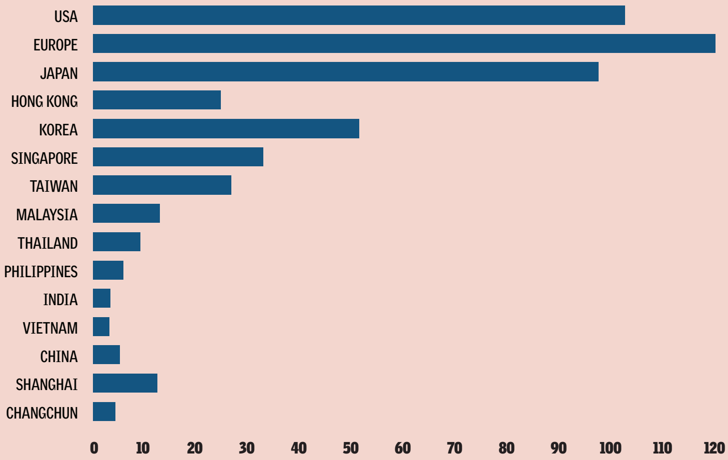
IMPROVING THE WORKER'S LOT

But Mekong Capital does not just look to improve the books; in an ironic twist, it has taken a capitalist firm in a communist country to improve the lot of the workers. One such example is Minh Hoang, a clothes manufacturer on the edge of HCMC, which has consigned the sweat shop mentality to the history books. Gone are the dimly lit, stiflingly steamy rooms. While the rows and rows of sowing machine workers still exist, the ceiling of the factory has been lowered so that the air-conditioning is now effective, the factory has a lot of light and it has 1,500 happier workers who are paid US$70 a month, more than many of their peers.

Nike is now one of Minh Hoang's major clients, with the American clothing giant placing an order for its entire range of football shorts – that's two million pairs – to be made at the factory. Nike, soundly slapped by negative reports about its use of cheap labour, now demands that all of its suppliers conform to higher working practices. With Mekong's investment and guidance the necessary changes were implemented, which in turn resulted in more impressive numbers. At the end of 2005, Minh Hoang's revenues had grown 67% year-on-year, while its profits increased 54.8% over the same period and its workers' absentee rate plunged. Instead of an average 30 people quitting every day, during the whole of June it was just five.

With Mekong Capital building this kind of track record, it shouldn't be short of companies wanting to become part of its stable as it looks to invest its next US$50 million fund over the coming months and years. The speed with which Mekong Capital can build its next portfolio will now depend on how many companies it can find operating within its strict investment requirements. But one thing is sure, Freund and his team will be beating trails down more un-built roads for some time to come.

HOURLY MANUFACTURING LABOR COSTS IN VIETNAM AND SELECTED ECONOMIES, 2004 (US = 100)



SOURCE: GENERAL STATISTICS OFFICE OF VIETNAM, CEIC, U.S. DEPARTMENT OF LABOR STATISTICS (HTTP://WWW.BLS.GOV/NEWS.RELEASE/ICHCC.T01.HTM) AND CITIGROUP ESTIMATES.

MEKONG CAPITAL'S investments range from garment manufacturing to gas.