Vietnam is perfectly positioned geographically to take advantage of the explosive growth in Chinese consumers for the next decade. However, the current condition of the Vietnamese economy and the relatively small number of Chinese tourists coming to Vietnam might make potential investors concerned. In this month's report, we take a look at Vietnam's coast as a potential investment opportunity and whether now is the right time to invest. With so many non-market factors artificially raising the cost of capital within Vietnam, those with less expensive sources of financing may find the

# Vietnam's Coastal Tourism Growth is Inevitable: Why, Where and When to Enter the Market

## Part III - When

## Why the Cost of Debt is Creating a Buying Opportunity in Vietnam's Coastal Tourism Industry

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**MGT Management Consulting**

**Quantify Your Strategy**

*The Vietnam Resort Report* is a paid monthly newsletter for stakeholders and potential investors in Vietnam's coastal tourism industry. Subscriptions are $100 USD for a year. To subscribe, send an email to info@mgtmanagement.com

# Why the Cost of Debt is Creating a Buying Opportunity in Vietnam's Coastal Tourism Industry

### Introduction

The questions of why and where to invest in Vietnam were addressed in the first two parts or our research, now we will discuss the issue of when. Specifically, is now a good time to invest in a Vietnam coastal tourism project. Investment decisions must include many considerations and many trade-offs, but in the end, the decision is whether future cash returns on the investment are greater than the cost of capital required. **An investor receiving a higher price for their contributed capital than the risk associated with that investment, will receive higher than required returns.**

We feel temporary non-free market factors within Vietnam's debt market has decreased the supply of capital to tourism projects, causing a rise in the price of money. Obviously if the price of money is artificially and temporarily increased, those who have the money are presented with a buying opportunity.

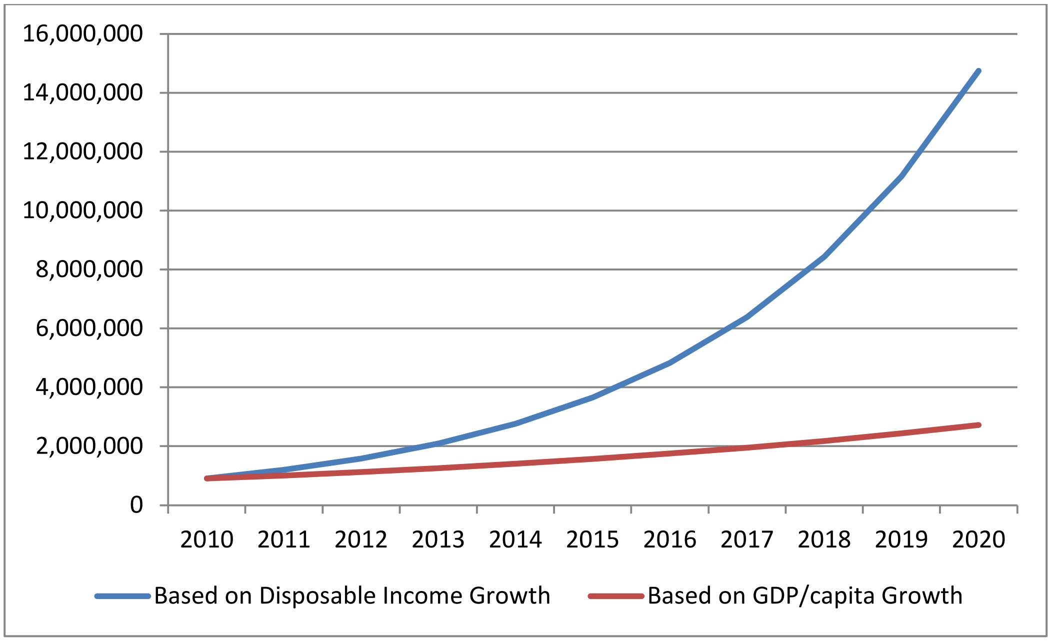
The purpose of this report is to draw attention to the non-market causes of the high cost of debt financing within Vietnam's banking system. We also examine the surprising new proposed draft of Vietnam's Central Government's amendment to the 2003 Land Law which, if approved, goes into effect in the 2nd quarter of 2013 and could reduce some of the factors driving up the cost of debt. Finally, we'll mention some considerations to make before investing.

Theoretically, all projects that have a positive discounted cash flow (DCF) valuation should be undertaken. In practice we understand investors have a finite amount of capital and must choose among all possible investments. The scope of this paper is to simply explain why we think pricing for supply of money in Vietnam is currently in a non-equilibrium position; each investor must determine if it is enough of a difference to warrant allocating their capital to Vietnam's coastal tourism industry.

### Cost of Capital and the Projected Demand Curve

Remember in Part I of our series, we projected the demand curve of Chinese tourists to grow exponentially over the coming ten years, as China's middle-class grows.

**Graph 1: Projected Demand Curve of Chinese Tourists to Vietnam**[1]




The exponential rate of growth in the demand curve emphasizes the importance of lower cost of capital in Vietnam's resort projects. We ran three different growth rates in occupancy for a resort model we created for a client, to see the difference in return rates.

**Table 1: Rates of Return for Various Demand Curves**[2]

| Type of Demand Curve | MIRR |
|---|---|
| Constant Demand | 35.6% |
| Linear Growth | 19.8% |
| Exponential Growth | 17.6% |

*MIRR = Modified Internal Rate of Return where excess cash is re-invested at 5%.*

Clearly, existing projects with high constant demand have much greater returns. But exponential growth compared to linear growth also makes a difference in returns for new projects. In the example above, a resort with a weighted aveage cost of capital of 18% would be built if linear growth is projected, but declined if growth rates were forecasted as exponential.

## Cost of Debt in Vietnam

The cost of capital for a project is the weighted average of the cost of debt and the cost of equity. In nearly every situation, the cost of debt is lower than the cost of equity for the obvious reason that debt has priority if a company needs to be closed. Also, debt can be assigned specific assets as a guarantee for repayment.

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[1] MGT Management, Vietnam's Coastal Tourism Growth is Inevitable, Part I

[2] Assuming 100 key resort for 10 years of returns. Constant demand was 80% occupancy, linear demand began at 40% and grew to 80% over 10 years, and Exponential Demand went from 40% to 80% with 8% year-on-year growth.

What we are seeing is Vietnamese tourism projects being financed with a much higher percentage of equity than debt. This makes no sense unless non-market factors drive up the cost of debt or eliminate it as a consideration. In a perfectly competitive market, the price of debt (borrowing interest rate) is determined by supply and demand. Therefore, any non-free market factors that artificially decrease supply will move the equilibrium price up or down to what it should be by shifting the supply curve.

One word of caution about the next section; MGT Management Consulting is not a legal firm and we do not want to represent ourselves as experts on Vietnam's incredibly complex banking and land laws. Before making any investment decision, proper legal council should be consulted. Whether we are 100% accurate on specific regulations or not, we feel our general argument that the following issues increase the cost of money to those who need capital, is correct.

1. **Government Regulations**
    1. *Land Rights and Banking Regulations*

       As a communist country, land in Vietnam is officially owned by "the people". This means the Central Government has the power to allocate land to companies and individuals as it sees fit. Coastal beach land for resort use is usually granted a 50 year lease in the form of a Land Use Rights Certificate (LURC). While several types of LURC exist, resort owners typically pay a land lease "rent" annually. This amount can vary depending on the province and other factors. Because the policies have only been enacted for a relatively short period of time, it is not entirely clear what happens after the 50 years is completed. The general feeling is that as long as the land is being used for the stated purpose, it will be re-allocated to the same company.

       A significant issue that arises from state land ownership is that the land (or the LURC) cannot be mortgaged at foreign banks, including the foreign banks that are registered to do business in Vietnam. In fact, the buildings on the land cannot be mortgaged or used as collateral in foreign banks, either. This severely limits the options for new projects without operating income, to raise capital. As you will see below, Vietnamese banks are seldom an option either. Even if the company operating from within Vietnam were able to find a lender outside of Vietnam willing to make a loan, the company must register the loan with the State Bank of Vietnam (SBV) which is a very complicated process.

       That leaves equity partners as the only means of obtaining financing, resulting in higher prices for equity than if more options were available to the developer.

    2. *Macro-Economic Policies*

       At the beginning of 2012, the Vietnamese Government decided to fight high inflation by having banks limit lending to projects that were not involved in the export of manufactured goods. This policy accomplished the desired effect, but it severely affected the real estate and land development market. Months after the policies were rescinded, a backlog of projects needing financing still exist.

2. **Banking System Inefficiencies**

A little over 100 commercial banks are registered in Vietnam with about half being foreign banks licensed to operate in the country. As mentioned above, foreign banks operating in Vietnam are not allowed to accept LURC or assets built on the land as collateral for a loan.

1. *Lending to State Owned Enterprises*

Unbelievably, Vietnam's SOE's have not been required to publish financial statements. Determining whether the massive amounts of loans these companies receive are inefficient is not possible without knowing the returns on investment, but we feel fairly confident stating that this capital allocation is not efficient. During 2007-2008, credit was loosened and a disproportionate amount of it went to the SOE's because of the incestuous relationship between banks, government, and SOE's. Four years later and several of the largest SOE's are billions of dollars in debt, their directors are in jail, and the amount of non-performing loans on the books of banks is not known.[3]

2. *Lending to Director's Companies*

Another shocking characteristic of Vietnam's banking system is the lending from the banks to companies owned by the bank's directors and major shareholders. In a recent interview, the Governor of the State Bank of Vietnam said that at some Vietnamese banks, between 70 and 90 percent of the loans are made to the companies controlled by the banks' shareholders.[4] That doesn't leave much available capital for other projects.

3. *Financing Vietnam's Boom and Bust Culture*

Based on our experience, observation, and research, Vietnam's culture is one where successful business models are copied over and over. In agriculture, successful farm crops in a region one year, encourages nearby farms to switch crops, resulting in over-supply and lower prices for that crop the next year. The negative effect is much greater for real estate, where production takes longer than a single growing season. For the period between 2005 and 2008, residential apartment buildings were the "hot" investment in Vietnam. Now, Dragon Capital estimates that Hanoi and HCMC have 35,000 unused apartments and it will take over seven years for the inventory to clear. That represents more than $3 billion in frozen

[3] The number has been estimated at near 8%, but we feel this is a low estimate.

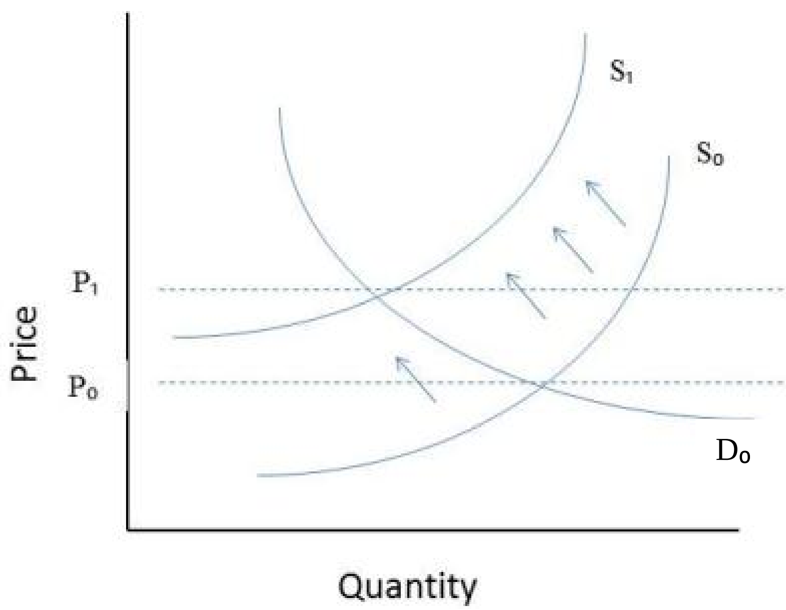
[4] english.vietnamnet.vn/fms/government/49882/governor-declares-war-on-the-banking-interest-group.html

> money, much of it financed by Vietnamese banks. When looking at 69 real estate companies, Professor Dr. Tran Dinh Thien - Director of the Institute of Economics of Vietnam - estimated the 69 companies had $3.2 billion of debt on their books, about one third of it short term. According to Mr. Thien, those companies EBIT can cover only a third of the annual interest. [5]

Going back to the first day of any economics class, we can see the effects of these shocks to the supply of money within Vietnam. The supply of money is both artificially constrained by government regulations and the misallocation of bank lending within Vietnam. The supply curve shifts from $S_0$ to $S_1$, causing the price of money to rise from $P_0$ to $P_1$.

Private equity investing in Vietnamese projects should receive $P_0$ rate of return, but because of all the problems in Vietnam's banking system, they are able to charge the borrower up to the $P_1$ rate.

**Graph 2: Change in the Price of Money**




**Selling Capital In Vietnam**

We have shown that the price of money in Vietnam is higher than what it would be in a perfectly competitive free market. But with all the problems listed above, is this really a good opportunity for those with capital to buy into a resort project[6]? We feel there are several other reasons why it is.

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[5] vccinews.com/news_detail.asp?news_id=27136&parent_id=0&cate_id=13

[6] Using the terms from the section above, the question should actually be "is this a selling opportunity" for those who have capital.

1. **Amendment to the 2003 Vietnam Land Law**
   Recently, a new draft of the amendment to the 2003 Vietnam Land Law was circulated for comments. If the draft is approved as is in May 2013, then significant changes in the ability for foreign invested companies to access capital may be on the way. If passed as is, we feel it will reduce the price of money which increases the cost of investing. In other words, the Supply Curve shown in Graph 2 will begin to move back towards $S_o$. For those who invest now, there could be an immediate jump in value of their investment.

   The first major change is that foreign invested companies will be allowed to mortgage the land use rights and buildings with foreign banks. However, some ambiguous terms were included, such as requiring approval from the government and having a long term investment horizon.

   The second major change is the possibility that joint ventures will not have to pay land use fees or land leasing fees. This saves developers hundreds of thousands of dollars or more.

   The third major change is that land clearance fees (the money paid to current users of the land when the government helps a developer receive the LURC), will be based on market values that are updated annually. It will, in effect, add clearance costs to developers.

   We feel that when passed, the first two changes will instantly add value to coastal beach land by making capital cheaper and projects cost less. The third change will also increase the value of land that has completed clearance because it raises the cost on alternative locations.

2. **Characteristics of Coastal Tourism**
   We mentioned the boom and bust cycles of the Vietnamese economy. One advantage of investing in coastal tourism is that supply of good beach land is limited geographically. With over 3,000 km of coastline, it may seem that Vietnam has a plentiful supply. Nevertheless, we pointed out in Part I that Mexico has three times this amount. Also, the expected growth in Chinese middle-class consumers is projected to grow by three times the amount of the U.S. middle class during the 1950's to 1970's. In the next ten years, we expect exponential growth in the number of foreign tourists staying in Vietnamese beach resorts, but the amount of good coastline will stay the same.

3. **Variables Affecting Tourism Demand**
   While Vietnam's slowing growth rates should cause many concerns for investors in Vietnam, we pointed out in Part I that a widening discrepancy in prices actually has a positive effect on tourism. The Mexico comparison determined the price variable co-efficient to be (-0.50), meaning as real prices in Vietnam fall 2% compared to China (and possibly Russia and other nearby countries), we expect to see a 1% growth in visitors.

> What is a much greater concern is the falling growth rate of Chinese income. The gap between Vietnam and Chinese growth still remains at about 2% as forecasted, but we know from our Mexico comparison that an increase in income has about two and a half times greater effect on tourism demand than price differences. Without the growth in the Chinese middle class, Vietnam is not an attractive investment.

**Cost of Equity**

In order to receive a premium on their investment, investors must first determine the real cost of capital required by a specific project. Unfortunately, determining the correct cost of equity for specific projects in Vietnam is very difficult. Unlike many developed countries, public companies and their limited reporting make it difficult to disaggregate specific information on tourism projects. Using the Capital Asset Pricing Model simply does not work well in Vietnam, particularly for tourism projects.

We recommend using the Build-out Method for determining equity pricing, but with modifications. Certain aspects of country risk are lessoned for the tourism industry. For example, high-end resorts typically quote prices in U.S. dollars. Many of the costs such as wages are also based in U.S. dollars. This significantly reduces inflation and currency risk, as inflation in Vietnam is typically followed by the devaluation of the Vietnam Dong versus the dollar. If costs rise 10% but the Vietnam Dong loses 10% of its value versus the dollars, the effect to a resort business is much less than for other commercial real estate such as apartment buildings.

Another example of reduced country risk in the coastal tourism industry is the country's economic volatility. Vietnam's economy is very volatile, but foreign tourism expenditures have been fairly steady (with the exception of regional issues such as SARS).

Appendix A has a table listing many factors when considering country risk.

**Choosing Investments in Vietnam**

Our recommendation is to invest in specific coastal resort projects, not real estate developers who have diversified holdings. Vietnam's overall economy will have difficulties in the coming years and there is oversupply in both apartments and office buildings. Our expectation is that Chinese investors will come with the Chinese middle-class tourists. This represents the most likely exit strategy for any non-resort operator that wants to invest in Vietnam. Low operating profits in the short term could still lead to high capital gains in the medium term.

Make sure the project has completed land clearance. Recently there have been a lot of issues in the north, where people are refusing to leave the land for the amount that is being offered. This forced the government to include the market pricing for land clearance in the new amendment. We are also seeing projects that have spent years clearing land, suddenly finding that more people have come back and begun settling on it again.

**Conclusion**

In Vietnam, non-market constraints and non-optimal allocation of debt reduced the total supply of capital available for projects shifting the supply curve of money and causing prices of all sources of capital to rise beyond what they would be in free market. Those "selling" other sources of capital now receive higher returns than what the free market would dictate.

In addition, the Vietnam Government is considering radically amending the 2003 Land Law enabling freer inflows of capital to Vietnam. These could have immediate positive impact to coastal development investors. Those who wait may have higher entry costs, particularly if the land has not been cleared.

Investors may not be seeing this opportunity if they are not computing the real cost of equity for projects. Vietnam tourism is not as inherently risky as many other commercial real estate investment in Vietnam. That must be factored into any analysis.

*MGT Management has had a presence in Vietnam for ten years, seven of those consulting for clients choosing locations for resort developments. We also specialize in creating discounted cash flow valuation models that are integrated into custom management accounting tools, budgets, and tracking reports based on value-added management practices. For more information, visit our website at* http://www.mgtmanagement.com/Reports_and_Research.html. *For questions or to be added to our mailing list, send to* info@mgtmanagement.com.