Country Risk Premiums and Pitfalls

Country Risk Premiums and Pitfalls

- Overseas investment implies additional risk.
- Overseas companies may have greater price and valuation volatility because of their country's economic, political and legal conditions
- This means that investors are likely to demand higher returns
- This brings us to the difficult question of Country Risk Premiums

Country Risk Premiums and Pitfalls

- Our starting point is work by Aswath Damodaran who has calculated Country Default Spreads and Risk Premiums
- You can find these here:
- http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/ctryprem.html

Country	Africa	Moody's rating	*Rating-based Default Spread*	*Total Equity Risk Premium*	*Country Risk Premium*
Abu Dhabi	Middle East	Aa2	0.44%	5.20%	0.48%
Albania	Eastern Europe & Russia	B1	3.98%	9.08%	4.36%
Andorra (Principality of)	Western Europe	Caa1	6.63%	11.98%	7.26%
Angola	Africa	Caa1	6.63%	11.98%	7.26%
Argentina	Central and South America	Ca	10.60%	16.34%	11.62%
Armenia	Eastern Europe & Russia	Ba3	3.18%	8.21%	3.49%
Aruba	Caribbean	Baa1	1.41%	6.27%	1.55%
Australia	Australia & New Zealand	Aaa	0.00%	4.72%	0.00%
Austria	Western Europe	Aa1	0.35%	5.10%	0.38%
Azerbaijan	Eastern Europe & Russia	Ba2	2.65%	7.63%	2.91%
Bahamas	Caribbean	Ba2	2.65%	7.63%	2.91%
Bahrain	Middle East	B2	4.86%	10.05%	5.33%
Bangladesh	Asia	Ba3	3.18%	8.21%	3.49%
Barbados	Caribbean	Caa1	6.63%	11.98%	7.26%
Belarus	Eastern Europe & Russia	B3	5.75%	11.02%	6.30%
Belgium	Western Europe	Aa3	0.53%	5.31%	0.59%
Belize	Central and South America	Caa3	8.83%	14.40%	9.68%
Benin	Africa	B2	4.86%	10.05%	5.33%
Bermuda	Caribbean	A2	0.75%	5.54%	0.82%
Bolivia	Central and South America	B2	4.86%	10.05%	5.33%
Bosnia and Herzegovina	Eastern Europe & Russia	B3	5.75%	11.02%	6.30%
Botswana	Africa	A2	0.75%	5.54%	0.82%
Brazil	Central and South America	Ba2	2.65%	7.63%	2.91%
Bulgaria	Eastern Europe & Russia	Baa1	1.41%	6.27%	1.55%
Burkina Faso	Africa	B2	4.86%	10.05%	5.33%
Cambodia	Asia	B2	4.86%	10.05%	5.33%
Cameroon	Africa	B2	4.86%	10.05%	5.33%
Canada	North America	Aaa	0.00%	4.72%	0.00%
Cape Verde	Africa	B2	4.86%	10.05%	5.33%
Cayman Islands	Caribbean	Aa3	0.53%	5.31%	0.59%
Chile	Central and South America	A1	0.62%	5.40%	0.68%
China	Asia	A1	0.62%	5.40%	0.68%
Colombia	Central and South America	Baa2	1.68%	6.56%	1.84%
Congo (Democratic Republic of)	Africa	Caa1	6.63%	11.98%	7.26%
Congo (Republic of)	Africa	Caa2	7.96%	13.44%	8.72%
Cook Islands	Australia & New Zealand	B1	3.98%	9.08%	4.36%
Costa Rica	Central and South America	B2	4.86%	10.05%	5.33%
Côte d'Ivoire	Africa	Ba3	3.18%	8.21%	3.49%
Croatia	Eastern Europe & Russia	Ba1	2.21%	7.14%	2.42%
Cuba	Caribbean	Caa2	7.96%	13.44%	8.72%

Country Risk Premiums and Pitfalls

- These are the steps Damodaran takes to determine a Country's Equity Risk Premium

Country Risk Premiums and Pitfalls

- 1 Find a country's credit (bond) risk rating
- e.g Brazil = Ba2
- Based on that rating determine the credit spread, which is the additional yield over a risk free investment
- e.g. Credit spread for Ba2 rating = 3.53%

Country Risk Premiums and Pitfalls

- To account for the additional stock risk over bonds, multiply the credit spread by the relative equity market volatility
- e.g. 3.53% credit spread x 1.25 relative equity market volatility = 4.41% country risk premium

Country Risk Premiums and Pitfalls

- Add the Country Risk Premium to the mature market risk premiums (obtained from the S&P 500 risk premium)
- e.g. 4.41% country risk premium + 5.23% mature market risk premium

Country Risk Premiums and Pitfalls

- The resulting value is the country equity risk premium
- e.g. 9.64% country equity risk premium

Country Risk Premiums and Pitfalls

- How do we apply this to companies?
- One simplistic way is to apply it directly to the company on the assumption that all the companies in that country are exposed to that country's risk and volatility

Country Risk Premiums and Pitfalls

- But companies may have international operations - so we could calculate the risk premia for each country the company operates in and take a weighted average based on revenues?

Country Risk Premiums and Pitfalls

- This may not be entirely helpful
- Small increases in risk premiums make significant differences to valuations
- Damodaran's approach may seem a little arbitrary and potentially unfair to those countries

Country Risk Premiums and Pitfalls

- I don't have an answer for this other than to recommend that your proceed carefully…
- Consider the following issues…

Country Risk Premiums and Pitfalls

- What adjustments do you need to make for currency rate fluctuations over time?
- How has inflation impacted returns in the country in question?
- What is the comparative return on that country's government 10 year bonds - a proxy for the local risk free rate?
- Where exactly does this country risk come from?

Country Risk Premiums and Pitfalls

- In particular, PWC assess country risk by comparing the spread on sovereign debt yields between the country in question and a developed country such as the US or the UK
- PWC publish this information quarterly

Country Risk Premiums and Pitfalls

- The Equity Risk approach compares country risk by reference to the relative volatility of equity market returns between the country in question and a developed country.

Country Risk Premiums and Pitfalls

- To summarise, there is no right or wrong approach
- I believe that you have to exercise judgement about the additional default or expropriation risk associated with another country
- One thing is certain, do not just accept a Country Risk Premium - challenge it and make sure you understand how it has been calculated or assumed.

Country Risk Premiums and Pitfalls