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Looking Ahead at 2019

Some of the Key Issues Likely to Impact Vietnam's Economy and Stock Market

Vietnam's government is doing a reasonable job managing the economy: inflation is under control, and the country's currency has been more stable than most of its Emerging Market peers in 2018. Furthermore, a torrent of foreign direct investment (FDI) continues to flow into the country (circa 7%/GDP in 2018), which helps to stabilize the country's currency and helps drive domestic consumption growth (those sustainable inflows are driven by Vietnam's low wage / high quality workforce, and Vietnam's close geographic proximity to the supply chains of regional manufacturers, especially in the electronics industry). For these reasons, external factors are likely to have a bigger impact on Vietnam in 2019 than internal issues.

THE US-CHINA TRADE WAR

- An escalation of US-China trade tensions (for example, if the US raises tariffs on Chinese imports from 10% to 25% in January), would:
 - 1) Increase the volatility of global stock markets, including Vietnam's.
 - 2) Likely lead to a depreciation of the Chinese Yuan past the widely watched '7' level (against the USD), which the Chinese government has already vowed to defend.
- A depreciation of China's currency past the '7' level could trigger a downward spiral for China's currency because Chinese companies borrowed about USD3 trillion in USD-denominated loans over the last five years that would become more expensive to repay, which is the same phenomenon that led to steep depreciations of the Thai Bhat and Indonesian Rupee in the Asian Financial Crisis. Note that details about the tenor of the USD-denominated debt owed by Chinese firms is not clear, but it is safe to assume that the average tenor is about five years, which is consistent with the recent rise in corporate defaults in China.
- The scenario outlined above would disproportionately impact Vietnam's stock market because locals tend to overestimate the negative impact on Vietnam's economy from Chinese Yuan depreciation.
- The trade war will benefit Vietnam in the long-run by encouraging companies to relocate production facilities from China to Vietnam, but it could also benefit Vietnam in the short-to-medium term as American companies place orders with Vietnamese companies instead of Chinese suppliers in order to avoid tariffs.
- Vietnamese industrial park and logistics companies are likely to reap the benefits of the trade war the most immediately, compared to companies in other sectors of Vietnam's economy, and as it has been reported, Apple iPhone suppliers such as GoerTek, Manwah, and Pegatron are likely to relocate production to Vietnam if tariffs on exports from China to US continue to increase.

- Chinese growth was already slowing from the beginning of 2018, before Trump escalated the trade war, because the Chinese government massively stimulated that country's economy during 2016-17 in the lead-up to the Chinese Communist Party Congress (CPC) at the end of 2017 (the economy slowed because stimulus was removed). One reason China's government overstimulated the country's economy in 2016-17 was Xi Jinping's desire to have the country's two-term leadership term limit abolished at the CPC. The resulting slowdown could impact Vietnam's exports to China (which grew 21% yoy in 10M18 and accounted for 16% of Vietnam's overall exports).

STRONG USD

- Fed rate hikes and other factors pushed up the value of the USD/ DXY index by 9% since February 2018. A strong USD is bad for Emerging Market economies and stock markets for a variety of reasons.
- Vietnam has spent about USD6 billion of its FX reserves to maintain the value of the Dong vis-à-vis the USD since July, thus depleting the State Bank of Vietnam's FX reserves to about USD58 billion, or 2.9 months' worth of imports, versus the three-month minimum recommended by the IMF, World Bank, and others.
- Note that the free market value of the VN Dong depreciated by about 3% YTD, and that figure remained more-or-less constant since the middle of 2018, while the depreciations of the INR/IDR/PHP approached double-digit levels earlier this year, before rebounding somewhat in recent weeks.
- Some of Vietnam's regional peers were forced to raise policy interest rates this year in order to defend their currencies (Indonesia and Philippines +1.75% pts, and India +.5%pts), but interest rates hikes will slow the GDP growth of those countries.
- Vietnam has not needed to raise policy interest rates this year to defend the VN Dong, in part because of the country's circa USD7 billion trade surplus in 10M18 (over 3%/GDP). We expect a comparable trade surplus in 2019.
- In addition to the Fed's interest rate hikes, other factors currently supporting the value of the US Dollar include the on-going dispute between Italy and the EU, regarding profligate spending plans by Italy's government (which is weighing on the Euro), the US-China trade war (tariffs on Chinese exports depress the value of the Yuan), and a shortage of USD outside of the US, at a time that USD-denominated debts outside the US have also soared. Note that USD-denominated debts outside the US are no longer rising, but the annual servicing of those debts probably exceeds half a trillion dollars a year, which helps explain the shortage of USD in the money centers of London, Hong Kong, Singapore, and elsewhere.

EPS GROWTH DECELERATION

- Vietnam's Earnings Per Share (EPS) growth is likely to fall from an expected 25% growth in 2018 to 12-13% growth in 2019, although EPS growth is being boosted by non-recurrent factors this year, without which we estimate that EPS growth would have been around 15% in 2018.
- The one-off factors that are boosting Vietnam's EPS growth in 2018 include a series of company-specific windfall gains, as well as extraordinary earnings in the banking sector due to: 1) upfront payments from international insurance companies to local banks, in exchange for those banks entering into bank assurance agreements to sell insurance products to their banking customers;

and 2) a circa 100-150 basis point plunge in bond yields in Q1 which generated outsized profits at banks adept at bond trading (yields have since returned to unchanged since the end-2017, but those savvy banks locked in profits before bond yields backed up); and 3) profit from divestments in equity investments/subsidiaries.

- Another reason we expect earnings growth to decelerate next year is that system-wide loan growth is likely to drop from a 16% pace this year to a 14% pace next year, which would reduce the core EPS growth of the banking sector by about 4%pts, *ceteris paribus*. Note the bank stocks account for about one-quarter of the combined market capitalization of Vietnam’s stock markets.
- We also expect the earnings growth of Vietnam’s real estate developers to slow from above 100% in 2018 (due to very high growth at Vinhomes) to 17% in 2019 as market activity decelerates following years of soaring activity (the total number of newly developed housing units launched for sale each year in HCMC and Hanoi essentially doubled from 2014 to 2017). Note that the real estate sector accounts for about one-quarter of Vietnam’s stock market capitalization.
- The recent correction in Vietnam’s stock market was partly driven by the diminishing expectations of analysts for EPS growth in Vietnam next year. As a result, Vietnam’s stock market valuation is still reasonable compared to its regional Emerging Market peers on a “Price Earnings Growth (PEG)” ratio basis, as can be seen in the table below:

	2019 P/E	EPS Growth	PEG Ratio
Vietnam	14	12%	1.2
Philippines	15.4	13%	1.2
Thailand	14	9%	1.6
Indonesia	14	14%	1.0
Malaysia	15.6	7%	2.3

Source: VinaCapital research team estimates for Vietnam, Bloomberg consensus figures for EM peers

- Vietnam’s falling EPS growth is consistent with a global trend that is partly being driven by expectations of global growth in 2019. Consensus expectations for EPS growth in the US are above 20% for 2018, but below 10% for 2019.
- In contrast to the previous point, we do not expect Vietnam’s GDP growth to slow next year, but since the primary drivers of Vietnam’s economic growth are not fully captured by companies listed on Vietnam’s stock market, there is a divergence between our expectations for slower earnings growth, and more-or-less unchanged GDP growth in 2019.
 - For example, we expect Vietnam’s manufacturing sector output to continue growing at a 12-13% pace in both 2018 and 2019, driven by continued FDI inflows.
 - We estimate that manufacturing contributes about 20% of Vietnam’s GDP (which is higher than the official 16%/GDP estimate), but the benefits of this high pace of manufacturing output growth in Vietnam are only indirectly captured by listed companies via higher consumption by factory workers for the consumer products of

Vinamilk, Mobile World, and others, or via higher revenues for logistics and industrial park companies.

NEW SECURITIES LAW

- A potential revision to Vietnam’s securities laws has been being discussed by the Ministry of Finance (MoF) since early 2018, although the discussion intensified from October, and MoF officials announced their intention to publish a draft of the new regulations in April 2019, with the hope of having the new laws finalized by October 2019 and take effect in the middle of 2020.
- The exact topics that would be covered by this possible revision to the securities law are still very much up in the air – no one knows what new revisions to the existing regulations the MoF intends – but there is widespread hope and speculation that a revision to the existing securities laws may address the issue of Foreign Ownership Limits (FOL) in Vietnam.
- In 2015, FOL restrictions were relaxed for companies listed on Vietnam’s stock market, such that most non-bank companies were allowed to raise their ownership limits to 100% (the previous FOL was 49% for such companies). The exceptions to the new rule are banks (which still have a 30% FOL) and companies in certain restricted sectors, such as telecoms, aviation, and pharmaceutical distribution.
- Under the current FOL regulations, companies that are eligible to raise their FOLs to above the previous 49% limit must take certain actions in order to raise their FOL, including holding a shareholder vote. If (eligible) companies do not take these necessary steps, then their FOL remains at 49%, by default. The problem is that only about 30 companies of Vietnam’s 700+ listed companies have taken the steps required to raise their FOLs to above 49%, so the 2015 legislation has not really helped make Vietnam’s stock market more investable to foreign investors. This is one of the main reasons that Vietnam’s stock market is still classified as a “Frontier” stock market, rather than an “Emerging Market” stock market by MSCI.
- There is hope that a revamping of Vietnam’s securities law would raise the “default” FOL (for companies in non-restricted sectors) to 60% or even higher. It is unlikely that anything concrete will come out of the current discussions about the new securities law until late 2019, but rumors and discussion about this topic are likely to influence the market during next year. Also, fixing the FOL problem would help pave the way for Vietnam to migrate from “Frontier” to “EM” market status (as Pakistan was elevated in 2017), but it is unlikely that such an upgrade would come before 2020 at the earliest.

PRIVATIZATION HAS STALLED

- Vietnam’s government is not close to achieving its ambitious targets to privatize and divest stakes in State Owned Enterprises (SOEs) this year. At the current rate of progress, it is very likely that less than 20% of the number of SOEs slated for privatization/divestment in 2018 will actually be privatized or will have meaningful stakes sold to investors.
- Foreign investors’ enthusiasm for privatization, SOE divestments and IPOs were among the main factors that drove the VN-Index up 48% in 2017. The weak performance of Vietnam’s stock market this year is probably one reason that the government has not pushed privatizations forward aggressively (especially in 2H18), however other issues include: valuation issues related to the assets owned by SOEs, management issues – especially issues related to SOE workers – and the unclear ownership status of land claimed by SOEs (Satra’s land plot near our offices in

Sun Wah Tower is one example of an ownership dispute that has both delayed the company's privatization and the construction of the hotel meant to go up on the former site of the Tax department store).

- Some foreign investors are concerned that the high valuations entailed in some of the offerings of both private sector and SOE companies (followed by a sharp fall in the aftermarket) are currently impeding IPOs and could continue to constrain the number of attractive new deals that come to the market in 2019. In the case of private sector companies, the issue is largely attributable to over-enthusiasm of foreign investors for newly listed Vietnamese companies, and a relative lack of high quality large-cap, liquid stocks to invest in. Two richly priced IPO deals that come to mind are the listings of Techcombank at around 3x P/B, and Vinhomes at 4x P/B, both of which occurred earlier this year.
- To some extent, the issue of high valuations for IPOs should self-correct (i.e., valuations should fall to the so-called "market clearing" level, at which deals start to become attractive again). In addition, some investors hope that Vietnam's securities regulators will take steps to encourage the "book building" method of offering equity to investors, because this method gives large institutional investors more input into the pricing of IPOs, which could result in more realistic valuations. However, while many investors regard the book building method of underwriting equity offerings as more sophisticated than other methods, we are not convinced this would solve the problem of high valuations of IPOs because investor overenthusiasm was the primary driver of high valuations in the case of private sector company deals (especially in the case of the two above-mentioned deals).
- High valuations of SOE listings are attributable to a strategy employed by the government in which a relatively small proportion of the company's outstanding shares are listed on the exchange, and then even a modest amount of buying by local retail investors sends the share price (and valuation) of the newly-privatized company soaring because of the limited free float of shares available for purchase. Although the government has never officially acknowledged this strategy, it is quite clear that the intention is to "pump-up" the valuation/stock price of the company in question as high as possible in preparation for selling a large stake in the company to a foreign strategic investor who is not overly price-sensitive. The government has "plausible deniability" in negotiating with strategic investors because it can tell those investors that it is unwilling to sell stakes to those investors at valuations below the "market price" (even though the market price has been artificially inflated by the limited free-float of the newly privatized company).
- Further to that last point, the most obvious example is the privatization of SOE beer company Sabeco. The "free float" of shares available for trading on the stock market was only 6% of the company's total outstanding shares when the government initially listed the company on the stock exchange in late 2016, at a P/E valuation of 16x. The company's share price subsequently soared, pushing up valuation to a peak of 44x in 2017, which facilitated the sale of a 54% stake in Sabeco to ThaiBev at the end of 2017. SAB currently trades at an 38x P/E valuation.
- ThaiBev was not overly concerned about the high valuation paid for the company because it views Vietnam as a part of its long-term growth strategy, and unlike financial fund managers it does not face the vagaries of day-to-day market-to-market accounting.

INFRASTRUCTURE DEVELOPMENT COULD DRIVE PRIVATIZATION

- The Vietnamese government's spending on infrastructure development will probably only achieve about half of the planned amount in 2018 (as it did in 2017), owing to various bureaucratic issues that the Ministry of Investment and Planning (MPI) has been working to address all year.
- The government has multiple, ambitious infrastructure projects that are either in progress, or are in the detailed planning stages, including the HCMC metro, the new Long Thanh airport, and the North-South highway. Also, despite falling far short of its infrastructure spending goals both last year and this year, infrastructure spending in Vietnam has grown at a double-digit pace since 2012.
- If the MPI succeeds in revising Vietnam's public investment laws to support an acceleration of the country's infrastructure development, and MPI is also able to successfully cooperate with Ministry of Transportation, as well as the relevant local governments, then Vietnam's central government could find itself with a pressing need to raise money in order to pay for infrastructure development. Note that the country's public debt-to-GDP ratio is currently around 61%, which is just below the 65% statutory maximum, so an acceleration of infrastructure development would probably compel a resumption of privatization / SOE stake sales by the government in 2019.
- Regarding Vietnam's public debt, note that about 60% of that debt is VND-denominated, and 40% is foreign currency denominated (most of which is in USD), and out of the foreign currency denominated debt, about half is owed to concessional lenders such as the World Bank, ADB, and ODA (i.e., about 20% of Vietnam's public, foreign denominated debt is owed to such lenders).

MID-CAP STOCKS

- Given the relatively cautious outlook outlined above, some market participants are anticipating that mid-cap stocks may outperform in 2019, following a challenging year for many popular stocks in 2018 vis-à-vis Vietnam's large cap stocks (many foreign investors employ a "top down" strategy when deploying capital into smaller stock markets like Vietnam's, which means that they simply buy the biggest, most liquid names with less sensitivity to valuation and other fundamental considerations).
- The reasons why some market observers expect mid-cap stocks to perform well in 2019 include:
 - Many local investors don't expect banking and property sector stocks – circa half of Vietnam's stock market capitalization – to perform well in 2019, following years of strong performance, so those investors expect a rotation out of those large-cap names into mid-caps (there are not enough large-cap, reasonably priced consumer stocks for the money to flow into). Note that some well-known local funds were (and continue to be) considerably overweight in the property sector in 2018.
 - There is a growing recognition that Vietnam's economy will ultimately benefit from the US-China trade war, but the companies that are actually listed on the stock exchange (and which will see the most immediate benefits of the trade war) are probably industrial park developers (i.e., relocation of factories from China to Vietnam), logistics companies, and

companies in the textile industry. These sectors are dominated by mid-cap names. Nevertheless, it is important to note that the benefits of the trade war will ultimately flow through to consumer companies, and large-cap banks and property developers when FDI companies open more factories in Vietnam, which will support consumption by the emerging middle class.

- The core businesses of many of Vietnam’s mid-cap stocks are intrinsically defensive because these companies predominately focus on the “nitty gritty” aspects of Vietnam’s day-to-day economy that will continue to function (and grow) unabated, even if there is turbulence in the stock market next year. For example, companies focused on producing packaging for domestic consumption, medical equipment / pharmaceutical, auto insurance, etc.

The counter-argument to the above is that mid-cap stock price movements in Vietnam tend to be driven by retail investors who account for about 85% of daily stock market trading volume in the country, but those investors typically rely on margin extended by stock brokers to fund their purchases. We expect margin lending to be constrained in 2019 by: 1) lower availability of credit, given the State Bank of Vietnam’s stated intention to reduce credit growth next year; and 2) rising interest rates.

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