OPEN FOR INVESTMENT

AUGUST 2007

KPMG in Vietnam

Written in co-operation with the Economist Intelligence Unit

Economist Intelligence Unit

AUDIT ▪ TAX ▪ ADVISORY

Methodology:

Vietnam: Open for Investment is a KPMG white paper, researched and written by the Economist Intelligence Unit. The author, Scott Morgan Robertson, conducted extensive interviews with industry professionals, government officials and executives at domestic and foreign-invested enterprises throughout Vietnam to research the paper. Data are sourced from the Economist Intelligence Unit except where noted. David Line was the editor of the report. Our thanks are due to all interviewees for their time and insights.

August 2007

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Executive summary

The speed with which Vietnam's economy is changing is staggering. From devastation after decades of war, 20 years of economic reforms have turned it into one of the world's most dynamic emerging markets. Its entry to the World Trade Organization (WTO) in 2006 underscored its importance as a trading nation—one whose competitiveness in certain products (footwear and coffee, to name the most prominent examples) has long worried established producers. With an improving legal system and a stable political structure, coupled with a young and capable workforce, manufacturers of all kinds (including mass-production and high-tech giants like Nike and Intel) are increasingly seeing Vietnam as a sound choice for their "China-plus-one" investments—despite concerns about corruption and a slow-moving bureaucracy. The rapid privatisation of state-owned enterprises, ongoing reform of the banking sector and a WTO mandate to open up the services sector mean many other foreign investors are taking note.

This KPMG white paper, written in co-operation with the Economist Intelligence Unit, analyses opportunities for foreign investors in Vietnam in light of the rapid transformation of its economy and investment environment in recent months. The research, based on extensive interviews with experts, government officials and executives from both domestic and foreign companies in Vietnam, is split into two parts. The first examines the macroeconomic and regulatory investment environment, while the second analyses investment opportunities with regard to supplying the domestic market, the equitisation of state-owned enterprises (SOEs), and producing for export. The key findings of each section are summarised below.

Investment environment

- **Vietnam's economy is already oriented towards private enterprise, and its population is more entrepreneurial and wealthy than is commonly thought.** Because state domination of industry was never as entrenched as in China, private enterprise plays a comparatively stronger role in the economy. And because much private enterprise is unrecorded, the population is likely to be more wealthy than is commonly thought, by as much as 30 percent in total—and by a considerably larger margin in the urban centres of Hanoi and Ho Chi Minh City (HCMC). These factors have enabled Vietnam to accelerate the import of capital equipment in recent years to develop its export industries faster than its "Asian tiger" predecessors.

- **Vietnamese workers are young, easy to train and keen to consume.** The preponderance of young people in the workforce means Vietnam is on the cusp of a "youth boost", with a falling dependency ratio and less pressure on the state to provide social services for the elderly. That said, state education is basic, and foreign investors are increasingly turning to supplemental training to help ensure workers have the necessary skills. However, studies by investors have shown Vietnamese workers are amongst the easiest to train in the world.

- **The regulatory process is improving, but unequal implementation and corruption remain problems.** The government is becoming increasingly consultative—with the public, the donor community and investors—about drafting laws, but the system remains complex and opaque. Although investment approval processes have been simplified, implementation varies from province to province, as does the authorities' flexibility in attracting investment. Corruption remains a pervasive problem, although its severity and the extent to which it impedes business also vary by province.

- Land and tax issues can be problematic for foreign investors. Although the land-registration process has proceeded well, and debt-financing using land-use rights as collateral has taken off, the state's control over most land means markets are inefficient. Foreigners may not directly obtain land in the market, meaning they must rely on local joint-venture partners, industrial zones, or provincial authorities to provide it. Tax laws are improving but again their implementation is patchy. Large firms (including foreign-invested enterprises) are targets for tax authorities, and the appeals process is flawed.

Investment opportunities

- Incomes and consumption are rising—and retail markets are opening. With an attractive demographic profile, rising disposable income (set to reach US$30 billion (bn) in 2007), and the retail sector set to open fully to foreign investment from 2009, foreign investors are jostling to increase their exposure in Vietnam. Major multinational retailers including Parkson, Metro Cash & Carry, Lotte Mart, Tesco, Wal-Mart and Carrefour are either expanding their operations or poised to enter the market.

- Domestic businesses are capital-hungry and keen to expand. The number of private enterprises has rocketed since the Enterprise Law was passed in 2000. Many Vietnamese firms are small but efficient, and many are starved of capital, as state-owned banks' lending priorities were previously skewed towards SOEs. Foreign ownership caps on acquisition of local firms (30 percent of any non-listed firm and 49 percent for listed firms) remain in place but are expected to be changed soon.

- The sale of the largest state firms offers attractive assets to foreign investors. Vietnam is only now starting to open up the largest state firms for foreign investment. This is creating a sizeable opportunity for investors looking to gain exposure in the Vietnamese market, both through direct and portfolio investment. The State Capital Investment Corporation should enhance competitiveness and remove some of the problems usually associated with buying into SOEs—including conflicting social and commercial priorities. The state will likely continue to control many strategic industries.

- Equitisation should boost capital markets, but the government is having to rethink its schedule. The equitisation of many SOEs over the next three years is expected to boost Vietnam's nascent capital markets considerably: the IPOs of four major state-owned banks should raise the value of the two exchanges in Ho Chi Minh City and Hanoi by 50 percent. However, weaker-than-expected bidding for IPOs in 2007 (particularly for the leading state-owned insurance company, Bao Viet) means the government is rethinking its ambitious equitisation schedule.

- State-owned banks are not that shaky, but a shortage of skilled staff might limit expansion. As Vietnam's state-owned sector is comparatively smaller than in China, the banking system is not thought to be weighed down with similar levels of non-performing loans (though accurate figures are difficult to obtain). With a 30 percent cap on foreign ownership in a local bank and 15 percent for any one investor (notwithstanding that creating a joint venture bank is typically an unpopular investment choice in any case), opportunities lie in new forms of market entry such as establishing a 100 percent foreign-owned subsidiary. However the limited ability of banks to assess creditworthiness and the dependence on land-use rights as security are problems, while a shortage of skilled staff could hinder expansion.

- Vietnam is a prime candidate for the "China-plus-one" strategy, but infrastructural limitations remain a concern. With political pressure from the U.S. and EU against Chinese exports, many light-industry manufacturers see Vietnam as a safe bet as an alternative production base. However, outside Industrial Zones (IZs), and especially in the north, power shortages are a concern, while poor road conditions and a lack of deepwater ports in the south hinder shipping.

- Local-sourcing requirements might present problems to manufacturers. Investors in the manufacturing sector have found it difficult to meet the state's local-sourcing requirements, as local parts suppliers are not yet capable of meeting foreign firms' quality levels, and reliable supply chains take time to establish. Local-sourcing requirements might be raised to 50 percent of input value for certain key sectors, such as motorbike manufacturing.

- The government is keen to attract high-tech investment. High-profile investments like those of Intel and Foxconn in recent months demonstrate both the government's desire to attract high-tech investment and that—within IZs at least—there are no infrastructural impediments to the establishment of such operations in Vietnam. However, major investments of this type still need shepherding through by the prime minister and may not be indicative of the typical experience of smaller firms.

Introduction

In 2006 Vietnam completed the most significant period of reforms in its modern history, culminating with its accession to the World Trade Organization (WTO). With the revision of its legal system, the development of stronger institutions to guide future reforms and the establishment of a buoyant securities market, opportunities for investors in Vietnam have never been greater. And the fundamentals for Vietnam's current economic growth are very solid—the most obvious of which is the post-war baby boom that has created a young, dynamic labour force that is eager to work and shows a large capacity to consume.

The economic reform programme that began in 1986 reached critical mass in 2005-2006, resulting in a substantially revised legal system. The strict ownership barriers that dominated Vietnam's economy, although not eliminated, have been significantly reduced. The government has demonstrated that it is serious about restructuring state-owned enterprises (SOEs) and promoting a more robust private sector. Crucial to this process is creating an inviting market for foreign investment to pump capital into both these segments of the domestic economy.

It is perhaps fortunate that the extensive changes in Vietnam's economic regulations have occurred at a time of a huge expansion of foreign capital into emerging markets. Demand for high-risk investments is at an historic high. Since late 2006, indirect investment has poured into Vietnam, helping fund a major expansion in the securities exchange, turning what began as an experiment in capital markets into an increasingly important source of funding for domestic business expansion.

On the direct investment side, manufacturers that are already well established in China are looking at Vietnam as a way to diversify production. The "China-plus-one" strategy of many firms protects companies not only from political risk (in particular concerning American and European concerns over cheap Chinese imports) but also from natural risks, such as Severe Acute Respiratory Syndrome (SARS), avian flu or natural disasters. For many businesses, Vietnam is the obvious choice for additional production.

Vietnam is gifted by being a late and lonely tiger economy. High growth has been commonplace across East Asia for the past 50 years, and Vietnam shows every indication of following the same path. In addition, some aspects of Vietnam's investment environment are more attractive than those in other South-east Asian countries, in particular political stability.

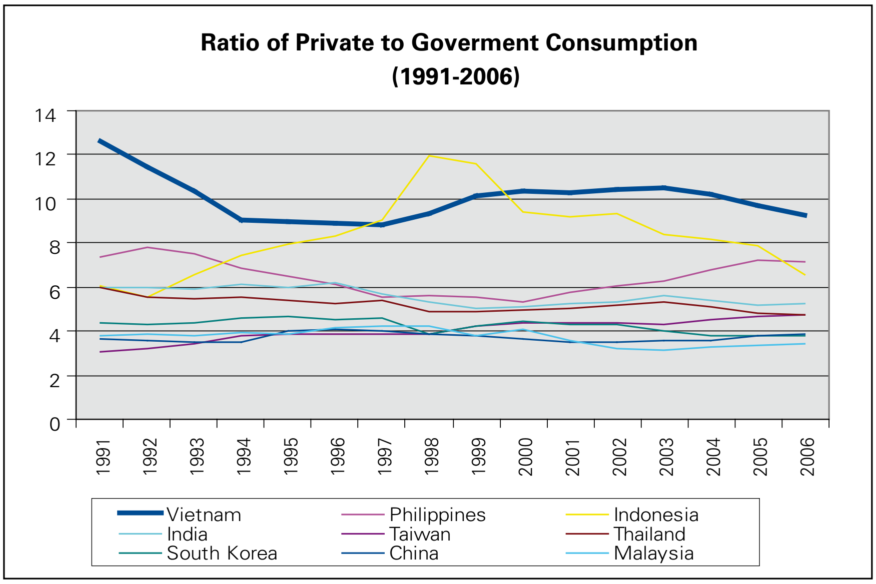
Nevertheless, hindsight provides a reminder of how overheated East Asian economies became 10 years ago, and of the dramatic market correction that resulted from some fundamental imbalances. Although Vietnam is currently experiencing a boom, there are some key areas to watch. For example, Vietnam is experiencing its first major exposure to fickle international markets. And although the Vietnamese government has learned how to entice foreign capital, a rapid increase in its capacity to maintain long-term relations with foreign investors is needed—whether through improved infrastructure, better courts or clearer market signals from the central bank. In spite of these problems, the chances are good for the economy to double in size over the next 10 years or so, and for foreign investors to participate in and benefit from this growth.

Part 1: Investment environment

Economic structure

Vietnam's reform process is creating an economy quite different from that expected of a communist country, or even from that seen in comparable developing countries—China in particular. In part because state domination of industry was never as entrenched as in China, private enterprise plays a comparatively stronger role in the economy. Because much private wealth is unrecorded, the population is likely to be more wealthy than is commonly thought. These factors have enabled Vietnam to import capital equipment to develop its export-oriented industries faster than its predecessors.

Although the private sector was only legalised in the 1980s, it is now a dominant part of the economy. Wartime demands limited the resources that could be dedicated to developing a state owned industrial sector. Having never experienced the consolidated period of state-driven industrialisation found in other transition economies, few Vietnamese SOEs are the behemoths seen in other comparable countries. Cradle-to-grave support for state employees therefore does not apply to a large portion of the population. The state share of the economy is much lower than in other communist countries, or even other ostensibly market-oriented Asian countries. Vietnam's ratio of private to government spending (as a percentage of GDP) is the highest among the region's rapidly growing economies.[1]



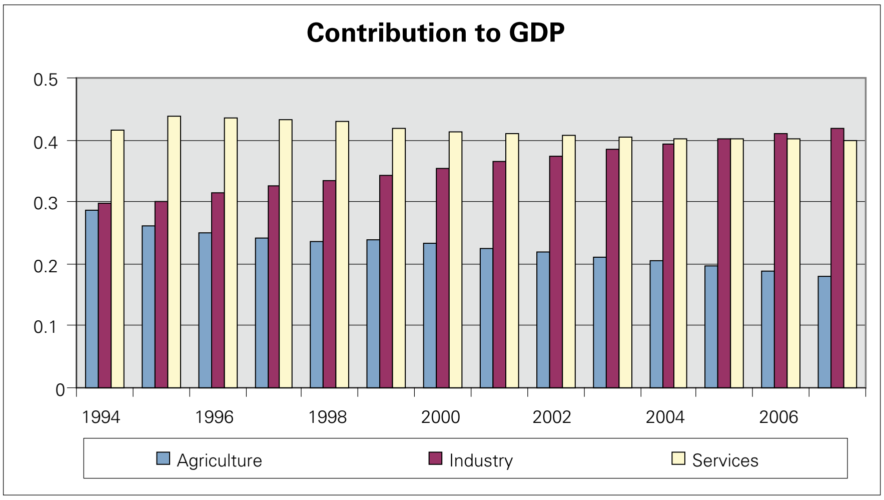
Source: Economist Intelligence Unit Country Data, accessed May 2007

1) Consumption by state-owned enterprises (SOEs) is included in the private sector, but direct fiscal expenditure (which includes support of SOEs) is quite low.

From 1991 to 2006, Vietnam averaged a GDP growth rate of 7.6 percent, the highest growth rate in South-east Asia and second only to China globally. Per-capita income is still far behind the regional leaders, at approximately US$800 in 2007—a value equal to Thailand in 1985, China in 1997 and currently on par with India.

However, these values do not account for the vast amounts of undeclared wealth. Several separate interviews suggested that undeclared wealth would push up per-capita incomes by at least 30 percent, and more so in urban areas. The market research company Taylor Nelson Sofres (TNS) Vietnam has found compelling evidence of the extent of hidden wealth in the economy from their Vietcycle project, an ongoing and vast panel survey of urban household consumption. According to Ralf Matthaes of TNS, "Vietnam is much wealthier than most believe." Incredibly, he estimates that "household incomes in Ho Chi Minh City are as high on a monthly basis as the [official annual] total national GDP figure. There is an obvious wealth polarisation."[2]

The growth in Vietnam's wealth in part comes from gains in the ongoing transition from an agrarian to an industry-and-services-based economy. With only 27 percent of Vietnam's population living in cities, it is one of the least urbanised countries in Asia. Yet the contribution of services and industry to the economy grew from 60 percent of GDP in 1987 to now comprise 80 percent of output. According to the Government Statistics Office, although unemployment is low at 2.2 percent, underemployment for the large number of workers who remain in agriculture remains a concern.



Source: Economist Intelligence Unit Country Data, accessed May 2007

2) *Interview with author, May 16th 2007.*

Vietnam: Forecast summary (% unless otherwise indicated)	2005a	2006b	2007c	2008c
Real GDP growth	8.4	8.2a	8.4	8.1
Industrial production growth	17.2	17.0a	17.2	16.2
Gross agricultural production growth	4.0	3.4a	3.0	3.0
Consumer price inflation (average)	8.3	7.4	7.2	6.9
Consumer price inflation (year-end)	8.9	6.6	7.1	6.6
Lending rate	11.0	11.2a	11.5	11.7
Government balance (% of GDP)	-1.2	-1.2	-2.3	-2.5
Exports of goods free on board (fob) (US$ bn)	32.4	39.9	46.0	53.9
Imports of goods fob (US$ bn)	33.3	40.6	47.9	57.1
Current-account balance (US$ bn)	0.2	0.1	-0.9	-1.9
Current-account balance (% of GDP)	0.4	0.2	-1.2	-2.4
External debt (year-end; US$ bn)	19.3	20.9	24.1	27.2
Exchange rate D:US$ (av)	15,859	15,994a	16,066	15,963
Exchange rate D:¥100 (av)	14,407	13,762a	13,633	15,024
Exchange rate D:€ (year-end)	18,775	21,186a	22,420	21,516
Exchange rate D:SDR (year-end)	22,748	24,152a	24,991	24,814

a Actual. b Economist Intelligence Unit estimates. c Economist Intelligence Unit forecasts.

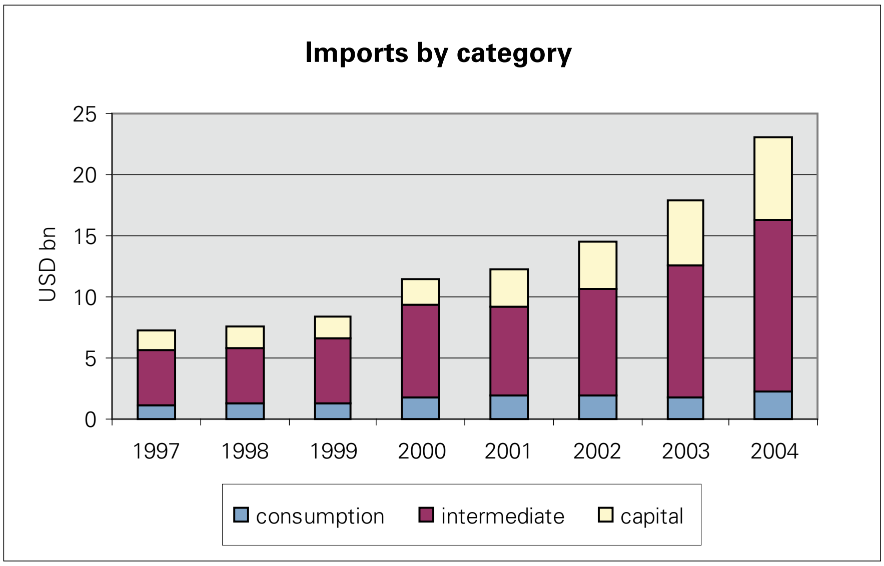
Even prior to joining the WTO, the economy was heavily engaged in trade. Measured by trade openness (imports and exports divided by GDP), Vietnam is the third- (and soon to be second-) most open economy in a region known for export-led growth. A country that once struggled with food security is now one of the largest rice exporters in the world. [3] Vietnam has since become highly competitive in agriculture, aquaculture and light manufacturing, and is often accused of adversely affecting world prices in coffee, shrimp, cashews and catfish.

Export-oriented Asian economies are not new to the world; however, Vietnam has been running a trade deficit. Some of the trade imbalance is due to oil price volatility. Vietnam exports oil but must import oil products for consumption, and will presumably do so until the first of a series of refineries comes online in 2009. However, most of the growth in the trade deficit is from purchases of intermediate goods and, more importantly, the purchase of capital equipment.

According to estimates by HSBC forex strategist Dan Hui, imports of capital equipment more than tripled between 1997 and 2004, with the remainder of import growth in intermediate goods.[4] Imports of consumption goods during this period remained fairly constant. The inflows of foreign machinery combined with Vietnam's rather favorable demographics are the solid foundations for increased productivity and continued economic expansion.

3) Vietnam overtook India as the second-largest rice exporter in 2004, exporting 4.3 million (m) tons (Thailand was first with 10.1m tons). Source: USDA, Foreign Agricultural Service, Production Supply and Distribution (PS&D) and Grain: World Markets and Trade, (Grain Circular), available at http://usda.mannlib.cornell.edu/usda/ers/89001/Table25.xls.

4) Dan Hui, Asian FX Strategy: VND: Appreciation Coming Soon, HSBC, May 21st 2007.

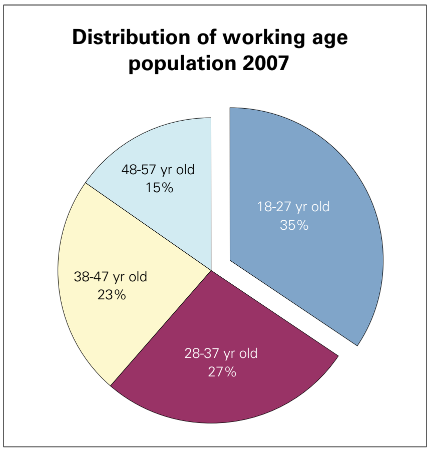


Source: HSBC

Demographic trends

Vietnam's population is the 13th largest in the world, at 85.2m people.[5] The baby boom after 1975 created an incredibly young population. The working-age population has a bulge between the ages of 18 and 27 (see graph, below). Most of these individuals have benefited from the extensive improvements in the educational system that occurred during the 1990s. The national literacy rate is around 90 percent, and 96 percent of the population has completed primary school.[6]

The age bulge has the additional benefit of being followed by a decline in the birthrate. Currently 1.2m people enter the Vietnamese labour force each year. Dependents (both young and old) are rapidly becoming a smaller portion of the population. In 1987 there were four dependents for every five workers and by 2007 this figure dropped to 2.5 dependents for every five workers.[7] The demographic change is having a multiplying effect on the share of disposable income per household. And ten years of high growth has coincided with an 83 percent increase in disposable incomes.



Source: Estimates from 1999 census

5) *Estimates from 1999 census*
6) *World Bank, World Development Indicators 2006*
7) *EIU calculations from Economist Intelligence Unit Country Data, accessed May 2007.*

The demographic change also had reduced the burden on social services, specifically education and healthcare.[8] However, this trend should not be taken as a positive statement on the overall conditions of these services, particularly higher education. In 2005, an estimated 1.2m students were enrolled in domestic universities, with around half of those enrolled in universities based in Hanoi and a quarter in Ho Chi Minh City. Many students have to supplement their coursework through private classes in English and, increasingly, computer skills. Vocational training schools are becoming a more important component of the education system, with 90 registered in HCMC in 2006. Helping to ensure the supply of skilled labour is necessary to attract foreign investment: the Vietnam Singapore Industrial Park (VSIP), to take one example, sponsors a vocational training center to help ensure their tenants have access to a skilled workforce.

Despite the shortcomings of national education, as the VSIP centre illustrates, a young, literate workforce with a basic education is well placed to absorb further, specific vocational training. Although often low-skilled, Vietnamese workers show an incredible aptitude for training. In fact, Toyota ranks Vietnam the second-most-trainable workforce in the world (Turkey is ranked number one).[9] Most manufacturers provide some form of additional training: a recent survey found that 60 percent of firms in the manufacturing sector have either additional internal or external training for workers.[10] This is occurring across all levels of manufacturing, as more companies entrench to capitalise on Vietnam's increasing productivity.

Regulatory process

Underpinning the dramatic growth in Vietnam is a regulatory-reform process to promote private-sector development and attract foreign investment. There are a number of interpretations of how this process is occurring. A particularly well accepted description is that the policymaking process is one of gradual experimentation, with pragmatic assessments of the impact of policy changes.[11] Political ideology is often less important than outcome. For the past 20 years of reforms this was a formula for success. However, as policies have become increasingly complex, the capacity of government institutions to evaluate policy is becoming questionable.

Laws are primarily drafted by executive line ministries, although on occasion the National Assembly takes responsibility. Laws are supplemented by Implementation Decrees and supporting documents, which provide more detail on procedures and practices. Provinces, in which the entire ministerial system is replicated, may draft interpretations that apply the national laws to the local situation. National laws tend to define principles rather than practices, and the variation between provincial performances is in part a result of different approaches to economic governance.[12]

8) Raymond Mallon and Brian Van Arkadie, Vietnam: A Transition Tiger? Asia-Pacific Press at the Australia National University, 2003.
9) Cited in Scott Chesier and Jago Penrose, The Top 200: Industrial Strategies of Viet Nam's Largest Firms, UNDP Viet Nam Policy Dialogue Paper 2007/5.
10) World Bank, Vietnam Investment Climate Assessment 2005.
11) Mallon and Van Arkadie, Vietnam: A Transition Tiger?
12) See the Provincial Competitiveness Index. http://www.pcivietnam.org/

The policymaking process is becoming more open to public discourse. Drafts are circulated for comments from business leaders and with the donor community. Public forums are held with top levels of government to discuss policy objectives and to answer questions, in particular through events such as the Vietnam Business Forum. However, it is important to understand that with the law-making process (that is laws, decisions, decrees and other forms of public ordinance) distributed among 19 ministries, the office of the prime minister, specialised committees, and the National Assembly, tracking all legal changes at all times is incredibly difficult, especially as more and more laws are being generated.

Reform occurs through a system of implementation and revision. For example, the legalisation of the private sector began through decrees that developed into the first enterprise law of the early 1990s, which was then revised into the 2000 Enterprise Law and revised again and expanded into the 2005 Enterprise Law, which now includes the foreign sector. Similar iterations have occurred with all major laws, with a tendency for more complex regulations (in part because of expanding types of legal economic behaviour) and to meet the WTO requirement of having a unified regulatory system for the private, state and foreign sectors.

The rather piecemeal nature of reforms means that the level of development is quite inconsistent. Almost 10 years' worth of surveys of Vietnam's private sector consistently find credit and land to be the major constraints to business development. The table shows the percentage of firms that report that their growth has been inhibited by the listed constraint. Preferential access for SOEs to credit and land is believed to be crowding out private firms. The average ratio of collateral to loan value is 33 percent higher for private firms than for SOEs.[13] Much of this policy is the result of centrally mandated lending plans imposed on state-owned commercial banks (SOCBs). Financial access is an area where the development of a private banking sector and foreign loan approval practices should have an immediate impact on enterprise growth (see 'Reforms in the banking sector', below). Land issues, however, are more complex (see 'Land issues', below).

Barriers to private-sector growth

Constraint	Vietnam	East Asia	World
Access to finance	37.4	17.4	30.1
Access to land	26.4	9.9	14.5
Labour skills	22.3	23.8	20.4
Transportation	21.6	15.2	12.4

Source: Vietnam Development Report 2006, Investment Climate Survey 2005, World Bank

13) World Bank, Vietnam Development Report 2006.

Major revisions in Vietnam's legal system

2003	Labor Code
2004	Law on Land
2005	Civil Code
2005	Law on Commerce
2005	Enterprise Law
2005	Law on Investment
2005	Law on Intellectual Property
2005	Law on Competition
2006	Law on Securities
2006	Law on Real Estate
2006	Housing Law

The iterative legislation process reached critical mass from 2003 to 2006, during which nearly the entire regulatory system was rewritten. As a requirement for WTO accession, the previous separate foreign and domestic legislation were unified into the Enterprise Law and Law on Investment. Under the previous system, foreign enterprises were ultimately tied to a single investment activity. The new laws provide for more diverse ownership structures of investments and enterprises. In addition, foreign businesses can now follow registration procedures rather than approval processes for investments that are under VND300bn (US$18m) and are in non-critical areas. Larger investments or projects in critical areas must undergo an evaluation process.

The legal system has a good deal of conflict and overlap, which in many instances provides opportunities for corruption. With law-drafting duties mostly in the hands of ministries, the lawmaking process suffers from some bias as institutions work in their own best interests. Most striking is the dual-registration system that requires a single piece of property to have a title or certificate for both the land and the buildings attached to it. In 2005 there was a move to create a triple registration system of immovable property, but this was eventually opposed by the National Assembly.

Legal reform is a major goal of the government, with government and party officials focused on developing the "rule of law". In some areas, such as business registration, these efforts are doing well across the country. In the 2006 Provincial Competitiveness Index (a measure of economic governance), only 9 out of 64 provinces were found to take longer than 2 weeks to register a business.[14] Levels of corruption tend to vary more widely: the prevalence of bribes as an obstacle to businesses activities ranges from 32 percent to 65 percent in some provinces.[15] Cracks in the system essentially make provincial leadership the most important component in the business environment.

The extent to which investment registration processes are simplified, the pervasiveness of corrupt practices, and the degree of state involvement in real-estate markets all are determined by provincial decision-making. In this regard certain provinces have shown an aptitude to invigorate the private and foreign sectors, such as Binh Duong, Da Nang and Lao Cai (a northernmost province that borders China), while other provinces have performed poorly, such as Ha Tay, which has so far failed to capitalise on its advantageous proximity to the Hanoi market, and ranked near the bottom of the PCI for two straight years.

Tax issues

Vietnam's tax laws, as is the case with a good deal of its national laws, are very well drafted and match international standards. Implementation and practice, however, require a good deal of further progress. There is a standard corporate income tax rate of 28 percent, with higher rates (up to 50 percent) applied to companies engaged in natural-resource extraction. Preferential tax rates of 10 percent, 15 percent or 20 percent, applicable for up to 15 years (with further tax holidays and reductions possible), may be given to encourage projects in certain industries or locations selected by the government.

14) The Provincial Competitiveness Index (PCI) is a U.S. Agency for International Development (USAID) funded project. See www.vnci.org

15) The PCI questionnaire uses a 5 point Likert scale by which respondents rate bribes as an obstacle to business activity. This is not the same as corruption frequency, which is nearly impossible to estimate.

Since the tax incentives system is rather complex, determining taxes often requires detailed consultation with tax officials. Self-assessment is only in its infancy and some negotiation on tax rates may be required. The tax authority is perceived to be efficient and incorrupt. Nevertheless, it is crucial for businesses and individuals to build relations—and establish a history of good faith—with local tax authorities.

According to Warrick Cleine, Managing Partner for KPMG in Vietnam, this is especially the case for foreign companies, which appear to be the most common target for official tax investigations—even though they claim to do everything possible to adhere to tax laws.[16] Considering the low incentive for a large foreign company to shave pennies from its tax bill, it is reasonable to assume that tax agents actively target higher-profile companies, of which foreign-invested enterprises are a large proportion. Moreover, the appeals process moves vertically through the tax authority, meaning that it is quite difficult to contest payments. The common view of the judiciary is that it is biased and expensive, and is not a viable option for resolving tax disputes in most cases. Practicing Vietnamese certified public accountants are rare, and domestic tax attorneys are rarer still.

The Ministry of Finance is in the process of drafting a Personal Income Tax law, and the hope is to increase the share of fiscal revenue that this form of taxation currently provides from 2-3 percent to much higher levels. (By comparison, China currently collects over 20 percent of its fiscal revenue from tax on personal income.)

This is crucial from a macroeconomic standpoint: there are few sources of tax revenue and oil, subject to huge price volatility, will likely provide a quarter of this in 2007—leaving Vietnam open to a fiscal crunch. Changes in customs tax collection (which accounts for 20 percent of fiscal revenue) to comply with WTO obligations will likely also lead to a reduction of tax income—tariffs will likely be lowered by an average of 13.5 percent. Over 60 percent of the current budget will likely need to be re-sourced. In this context, increasing the share of taxes collected on personal income to regional levels is incredibly important. Yet uncertainties remain given the current tax system and the lack of an independent system of appeals.

According to Cleine, the intensive campaign for public input on the drafting of the law shows the government's determination to have an effective personal income tax. Although the law will not be effective until 2009, officials began a public dialogue in late 2006 and it is expected to be promulgated in late 2007. Initial findings are that many people are willing to pay higher taxes if it leads to tangible improvements in public services, roads and healthcare.

As only around 1m private citizens currently pay income tax there is enough potential revenue to cover expected losses from the reform of customs duties from WTO obligations, depleting oil revenue, and SOE equitisation. However, if current tax-collection practices are not improved, concerns about how effectively the new law will be implemented will likely remain.

16) Interview with author, May 16th 2007.

There will likely need to be huge growth in Vietnam's tax administration and a more nuanced, technical approach to penalties if the new law is to be effectively implemented. A personal income tax tacked onto an erratic collection mechanism could be self-defeating. With the high degree of unclaimed wealth in Vietnam (as mentioned above, a safe estimate is around 30 percent of GDP), the tax base will likely be small until there is some increased measure of confidence in the collection system.

Land issues

Vietnam has been extremely successful in the first stage of land reform. The initial registration of land assets is nearly complete, leading to a rather strong debt-financing system: approximately 90 percent of formal businesses have debt financing, with land-use rights as collateral.[17] However, these successes do not mean there is anything remotely like an efficient real-estate market.

Land prices in Vietnam's major cities can approach those of Tokyo, even though Vietnam has 100 fewer people per square metre and only 2 percent of Japan's GDP per capita. Provincial governments have a mandate to push more land into industrial/manufacturing sectors and develop land through a process of "land conversion", which can be complicated if land is expropriated by the state from private owners. While the state is often needed to consolidate fragmented land holdings, in a 2005 survey of 6,200 businesses, a staggering 40 percent of the firms leasing land did so from a state entity.[18] The government is the major broker of land assets in Vietnam and real-estate transactions are not very transparent or efficient.

For foreign business looking to acquire property, the process either occurs through a state-issued lease (with full price paid up-front) or in a designated Industrial Zone (IZ). Foreign businesses are not allowed to acquire land on the domestic private market; in many cases land is contributed by a local partner through a joint-venture. For most multinationals in manufacturing, setting up in an IZ circumvents all the problems associated with the real-estate market. IZs have long-term leases from the state and can directly sublease plots to businesses.

In addition, the process of creating IZs is increasingly being decentralised. In 1998, authority for the creation of IZs moved from the prime minister's office to the provincial authorities. Currently there are additional IZ-type strategies reportedly being pursued down to the district and commune levels, typically called industrial clusters and industrial points.

Foreign firms that must acquire land outside IZs often rely on a local partner. It is not mere coincidence that the major contribution of domestic firms to many joint ventures is land. For example, Honda Vietnam's national partner, Vietnam Engineering and Agriculture Machinery Corporation, has a 30 percent stake in the joint venture (JV) principally from providing a 50,000 square metres factory site.

VSIP—Vietnam-Singapore Industrial Park

Begun in 1996, VSIP is a government-to-government initiative between Singapore and Vietnam. The project is carried out by a Singapore consortium (led by SembCorp Parks Holdings Ltd) and Becamex. VSIP I is an industrial zone specializing in light manufacturing in Binh Duong province, currently at full occupancy.

The park provides onsite customs clearance, and conducts regular consultations between government and businesses. In addition, VSIP sponsors a vocational training center to supply residents with a skilled labor pool. The success of the park has led to VSIP II, also in Binh Duong, and VSIP Hanoi.

17) *Data from Vietnam Provincial Competitiveness Index 2006.*
18) *Land Tenure and the Private Sector, Scott Robertson, Vietnam Competitiveness Initiative (VNCI) policy paper, 2007.*

Part 2: Investment opportunities

Domestic consumption trends

Domestic demand is attracting much more attention from foreign companies as disposable incomes increase. Retail markets are developing in the urban areas, but penetration in the rural regions is expected to be slow. Disposable income is increasing by around US$2bn per year, to reach US$30bn as of 2007. Growth of retail sales (by US dollar value) is still strong at 12 percent to 16 percent since 2003. The underlying potential of a young population with improving incomes continues to drive the consumer market.

National income per capita is estimated at US$800 in 2007, or over US$1,000 if undeclared wealth estimates are included. But in the major urban centers, such as Ho Chi Minh City, incomes are reportedly double the national average. These understated figures explain in part why Vietnam's total retail sales, at 43.5 percent of nominal GDP, are higher than China (35 percent) and Thailand (33 percent).

Shifts in fast-moving consumer goods (FMCG) are following standard patterns of increased spending in nutrition and personal care. According to TNS's Vietcycle, growth in FMCG is being driven by higher demand for healthier products, in particular milk products, fruit juices, and canned foods. Non-food consumption growth is highest in personal care products and household products. Since 2000, clothing, footwear, cosmetics and perfume producers all averaged 11 percent to 14 percent year-on-year growth in volume. Purchases of household appliances have been mixed, television sets have only had 6 percent growth while sales of washing machines have grown by 11 percent year on year.

Pharmaceutical sales have shown steady growth in sales over 10 percent and averaged 13 percent year on year since 2000.

Vietnam's WTO accession agreement requires for most cases a 5-10 percent reduction in tariffs for imported consumer goods by 2012, but the major change will likely be from direct retailing. After January 1st 2009, foreign companies can wholly own and operate retail companies with very few restrictions on products. Some foreign companies have already made significant progress into the Vietnamese market. The Espace Bourbon Group, Parkson, and Metro Cash and Carry are expanding operations, while Tesco, Wal-Mart and Carrefour have made indications of investments in the immediate future. In 2007 Metro Cash and Carry intends to open its eighth store. Parkson reportedly intends to have 10 stores by 2009. Most existing retailing services are conducted in open-air public markets, but according to TNS, consumption patterns are shifting from open markets to supermarket and direct sales outlets.

Growth in direct sales outlets will likely be quite significant both as a result of the 2005 Commercial Law and the WTO service schedule. Under current distribution systems, many products made in Vietnam, such as footwear and apparel, must be exported and then imported back into the market for domestic consumers. End consumer costs of these name-brand products can be twice that of other countries in the region. As expected, many consumers are instantly turned off by having to pay reimport prices for locally made products. With the retail and distribution changes, companies should be able to directly source and sell in Vietnam.

Vietnam also has a Special Consumption Tax (SCT) on certain goods, in particular on cars. Intended to generate revenues while at the same time limiting road congestion, the tax has had a dramatic effect on consumption. It encourages people to buy cars second-hand rather than new or to purchase larger vehicles that are taxed at a lower rate.

Domestic businesses

The Vietnam market continues to show a hyper-sensitivity to incentives, and the reaction to reforms has been immediate and incredible. According to Markus Taussig, a long-term analyst of Vietnam's economy currently at Harvard University, "As in China, what was an especially ineffective version of communism—in terms of providing public services—made almost everyone an entrepreneur.
As a result, moves over the past few years to remove obstacles to firm entry and limit disincentives to subsequent firm growth have really unleashed serious competition."[19]

After the passage of the Enterprise Law in 2000, the private sector grew from 30,000 firms to almost 100,000 in 2005. Official statistics show that the private sector employs nearly 90 percent of the total labour force, and is responsible for 70 percent of non-oil exports. However, it is likely that these estimates include vast numbers of informal household firms (between 3m and 9m businesses) as well as the smaller proportion accounted for by formally incorporated businesses.

Vietnamese firms are as a whole quite small; however a number of larger private firms are developing. Many of these businesses are quite capital-efficient, having prospered even without the policy-directed SOCB lending programmes. The changes in the Investment Law and Enterprise Law relating to corporate structure and investment vehicles have created an incredible opportunity for foreign investors to connect with capital-starved private businesses. Although Vietnamese private firms have been too small to present a viable opportunity for foreign partnership, in recent years a number of businesses have become sufficiently sizable to make foreign investors pay attention.

While the opportunities may be developing, the regulations are not. Although the opening of the services sector to foreign investors is required in the WTO agreement, there are no obligations in other sectors, such as manufacturing. Given the government's intentions to steer investment toward greenfield developments rather than acquisitions, barriers to foreign acquisitions of private firms still remain in place.

How this strategy translates into law and practice is a bit odd. Foreign firms wanting to buy into sectors not in the WTO services schedule (most importantly manufacturing) are limited to a 30 percent ownership cap for unlisted Vietnamese firms and a 49 percent cap on firms listed on the stock exchange. However, for a greenfield start-up a foreign partner can own up to 100 percent of the shares or 100 percent of the capital. These ownership limits restrict domestic firms that are willing to sell off majority rights for much-needed capital and foreign training. Indications from the 2007 Vietnam business forum are that officials are considering changing these restrictions in non-strategic sectors.[20]

Kinh Do Corporation

Kinh Do is one of Vietnam's largest private companies. Founded in 1993 the company focuses on manufacturing and distributing a wide range of confectionary products, such as snacks, cakes and cookies.

Starting with US$125,000 investment, the company's market capitalization reached US$410m as of January 2007. The firm has nine subsidiary companies, of which seven are involved in food production and two in real estate.

Kinh Do is continuing its expansion with a US$40m export-focused soft drink factory and a US$70m luxury commercial center in Ho Chi Minh City.

19) Interview with author, May 30th 2007.
20) Transcripts available at: www.vbf.org.vn

Vinamilk

Vinamilk was founded in 1976 and is the nation's leading producer of dairy-based products. Vinamilk's major products are yoghurt, fresh milk, and condensed milk—products with consumption that correlates with growing incomes. The majority of Vinamilk's sales are in the domestic market; exports accounted for only 14 percent of revenue in 2006.

According to the WTO goods schedule, tariffs for dairy products will decrease by 5-10 percent, opening up foreign competition for consumer goods with high price elasticity. In addition, Vinamilk will no longer enjoy protection through regulations on foreign distribution. Critical for Vinamilk's long-term success will likely be to channel securities-market windfalls into productive capital investments.

In 2003 the company conducted an IPO of shares on the HCMC exchange. It is one of the largest firms in Vietnam by market capitalisation, which reached US$1.87bn in January 2007. Demand for Vinamilk's shares remains high. In June 2007, foreign ownership, capped at 49 percent, was at 44 percent, providing little room for additional buyers. The price of shares have continued to exceed earnings, with a recent P/E ratio of 42. In March 2007 Vinamilk announced plans to list on the Singapore exchange.

Reform of the state sector

Vietnam is only now starting to open up some of its largest state firms for foreign investment. This is creating opportunities for investors looking to gain exposure in the Vietnamese market, both through direct and indirect investment. Recent changes in the way the state holds shares clear up many of the corporate governance concerns for joint state, private, and foreign ownership structures.

The reform process of state industries is incredibly complex, primarily because of vested interests and tangled corporate governance structures. Much of the process of reform has involved either consolidating various companies into large conglomerates or equitisation. The consolidation process involved the formation of General Corporations (GCs) either under the Prime Minister (GC-91s) or under ministries and provincial people's committees (GC-90s).[21] At the most general level, GCs are umbrella organisations of SOEs within a specific sector—often with the largest firm taking a management position over the smaller firms. Currently the government is refining the corporate structure of state firms into Parent-Subsidiary Groups (also literally translated as Parent-Child Groups) and larger Economic Groups.

Although the equitisation process has not always been clear, recent institutional changes appear to be speeding things up. By the end of 2006 over 3,000 SOEs had been equitised, although most were smaller, commercial SOEs. However, following Bao Viet's rather chaotic initial public offering (IPO) in May 2007 (see box on next page), the government voiced fears about overextending the equity market. Having originally announced an ambitious IPO schedule (with 550 equitisations to be completed by the end of 2007 and an additional 1,500 firms by 2009), on July 9th 2007 the prime minister announced that this timetable would be reviewed. The message to investors is still that Vietnam is pushing ahead with the equitisation process, although the government is likely to ensure that high-value SOEs are not undersold for the sake of speed.

In August 2006, the government formed the State Capital Investment Corporation (SCIC) to be the centralised authority on state shares in equitised SOEs. The SCIC is designed to be independent in making board decisions on investment and management. Furthermore, the profit incentive that the SCIC promotes should lead to a push for more efficient SOEs.

21) The GCs are named after Decision 91 and 90 respectively.

The establishment of the SCIC seems to solve many of the bureaucratic problems with equitisation, in particular regarding responsibility and future corporate-governance issues post-equitisation.[22] In addition, with ministries no longer drafting regulations over their own commercial interests, there is hope for a separation of vested interests.

At the time of this report, it is too soon to tell what the full impact of the SCIC will be. By design it will be a strategic investor in Vietnamese firms, yet there is not enough history to judge if this will work. It is also not known how the SCIC will engage other private and foreign shareholders. General impressions from interviewees and experts are favourable, but the SCIC is still too young to judge.

Bao Viet

Bao Viet is Vietnam's leading insurance company with 7 subsidiaries, 16 joint ventures and 5,000 staff. It ranks first in non-life insurance with a 38.7 percent market share and second in life insurance with a 36.5 percent share. In 2006 it had revenue of VND 6.8 trillion (trn) (US$425.1m). Its initial public offering tempered some of the exuberance connected with Vietnam's hitherto buoyant stockmarket—and has made the government think twice about its ambitious equitisation schedule.

Bao Viet's IPO, on May 31st 2007, was expected to raise US$72m by selling more than 15.6m shares. However, the silent auction did not go as planned, with over 30 percent of the offering remaining unsold after a number of investors walked away from their bids. The auction itself was described as chaotic, with significant price discrepancies in the bids offered by domestic companies and those offered by foreign investors. Vietnamese investors bid an average of VND74,000 per share compared with the VND30,000 to VND40,000 per share offered by overseas bidders. When they realised that they had overbid, many of the domestic investors forfeited the 10 percent deposit they had paid and abandoned the shares.

A second auction, on July 23rd, was similarly disappointing, with only 12 percent of the shares abandoned at the earlier auction actually sold, to 19 investors. With the IPO complete but not all the shares sold, Bao Viet will have to adjust its charter capital and ratio of state holdings, according to ministry of finance guidelines. The underwhelming response to the IPO of one of Vietnam's major state-owned enterprises has led many to question the attractiveness of Vietnamese equities--and the government to think twice about rushing to equitise its most valuable SOEs.

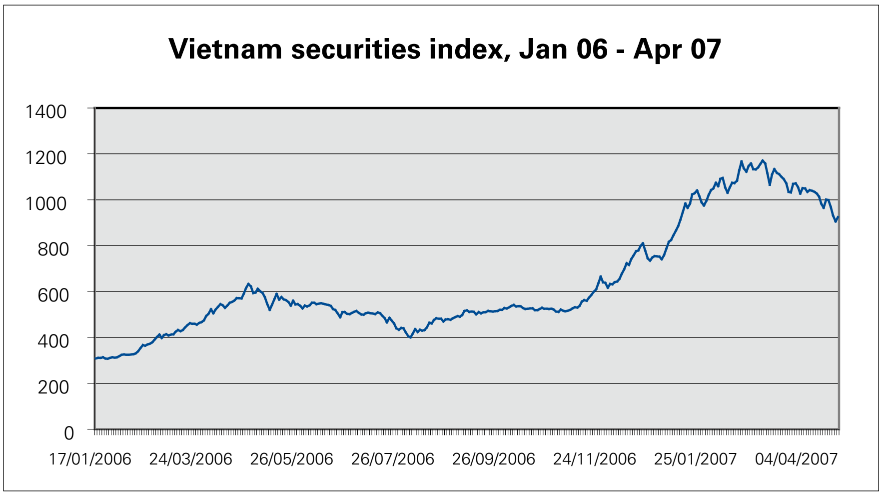
22) *See Scott Chesier, Jago Penrose and Nguyen Thi Thanh Nga, The State as Investor: Equitization, Privatization and the Transformation of SOEs in Viet Nam, UNDP Viet Nam Policy Dialogue paper, 2006.*

Capital markets

Two years ago there was very little to say about Vietnam's capital market beyond that it was "a work in progress". Vietnam developed two exchanges: the Ho Chi Minh City Security Trading Center (HOSTC) began operations in 2000, and an over-the-counter exchange in Hanoi (HSTC) started in 2005. The 2 exchanges were quite isolated until 3 events occurred in 2006. In that year Vietnam received WTO membership, hosted the Asia Pacific Economic Co-operation (APEC) forum, and net private capital flows to emerging markets exceeded US$550bn (the same is predicted for 2007).[23]

The HCMC exchange expanded from just 30 listed firms in 2005 to 110 in early 2007. The value of the securities market grew from only US$4bn at the end of 2005 to US$13.4bn at the end of 2006, and was close to US$17.6bn as of April 2007.

The HCMC exchange is directly tied into the SOE equitisation process, with many of the equitised firms listing shares on the exchange. After a year of extremely high levels of investment mobilisation on the exchange, the government and listed firms seemed to have good reason for advancing SOE reform. Until the announcement in July 2007 that the IPO timetable was going to be revised, 2007 was expected to be a benchmark year for these reforms, with IPOs expected to double the size of the exchange. Now, however, the eagerly anticipated IPOs of four of the five largest state-owned commercial banks (Vietcombank, Bank of Investment and Development of Vietnam, or BIDV, Incombank, and the Mekong Housing Bank) could be delayed until 2008 or later.



Source: Bloomberg market data, accessed May 25th 2007.

23) Institute of International Finance. http://www.iif.com/press/press+32.php

SSI: Saigon Securities Inc

A company that had tremendous foresight of the coming boom in the equities market was SSI. One of the three original Vietnamese securities companies started in 2000, and the only one of those that was private (BIDV and Bao Viet were the others, both state-owned), SSI began with approximately US$370,000 in capital and 10 employees. By 2007 it was valued at US$19m and had 400 employees. SSI has become a local favourite among a number of institutional investors and is currently the second-largest company on the OTC exchange, with plans for an IPO on the HOSTC later this year. In early July Australia & New Zealand Banking Group bought 10 percent of SSI for US$88m, while Japan's Daiwa Securities announced that it is also investigating a formal tie-up after buying a 1.25 percent stake.

According to Nguyen Duy Hung, Chairman and CEO, finding and keeping skilled human resources is an important issue, especially for a company that relies in part on the advice of its auditors for making investment decisions. Nguyen claims SSI is developing an aggressive recruiting strategy, based on promoting a strong corporate culture. [24]

Originally intended for SMEs, several large private firms are currently listed on the Hanoi OTC exchange, such as Asia Commercial Bank (ACB) and Saigon Securities Incorporated (SSI). The number of registered companies on the Hanoi exchange rose from nine in 2005 to 77 by the end of 2006, with a total exchange value of US$677m. A common strategy is for firms to first develop in Hanoi before moving to the HCMC exchange.

For most of 2007, foreign participation in the exchange has been around 25 percent of value and daily turnover, with many of the domestic brokers following the trading of the foreign managed funds. Foreign ownership of Vietnamese listed firms is restricted to 49 percent in most cases and 30 percent for banks. The WTO services schedule is quite specific on timeframes for increased participation, and in five years the caps on most sectors will likely increase. However there are no obligations in the WTO agreement on ownership outside of the services sector.

The foreign caps and the level of investment entering the market mean a large portion of foreign investment is chasing the same small group of assets. Most investors have some holdings of the three largest listed stocks (Sacombank, Vinamilk, and FPT, a state-funded IT company) because they represent so much of the market. At a recent high mark of the index, the top 20 companies had an average price-earnings ratio of nearly 73, compared to regional averages of around 10 or 20. In the case of Sacombank and Vinamilk, their foreign-ownership ceilings have either been reached or are very close to being reached.

While the market for equities is certainly high (HSBC had reported that at least US$871m is expected to enter the Vietnamese market in 2007 from Korea alone[25]), demand is perhaps not high enough to give attractive valuations for the stocks that would have flooded in from the ambitious equitisation schedule between 2007 and 2010. The underwhelming response to Bao Viet's IPO in May 2007 has prompted the government to revise the equitisation schedule, with a new timetable expected by the end of September. It is possible this move will bolster demand for SOE equities, but a new air of caution is pervading the markets. For example, Merrill Lynch, in a research note in early July, recommended withdrawing from Vietnamese equities altogether, citing reduced earnings per share, a falling P/E ratio and high volatility.

Some restrictions on establishing transactions may also make foreign investors cautious. While foreign investors may enter the market through direct transactions, the process requires businesses to surrender power of attorney to a local broker as obtaining a trading code is difficult and subject to long delays. Some of the highest growth has been in the specialised investment funds, which have multiplied from around 20 funds at the start of 2006 to 43 separate funds as of the second quarter of 2007, with a combined current value of US$5.6bn. Dragon Capital, Indochina Capital, Mekong Capital and Vinacapital all have positions on the exchange as well as direct company investments. These closed-end funds have so far been key investment vehicles, but as restrictions on foreign access are reduced (in particular the power-of-attorney requirement) larger institutional investors will likely enter.

24) Interview with author, May 11th 2007.
25) HSBC Vietnam Monitor (Issue 1, May 2007).

Reforms in the banking sector

Vietnam's banking sector has followed the trajectory of the rest of the economy, albeit at a much slower pace. Starting from a monolithic banking system centred on the State Bank of Vietnam (SBV, the central bank) and two SOCBs (the Bank for Foreign Trade of Vietnam, known as Vietcombank, and the Construction and Investment Bank), the reform process has moved into a multi-sector system of state, private, and foreign institutions. The formerly bold lines between these divisions, as in other sectors, continue to blur as foreign banks in particular acquire shares in both private and state banks.

The five SOCBs account for 70-80 percent of the total market share. These are Vietcombank, the Industrial and Commercial bank of Vietnam (Incombank), the Investment and Development bank of Vietnam (BIDV) the Vietnam Bank for Agriculture and Rural Development (Agribank), and Mekong Delta Housing Bank (MH Bank). The four urban joint venture and foreign bank branches make up the next 10-15 percent of market share, while another 35-plus joint-stock banks have the remaining 10-15 percent.

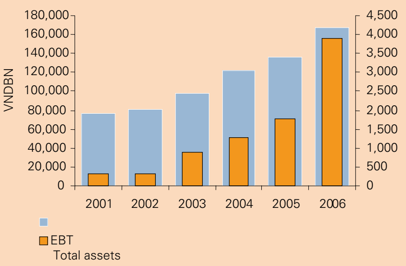
The state banks have received some preferential treatment, but not to the degree of those in other Asian transitional economies. Estimates on non-performing loans for state banks range from 10 percent to 20 percent (if international standards are used), but the total value of the banking sector is quite low. Total disbursements as part of the recapitalisation program have been around US$675m.

Foreign investors in Vietnamese banks

Announced	Deal status	Acquirer	Target	Deal value (US$m)
July 2007	Completed	HSBC	Techombank (additional 5%)	33.7
Feb 2007	Pending	Deutsche Bank	Hanoi Building Commercial Joint Stock Bank (20%)	Undisclosed
Jan 2007	Pending	United Overseas Bank	Southern Commercial Bank	Undisclosed
Nov 2006	Pending	BNP Paribas	Oriental Commercial Bank (OCB, 10%)	Undisclosed
Nov 2006	Pending	Citigroup	East Asia Bank (10%)	75.0
March 2006	Completed	Overseas-Chinese Banking Corporation	Vietnam Joint-Stock Commercial Bank for Private Enterprises (VPBank, 10%)	15.7
Dec 2005	Completed	HSBC	Techombank (10%)	17.3
June 2005	Completed	Standard Chartered	Asia Commercial Bank (9.6%)	22.0
Mar 2005	Completed	ANZ Banking Group	Sacombank (10%)	27.0

Source: Deutsche Bank, Vietnam Banks Primer, April 2007, press reports

Vietcombank, total assets and earning before tax



Source: Vietcombank 2004 and 2006 audited reports

Vietcombank

The Bank for Foreign Trade of Vietnam (Vietcombank) was established in 1963 as a state-owned commercial bank (SOCB). It is Vietnam's oldest commercial bank for external trade, and with 2m clients and 6,000 employees it is now one of the largest banks in the country. It is the inter-bank foreign exchange payment center for over 100 domestic banks and foreign banks' branches operating in Vietnam. It is also responsible for managing and serving government loans and aid, and many official development assistance projects in Vietnam. In 2006 it had assets of VND166.94trn (US$10.36bn), up 22 percent from the previous year, with equity of VND11.13trn.

Vietcombank was originally planning to launch its IPO in mid 2007, selling 10 percent of its charter capital. It is in the process of looking for a strategic partner to help prepare it for the IPO. It plans to list on the HOSTC but the details of the listing are still awaiting approval from the government—and may well be delayed pending revision of the government's equitisation schedule.

Vietcombank, the second largest after Agribank, at the end of 2006 has around US$620m in chartered capital of which 10 percent will likely be sold in the 2007 IPO, scheduled for August (see box). The securities market will likely be the major capital sourcing mechanism, with further IPOs planned for the other SOCBs.

Household strongboxes remain quite important for savings but are becoming less so. According to TNS, bank-account ownership in four major cities climbed from 14 percent in 2001 to 35 percent in 2006. The estimated deposits for 2006 were US$31.6bn, and the EIU anticipates this to reach US$70bn by 2011. As the taxation system improves, and as do the benefits for formally declaring wealth, bank participation will likely continue to increase.

According to TNS, Vietcombank has the most name recognition, followed by ACB, Agribank and EAB.[26] Most concentrated development is occurring in urban areas. Rural areas have great growth potential but are more difficult to access.

Many foreign banks have established strategic partnerships with major joint-stock banks by purchasing stakes in them. Until recently maximum foreign equity ownership in a Vietnamese joint-stock bank was 30 percent, and no single institutional investor could own more than 10 percent. However, HSBC recently received approval to raise its stake in Vietnam Technological and Commercial Joint-Stock Bank (Techcombank) from 10 percent to 15 percent.

Although from April 2007 WTO obligations permit the establishment in Vietnam of wholly-owned foreign banks, they do not require the Vietnamese government to raise the 30 percent cap on foreign investments. Even before the HSBC deal, however, there were indications that the individual 10 percent limit would be increased to 20 percent some time in 2007. Both foreign and domestic banks want these limits to increase. Foreign banks see these partnerships as a way both to access banking networks that extend outside major cities and to gain local knowledge. Domestic banks are in need of additional capital for growth and exposure to international banking practices.

26) "Vietnam's Consumers Driving a Banking Bonanza", Taylor Nelson Sofres, December 2006.

Staff shortage

The need for a more skilled workforce is a major concern for all banks in Vietnam. In 1989, when legislation allowed the establishment of credit institutions, many of these were formed by academics and entrepreneurs without any banking experience. While more international exposure has increased local knowledge, it has done so at a rate below demand. Human resources are a constant challenge; a well-groomed branch manager may be offered a position as vice president or division head by virtue of a lack of more qualified candidates.

Increased foreign bank presence has added additional pressures. According to Dam Van Tuan, Head of Asia Commercial Bank's strategic planning department, voluntary staff turnover was around 8 percent in mid-2006 even as front-office wages increased by 30 percent. Asia Commercial Bank (ACB) increased wages in early 2007 by 50-100 percent and has plans to provide share options for employees.[27]

It is not just the increased volume of banking that is making finding qualified bank staff so critical. The need to graduate from debt-based financing is a major reason. While household mortgages still provide banks with room to grow, debt financing for private businesses is nearly maxed out under the current system. Approximately 90 percent of businesses have secured lending using their properties and Land Use Rights Certificate as collateral, of which the latter actually requires physically handing over the document. For most businesses this is the only method of acquiring credit, with other forms of secured lending underdeveloped, and very little unsecured lending on offer. This has led to the development of some interesting coping mechanisms, such as ACB's comparative pricing maps on urban land, but it acts as a hard ceiling on credit growth. Generating more experienced bank officers with greater skill in evaluating loan applications is one of the few ways this can change.

Light industry

The bulk of Vietnam's manufactured exports are processed agricultural products or low-skilled, cut-make-trim (CMT) textiles. The clothing and textiles business, to take one example in this sector, is one of Vietnam's key export industries and has performed solidly (with export revenue rising by 20 percent in 2006 and accounting for 18.5 percent of total non-oil export revenue) despite the continued imposition of export quotas in its most important market, the U.S. Even with restrictions on exports, Vietnam's competitiveness in the U.S. market has been remarkable. This is quite significant given the end of the Multi-Fibre Agreement at end-2004, where most countries feared a loss of market share in export destination countries to a China unrestrained by quotas (although the EU and U.S. did impose safeguard curbs on Chinese textile imports).

27) Interview with author, May 17th 2007.

Spurred by Vietnam's competitiveness and its entrance to the WTO, protectionist elements of the U.S. congress developed the Vietnam Import Monitoring Program (IMP) to monitor imports of trousers, shirts, underwear, swimwear and sweaters. Presumably, anti-dumping measures would be initiated by the Department of Commerce if there were a sudden surge of imports. The increased risk now associated with sourcing these products has had, in the words of one U.S. importer, "a chilling effect" on the trade of these goods. While hearings continue on the validity of the program, the IMP is currently planned to continue until the end of the Bush administration in January 2009.

For low-skilled manufacturing exporters, the major political risks for operating in Vietnam are U.S.- and EU-imposed trade restrictions. While WTO membership should provide a mechanism for the Vietnamese government to contest any abnormal restrictions, the time the process for settling disputes takes means the restrictions can nonetheless have a major effect on the economy.

According to Anthony Tan, deputy general director of the Vietnam Singapore Industrial Park, foreign manufacturers tend to have three major complaints in Vietnam: taxation, customs, and infrastructure.[28] Taxation concerns are due to the lack of appeal process mentioned in the section above (p16). Customs-clearing processes need to be modernised for manufacturers to adopt more streamlined inventories systems.

Infrastructure is by far the largest and most commonly seen setback in manufacturing. One major problem is that Vietnam does not have nearly enough power to meet current demand. For most of 2007, northern provinces have had regular power shortages and rolling blackouts. The shortages are expected to increase until 2011, when several new power plants come into operation (such as the 1,200MW Vietnamese-U.S. built coal-fuelled plant in Quang Ninh). There are also approximately 38 small and medium sized hydroelectric projects in development. In the south the power issue is less severe. Although VSIP maintains an independent power generator, for example, sources report that the national power grid is perfectly reliable.

Insufficient transport infrastructure also poses problems for investors. The road and highway system is overcrowded and poses logistical problems and additional costs. Amanda Tucker, chief representative of Nike, in particular stresses the need for more deepwater ports in southern Vietnam to address port congestion that will likely affect shippers in the short term, and the importance of reducing the cost of using feeder vessels when these ports are completed.[29] The Ministry of Planning and investment recently announced that licenses were issued to foreign companies to develop five ports in HCMC and Ba Ria-Vung Tau. In particular the Saigon Central Container Port in Hiep Phuc Industrial Zone, a US$259m investment, should dramatically improve shipping when it becomes operational in 2009.

28) Interview with author, May 14th 2007.
29) Interview with author, May 18th 2007.

Vinashin

The Viet Nam Ship Building Industry Corporation (Vinashin) is a GC-91 being converted into an economic group. Vinashin jumpstarted Vietnam's shipbuilding industry and is now one of the largest shipbuilders in Asia.

In order to convince international buyers that Vinashin could produce ocean-worthy vessels, the company built the Vinashin Sun and sailed it to potential clients. This rather risky and expensive marketing campaign (and a very unusual strategy for an SOE) has so far paid off with several large international orders.

With shipyards in China the major threat to the growth of Vinashin, the economic group is focusing on quality and is vertically expanding into steel mills and higher-quality imported engine technology.[30]

Labour agitation has become another problem for foreign invested enterprises (FIEs) in low-value-added export industries. The increase in sit-downs and strikes since 2005 is commonly thought to have been the result of a sudden rise in wage demands and a precursor for a shift in manufacturing exports. However, interviews conducted for this research suggest much of the labour disruption was caused by miscommunication regarding the implementation of the labour code, where an increase in the minimum wage was announced in the press without managers being informed beforehand. Since this experience, many companies and industrial zone management boards are now taking a more active role in developing labour unions. Most of the work disruptions have concerned demands for full enforcement of the law and improved work environments.

Being late to the Asia Miracle, yet ahead of some of the slower developers, Vietnam is in a unique position. Producers are now concentrating on improving production processes, increasing worker skills, and adopting modernised work lines. For example, Nike's lean manufacturing initiative (Novus Ordo Seclorum, or NOS) has a training centre based in Vietnam. Rather than looking to move from Vietnam for cheaper labour destinations, many manufacturers see Vietnam for the time being as the best available production source, and are consequently entrenching their operations there.

Heavy industry

Developing heavy industries is a major goal of the Vietnamese government. Current strategies are principally related to attracting larger foreign investment projects in certain sectors while also retaining state interests in key strategic sectors. Ba Ria-Vung Tau, a province adjacent to Vietnam's major oil deposits, is the major heavy-industry investment destination. In 2006, investment licenses were issued for 2 steel factories valued at over US$1.1bn apiece.[31] In the north, Hai Phong is attracting similar projects, although at smaller scale, while it is also a major shipbuilding area.

Many heavy industry sectors are classified as strategic sectors under Decision 155 of 2004. Some sectors, such as toxic chemicals, are required to have 100 percent state capital. Some areas of heavy manufacturing, sea transport and chemical fertilizer production require over 50 percent state investment.

30) See Chesier and Penrose, 2007, op cit.

31) One project is from Posco, a South Korean firm, and the other is from Tycoons World Group of Thailand.

The promotion of increased local content requirements has been a problem for automobile manufacturers. Current requirements are around 15 percent of the input value, but officials hope to enforce an increase to 40-45 percent by 2010. While many car makers actively seek local suppliers for parts, it takes time to find and develop local industries to a standard sufficient to meet foreign producers' quality requirements. If the example of motorcycles can provide a guide, when Honda started production in 1997, local content was only around 33 percent. With the release of the Honda Wave Alpha in 2003, local content jumped to 80 percent. According to Atsushi Kikuchi, CFO at Honda Vietnam, developing a local supplier can takes 2 to 3 years of direct technical assistance.[32]

Honda in Vietnam[33]

Honda-Vietnam is a joint venture between Honda Motor (Japan), Asia Honda Motor (Thailand) and the Vietnam Engineering and Agriculture Machinery Corporation (VEAM). Honda developed a very good brand reputation with their early bikes, using high-quality parts mostly produced abroad. Many of the early Honda Dream bikes are still on the road.

Honda-Vietnam currently has 32 percent of the motorcycle market, behind only the mass conglomeration of cheap Chinese bike manufacturers, which control a 39 percent market share. Honda-Vietnam's domination of the non-Chinese bike market (currently 60 percent) was secured with the development of the Wave Alpha—a low-cost, high-quality bike with 80 percent of inputs produced locally.

Honda-Vietnam is building from its success with motorcycles and began producing Civic sedans in August 2006. Honda-Vietnam is moving more cautiously than its rivals into Vietnam's car market and produces from the smallest Honda car factory in the world. The yearly capacity of the Vinh Phuc factory is 10,000 units; the Honda factory in Suzuka, in Japan's Mie prefecture, can produce 8,000 units every day.

Although production only began in August 2006, the demand for the Honda Civic has been very strong. It is currently the fastest selling sedan in Vietnam, with 286 units sold from the August 2006 launch until June 2007.[34]

32) Interview with author, May 30th 2007.
33) Figures from interview with Atsushi Kikuchi.
34) Source: Vietnam Automobile Manufacturing Association

High-tech investment

While low-value manufacturing appears to be digging in, higher value manufacturing is moving rapidly into Vietnam. In 2006 the total value of FDI commitments for new projects reached US$10.2bn, a year-on-year increase of 45%, and bringing the total stock of commitments to more than US$60bn at end-2006. Much of this investment has been in the high-tech sector.

Although not the largest single investment, the highest-profile project is the Intel investment in Ho Chi Minh City. Meanwhile, Foxconn, one of the world's largest OEM/ODM electronics-parts suppliers, has initiated the first US$1bn of what will likely be a US$5bn investment in northern Bac Ninh and Bac Giang provinces. Brother has a US$40m dollar laser-printer facility in northern Hai Duong. Canon is also developing the largest laser-printer production centre in the world, also in Bac Ninh.

While some of these companies, such as Canon, have had a long presence in Vietnam, most of these investors have stated that these investments are the first of a multi-phase process. Both Nike and Intel mentioned in interviews that after establishing large production bases in China, Vietnam provides a way to diversify risk—in particular to mitigate political risk, often most severe from export destination countries imposing trade restrictions, and risk from natural calamities, whether tsunamis or SARS.

What is most clear from the experiences of these investors is the commitment of the Vietnamese government to ensure the further development of high-tech exports. Although WTO entry obliged Vietnam to end tax breaks for export-focused businesses specifically, such concessions remain in place for high-tech investors—as well as various other provisions.

Value of investment commitments (US$ m)

	New commitments, Jan-May 22nd 2007	Stock of all commitments to May 2007 (registered)	Stock of all commitments to May 2007 (disbursed)
Total	**3,699**	**65,570**	**30,722**
Breakdown by sector			
Heavy industry	1,233	n/a	7,279
Oil & gas	12	2,005	5,829
Light industry & food	823	n/a	5,804
Agriculture, forestry & fishing	84	4,065	2,078
Hotels & tourism	754	4,315	2,425
Office buildings, apartments & construction	273	13,014	4,968
Transport & communications	169	3,699	742
Other sectors	361	7,503	3,623
Breakdown by province			
Ho Chi Minh City (south)	206	14,418	6,602
Hanoi (north)	253	10,417	3,922
Dong Nai (south)	23	9,438	4,175
Binh Duong (south)	255	6,458	2,054
Ba Ria-Vung Tau (south)	700	5,478	1,357
Haiphong (north)	27	2,198	1,276
Other provinces	1,195	16,473	10,708

Sources: General Statistics Office; 2007, press reports

Much of the current approach is based on the successful experiences in IZ developments, in particular to create safe havens for investment where many of the institutional shortcomings in the national investment environment end at the industrial zone gates. By providing in-house customs clearance and investment licensing, and independent power, water and sewage, IZ occupants are not bothered by the major problems exporters outside the zones face (except of course limited deep water ports and poor connector roads). Provincial and national governments have worked closely with IZs such as VSIP and have become much more experienced in ensuring a suitable work environment for foreign-invested export manufacturers.

Intel's investment

Although regulatory reform and WTO accession in 2006 were seen as the catalysts for Intel's US$1bn investment, according to Jeff Prunty, a finance director at Intel, the project was actually the result of a continual investigation to site new semiconductor Assembly Test Facilities, which handle final-stage quality control.[35] Vietnam was one of many potential sites with initial investigation dating back to year 2000 and this new facility is part of Intel's worldwide expansion of production. The Vietnam facility is the largest single factory in Intel's assembly and testing network.

In similar investments of this type, the complimentary investments of third-party input producers can be double to triple the initial investment. With expected employment of 4,000 workers and an export value of US$5bn-6bn, the government was keen to provide incentives, tax holidays, 24-hour customs processing and infrastructure at an international standard to secure the investment. Many of these conditions are provided through the Saigon High-Tech Park (SHTP), Intel's main government partner. According to Intel the provision of 24 hour customs and electronic clearance is currently being discussed and has received positive feedback from officials.

Vietnam, by attracting increasingly large high-tech investments, has shown a capacity to exceed its current peers. However, further research for this report suggests that large-scale projects need to be shepherded by senior government officials. In order to absorb more investment there will likely need to be further decentralisation of authority and a greater understanding of the needs of high-tech manufacturing at the provincial level.

According to Prunty, it was the seriousness that the Vietnamese government demonstrated in co-operating with Intel that made the deal possible. Higher-value manufacturers, like Intel, are looking to employ the best workers in a country and are not basing investments on the mean scores of the workforce. So far Vietnam has attracted much of its foreign investment by capitalising on higher-than-world-average but still low-skilled labour. This movement up the value chain and continued absorption of higher-tech investment will likely be Vietnam's 20-year challenge.

35) Interview with author, May 17th 2007.

Conclusions

If one is left with a positive impression having read this report, it is because there is much to be positive about. Prospects for investors in Vietnam have never been more attractive: the economy is likely to double in size in the next 10 years, while the young and well-educated population provides a willing and still relatively low-cost workforce, and demonstrates an increasing propensity to consume. While the state's equitisation programme is under review, the driver for this move is more about ensuring market stability than any desire to maintain state control. These IPOs, when they do go ahead, will likely offer attractive assets to investors in an increasingly stable and coherent regulatory framework. WTO accession has liberalised further the country's already open trade regime.

Much of the most significant change has happened in the past year, leading to an explosion of foreign interest and a flood of money: foreign direct investment commitments in 2006 soared to over US$10bn, and the total this year is likely to exceed that. In the year leading to WTO accession Vietnam revamped much of its legal system, making the investment environment much more secure. The equitisation programme, once its new schedule is confirmed, will likely greatly diversify the assets available to domestic and foreign investors, as will the development of Vietnam's capital markets.

Yet the negatives cannot be brushed over. Foreign investors need to be aware of Vietnam's sometimes torturously slow bureaucracy. (Real-estate and association laws have taken years to release, and implementation decrees can be similarly slow—although the lawmaking process is being streamlined.) Corruption remains a major problem, although its severity varies by province. There are some idiosyncratic regulations that complicate investment planning, including strict caps on foreign shareholding in Vietnamese firms. Outside the services sector, which must be liberalised according to WTO stipulations, Vietnam is not obliged to alter these caps—although business leaders in Vietnam have been informed by officials that the caps may be abolished in late 2007.

As in any nominally communist regime, the control and usage of land—the literal and figurative foundation of the development of private enterprise—remains a key problem. Foreign investors may not own the land on which their facilities will be built: even in an IZ, land may only be sublet from the state. Obtaining land elsewhere, even with a joint-venture partner, is not straightforward, especially given the state's preponderant land interests. There have been cases where local JV partners claim to have sorted out land issues, only for the foreign partner to find the situation still legally uncertain after the JV contract has been signed. In fact, uncertainty is something nearly all foreign investors must deal with at some stage of their operations in Vietnam—especially given the varying degrees of rigidity with which laws are enforced.

The market reception to Bao Viet's IPO in May and the repercussions thereof also give some reason for caution. Bao Viet's equitisation had been built up to be the largest ever in Vietnam, and many observers were surprised that it failed to take off, with 30 percent of the shares remaining unsold or unclaimed after the first auction. Concerns about over-valuation and a glut of stocks has tempered enthusiasm about the equitisation programme. A revised IPO timetable is not expected to be announced until either at the end of September or beginning of October 2007. Delays to some of the larger IPOs, inclusive of the largest banks, are now expected.

That these problems are not the central theme of the report was a conscious choice: it would be easy in an overview of this nature to play up the headline-making troubles that bedevil a developing economy of this nature, particularly corruption, opaque decision-making and the lack of democratic accountability in governance. Similarly, this report lacks the space to discuss Vietnam's non-existent environmental oversight (something foreign investors would be well advised to investigate) and its human-rights regime. Both are likely to come under greater scrutiny as more foreign money enters.

Nevertheless, the key conclusions that can be drawn from this research are that Vietnam is open for investment and will likely remain an increasingly attractive investment destination for the foreseeable future. Despite teething problems, the sale of major state-owned enterprises in particular should provide a sizeable opportunity for direct and portfolio investors who recognise that Vietnam is on the cusp of prosperity, and want to participate in (and benefit from) its long journey to affluence.

ANNEX I: Original equitisation schedule of major state-owned enterprises

(Prime Minister's Decision #1729, December 2006, sorted by current ownership designation. NB: This is under revision.)

2007	2008	2009	2010
Economic groups (1)			
	Vietnam Textile and Garment Group (Vinatex)		
Corporations 91 (6)			
	Vietnam Airlines Corporation	Vietnam Paper Corporation	Vetnam National Chemical Corporation
		Vietnam Steel Corporation	Vietnam Cement Corporation
		Northern Food Corporation	
Ministry of Industry (6)			
Sai Gon Beer, Alcohol and Beverage Corporation (SABECO)	Electrical Technical Equipment Corporation		
Hanoi Beer, Alcohol and Beverage Corporation (HABECO)	Vietnam Industrial Construction Corporation (VINAINCON)		
	Vietnam Engine and Agricultural Machines Corporation (VEAM)		
	Industrial Machinery and Equipment Corporation		
Ministry of Construction (14)			
Construction Mechanical Corporation	Bach Dang Construction Corporation x		Song Da (Da River) Construction Corporation
Song Hong (Red River) Corporation	Central Vietnam Corporation		Vietnam Machinery Installation Corporation (LILAMA Corporation)
Housing and Urban Development Investment Corporation	Infrastructure Construction and Development Corporation		Urban and Industrial Zones Development Investment Corporation (IDICD)
Construction Corporation No. 1	Construction Glass and Porcelain Corporation		Vietnam Construction Investment Corporation for Water Supply and Drainage and Environment
	Construction Materials Corporation No. 1		
	Hanoi Construction Corporation		
Ministry of Transport (10)			
	Traffic Works Construction Corporation No. 1	Traffic Works Construction Corporation No. 4	
	Traffic Works Construction Corporation No. 5	Traffic Works Construction Corporation No. 6	
	Thang Long Construction Corporation	Traffic Works Construction Corporation No. 8	
	Waterway Construction Corporation	Vietnam Automobile Industrial Corporation	
	Southern Riverway Corporation	Northern Riverway Corporation	

2007	2008	2009	2010
Ministry of Fisheries (3)			
Vietnam Fisheries Corporation			
Ha Long Fisheries Corporation			
East Sea Fisheries Corporation			
Ministry of Agriculture and Rural Development (12)			
Vietnam Mulberry, Silkworm and Silk Corporation	Vietnam Forestry Corporation	Vietnam National Salt Corporation	
Sugarcane Corporation No. 1	Vegetable, Fruit and Farm Produce Corporation	Agriculture and Irrigation Mechanization, Electrification-Construction Corporation (Agrimeco)	
Sugarcane Corporation No. 2	Animal Husbandry Corporation	Irrigation Construction Corporation No. 4	
Agriculture and Rural Development Construction Corporation		Vietnam National Tea Corporation	
Agricultural Supplies Corporation			
Ministry of Health (1)			
Vietnam Medical Equipment Corporation			
Ministry of Finance (1)			
Vietnam Insurance Corporation			
State Bank of Vietnam (5)			
Bank for Foreign Trade of Vietnam (Vietcombank)	Bank for Investment and Development of Vietnam (BIDV)	Vietnam Bank for Agriculture and Rural Development (Agribank)	
Mekong River Delta Housing Development Bank			
Industrial and Commercial Bank of Vietnam (Incombank)			
People's Committee of Hanoi City (5)			
Hanoi Housing Investment and Development Corporation	Hanoi Tourism Corporation (Hanoitourist)	Hanoi Trade Corporation (HAPRO)	
Urban Infrastructure Development Investment Corporation		Hanoi Transportation Corporation (Hanoi Transerco)	
People's Committee of Ho Chi Minh City (7)			
	Ben Thanh Corporation	Sai Gon Tourism Corporation (Saigontourist)	
	Sai Gon Trade Corporation	Sai Gon Agricultural Corporation	
	Sai Gon Transport Mechanical Corporation	Sai Gon Construction Corporation	
		Sai Gon Real Estate Corporation	
TOTAL: 71			

ANNEX II: Map of Vietnam by province

Source: Wikimedia Commons, available at
http://commons.wikimedia.org/wiki/Image:VietnameseProvincesMap.png

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Publication date: August 2007