

July 11th, 2017

TOUR DE VALUE



Team iiBV Tours the Global Valuation Landscape

TOUR DE VALUE: COUNTRY SPECIFIC RISK PREMIUMS

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DISCLAIMER

- The views expressed are my own and do not necessarily reflect those of any other individuals or organizations.

INTRODUCTION – ONE VIEW ON COUNTRY RISK PREMIUMS

- In most **emerging** market valuations, a “country risk premium” is added to the CAPM discount rate of an equivalent investment in a developed market. However, this is not only a flawed procedure, but it is also extremely difficult to gauge how country risk might affect the discount rate.
- This article is **proposed to appraise country risk mainly through its impact on projected cash flows**, leaving its **possible effect on the discount rate as a secondary consideration**.
- The main emphasis is on building a model where all relevant variables and risks are adequately integrated.
- Then a Monte Carlo simulation is performed to obtain a probability distribution for the present values of the firm or project.
- Finally, the discount rates selected by the analyst (however inaccurate) together with their corresponding expected present values are contrasted with the simulation’s results in order to make an educated decision
- *Source: A Practical Approach for Quantifying Country Risk*, Jaime Sabal, Professor of Finance, ESADE, GCG Georgetown University - *Universia* 2008 Vol. 2 Num. 3 ISSN: 1988-7116 .

KEY CONCERN

- Greater potential uncertainty for projections for emerging markets. Significant country specific risk factors should be addressed.
- Less uncertainty for developed markets given their greater integration with other developed markets and lower degree of idiosyncratic risk.
- See Damodaran's calculated country risk premiums on his website.
- Given the significant judgments associated with country risk premiums for developing emerging country discount rates, capturing risks in the expected cash flows rather than in the discount rate requires consideration. This is consistent with the FASB and IASB general perspectives as set forth in ASC 805 and IFRS 13.
- For emerging countries, with limited information on debt and equity returns, incorporating risks into the cash flows would seem appropriate.

TYPES OF RISKS FOR INTERNATIONAL INVESTMENTS

1. Financial
 - a. Currency volatility
 - b. Default / restructuring
 - c. Other
2. Economic
 - a. Inflation
 - b. Other
3. Political
 - a. Repudiation / expropriation
 - b. Other

COUNTRY RISK PREMIUM CHALLENGES

- In principle, incorporating a country risk premium in the discount rate is flawed for several reasons:
 - First, **not all projects and/or companies are equally exposed to country risk in every country.**
 - Second, whenever country risk is quantified as the yield spread between the relevant country government bonds and their “risk-free” equivalent (i.e. US T-Bonds), the **risk premium is contaminated with the risk of default of the developing country’s government.** Although there might be some linkage between the probability of default and country risk, this relationship tends to be quite tenuous for most business propositions.
 - . . . an acceptable proxy for country risk is generally hard to pinpoint
- *Source: A Practical Approach for Quantifying Country Risk, Jaime Sabal, Professor of Finance, ESADE, GCG Georgetown University - Universia 2008 Vol. 2 Num. 3 ISSN: 1988-7116 .*

DISCOUNT RATES AND CURRENCY OF PROJECTIONS

- Discount rate and currency of projections should be consistent
- Assume value opinion to be expressed in USD
 - Option 1
 - Local-currency cash flows should generally be converted to USD at the forward rates to appropriately address currency risk, and the discount rate should be based on USD denominated yields
 - Country risk premium should be included in the weighted average cost of capital ("WACC") to appropriately address systematic risks related to country-specific issues
 - (i.e., political, social or economic issues), which are not otherwise addressed in the cash flows.
 - Option 2
 - Use the local currency CF and discount rate.
 - Convert value indication using the spot exchange rate between local currency and USD.

METHODS TO ESTIMATE INTERNATIONAL COST OF EQUITY

1. Global CAPM
 - Beta measured using a world portfolio of stocks
 2. Single country version of CAPM
 - CAPM with all inputs from subject country
 3. Country Risk Spread Models
 - Include adjustment for relative risk free rates
 4. Relative Volatility Models
 - Uses U.S. CAPM and adds a relative volatility adjustment
 5. Erb-Harvey-Viskanta Country Credit Rating Model
 - Regresses country credit ratings from Institutional Investor
- Source: International Cost of Capital – How to price international country risk and use the *2015 International Valuation Handbook – Guide to Cost of Capital*, Roger Grabowski, Managing Director, Duff & Phelps, ASA Advanced BV Conference October 2015, Las Vegas, NV

DAMODARAN - 2017 ESTIMATED COUNTRY RISK PREMIUMS BY REGION

Region	Weighted Average: TRP	Weighted Average: CRP	Weighted Average: Default Spreads	Tax Rate
Africa	12.00%	8.31%	5.12%	27.91%
Asia	7.12%	1.43%	1.16%	26.68%
Australia & New Zealand	5.70%	0.01%	0.01%	29.76%
Caribbean	13.92%	8.23%	6.69%	24.50%
Central and South America	10.21%	4.52%	3.67%	31.09%
Eastern Europe & Russia	9.09%	3.40%	2.77%	18.97%
Middle East	7.50%	1.81%	1.47%	20.81%
North America	5.69%	0.00%	0.00%	38.93%
Western Europe	6.81%	1.12%	0.91%	26.36%
Global	7.08%	1.39%	1.13%	29.76%

Source: Aswath Damodaran, Ph.D, website. Information from January 2017

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DISCUSSION