# Frontier Markets: Traveling through the Mekong Region

*January 2015*

Oliver Bell, Portfolio Manager, Middle East & Africa and Global Frontier Markets Equities Strategies



## EXECUTIVE SUMMARY

The Greater Mekong Region designates a development project formed by the Asian Development Bank in 1992 that brought together the six states of the Mekong River basin, namely Cambodia, Laos, Myanmar, Thailand, Vietnam, and the Yunnan Province in China. Investor interest has increased markedly in the past few years, and Foreign Direct Investment (FDI) inflows to countries such as Myanmar, Cambodia, and Vietnam have risen notably.

In this Price Points, Oliver Bell, portfolio manager for T. Rowe Price's Middle East & Africa and Global Frontier Markets Equities Strategies, highlights why he is excited by this area of Asia, especially Vietnam.

## Vietnam—Follow the Ho Chi Minh Trail

In my travels with the frontier markets team, we have been especially encouraged by our recent visits to Vietnam. After a slowdown, the country's economy has stabilized, prompting investor sentiment to improve and money to flow back. The various indications include rising business confidence, a foreign currency ratings upgrade, and overwhelming demand for Vietnam's recent sovereign bond offering (over 10-times oversubscribed). Meanwhile, the official real gross domestic product forecast for 2015 has been raised to 6.2% from a targeted 5.8% in 2014. Most importantly, the government and central bank seem to be making the right decisions this time around. They are acting in a more technocratic way by forcing banks to properly recognize non-performing loans (NPLs) and are also pushing through state-owned enterprise (SOE) reforms.

## Push and pull with China

China has a large impact for many frontier markets in Asia, and Vietnam is no exception. We can probably explain this trend as being the result of two key influences—one more of a push and the other more of a pull. The push factor is that cost inflation in China has been substantial over the past decade, and this is pushing more production and manufacturing to frontier countries. However, it is important to recognize that what is happening has less to do with manufacturing closing down in China and more to do with incremental investment moving elsewhere. Primarily, we have seen this in textiles/apparel and in electronics assembly. While the main manufacturing centers are still in China, they are being actively encouraged by their customers to put incremental investment in Vietnam, Cambodia and other parts of the region.

The resulting benefits are diversification away from concentrated China risk, lower manufacturing costs (wages are approximately 50% less in Vietnam and 75% cheaper in Cambodia), and potentially lower corporate tax rates. Cambodia has waived the corporate income tax for garment manufacturers for the first five years, while in Vietnam, high-value-added manufacturing industries such as electronics and healthcare pay a 10% corporate tax instead of the standard 22%.

Samsung Electronics, already the single-largest exporter in Vietnam, recently announced a US$3.0 billion investment in Vietnam as it plans to build another factory near its current one in the eastern province of Thai Nguyen, close to the capital, Hanoi. (The announcement came just a month after Samsung Electronics revealed plans to build a US$560 million factory in Ho Chi Minh City, where it intends to make TVs, washing machines, and air conditioners.) The US$3 billion investment figure is the maximum amount that can be invested during a certain period, but it takes its total investment in Vietnam to US$5.5 billion. By 2015, Samsung expects that up to 40% of its mobile handsets will be shipped from Vietnam.

One pull factor is that many Southeast Asian nations have high rates of economic growth and large populations—so large and increasingly wealthy addressable markets. Vietnam's population is approximately 93 million, Thailand 67 million, Myanmar 53 million, Yunnan Province 46 million, while Cambodia has 15 million residents. Companies can put production closer to their customer base in these new markets. The other pull factor is that companies from more mature Asian economies are seeking new growth opportunities elsewhere in the region.

## Moving up the value chain—We can do it too!

Although manufacturing remains a crucial part of Vietnam's economy, we sense that the best time for low-end manufacturing in Vietnam lies in the past. Due to high labor requirements and environmental concerns, traditional manufacturing sectors such as textiles are not strongly encouraged by the government.

Instead, the government now favors high-value-added industries such as electrical and electronics, healthcare, education and environmental and energy efficiency technologies. As mentioned, it grants a preferential corporate tax rate to these sectors, leading to an increasing shift in Vietnam's exports from low-end manufactured goods to higher-end electronics. Mobile phones have recently overtaken textiles as Vietnam's largest export.

Vietnam is also being proactive with its free trade agreements (FTAs). It is in the middle of finalizing an FTA with the European Union and South Korea, its second- and fourth-largest trading partners, respectively, with the aim of concluding negotiations by the end of 2014. This should be a further catalyst for attracting FDI, facilitating more supply chain networks, and making Vietnam more competitive.

## Vietnamese banking sector: A "levered" play waiting to happen

Currently, the banking sector is very fragmented—state-owned banks have 40% — and only one bank has double-digit market share. However, banks are now starting to own up to NPLs, which is encouraging. This means that bad debt provisioning will be higher in the near term, but, with the economy already rebounding, we have identified through our research and discussions with banks that underlying growth is starting to accelerate. This, however, is being masked by the current high provisioning and thus will not translate into strong earnings growth for a couple of years.

In general, though, we see financials as a good area for investment. Financials can, in some respects, be considered a "levered" investment linked to an underlying economy. A banking system operating within a growing economy with controlled NPLs is likely to be a good starting point if you wish to identify growing, profitable banks. We see many such examples in Vietnam and other frontier Asian markets.

Additionally, the banking systems in many of these countries have been through a crisis in the past 20 years. Having learned from the painful experience of excess leverage and a severe bad debt cycle, lending practices have been improved, and banks, therefore, tend to operate on a more traditional basis. Simplistically, most concentrate on taking deposits, making loans to consumers and businesses, and processing transactions; this model can been supportive of profitability, if well-managed. The valuations for these banks are also favorable.

## Challenges for Vietnam and the region as a whole

Against this positive backdrop, there are challenges that Vietnam and other areas of The Greater Mekong Region need to address, both in order to maintain the high FDI inflows they continue to enjoy, and to encourage stock market investment. These include:

- Lower liquidity/foreign ownership restrictions
- The need to restructure large state-controlled corporations
- Poor infrastructure (e.g., roads, rail, port, power)
- Under-developed local supply chains and inefficient logistics
- Rising costs—This is particularly true as Vietnam moves up the value chain
- Lower worker efficiency—Many companies have reported lower productivity in South East Asia partially offsetting lower wages
- Language can also be a barrier

Faltering attempts at equitization in Vietnam have also been disappointing. The long-awaited privatization program finally kicked off in 2014, with the sale of stakes in apparel-maker Vinatex in September and Vietnam Airlines in November. However, the stakes offered were small and unlisted, and, therefore, foreign participation was non-existent. Given the lack of transparency in the process, it was a missed opportunity to bring about transformational improvement in SOE performance. We hope this will change going forward.

## Winners and losers: Great opportunities for stock pickers

In terms of valuations, equity multiples in Vietnam are only slightly ahead of other frontier markets as the market has outperformed on the back of positive macroeconomic news. It trades on a P/E of 13.5x and a P/B of 2.0x.[1] However, currently there are areas of the market where earnings are at cyclical lows, and we expect those to rebound as the economy continues to pick up.

With all frontier markets there are winners and losers. Identifying a theme or a trend does not necessarily make a successful growth investment. Stock returns within the same country and industry can exhibit notable dispersion. Therefore, it is important to spend a great deal of your research figuring out who really is winning in these marketplaces. This will help to refine stock-picking ideas.

Overall though, Vietnam and other markets in the Asian frontier region are becoming more important to investors. Positive demographics, low penetration levels in consumer sectors, and poorly-developed banking systems provide a robust backdrop for investing. The region remains a relatively high-beta area compared with developed markets, but careful stock selection can help to mitigate some of the risks and potentially reap significant long-term rewards for experienced investors.

[1] Source: Bank of America Merrill Lynch as at October 31, 2014

## IMPORTANT INFORMATION

This document, including any statements, information, data and content contained therein and any materials, information, images, links, sounds, graphics or video provided in conjunction with this document (collectively "Materials") are being furnished by T. Rowe Price for your general informational purposes only. The Materials are not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the Materials and in certain countries these Materials are only provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction. Under no circumstances should the Materials, in whole or in part, be copies, redistributed or shown to any person without consent from T. Rowe Price. The Materials do not constitute a distribution, an offer, an invitation, recommendation or solicitation to sell or buy any securities in any jurisdiction. The Materials have not been reviewed by any regulatory authority in any jurisdiction. The Materials do not constitute investment advice and should not be relied upon. Investors should seek independent legal and financial advice, including advice as to tax consequences, before many any investment decision.

Issued in Australia by T. Rowe Price International Ltd ("TRPIL") (ABN 84 104 852 191), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. TRPIL is exempt from the requirement to hold an Australian Financial Services license ("AFSL") in respect of the financial services it provides in Australia. TRPIL is authorised and regulated by the UK Financial Conduct Authority (the "FCA") under UK laws, which differ from Australian laws. For Wholesale Clients only.

Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services. T. Rowe Price (Canada), Inc. is not registered to provide investment management business in all Canadian provinces. Our investment management services are only available for use by the Accredited Investors as defined under National Instrument 45-106 in those provinces where we are able to provide such services.

Issued in the Dubai International Financial Centre by TRPIL. This material is communicated on behalf of TRPIL by the TRPIL Representative Office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

Issued in the EEA by T. Rowe Price International Limited ("TRPIL"), 60 Queen Victoria Street, London EC4N 4TZ which is authorised and regulated by the Financial Conduct Authority. For Qualified Investors only.

Issued in Hong Kong by T. Rowe Price Hong Kong Limited ("TRPHK"), 21/F, Jardine House, 1 Connaught Place, Central, Hong Kong. TRPHK is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

Issued in Japan by T. Rowe Price International Ltd, Tokyo Branch ("TRPILTB") (KLFB Registration No. 445 (Financial Instruments Service Provider), JIAA Membership No. 011-01162), located at GranTokyo South Tower 7F, 9-2, Marunouchi 1-chome, Chiyoda-ku, Tokyo 100-6607. This material is intended for use by Professional Investors only and may not be disseminated without the prior approval of TRPILTB.

Issued in New Zealand by T. Rowe Price International Ltd ("TRPIL"). TRPIL is authorised and regulated by the UK Financial Conduct Authority under UK Laws, which differ from New Zealand laws. This material is intended only for use by persons who are not members of the public, by virtue of section 3(2)(a)(ii) of the Securities Act 1978.

Issued in Singapore by T. Rowe Price Singapore Private Limited ("TRP Singapore"), No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. TRP Singapore is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

Issued in Switzerland by T. Rowe Price (Switzerland) GmbH ("TRPSWISS"), Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

T. ROWE PRICE, INVEST WITH CONFIDENCE and the Bighorn Sheep design are, collectively and/or apart, trademarks or registered trademarks of T. Rowe Price Group, Inc. in the United States, European Union, and other countries. This material is intended for use only in select countries.

2014-GL-1138
12/14