A Look at Vietnam's Bond Market

Vietnam's equity market has shown solid growth this year, but the bond market is showing signs of life too.

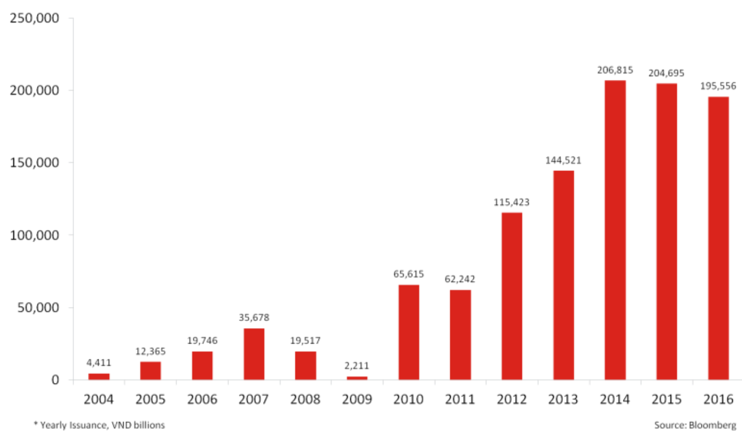
In frontier countries, the equity markets tend to be the focus for foreign investors seeking access to and participating in the rapid growth these countries are experiencing, and Vietnam is no exception. After starting the year affected by global issues, Vietnam's stock markets have recovered well, breaking through several historical barriers and reaching eight-year highs. Corporate earnings are generally solid, liquidity has been increasing, and additional privatizations and the lifting of foreign ownership limits all point to continued market growth. In contrast, Vietnam's bond markets have, until very recently, shown little such promise. While government bonds ("g-bonds") continue to be an important vehicle for raising funds and have seen reasonably robust sales in the past six months, corporate bonds ("c-bonds") have been relatively static. But change seems to be afoot. Is now the time for foreign investors to include bonds in their Vietnam portfolios?

Government Bonds

The government has raised two-thirds of its 2016 g-bond target in six months.

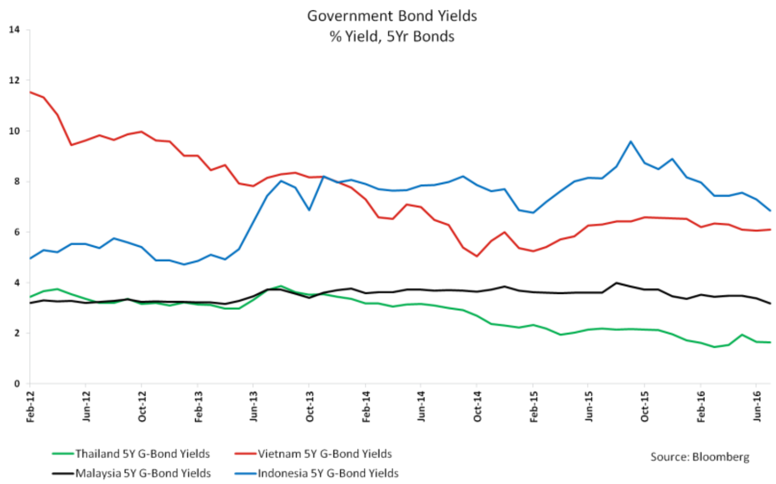
G-bonds, which account for approximately 90% of the total bond market, are of critical importance to the Vietnamese government: their proceeds drive the infrastructure and other investments fuelling the country's development and enable the government to restructure its debt. With the fiscal deficit rising, bond sales are a vital source of capital. In 2016, the government set a target for domestic bond sales of approximately USD9.8 billion, and two-thirds of that annual target was already raised by 26 May.[i] The average tenor of debt reached 6.79 years.[ii]

Vietnam Government Bond Issuance by Year



Local banks account for 80% of g-bond purchases; maturities of 5-years and less are preferred.

Local banks, insurance and securities companies account for 80% of g-bonds purchases, with the other 20% comprised of foreign banks. One of the reasons for high bank participation is that they need to purchase g-bonds to satisfy their capital ratios for State Bank of Vietnam compliance.



The bonds presently outstanding in the market mostly concentrate on maturities of five-years or less, which are preferred by banks. Year-to-date, the total amount of g-bonds issued with maturities greater than five years make up 19% of total issued volume, although the State Treasury has indicated that most of the bonds sold in the second half of 2016 will have tenors over five years.[iii]

Some foreign banks are said to use g-bonds as part of a "carry-trade" investment strategy, whereby they convert US dollars into Vietnamese Dong to buy g-bonds, which currently yield 6% per year. Adjusting for 2% year depreciation of the VND, foreign banks can still earn a spread of 2% per year. Under the amended Circular 36, foreign banks may use up to 35% of their short-term capital to purchase g-bonds.

With the SBV keeping monetary policy fairly loose to stimulate economic growth, liquidity in the banking system is expected to remain positive for the remainder of the year. While lending is rising (credit growth is expected between 18-20%), liquidity is sufficient to prompt additional g-bond purchases.

While still fairly small, the g-bond market in Vietnam has expanded quickly. By 2015, g-bond sales reached 21.5% of GDP; the goal is to reach 40% by 2020.

Corporate Bonds

Corporate bond issuances dropped 50% between 2009-2014, thanks largely to the Vinashin fiasco.

Vietnamese corporations have typically relied on bank loans when seeking capital. Prior to 2010, the economy was largely driven by credit relationships between state-owned enterprises ("SOEs") and banks. About USD64 billion – or 50% of outstanding loans – were taken out by the top 100 largest SOEs, resulting in very little need to go to the debt market. Nevertheless, some companies did sell bonds, with particular successes at Electricity Vietnam (EVN) and Bank for Investment and Development (BIDV). However, these positive experiences were largely negated by one colossal failure: Vinashin (see sidebar). During the period 2009-2014, the corporate bond market contracted by 50%.

Today, not a whole lot has changed. Loans continue to be the preferred source of capital, resulting in them comprising four-fifths of total debt. Although a growing number of companies are issuing bonds, the market remains small – just USD5.7 billion or 2.8% of GDP (compare that to Thailand, where the value of outstanding c-bonds reached 18% of GDP in 2015[iv]).

Bank loans have traditionally been the key source of capital, but a small and growing number of companies are starting to turn to the debt market.

Most corporate bonds tend to be convertible into equity, unrated, and issued via private placement. They are typically of short tenors (2-5 years) and come in a range of sizes. The yield spread between corporate and government bonds of similar maturities average 200bps to 350bps.

It is important to note that c-bonds in Vietnam are often used by companies that are, for whatever reason, unable to take additional bank loans. For example, they may have maximized the amounts they can borrow, or have exhausted collateral. Banks have been known restructure bad debts into bonds, and companies will structure bonds so that banks and/or insurance companies will purchase them.

Vinashin

Founded in 1996, state-owned Vietnam Shipbuilding Industry Group, better known as Vinashin, had ambitions of becoming one of the world's leading shipbuilders. Like many inefficient SOEs, it had easy access to credit and rapidly expanded into areas outside of its core expertise, such as property. In 2005, Vietnam issued its first-ever USD-denominated bonds worth USD750 million, the proceeds of which were entirely channelled to Vinashin. Two years later, the government provided a letter of support for the company to obtain an additional USD600 million in an eight-year syndicated loan. In late December 2010, Vinashin defaulted on the first scheduled payment to creditors on that loan, while the government refused to step in and help pay the debt. With more than USD4 billion in total debt, Vinashin went bankrupt in 2010. Former executives were arrested and thousands of workers lost their jobs.

Vinashin's collapse highlighted the risks investors take when investing in frontier markets. It caused a downgrade of Vietnam's sovereign rating and perhaps more importantly, cast serious doubt on the integrity of other government-guaranteed bonds, as local and foreign investors alike had reason for scepticism. Since renamed, the company continues to restructure its operations.

The vast majority (80%) of buyers of c-bonds are commercial banks, who typically hold them to maturity and seek their higher yields given the low yields of g-bonds. Foreigners are estimated to make up less than 5% of corporate bond investors. There is no liquidity in the secondary market.

Slowly but surely, an increasing number of companies are turning to the debt market. The biggest bond-related news of the year occurred in February 2016, when real estate developer Vingroup raised USD134.1 million (VND3 trillion) from a fixed-rate, unsecured senior bond offering backed by the Credit Guarantee and Investment Facility (CGIF) of the Asian Development Bank. The five-year and ten-year bonds have annual coupon rates of 7.75% and 8.5%, respectively.[v] The proceeds from that one offering in the first quarter of 2016 exceeded the total from *all* corporate bond offerings in the same quarter a year earlier. Nam Long Investment, a real estate concern, issued approximately USD22 million in convertible bonds, while Rong Viet Securities, VNDirect Securities, and An Phu Irradiation are all planning debt sales,[vi] as are Son Hai Saigon Corp., SBT and BHS.[vii]

How did Thailand's c-bond market develop?

Thai corporations issued bonds totalling more than USD281 billion in 2015, more than fifty times that of their Vietnamese peers. Until 1997, Thai companies - like their counterparts in Vietnam today - were almost wholly reliant on bank loans for funding. As a result of the Asian financial crisis, banks saddled with non-performing loans and recapitalization needs severely curtailed lending, forcing companies to look at financing alternatives. Led by the Ministry of Finance, the Domestic Bond Market Development Steering Committee moved quickly to meeting its goal of enhancing funding sources and investment alternatives in the market, leading to a "better distribution among bank financing, equity financing through the stock market, and debt financing through the domestic bond market." Existing laws and regulations were quickly reformed to facilitate the formation of a functioning corporate bond market, which has shown steady growth over the past seven years.

Sources: "The corporate bond market in Thailand," Ruengvirayudh and Panyanukul, Bank of Thailand, 2006; Thai Bond Market Association, statistics; "What's behind recent trends in Asian corporate bond markets?," DeutscheBank, January 2014

What's holding back the market?

There are a number of barriers that are stymieing the establishment of a real, functioning and liquid bond market:

With help from the IFC, a trading platform is under development and could launch in Q1 2017.

- Lack of infrastructure. The Hanoi Stock Exchange and the Ministry of Finance are working on launching a bond-trading platform that could start operating as early as the first quarter of 2017.[viii] This platform, which will connect to the ASEAN +3 markets of Singapore, Malaysia and Thailand, is being developed in part with funding and counsel from the International Finance Corporation (IFC).
- Subpar corporate governance and disclosure. Vietnam ranked last among the six largest ASEAN countries for corporate governance[ix], with significant

Comparison of recent bond issues

Terms & Conditions	Masan Group	Vingroup
Amount	~USD29.1 million	~USD30.7 million
Type	Straight bond, collateralized	Straight bond, collateralized
Interest rate	Fixed 12 month deposit rate + 3%	Fixed 6 month deposit rate + 3.5%
Issuance date	Nov 2015	Sep 2014
Maturity	Nov 2020	Sep 2019
Security	• Shares of Masan Consumer Company (MSC), valued at VND 88,384/share, to be revaluated every 6 months. • Loan to collateral ratio: 83.33%	• Land use rights, assets and other rights of two resorts • Loan to collateral: 70%
Use of proceeds	Capital restructure and business expansion	Debt refinancing

concerns about the level, accuracy and timeliness of information some companies disclose to investors and the public. Without a greater degree of transparency into companies' operations, investors are likely to remain somewhat hesitant about c-bonds.

Better governance, independent local rating agency, less reliance on banks needed before a real c-bond market takes shape.

- Lack of a local rating agency. Vietnam's nascent credit culture has not yet really called for ratings. While large corporations can (and some have) seek a credit rating from one of the "big 3" global firms, most are unlikely to do so for a number of reasons, namely whatever rating they ultimately receive will make the sale of c-bonds too expensive. Three years ago, the government announced a plan to establish a local rating agency and yet none exists today. There are concerns among some people about how large corporations – many of them owned by the state – would react to a less-than-positive rating. Further, the government's plan to establish such an agency calls into question the impartiality of such an organization. Would state-owned enterprises be treated differently than private ones? Would there be external pressures to issue a particular rating? While rating agencies can be imperfect, their independence is important.

- Bank loans are relatively easy to obtain. Companies and banks have a high level of comfort with loans, while bonds can be more complex. Furthermore, in the current interest rate environment, loans are fairly inexpensive while bonds are more costly.

While a trading platform may be up-and-running in the near-future, some of the other issues above, corporate governance and preferences for loans in particular, will take longer to change. Until they do, we believe that the development of the c-bond market will be impeded.

Conclusions

C-bond issuances are increasing, but we believe it will take a few more years to achieve a robust market.

Vietnam's corporate bond market is beginning to show some signs of life, yet another indication that the country's economy is developing in a sustainable away. In our view, however, there remains a fair amount of work to be done in order for corporate bonds to become a vibrant part of Vietnam's financial market. We believe that it will likely take another two-to-three years before all of the pieces are in place for corporate bonds to become a viable asset class for most foreign investors. Government bonds could be a better way to gain exposure to this security, although the opportunity for foreigners to do so is limited.

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[i] "Solid liquidity, falling rates boost demand for Vietnam bonds," *Reuters,* 30 May 2016
[ii] "State Treasury to issue VND40 trillion bonds," *Vietnam Net Bridge*, 9 July 2016
[iii] *Ibid.*
[iv] "Thai firms flock to bond market into arms of yield-starved investors," *Reuters*, 9 February 2016
[v] "Vietnam's Vingroup raises $134 mln via domestic bonds," *Reuters*, 23 February 2016
[vi] "Vietnam's biggest developer gives jolt to dormant bond market," *Bloomberg*, 18 April 2016
[vii] May 2016 and June 2016 monthly reports, Vietnam Bond Market Association
[viii] "Vietnam plans first corporate bond platform to meet debt demand," *Bloomberg*, 25 February 2016
[ix] "Vietnam's poor governance a danger to equity market," *Vietnam Net Bridge*, 15 June 2016

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