Mekong Project Development Facility

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Establishing a Venture Capital Firm in Vietnam

A Preliminary Study

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INTRODUCTION

Vietnam's corporate private sector is highly undercapitalized with very limited access to investment capital either in the form of equity or long-term bank loans. One possible way of addressing this shortage of capital available to private companies would be the establishment of an on-shore venture capital fund. This report takes a preliminary look at the feasibility of establishing such an independent, commercially-viable venture capital fund in Vietnam.

This report was sponsored by the Mekong Project Development Facility, a multi-donor initiative, managed by the International Finance Corporation and designed to promote private sector development in Vietnam, Cambodia and Laos. The Facility's experience evaluating private investment projects in Vietnam has shown there to be a significant pool of worthy private firms, ready to absorb proven technologies and business models and with potential for eventual stock exchange listing. These firms are in general already quite profitable, taking advantage of Vietnam's rich reserve of skilled low-cost labor and certain natural resources. Access to the investment capital and management experience that a venture capital fund could provide would allow them to accelerate their growth.

However, while venture capital funds have been quite successful in other countries in the region, their performance in Vietnam has been disappointing thus far. Funds in neighboring countries relied heavily on local stock markets, an institution that has still not been set up in Vietnam. Funds in Vietnam, in contrast, have structured themselves off-shore to attract hard currency capital, thereby exposing themselves to devaluation of the Vietnamese Dong. Furthermore, by assigning only marginal roles to Vietnamese, the funds have had limited access to local networks and deal flow.

The authors conclude that there is sufficient demand to merit moving forward with a Vietnamese venture capital fund. As allowed by the Domestic Investment Law, the fund could attract up to 30 percent of its capital from an international finance institution, while the rest would need to come from inside Vietnam. Preliminary research suggests that this could be done. International organizations such as MPDF and IFC could make valuable contributions by underwriting further feasibility work and technical assistance.

EXECUTIVE SUMMARY

This report was commissioned by MPDF and undertaken by Adam Sack and John McKenzie during May/June, 1998, with the purpose of taking a preliminary look at the feasibility of establishing a new, independent, commercially viable venture capital fund in Vietnam.

A venture capital fund would be an appropriate partner to support the development of the Vietnamese private sector. Establishing a venture capital fund is one way of addressing the current undersupply of term capital to expanding Vietnamese private sector firms. It also serves to provide a bridging mechanism between private firms and the soon to be established Vietnamese stock market. A venture capital fund is considered to be an appropriate institutional partner for small and medium sized Vietnamese companies because, in addition to providing capital, it normally works closely with its investee companies to strengthen management and build assets.

Venture capital funds have been active for many years in neighboring markets. Venture capital funds are already active in neighboring South East Asian countries including Indonesia, Malaysia and Thailand. In each case, a supportive and structured environment for private enterprise, established stock markets and existing legal and regulatory frameworks for non-bank financial institutions were in place before venture capital funds were set-up. **Good returns were generated on the back of buoyant stock markets.** There is no published data on returns. Anecdotal evidence, from Thailand in particular, suggested that before the recent financial crisis a number of funds achieved impressive returns.

Vietnam has a limited supply of institutional capital for private equity and only a small part of this is available for domestic venture capital. The supply of capital for small and medium sized enterprises in Vietnam has so far been the domain of a small number of offshore investment funds (currently four) that were established with US and European institutional investment in the boom-years of the early 1990's. One year ago there were six funds operating in Vietnam, but one fund (Lazard) has since withdrawn and the other (Templeton) has been rolled-over into a regional fund. Two of the remaining funds, Vietnam Fund and Vietnam Enterprise Investment Fund (Dragon Capital) have, between them, made only twelve investments in domestic companies. The others have invested entirely in foreign invested enterprises, typically joint ventures.

The performance of the funds in Vietnam has been disappointing. There have been no successful exits despite fund lives of four to date or more years, and anecdotally several investments in each portfolio are suffering. There are a number of reasons for this performance, some of which are structural and some are due to the particular strategies of the funds. Without a stock market, the funds have had very limited exit routes. The environment for the private sector has not been supportive, although this does seem to be gradually improving. Until recently, foreigners were not explicitly allowed to invest in domestic companies. The funds were structured as offshore investment vehicles to attract US Dollar capital. They have thus been exposed to the devaluation of the Vietnam Dong. Further limitations on the funds' performances have been the managers who have had rather limited previous venture capital experience and as foreigners, had limited networks and dealflow.

The proposal developed in this report seeks to learn from these experiences by carefully structuring a fund to avoid a number of the constraints that have faced the existing investment funds.

Demand for venture capital appears strong at this stage of the development of Vietnam's private sector. There are currently around 24,000 registered private companies, of which 7,000 are limited liability companies and joint stock companies that are assumed to be of a size that may interest a venture capital fund. If present Government targets for equitization are achieved, an additional 1,500-1,700 newly equitized companies may be added to this number by the end of the year 2000. Vietnamese firms have a comparative advantage in a number of sectors due to the availability of natural resources and skilled low-cost workers. There are high-growth companies, ready to absorb proven technologies and business models and with potential for an eventual stock exchange listing. This much has been proved in particular by MPDF's project development experience. In almost every case, domestic private firms are undercapitalized and have very limited access to investment either in the form of equity or long term bank loans.

From an investor's perspective, this demand is tempered by some constraints. The most important of these is transparency; there are currently no international accounting standards or statutory audit requirements. Because of the harsh private sector regulatory and tax environment, firms tend to protect their interests by being secretive. Under such conditions, it is much harder for venture capital funds to evaluate companies prior to investing and to supervise and strengthen them thereafter. Another important constraint is the absence of a mature legal environment. There is a body of law relating to companies, but it is still developing, and much remains untested. This contrasts with other regional markets, where legal and accounting frameworks exist. However, in these markets the regulations are apparently regularly ignored.

The offshore fund has a number of structural disadvantages. The offshore fund structure used by the existing funds does not appear an effective way of serving the domestic private sector firms. The funds are exposed to exchange rate risk. They are only allowed to take minority equity positions in domestic companies (up to 30 per cent), with the ensuing lack of control. As the funds are managed by foreigners, the vital resources of networks and deal flow are limited.

An onshore investment fund appears more viable. A more viable option in terms of serving the needs of domestic companies, and the proposal resulting from the present study, is the establishment of an <u>onshore</u> investment fund. This fund would raise capital from Vietnamese institutions, but it could also seek up to 30 percent seed capital from an international financial institution (as allowable under the Domestic Investment Law). The onshore fund would be unrestricted in terms of size of investment stake or position in respect of management control. It could raise funds and invest in Dong, avoiding any exchange risk. It would be managed by a Vietnamese management team, with the critical advantages this should bring in terms of access to deals and networks and ability to monitor more effectively. The management team could be supported technically, at least initially, by experienced international venture capitalists (possibly seconded from a regional firm). The onshore fund also serves the Government's aims of mobilizing domestic capital and developing local capacity.

There are however, some important concerns with the onshore fund. The stock market is the major exit route for venture capital investments. The establishment of the stock market in Vietnam within, say, 3-4 years (the time required to establish a fund, make some investments and have one ready for exit) would have to be considered highly likely before any such fund can be established. There are alternative exit routes to a stock market. For example, an investment can be structured as redeemable capital that can be repaid by the investee company prior to a full exit. This would work only for the few investee companies that would be cash generative in their early years. Reliance should not be placed on this exit route alone. The second concern is that the concept of establishing an onshore fund has no precedent in Vietnam. As the legal and regulatory structure is untested, official approvals for establishment would be required. Approvals would need to cover a number of sensitive issues, such as tax, so are unlikely to be automatic. The third concern, is that we have not sufficiently tested if Vietnamese institutions have surplus cash to invest, or if they would accept the terms of investment in a fund with respect to duration and risk. Preliminary soundings have however indicated that there may be sufficient interest. An onshore fund would also require support from an international financial institution to provide some seed capital, underwrite some technical assistance and help mobilize official support.

Next steps. If MPDF and IFC decide to develop a full proposal to establish an onshore venture capital fund, a further in-depth feasibility study should be undertaken. The study could include the following:

- A survey of potential Vietnamese institutional investors
- Feedback from international financial institutions on their interest in participation
- Identification of possible senior Vietnamese managers
- A survey of domestic companies to evaluate demand
- A timetable for the establishment of the Stock Market
- Legal input to define the structure of the fund and the required approval process
- An investigation into tax issues with accountants
- Feedback from relevant authorities (SBV, MoF, Prime Minister) regarding degree of support
- A preliminary business plan

A. OBJECTIVES OF THE STUDY

This report makes a preliminary assessment of the potential for a new, commercially viable, venture capital fund in Vietnam.

During its first year of operation, MPDF has identified and assisted a number of well-managed Vietnamese private companies with strong growth potential. However, lack of access to capital and long-term loan financing are critical constraints to the development of these companies in almost every case. Vietnamese banks have limited available long-term resources; there are no non-bank financial institutions; and offshore investment funds have been restricted from buying shares in domestic private companies or have avoided such investments entirely.

Now that the Vietnamese stock market is on the verge of becoming operational (expected opening within one year), the timing seems appropriate to consider the establishment of a venture capital fund that would target domestic private companies. Venture capital is a potential response to meeting the needs of Vietnam's under-capitalized and investment-starved private sector. As well as providing equity investment, venture capital funds typically get involved at an early stage of an enterprise's development. Venture capitalists' methods and objectives for evaluating investments are more appropriate to small and medium sized companies than those of banks. Venture capital funds are usually active investors that work closely with company management teams to develop capacity and build assets. They also assist their invested companies to prepare for listing on the stock market to raise further funding.

Establishing a venture capital fund not only fits with MPDF's objective of mobilizing investment to expand domestic private sector companies, it also provides the necessary link between those companies and the stock market.

This report discusses the pre-conditions for establishing a venture capital fund in Vietnam. It considers experience in the region, assesses the current supply of venture capital in Vietnam and the potential demand for venture capital among domestic private firms, and looks at the legal and regulatory framework for venture capital funds. The report concludes with a number of findings and recommendations and suggests the next steps in the event that MPDF, IFC, or others, see merit in moving the concept forward.

B. WHAT IS VENTURE CAPITAL ?

There are two widely used definitions of the term venture capital, a broader and a narrower definition.

Broad Definition. Venture capital is finance provided to private companies in the form of equity or quasi-equity investments over the medium term (three to five years). The stakes acquired in the investee companies can range from small minority stakes to majority positions. The purpose of the investment is to realize above average capital gains. The gains are realized after the investment is sold either to a trade buyer or more commonly in Asia to the public markets. In addition to providing capital, the venture capitalist provides advice at the strategic level to guide the investee company through the next stage of its growth and to prepare it for transfer to the next set of shareholders. This advice is a vital and distinguishing feature of venture capital. Investors typically take a seat on the board of the investee company. From this position, and drawing on experience gained from other companies, the venture capitalist is in a position to influence the development of the investee company. Differing venture capital firms place differing emphases on the degree of involvement. This ranges from minimal involvement often in conjunction with small equity stakes, to almost daily involvement in the role of Chair of the board, often in conjunction with majority stakes. The term venture capital in this broad definition is used interchangeably with the term private equity.

Narrow Definition. This sub-set of the broad definition defines venture capital as medium term private equity investments in immature investee companies. In other words, the company in which an investment is being made is at an early stage of product development, production capacity or service delivery. As companies at this earlier stage tend to have shorter histories and tend to be smaller than the majority of investments under the broad definition, risks tend to be higher. The venture capitalist will therefore be seeking higher potential capital gains.

The difference between the two definitions is the maturity of the investee companies. There are no clear rules (such as turnover thresholds) that differentiate these two categories. Rather, the narrow definition is seen as operating at one end of the maturity spectrum of private equity investments. In an established private equity market such as that in the US or the UK, providers of capital tend to specialize at one end or the other of the maturity spectrum. However, a number are prepared to invest across the range. For purposes of convention in this report, the term “venture capital” will refer to the narrow definition and “private equity” will refer to those private equity investments which are not "venture capital" investments.

The Vietnam Market. This report will draw on both definitions of venture capital in the review of the Vietnam market. Investments in small privately owned domestic companies and in newly established companies are considered to be venture capital investments. Investments in equitized companies, subsidiaries of SOEs or in established joint ventures with foreign partners are considered to be private equity investments. As will be seen later in this report, the funds operating in Vietnam currently have made both venture capital and private equity investments. These funds are referred to as offshore investment funds. It is currently envisaged that any new firm that might be established in due course as a result of this work, would focus on venture capital investments (that is the narrow definition of the term).

C. VENTURE CAPITAL IN SOUTH EAST ASIA

Summary. The experiences of the private equity and venture capital markets in Indonesia, Malaysia and Thailand were examined to determine if there were any parallels to be drawn with Vietnam. Telephone interviews were carried out with fund managers, fund raisers and investors. These interviews were supplemented with data published by the Asian Venture Capital Journal.

Table 1: Private Equity and Venture Capital Pool
(US$ Millions)

	1991	1992	1993	1994	1995	1996	1997
INDONESIA	76	57	99	225	245	289	298
MALAYSIA	75	147	160	194	437	448	448
THAILAND	64	90	98	117	165	201	201

Source: Guide to Venture Capital in Asia - 1998 Edition

The markets in each country have been active for at least the last eight years. With the exception of 1992 in Indonesia, the pool of funds has grown each year in each market (see Table 1 above). The markets are reviewed separately in the following sections. Some common features emerge from that review and are discussed here.

⇒ Established stock markets preceded the growth of the venture capital industry in each country.

⇒ The stock market has been the exit route for the vast majority of investments.

⇒ Reliable data on the performance of funds is not available.

⇒ The private sector in each country has been encouraged for many years and is subject to a stable regulatory environment.

⇒ A legal and regulatory framework for non-bank financial institutions existed prior to establishment of venture capital funds; in some cases additional incentives and tax breaks were granted.

⇒ The legal and accounting practices fall far short of international best practice. This does not appear to have deterred venture capitalists. Rather, venture capitalists rely heavily on pre-investment due diligence, particularly the collection of references on firm owners and managers through personal networks and contacts.

⇒ Managers of private companies are perceived to be generally reluctant to share control or information with external investors; however, when they have overseas experience or business school education the relationship is easier.

Indonesia. *Market.* All of the players in this market are referred to as venture capital firms by the Venture Capital Association of Indonesia. The industry began in 1991 and at the end of 1996 there were 46 domestic venture capital firms registered with the Ministry of Finance. A number of regional funds based in Singapore and Hong Kong can also invest in Indonesia. The majority of the domestic firms are small and are sponsored by the government. 22 are regional firms whose dispersal of investment is highly politicized, according to one commentator. There are estimated to be fewer than 10 domestic funds operating according to international principles.

Regulatory Environment. Regulations governing venture capital firms were introduced in December 1988 as part of a set of regulations covering non-bank financial institutions. These regulations were amended in 1994 to further encourage foreign ownership (allowed to increase from 85% to 100%) and to promote activities by removing restrictions on the size and scope of investments. Tax incentives are available to domestic venture capital firms. Capital gains arising from the sale of investee companies and dividends from investee companies are tax exempt for a large range of sectors.

Legal and Accounting Environment. A solid legal framework exists. But as one participant commented, documents "can be elaborately drafted but are unenforceable". Accounting standards are reasonable but are poorly applied and monitored. The recent financial crisis has exposed numerous cases of very poor record keeping and reporting.

Demand for Venture Capital. From 1991 to 1996, entrepreneurs increasingly viewed venture capital as just another source of capital, whose terms were to be judged alongside the stock market and bonds. Managers were reluctant to share information and concede control.

Exit. The vast majority of exits has been via the stock market. In 1988, listing requirements were simplified for the Jakarta Exchange and an Over-The-Counter

(OTC) market was established. This parallel market was restructured in 1996 to further promote the flotation of small and medium sized companies. The merger and acquisition (M&A) market is not liquid.

Malaysia. *The Market.* Although formally initiated in 1984, there were few entrants to the market until 1989. At the end of 1996 there were 22 private equity and venture capital firms based in Malaysia. Regional funds, such as those based in Hong Kong and Singapore also invest in Malaysia. A participant commented that only approximately 5 Malaysian based funds are active. The industry was seeded by government funding in 1991 when M$ 115 million was allocated to technology-related venture capital financing. In addition, a company was established by the government specifically to provide venture financing to potential Bumiputra or ethnic Malay entrepreneurs. The government continues to provide funds to a number of domestic venture capital firms.

Regulatory Environment. The regulatory environment is described as stable and supportive. Tax incentives are available for venture capital firms with exemptions for capital gains and dividends arising from investee companies in certain circumstances. Certain expenses incurred at the level of the venture capital firm are also tax deductible.

Legal and Accounting Environment. The legal and accounting systems are immature. Legal contracts are not considered to be the enforceable basis of agreements. For that reason, the terms of contracts are rarely tested in court. Similarly, the audit practice is not considered to be rigorous. One participant gave an example of a case in which a manager had been allocating profits away from the venture capital financed subsidiary to another subsidiary in the same family business via transfer pricing. Owing to such difficulties of post-investment control, venture capitalists rely heavily on due diligence, particularly the collection of references on a potential entrepreneur through personal networks and contacts.

Demand for Venture Capital. Demand for capital is regarded as high. Historically, many investee companies have been in family-controlled business groups where there has been a reluctance to concede control. So, there is a demand for cash but not necessarily for the conditions which normally accompany the provision of venture capital. One participant commented that company managers are becoming increasingly professional. Founders of businesses are retiring and an increasing number of foreign trained Malaysians are returning to run companies. The future development of the industry is thus expected to see a closer relationship develop between venture capital and these business school trained managers of its investee companies.

Exits. The establishment of the Kuala Lumpur Exchange predates the private equity and venture capital market by many years. The vast majority of exits has been via the stock market. An OTC market is due to become operational shortly, with less stringent listing requirements.

Thailand. *The Market.* The market began in 1987, with the establishment of a locally financed firm. At the end of 1996 there were 10 firms. A number of regional funds in Hong Kong and Singapore can invest in Thailand. Unlike in Indonesia and Malaysia, these regional funds have been active in Thailand. One participant believes that there are at least 20 active funds in the market.

Regulatory Environment. The regulatory environment is considered stable and supportive. There are no special tax incentives available for venture capital firms, but certain sectors in which they invest attract some incentives.

Legal and Accounting Environment. The legal framework is stable and an established body of commercial law exists. However, the process to advance a claim is very lengthy and acts as a deterrent to the pursuit of actions through the courts. Accounting standards exist, but are considered to fall short of international standards. Their application is not rigorous. One participant believes that is common to find several sets of books being kept at companies.

Demand for Venture Capital. In recent years, companies have been able to obtain cheap funds from a variety of sources including finance companies and banks. Venture capital funds have had to compete with these other sources. Managers are reluctant to allow venture capitalists access to information and the right to exercise control. With alternative sources of funds available, the managers have had considerable negotiating power. As one participant commented “managers listen to the venture capitalist only when they have to”. Following the recent financial crisis, the negotiating power of those venture capitalists with cash has increased significantly.

Exits. Almost all of the exits have been via the main stock market, the Securities Exchange of Thailand. An OTC market for small and medium sized companies was launched in 1995.

D. SUPPLY OF VENTURE CAPITAL IN VIETNAM

Summary. Table 2 summarizes the major elements of the four funds that are active in Vietnam. More details on each of the funds are given in Appendix I. The table shows that the capital available for investment totals US$68 million. Of this, US$18 million is available for domestic companies as Beta and Vietnam Frontier fund will not invest in domestic companies. There were six funds 12 months ago, but Lazard closed and Templeton shifted its focus to other markets in the region. A number of regional funds state their interest in Vietnam but are not considered active at the moment. Participants spoken to in Thailand and Singapore maintain that South East Asian markets other than Vietnam are more favorable in terms of supply of opportunities and ease of investing.

Table 2: Active Vietnam Investment Funds

NAME OF FUND	Fund Raised	Fund Size	Amount Spent	Local [2] Invests	FIE [3] Invests	Size of Invests
Beta	1993/4	$80m	$50m	0	17	$1-5m
VEIL [1]	1994	$27.5m	$18.6m	6	4	$0.5-2m
VN Frontier	1994	$50m	$30m	0	9	$1-5m
Vietnam	1991	$51m	$42m	6	5	>$1m

Source: Interviews with Directors of the Funds
Notes: 1 Managed by Dragon Capital
2 Investments made in domestic private companies
3 Investments made in Foreign Invested Enterprises such as JVs and foreign owned ventures

The performance of the four funds has not been good. Some possible contributory causes to the poor performance are listed below.

- No stock market. For the few investments that have performed reasonably, the absence of a stock market has denied the funds the exit route that has been the major route in other regional markets.

- Private sector constrained. During the last few years, official policy has

- favoured SOEs over private firms in terms for example of access to credit, licenses, quotas and public contracts. The operating environment for private firms is beset with red tape and with unclear and changing regulations. This has limited the investment opportunities for the funds.

- Exchange rate exposure. All funds are US Dollar based and raised from international investors. Even if the investee companies had performed well locally, much of the capital gain would have been eliminated by the devaluation of the Dong against the US Dollar. Exchange rate exposure can be partially offset by investing in firms with a high percentage of US Dollar earnings, which some funds have tried to do.

- Constraints on investment in domestic companies. Until the April 1998 Domestic Investment Law allowed foreigners to invest up to 30 per cent in domestic firms, Investment Funds (except with special cases like Joint Stock Banks) were restricted from investing in domestic private companies. The funds found ways and means of making investments in Vietnamese private sector companies. Separate rules allowed the offshore funds to invest in joint ventures and wholly owned foreign invested enterprises.

- Most senior managers are foreigners. The ability to assess opportunities must be constrained by the lack of senior Vietnamese professionals in the teams.

- Limited experience. In general, the executives managing the funds in Vietnam have limited venture capital experience.

- Lack of strategic focus. All funds invest across sectors opportunistically. The style could generally be described as reactive rather than proactive.

The first two reasons, lack of stock market and constrained private sector, are characteristics of the business environment. The exchange rate exposure and legal restrictions are consequences of the chosen offshore fund structure. The last three reasons are due to the particular management set-ups in the funds.

Investment Fund Profiles. *Beta Fund.* This is managed in Vietnam by two British accountants and a US lawyer. The fund has seen a number of changes in senior managers since its inception in 1993. The current focus of the fund is to invest only in companies that are managed by foreigners. Start-ups and domestic companies are not considered for investments. It is unlikely that Beta will invest further in foreign invested joint ventures as the experience has not been positive. The director of Beta Fund believes that the incentives of a foreign industrial partner and a Vietnamese state-owned entity are incompatible. The approach to investment is opportunistic. Once an investment is considered interesting, there appears to be a reasonably diligent approach to investigation in line with the US-UK model.

Vietnam Enterprise Investments Ltd (Dragon Capital). Dragon Capital, which invests this fund, is managed by 3 Vietnamese and 3 Vietnam based British principals. The latter have experience in the public securities markets in Europe and Asia. As the inauguration of the Vietnam stock market receded, so did Dragon's strategy of arbitraging the private and public markets. The managers have increasingly turned to investing in domestic companies, where the fluency of the foreigners running Dragon in Vietnamese has clearly helped in accessing Vietnamese managers. Dragon displays considerable entrepreneurial drive in constructing deals, for example, it arranged and invested in the first convertible bond in Vietnam. There is little direct management involvement sought after the investment has been made.

Vietnam Frontier Fund. This is managed by Finansa which is a Bangkok based merchant bank. After a recent down scaling of its operations in Vietnam, the fund is run by two relatively junior managers in Vietnam. Senior staff were transferred back to Bangkok and all major decisions are made there. Similar to the Beta Fund, the Vietnam Frontier Fund invests only in companies with foreign managers. Joint ventures are not excluded. Given the recent reduction of staff in Vietnam, it is not clear that senior management expect many further investment opportunities for the fund.

Vietnam Fund. The six foreigners from various countries who run the fund have a range of backgrounds, including accounting, banking and industry. This fund has invested in both foreign and domestic companies, and will continue to back foreign-managed and Vietnamese-managed companies. Thus, the scope is similar to that of the Vietnam Enterprise Investment Fund. The stated approach of the Vietnam Fund puts emphasis on a careful due diligence process which is carried out in-house. However, the managers indicate that it is difficult to obtain reliable information from domestic companies. It is unclear how the managers reconcile the gap between policy and practice. The Vietnam fund is the oldest of the four active funds in Vietnam and has only US$9 million left for investment. So, a major priority for the next year is the challenging task of raising more capital.

E. DEMAND FOR VENTURE CAPITAL IN VIETNAM

Summary. Broadly, Vietnam's business sector comprises 6,000 State Enterprises, 3,000 collectives, 2 million private household enterprises and 24,000 registered private companies. In this last category, 7,000 companies are incorporated as limited liability companies or joint stock companies and are possibly of a size or type that would interest venture capitalists. In addition, 1,500 to 1,700 state enterprises are supposed to privatize before the end of the year 2000, if objectives are met. These firms may also be potential investment targets.

Vietnamese firms have comparative advantages in a number of sectors. For example, export-led manufacturing is a growth area. In addition, the domestic market is large, has been deprived by past isolation and will generate demand for many types of goods and services as real incomes rise. However, the framework of rules that governs investment activities in market economies does not yet exist in Vietnam. This places a serious constraint on potential investment activity.

Current Status of Vietnam's Corporate Private Sector. The formal private sector in Vietnam comprises three main types of registered companies: sole proprietorships, limited liability companies, and joint stock companies:

- Sole Proprietorship/: Private Enterprise — A company with a single registered owner.
- Limited Liability: — A company with up to seven registered owners; ownership is registered in percentage terms, no shares are issued. Transfer/sale of a part by an owner must have approval of all registered owners.
- Joint Stock Company: — A company owned by shareholders. Shares can be freely and publicly traded.

The number of companies in all categories has grown fast since the early 1990's when the Law on Companies and the Law on Private Enterprises were passed and confirmed in the Constitution. Today there are more than 24,000 registered Vietnamese private companies.

Table 3 : Number of Companies by Type

	1993	1994	1995*	1996	1997
Total Private Registered Companies	6,808	10,881	15,276	18,894	24,067
-Sole Proprietorship/ Private Enterprise	5,182	7,794	10,916	12,464	17,163
-Limited Liability Company	1,607	2,968	4,242	6,303	6,746
-Joint Stock Company	19	119	118	127	158

* Figures for 1995 for private firms include categories not enumerated in other years including finance, technology, real estate, sports/culture. SOURCE: General Office of Statistics.

Forty-four percent of registered companies are located in Ho Chi Minh City and Hanoi. Sixty-one percent of the total are located in southern areas, half of these are in Ho Chi Minh City and half in the densely-populated Mekong Delta region. Three quarters are sole proprietorships, the simplest legal form. Roughly two thirds are engaged in trading activities with one third in industry. Within industry, roughly half of firms are engaged in food-processing. See Table 4 for a sectoral breakdown of private firms.

Table 4: Vietnamese Private Companies by Sector

	1993	1994	1995*	1996	1997
Total Private Corp. Firms	6,808	10,881	15,276	18,894	24,067
- Mining	N/A	22	55	60	N/A
- Industry	3,322	4,392	5,006	5,767	N/A
- Construction	462	892	1,294	371	N/A
- Trade	1,835	3,894	7,645	12,696	N/A
- Transport	N/A	169	293	N/A	N/A
- Other	1189	1512	983	N/A	N/A

SOURCE: General Office of Statistics.

The State Enterprise Equitization Process. In addition to the corporate private sector, the Vietnamese State Sector currently has 6,000 enterprises. In the early 1990's there were around 12,000 State Enterprises, but in the process of a Government reform program about 2,000 firms were liquidated and a further 4,000 were merged. State Enterprise are owned either by Central Authorities, Provincial Authorities or by State Corporations. In 1997, 1,140 of 6,020 State Enterprises belonged to State Corporations which accounted for 47 per cent of total State sector employment and 74 per cent of the sector's profits. State Enterprises produce 68 per cent of Vietnam's industrial output.

The Vietnamese Government has recently reaffirmed its commitment to equitize State Enterprises. Only 37 firms have so far undergone this transition since 1992, but the State has set ambitious new targets for equitization of 150-200 firms this year, 400-500 firms next year and another thousand in the year 2000. The majority of equitized companies will transform into Joint Stock Companies.

Potential Target Firms. Target firms will most probably be limited liability or joint stock companies. According to the statistics, this represents a current pool of around 7,000 companies, plus around 1,500-1,700 newly equitized companies by the year 2000 if targets are achieved

MPDF's experience in providing project development services indicates that there are numbers of well-managed and high-growth potential companies looking for investment. In general, medium-sized private Vietnamese companies are undercapitalized and need to expand their equity base. Additionally, most firms are relatively unsophisticated and can benefit from the corporate and advisory support that a venture capital investor can offer. Two of the offshore investment funds have already made a total of 12 investments in domestic companies.

Vietnamese companies have comparative advantages in a number of sectors due to access to natural resources and the availability of a skilled low-cost workforce. There is current growth in export-led manufacturing, but Vietnam also has a large domestic market that will generate demand for many types of goods and services as real incomes rise. Target firms would be high-growth companies, for example those able to absorb proven technologies or business models. Such companies may have been private since inception, or post–equitization companies. In most cases, target firms will need to have potential for an eventual listing on the Stock Exchange.

Constraints on Investment in Target Firm. The venture capital fund relies on a legal and regulatory framework to provide the rules by which it can invest in a target company, monitor the investment, and have recourse in the event of a breach of an agreement. In other South East Asian countries, as noted in Section

4, the corporate regulatory framework is already established, even though in practical terms it may not function well.

In Vietnam, the corporate regulatory framework is poorly developed and the area of legal recourse and enforcement (as opposed to administrative recourse and enforcement, which is the norm) is like an uncharted sea. International accounting standards are not yet in place, nor are Vietnamese companies subject to statutory auditing requirements.

It is also important to note that in Vietnam, where the private sector has only been in official existence since the early 1990's, the operating environment for private firms is difficult. Official policy favors state over private enterprises in terms of access to credit, foreign investment, licenses, quotas, public contracts and almost all forms of official support. In addition to having to deal with excessive red tape, private firms are subjected to regulations which are constantly changing, unclear and often conflicting, and are often exposed to petty official hostility and rent-seeking. In such an environment, private companies try to keep a low profile, and this discourages the openness and transparency that investors such as venture capital funds seek in their relationships with target firms.

A further possible constraint is the willingness of Vietnamese private companies to accept outside investors. Vietnamese small and medium companies are predominantly family-managed. The issue of control is often important to family-owners and this leads to an investment preference for debt rather than equity.

These constraints present a much more significant obstacle to foreign investors than they do to domestic investors, who have networks of contacts for information gathering and informal channels of recourse in the event of a breach of an agreement.

F. REGULATORY AND LEGAL FRAMEWORK

The discussion below is based on separate interviews with three Hanoi-based international lawyers.

Regulatory Framework. There is no specific set of regulations that governs the operations of venture capital firms in Vietnam. There are plans however to issue regulations covering the activities of non-bank financial institutions over the next 12 months. It is possible that this legislation will refer to venture capital. A second piece of regulation, governing securities, is currently in draft form. The final version may refer to the holding of unlisted securities and therefore be relevant to venture capital firms. The Law on Credit Institutions may also impact on future funds.

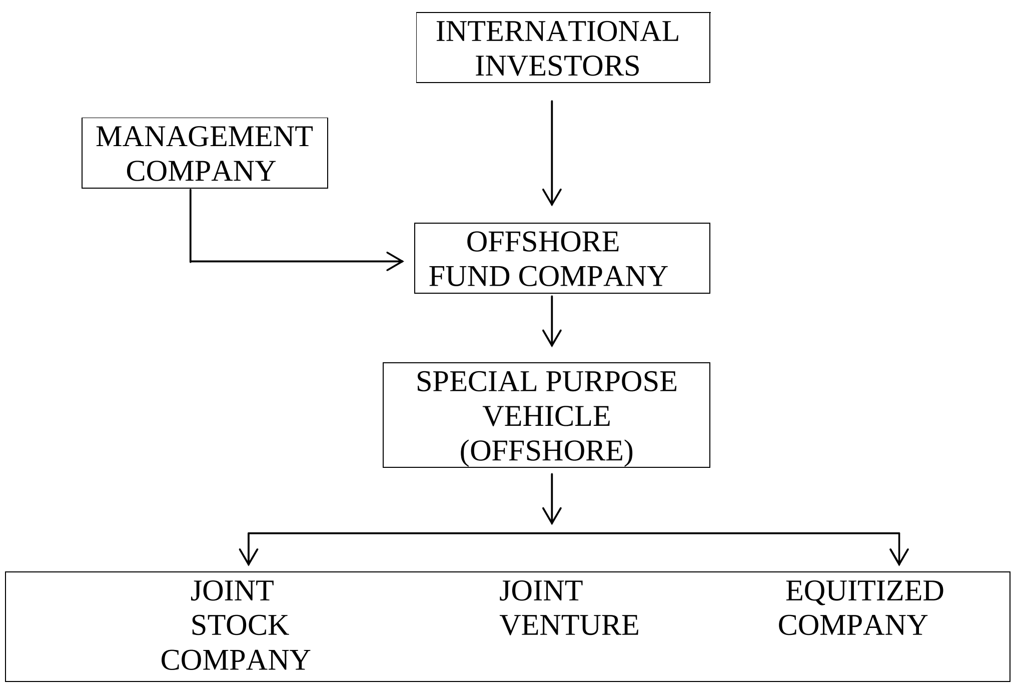
As the regulations concerning the financial sector are evolving, there is a degree of uncertainty around any scheme that may be advanced to establish a new venture capital firm. In the absence of specific regulations, it is advisable to seek approvals from the relevant authorities. This would probably include the State Bank of Vietnam, the Ministry of Finance and the Prime Minister's Office.

Legal Framework. There are two principal laws that govern venture capital activities in Vietnam. The first is the Law on Foreign Investment which governs the operations of the existing funds in Vietnam. This sets out those entities into which foreign investors can subscribe for shares, predominantly joint ventures and wholly foreign-owned enterprises. Investments in areas that could be considered a threat to national security and the environment are prohibited. The second principal law is the Law on Companies (as amended by a recently passed Domestic Investment Law). This governs the activities of domestic Vietnamese companies. Foreign owned enterprises are allowed to acquire up to 30% of the shares in a domestic private company, subject to the approval of the Prime Minister. This law sets out the guidelines for the articles of association of a domestic company. These laws are evolving and so legal advice can only be given with certain reservations.

G. STRUCTURES FOR VENTURE CAPITAL FIRMS IN VIETNAM

This section examines two contrasting structures for venture capital firms and considers their respective strengths and weaknesses. The first is the structure used by the investment firms currently operating in Vietnam and is called here "the Offshore Fund". Although this is the structure used by all the funds, it has proven to be far from ideal. The second structure to be reviewed, "the Onshore Fund", offers a more promising but untested route. The strengths and weaknesses of each structure are reviewed after the following brief descriptions.

Offshore Fund. This structure has been designed principally to accommodate international institutional investors and in so doing keeps their capital offshore in jurisdictions whose legal and accounting regimes provide optimal conditions for investors and fund managers.

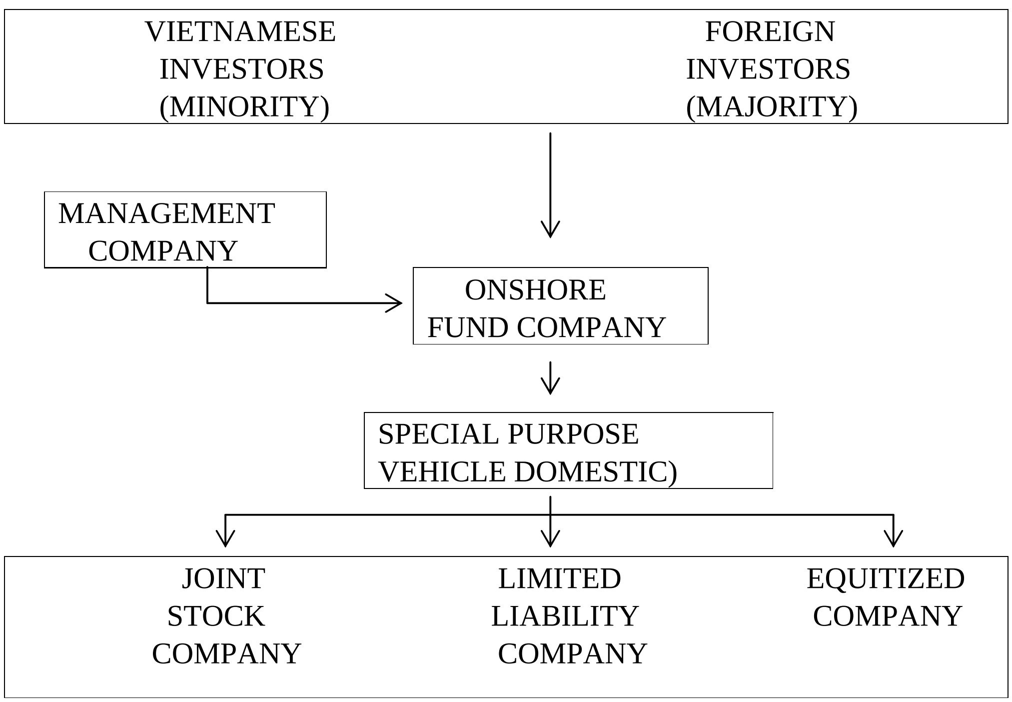


As investment opportunities are identified, cash is drawn down from the international investors into the Fund Company. The managers, who manage the Fund Company, are ultimately employed by an offshore company (Management Company). The cash subscribes for shares in a Special Purpose Vehicle whose sole purpose is to make an investment in the Vietnamese enterprise. The investment may be in shares of a Vietnamese private company, typically in the form of a joint stock company, a joint venture with foreign partners, or a part of an equitized company. The SPV is often a company incorporated in the British

Virgin Isles. So when the Fund wishes to exit the investment, it may wish to sell the shares of the SPV. The entire transaction will in this case have remained offshore.

Most of the investments by the existing funds have been made in those types of companies permitted under the Law on Foreign Investments. These are: wholly foreign-owned enterprises, a joint venture or business cooperation contracts. Under the recently passed Domestic Investment Law, investments of up to 30% in private domestic companies may be made, subject to the approval of the Prime Minister.

Onshore Fund. The key elements are that the Onshore Fund would raise domestic capital to invest in domestic companies and would be managed predominantly by Vietnamese staff.



Capital for the Onshore Fund would be raised primarily from domestic institutions. There are believed to be a number of cash rich Vietnamese companies (large SOEs) for whom the possibility of accessing a portfolio of high growth companies would be attractive. The cost structure of the Offshore Fund Company and the Management Company would determine the appropriate minimum fund size. It will then be possible to conduct an initial survey of potential investors to assess the availability of the necessary capital. In an initial sounding with a senior representative of a Vietnamese financial institution, it was suggested that for local capital to be mobilized, investors would require a capital contribution from a well-respected international financial institution to lend credibility to what would be the first domestic fund. The capital would be committed to a domestic fund company. The establishment of this entity is not explicitly allowed under current legislation. Approvals would almost certainly be required from the State Bank, the Ministry of Finance and the Prime Minister's Office.

It is proposed that the Onshore Fund should be managed predominantly by Vietnamese staff, with a respected Vietnamese businessman as Managing Director. In the early years of such a fund, there would be an important role for technical assistance from international staff with venture capital experience. There would be several benefits:

- It would be easier to attract domestic capital.

- Due diligence relies heavily on the accurate assessment of the entrepreneur. This assessment in the emerging Vietnamese market is enhanced by investigations through personal networks.

- The sustainability of the initiative would be greater with maximum Vietnamese participation.

The Onshore Fund would subscribe for shares in domestic SPVs which would acquire shares in domestic companies (limited liability companies and joint stock companies). Unlike Offshore funds, the Onshore Fund would probably be able to invest in majority stakes. The corporate acts undertaken by the Onshore Fund would be governed by the Companies Law.

Although no Onshore Funds have yet been established, there are at least two initiatives which are currently being studied. These are:

- *AIG/Bao Viet.* AIG has been trying to establish an onshore fund (with a reported amount of $100 million) with the state insurance company, Bao Viet. This is on condition, however, that AIG is granted a license to provide insurance services in Vietnam. No foreign company has yet been granted such a license.

- *ADB/China Development Corporation.* The Asian Development Bank, in partnership with Taiwan's China Development Corporation, is studying the potential for establishing an equity fund.

Strengths and Weaknesses of the Two Model. Primary strenghs and weaknesses of the two models are as shown:

Offshore Fund

Strengths:	Weaknesses:
• Can appeal to large pool of foreign capital • Stable tax and regulatory environment • Legal structure tested and approved in Vietnam	• Foreign capital less interested in Vietnam currently • Limitations on investments that can be made • Can only invest in minority stakes in domestic companies • No local "feel"

Onshore Fund

Strengths:	Weaknesses:
• Mobilizes domestic capital • Avoids forex risk on local investment • Develops local capacity • Can invest in majority stakes • Domestic company can operate with fewer restrictions than foreign company • Access to deal flow probably greater as will be "local" company • Enhanced due diligence through senior manager	• Uncertain if there is sufficient long- term domestic capital • Would take time to establish (more than one year • Will need official approvals • Probably needs "seed money" from IFI • Legal structure untested

H. FINDINGS AND RECOMMENDATIONS

In neighboring South East Asian countries, a number of fundamentals were in place before venture capital firms were established, namely the existence of a stock market, an appropriate legal and regulatory framework and a benign private sector environment. The same cannot be said of Vietnam where the absence in particular of a stock market would present a serious constraint to the development of a venture capital firm. On the basis that constraints relating to the environment for a venture capital firm will be resolved in the medium term, and in view of the benefits that a venture capital fund can offer, it is proposed that further work be carried out towards establishing a domestic venture capital fund in Vietnam. Preference is given to the concept of a domestic fund because of the importance of establishing a domestic capital market and owing to the inherent disadvantages of using the existing offshore fund model.

In order to pursue this concept, a number of significant issues must be addressed. These are listed below with recommendations as to how they might be addressed:

- **Existence of a functioning stock market to provide an exit route.** The major exit route for the venture capital fund would be an established and liquid stock market. It is assumed that during 1998/99, the stock market will start to function in such a way as to provide an appropriate exit channel for investments. However, there is a degree of safety built in to the process in this regard. It may take 18 months before a venture capital fund is ready to close (see Appendix II, Provisional Timetable). If during this period it becomes clear that the stock market is unlikely to become operational imminently, then plans for the timing of the close could be reconsidered.

The stock market is not the only exit route. Investments can be structured such that the capital is subscribed in the form of a redeemable instrument, either equity or debt. This can be repaid to the fund whilst the investee company is still owned by the fund. Of course, any redemption requires both a level of profitability and cash generation that may be achieved only by a few investee companies in their early years. Thus, this should not be considered as the major exit route.

- **Existence of cash-rich local investors and how to encourage them to participate.** Setting-up a domestic fund assumes that there are institutional investors like insurance companies, banks, and corporations with cash surpluses that are willing to invest. This assumption would need to be tested. There may be limited availability of cash from these institutions, or they may be seeking to place money in lower risk dividend-yielding investments. It has been suggested that potential investors would be encouraged to invest if a major international institution, such as IFC, also took a stake in the fund. More work is now required to identify potential institutional investors and to involve a major international financial institution.

It has also been suggested that there may be funds available from development institutions. These funds could possibly underwrite the start-up costs and/or some or all of the management fees. Capital may also be available to invest in the venture capital fund itself possibly requiring rates of return below market levels.

- **Obtaining the necessary skills and experience to operate the fund.** Despite the growing number of Vietnamese nationals with formal financial training and experience, venture capital is a new area. It will be important to identify a Vietnamese fund management team with high level commercial and financial skills, but it will be equally important to involve experienced venture capitalists (perhaps seconded from a respected regional firm) as advisors. This advisory service might be funded under a technical assistance budget provided through an IFC trust fund.

- **The legal and regulatory framework for establishing the fund is not yet in place** To date there is no law or regulation governing non-bank financial institutions or venture capital funds, therefore special approvals must be obtained. Such approvals will have to take into consideration a number of complex issues, such as tax issues, and this may take time.
-
- **Absence of a framework of corporate governance.** Currently the legal and accounting rules governing the way in which companies are run are undeveloped. For example, shareholders' agreements are rarely used and only a few companies have their accounts audited on a routine basis. This is not only a question of rules but of practice; as previously mentioned, the business environment discourages firms from operating in a transparent and open manner. Once the venture capital fund is established, effective procedures for ensuring control of target companies will have to be developed.

- **How to structure the fund in an optimal way in view of the nature of the market.** A number of decisions will need to be taken by the fund managers with regard to structure and strategy, including:

  - investment focus; the fund should aim to be proactive
  - duration of the fund
  - whether to separate the fund from its managers
  - the organizational structure (will there be an internal or external investment evaluation committee...)

- level of fund management fees
- incentive structure for fund executives

These decisions can be taken once some of the fundamental issues regarding the legal and regulatory framework, investors, support from international financial institutions and the establishment of the stock market have been resolved.

I. NEXT STEPS

Step 1. Does MPDF/IFC wish to proceed further? On the basis of this overview, does MPDF and/or IFC consider that there is potential for the domestic fund concept and, if so, is there interest to go forward and can the required funding to do so be mobilized ?

Step 2. Feasibility study. A feasibility study would involve a number of aspects including:

- A survey of 10 Vietnamese potential investors: The survey would establish whether there are domestic institutions with funds to invest, under what conditions they are prepared to invest, and how much they can invest.

- Preliminary discussions with international financial institutions: In view of the pioneering nature of the proposed project, support from one or several international financial institutions will be required. As well as putting up an amount of seed capital (say 30 per cent of the total fund) the international financial institutions would also be expected to underwrite the technical assistance required for establishment and start-up. The study should indicate to what extent the international financial institutions show an interest in participating.

- A survey of domestic companies to evaluate demand: The survey would be undertaken by a local consulting firm to define the nature and level of demand for venture capital at the level of private and equitized firms.

- A preliminary assessment of potential senior Vietnamese managers: The success of the fund will rely to some extent on the quality of the senior Vietnamese managers. They will assist in securing capital from domestic investors and will be critical in developing deal flow and monitoring. Whilst assessing potential candidates should be done relatively early in the process, it will be important not to raise expectations too high whilst there is a high degree of uncertainty about the project.

- Timetable for establishment of stock market: In view of the importance of a functioning stock market to the success of a venture capital fund, the study must provide a clear indication as to when the stock market will be operational and how the venture capital fund will interact with it.

- Input from a Lawyer to define legal structure: In the absence of specific legislation on non-bank financial institutions, a legal opinion on options for providing the domestic fund and management company with a legal structure is required. Aspects of establishment requiring special approvals should be highlighted at this time.

- Investigate tax issues with Accountants: The fund and its investors may have an issue of double capital gains tax liability, first at the sale of holdings in target companies, and second when funds are paid-out from the fund to investors. In neighboring countries such as Malaysia there is a specific tax exemption in this case. Tax experts will need to establish the status in Vietnam, and indicate if special exemptions should be applied for. A further tax issue to be investigated is with regard to the personal liability of fund executives on payment of performance incentives, a standard practice in the venture capital industry. The tax regime on personal income for Vietnamese nationals is harsh once basic salary thresholds are crossed.

- Preliminary discussions with relevant authorities: On advice from the Lawyer, the relevant official authorities should be contacted to discuss issues of establishment and special approvals. This may involve discussions with the State Bank, the Ministry of Finance, the State Securities Commission and the Prime Minister's Office.

- Development of a concept business-plan: The output of the feasibility study phase will be a project document incorporating the above issues and providing details of a business plan. This would be the document required to elicit commitment and agreement from potential investors, official authorities and International Financial Institutions.

Step 3. Establishment issues. Assuming that the feasibility study attracts the necessary support, the steps toward establishment of the venture capital fund include the following:

- Identify the Vietnamese senior fund manager and the fund management team
- Identify experienced venture capitalists to advise and support the management team
- Define the structure and strategy of the fund and a business plan
- Start to mobilize funding

APPENDIX I

INVESTMENT FUNDS

Name of Fund	**Beta Vietnam Fund and Beta Mekong Fund**
Fund Manager	Indochina Asset Management
Fund Size	US$ 80 million
Amount Invested	US$ 50 million
Capital Raised	1993 and 1994
Sources of Capital	Institutional investors mainly European. Balance from US and Asia
Fund Structure	Closed end, Dublin listed fund.
Number of Investments	17
Number of Exits	0
Number of Professionals	4 Expatriates (1 in Bangkok) and 3 Vietnamese
Focus	Investments of US$ 1-5 million for minority stakes in foreign-managed companies. Start-ups and domestic companies are avoided.
Perceived Constraints	• Lack of exit routes • Lack of transparency • Too few strong local managers
Investments	Apex International Ltd. Anzoil Iddison Group Vietnam Indotel Vietnam Industrial Investment Frontier Petroleum Building Products Corporation Indochina Finance Indochina Juice Company Ltd. Beta Hotels and Resorts Dalat Palace Golf Club and Phan Thiet Golf Club Mekong Leisure Ltd. Bio Asia Beta Vietnam Textile Industries Ltd. Vinataxi Ltd. Greater Indochina Investments Ltd. Indochina Leasing

Note: The list of investments excludes investments in companies not operating in Vietnam and excludes holdings of debt securities.

Name of Fund	**Vietnam Enterprise Investment Ltd.**
Fund Manager	Dragon Capital Limited
Fund Size	US$ 27.5 million
Amount Invested	US$ 18.6 million
Capital Raised	1994
Sources of Capital	Institutional investors from Europe, US and Asia
Fund Structure	Closed end, Dublin listed fund.
Number of Investments	10, 6 in domestic companies (75% of capital invested)
Number of Exits	0
Number of Professionals	Expatriates and 3 Vietnamese (10 other deal related staff)
Focus	Investments of US$ 0.5-2 million in stakes of up to 30%. Increasingly focused on domestic companies
Perceived Constraints	• Lack of exit routes • Running short of capital to invest • Regulatory environment is uncertain
Investments	VP Bank Refrigeration Electrical Engineering Corp. Commercial Property Vietnam Industrial Investments Dakman Coffee Asia Commercial Bank TOGI Construction Thanh My Viet Trung Cement Specialty Tiles

Name of Fund	**Vietnam Frontier Fund**
Fund Manager	Finansa
Fund Size	US$ 50 million
Amount Invested	US$ 30 million
Capital Raised	1994
Sources of Capital	Institutional investors from US, Europe and Japan
Fund Structure	Closed end, Dublin listed fund.
Number of Investments	9
Number of Exits	1 (shares in gold mining company listed but not sold)
Number of Professionals	4 Expatriates (2 in Bangkok) and 2 Vietnamese
Focus	Investments of US$ 1-5 million in minority stakes in foreign invested enterprises and JVs, both with foreign managers. Hard currency earnings are favored.
Perceived Constraints	• Domestic companies lack capital, technology and marketing • Lack of exit routes • Perceived decline in available opportunities led to operation being reduced.
Investments	Barlile Group Northbridge Communities Indotel Indochina Building Supplies Vietnam Industrial Investments Tuk Tuk Vietnam Quang Nam-Da Nang Hydroelectric Construction Co. Vietnam Maritime Commercial Joint Stock Bank Indochina Goldfields

Name of Fund	**Vietnam Fund**
Fund Manager	Vietnam Fund Management Company
Fund Size	US$ 51 million
Amount Invested	US$ 42 million
Capital Raised	1991
Sources of Capital	Institutional investors mainly from Europe. Some US and Australian
Fund Structure	Closed end, Dublin listed fund.
Number of Investments	11, 6 in domestic companies
Number of Exits	2
Number of Professionals	6 Expatriates and 4 Vietnamese
Focus	Investments of more than US$ 1 million in minority stakes in domestic and JV companies. Turnover between US$ 4-10 million preferably in the export sector.
Perceived Constraints	• Lack of information and transparency form investee companies • Leverage is high in domestic companies • Restrictions imposed by shareholders agreements are alien to domestic managers
Investments	Dragon Properties Asia Holdings Anglo-Vietnam Sugar Investment Huy Hoang Co. Viet Hoa Construction Co. VP Bank VF-CGZ Hun San Co. Maritime Bank Johnson Suisse (Asia) Agravina Asia Commercial Bank

APPENDIX II

PROVISIONAL TIMETABLE	
Task	**Time (in months from Month 0)**
Discussions with IFCto gauge interest	0
Feasibilty study (see p.26 Next Steps)	0-3
Indicative approval from IFC/IFI as sponsor	4
Presentations to potential investors	7-9
Follow-up meetings with investors	9-11
Investors agree in principle (soft circle)	10-13
Establish legal entities	12-18?
Official approvals sought	12-18?
Arrange logistics (premises, junior staff)	14-18
First closing	19

NOTES:

1.As the legal structure of an onshore fund is untested, the time the approval process will take is uncertain. A clearer view on this should be possible after the feasibility study. It may be appropriate to start the approval process earlier in the schedule.

2.It is usual for there to be various iterations between the investors, the structure and the prospectus as the process develops. In this case, the approval process may also lead to modifications in the structure that would then require additional iterations with investors etc.