

WHY INDEX INVESTING IN FRONTIER MARKETS IS NOT ALWAYS A GOOD IDEA



**FLC FAROS – A CORPORATE
GOVERNANCE CASE IN VIETNAM
NOVEMBER 2017**

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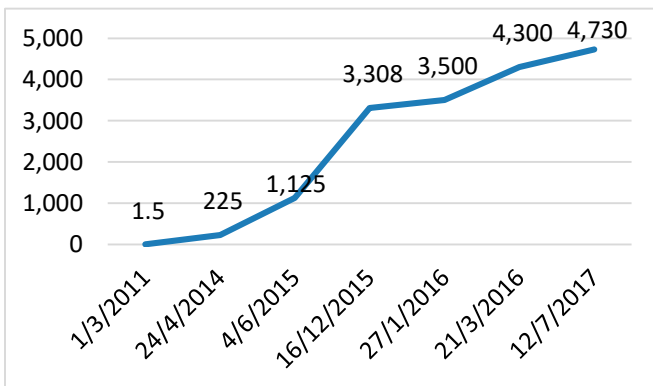
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FLC FAROS CONSTRUCTION JSC (ROS) A CASE STUDY

FLC Faros Construction JSC (ROS) is a new blue chip stock in Vietnam with a market cap of USD 3.8bn that has run close to 1,800% since its listing debut a little over a year ago. It is now the 7th largest company in Vietnam's stock market. ROS was included in the main ETF index FTSE Vietnam in April 2017 where it constitutes around 7.5% of the index. It also comprises 3.6% of the VN Index. Furthermore, ROS has even made it past MSCI's scrutiny and currently constitutes 0.8% of the MSCI Frontier Market Index. Despite all these indicators, Tundra has grave reservations about the company's corporate governance and believes there is a risk that the company might be virtually worthless. Let us briefly explain the basis for our misgivings:

1) Suspect capital raising, multiple warning signs. ROS was created in March 2011 with a charter capital of merely VND 1.5bn (USD 70k). Through 6 rounds of capital raising it skyrocketed to a market cap of VND 4,730bn (USD 210mn, or 3,153 times vs initial). (See chart 1). This was done through issuing shares to existing shareholders (new issuance of stock or bonus shares), except for the last share issue, which was a share swap with a related company. To further complicate matters most of the capital was used to lend to individuals and institutions via investment trust agreements, which in turn contributed to the capital. It is our understanding that, the borrowers, both individuals and institutions, are related to major shareholders of ROS. This information is supported by a report from an independent auditor (audit report 2015) revealing that a total of VND 3,332bn was used in this manner. This shows that ROS received money in share issues from investors who were then repaid via 'investment agreements.' ROS then gradually replaced this investment trust amount with long & short-term investments but all in companies that the key shareholders control, which amounts to the same thing. Few details are available about how these supposed investments are used and how the company will benefit.

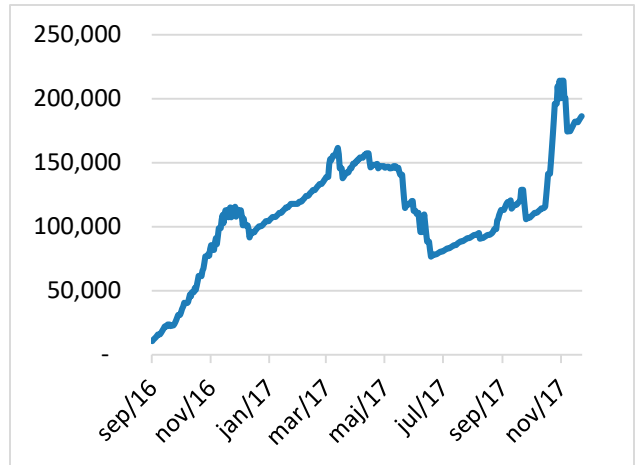
Chart 1: Paid-In Capital (VND billion)



Source: ROS company charter

2) We believe there is a very high risk the share price has been manipulated in order to sell overvalued shares to index funds and less knowledgeable investors. As the capital of ROS has changed hands among the related parties and insiders hold almost all of the shares (chairman and related), it is not difficult to push a share price up to whatever level is suitable to the insiders. The stock went through three months of straight limit ups to reach VND 104k/share (890%) at the end of 2016, and another 106% in 2017 (peaking at VND 214k). (See chart 2). The share price is now completely detached from any sort of fundamentals, trading at P/E 175 times and P/B 17.6 times, making it one of the more expensive stocks in the world. The goal seems evident: to sell as much as possible to (1) Exchange Traded Funds (ETFs) with around USD 1bn in AuMs and other passive funds that track index and who have to buy in regardless of fundamentals; and (2) retail investors who like to speculate on stock prices but may have limited knowledge of fundamental valuation methods. To date, the company has successfully sold 8.05 million shares to foreign ETFs and index funds, and a sizable, but unknown, amount of shares to retail investors. The higher the market cap grows, the higher weightage it will have in the benchmarks which in turn means more buying from ETFs and passive funds.

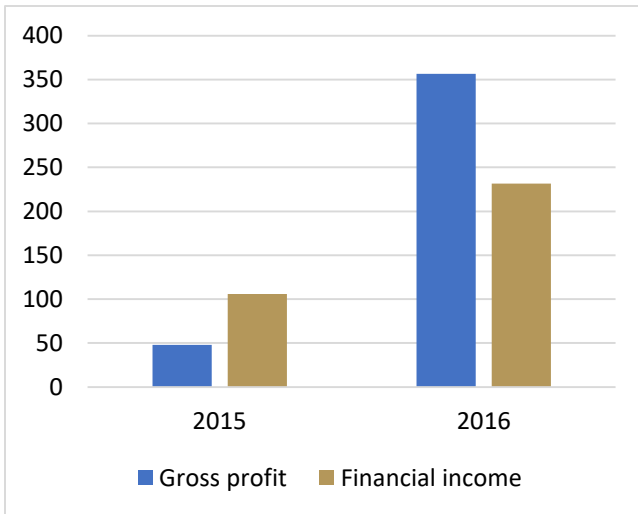
Chart 2: ROS Share Price (VND)



Source: Bloomberg

3) Vague business model and poor corporate governance. ROS was set up to act as the construction company of choice for the property projects that FLC JSC (FLC) develops, including residential property, hotels, resorts etc. across Vietnam. Both companies share the same chairman, who officially owns ~30% of FLC and 75% of ROS. The audit reports revealed that most of ROS' workload (if not all) is awarded by FLC and its related companies.

Chart 3: Gross Financial Profit vs. Income



Source: ROS audit report 2016

Outside of these contracts, ROS has a very limited profile in construction and does not appear to take on outside projects. In addition, there are a number of internal transactions between ROS and its related companies. The majority of the profitability comes from the interest of the investment trust agreements. In 2016, ROS reported a Net Profit of USD ~20mn while Interest income contributed USD 32mn. This means that if interest income was excluded, the company would have reported losses on its core business. In addition, a significant part of its earnings is in the form of receivables, not cash. The company has series of transactions with related parties (receivables, payables, advancements, investment agreement etc.). In short, this is a dependent business with a doubtful source of profit.

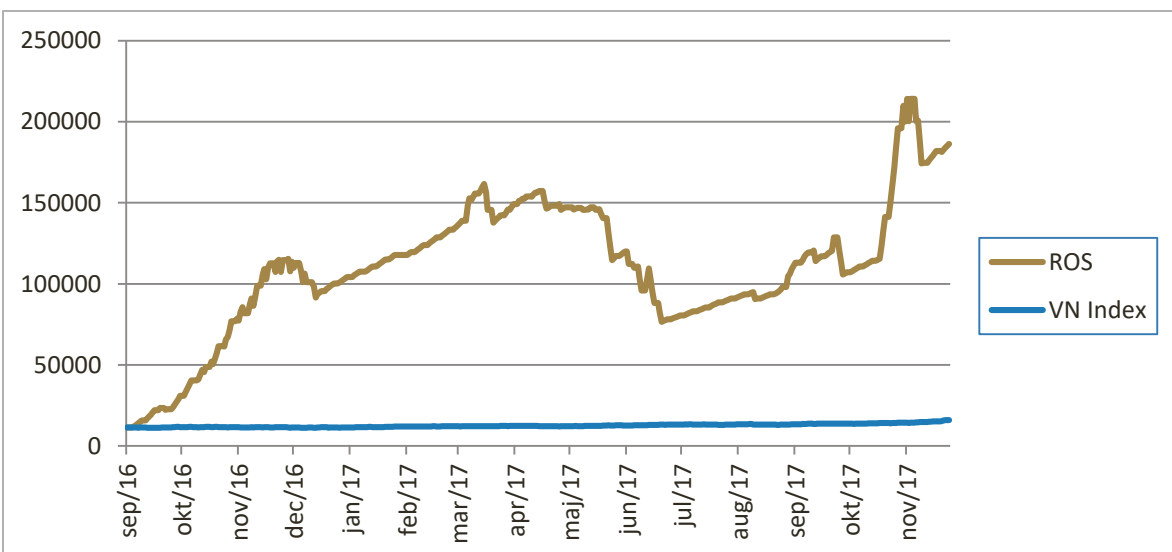
WHY INDEX INVESTING IS NOT ALWAYS THE BEST OPTION

ROS's share price manipulation has been heavily distorting the market index. As of November 20th, it has added ~1.5% to the FTSE Vietnam's performance (since April) and 4.2% to the VN Index performance YTD (or 14.2% to VN Index performance since September 2016). There is a significant probability risk that these gains may evaporate and stockholders face the risk of a virtually complete loss of capital. We believe that the questionable way ROS has become Vietnam's 7th largest company and included into important index benchmarks in Vietnam constitutes a risk to Vietnam's credibility as a capital market that should be addressed. We believe all active frontier markets fund managers like Tundra have an obligation to work towards improving transparency in the markets where we operate. (See chart 4).

ESG ANALYSIS IS BECOMING MORE SIGNIFICANT

All of Tundra's frontier funds are subject to a thorough ESG-analysis (including a range of environment, social and governance issues). Furthermore, we have two analysts dedicated to ESG related issues. A serious corporate governance issue like ROS' would be easily detected provided that a fundamental due diligence process of the investment was undertaken. As passive index capital plays an increasingly larger role in the world of financial markets it is essential to initiate a discussion on the responsibility assumed by Exchange traded funds, if any, before investing in companies where corporate governance issues are as severe as is the case with ROS. As a leading fund manager in frontier markets, with a strong focus on ESG analysis, Tundra would be happy to contribute its expertise in a broader discussion on how to avoid unnecessary setbacks for Vietnam's capital markets and for frontier markets as an asset class.

Chart 4: ROS vs. VN Index



Source: Bloomberg

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