Political risk and international valuation ☆

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ABSTRACT

Measuring the impact of political risk on investment projects is one of the most vexing issues in international business. One popular approach is to assume that the sovereign yield spread captures political risk and to augment the project discount rate by this spread. We show that this approach is flawed. While the sovereign spread is influenced by political risk, it also reflects other risks that are likely included in the valuation analysis — leading to the double counting of risks. We propose to use "political risk spreads" to undo the double counting in the evaluation of international investment projects.

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1. Introduction

When evaluating international investment projects, accounting for political risk remains an important challenge. Political risk refers to the risk that a foreign government action will negatively affect the cash flows of a company conducting an international investment. The theory on project valuation or capital budgeting, which we review in more detail in Section 2, is straightforward: the multinational corporation must assess the effects of political risk on expected cash flows and discount the expected cash flows

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at a discount rate reflecting systematic (not political) risk. In practice, it is difficult to quantify political risk (see Bremmer, 2005; Henisz and Zelner, 2010). Moreover, as the available political risk ratings are mostly subjective assessments of experts, it is difficult to incorporate them in a quantitative valuation analysis.

Instead, many textbooks and practitioners propose to account for political risk through an adjustment to the discount rate. That is, the investment analysis initially ignores political risk and forecasts the company's cash flows assuming that no political risk event will take place, but then applies an upward adjustment to the discount rate to reflect the political risk. The majority of such approaches make use of sovereign yield spreads to obtain market-based and forward-looking readings on political risk (see, for example, Damodaran, 1999, 2003; Mariscal and Lee, 1993).[1] The sovereign yield spread, or simply sovereign spread, is the difference between the yield on a bond issued by a foreign country in U.S. dollars and a U.S. Treasury bond of similar maturity. It depends, among other factors, on the probability of sovereign default and, conditional on default, the expected recovery value of a country's sovereign bond, and is therefore also referred to as country (credit) spread. Political risk is then incorporated into the valuation of an investment project by augmenting the project's discount rate by the country's sovereign spread. That is, the project's cash flows are forecasted in the absence of political risk events, which are then incorporated via an upward adjustment to the discount rate based on a country's sovereign spread.

The first contribution of our article is normative. We show that the standard sovereign spread procedure is flawed and tends to lead to costs of capital that are too high. This implies that use of such a procedure may decrease foreign direct investment (FDI) and lead to international capital mis-allocation. The implicit assumption in existing capital-budgeting methods is that sovereign spreads, to a large extent, fully reflect political risk. We show that this is false.

Building on an extensive literature examining the determinants of sovereign spreads, in general, and the recent work of Bekaert et al. (2014) (BHLS, henceforth), we decompose the cross-sectional and time series variation of sovereign spreads into four major factors: international economic and financial risk conditions, local macroeconomic conditions, bond market liquidity, and political risk. On average, less than a third of the variation of sovereign spreads reflects political risk. A cost of capital adjustment that simply "adds" the entire spread to the discount rate therefore double counts global systematic risk exposures, which should already be reflected in the discount rate. It further reduces the value of the project by including local macroeconomic conditions, which should be reflected in the expected cash flows as well as bond market liquidity, which is likely irrelevant to the value of the project.

We outline a new, alternative procedure to more accurately reflect political risk in a project's net present value (NPV). Specifically, we propose to use the concept of a political risk spread recently introduced by BHLS (2014), which essentially extracts the political risk component from sovereign spreads using available information in political risk ratings. This political risk spread can be used to infer the probabilities of a political risk event with which to adjust the expected cash flows. Under certain assumptions, a corrected discount rate adjustment can then be obtained by adding the political risk spread, rather than the full spread, to the usual discount rate.

Given the importance of NPV analysis for international investment decisions (see, for example, survey evidence in Graham and Harvey, 2001; Keck et al., 1998), it is crucial to properly account for political risk in corporate decision making. For example, Holmen and Pramborg (2009), surveying the capital budgeting techniques for FDI among Swedish firms, show that firms are less likely to use theoretically correct NPV approaches for investments in host countries with elevated political risk. The economic implications are large. In a practical example using recent data, we show that the cost of capital may be over-estimated by anywhere from about 2% to 4% using the standard sovereign spread procedure leading to a misallocation of global investment.

The rest of the paper is organized as follows. Section 2 defines political risk and surveys some standard approaches to account for political risk in international capital budgeting. We also outline our new approach. Section 3 briefly summarizes the data, and reports our empirical analysis of sovereign spreads which is the main input for our political risk adjustment. Section 4 then reviews market-based political risk spreads and demonstrates how to use them in political risk assessment. We also reflect on the largely unexplored issue of whether political risk is priced in international equity returns. Section 5 offers some concluding remarks.

2. Political risk and sovereign yield spreads

In this section, we provide a definition of political risk and review the theory regarding the incorporation of political risk into the capital budgeting process. We then analyze a number of practical approaches, most of which use sovereign spreads to adjust the project discount rate for political risk. Finally, we propose a new approach which overcomes the shortcomings of existing methods.

2.1. Political risk and the cost of capital

There is a large and growing literature on the effect of political factors on corporate valuations. This includes examining the impact of tax policies (McGrattan and Prescott, 2005; Sialm, 2009) and uncertainty regarding regulations and government policy

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[1] A large number of consultants promote the use of sovereign yield spreads, for example Price Waterhouse Coopers (see Ogier et al., 2004), TAC — Applied Economic and Financial Research (see Apotheker, 2006), and Zanders (see Boere, 2006), as well as investment banks such as Goldman & Sachs (for an overview, see Harvey, 2001). Duff & Phelps (2014), a leading vendor of cost of capital estimates in the U.S., provides an "International Valuation Handbook." For each market, several estimates are provided: the country-risk rating estimate following Erb et al. (1996), a sovereign spread adjustment, and a relative equity market standard deviation adjustment. Finally, the major international financial management textbooks such as Shapiro (2009) and Bekaert and Hodrick (2011) also mention the practice.