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Assessing Risk in Emerging Markets

Despite lucrative opportunities in frontier locations, operating in a politically or economically unstable country carries potentially devastating personal and business risks. As current events show, terrorism honors no boundaries.

By Ann Moline

The draw of cheap labor and big profits can be risky business for companies eyeing emerging markets.

In Indonesia, for example, the U.S. State Department has warned about "acts of intimidation and violence directed at American companies." Ethnic violence in the northwestern province of Aceh forced Exxon-Mobil to evacuate employees from a production facility in March 2001. The nation's political turmoil, lack of governmental oversight and dire economic situation contributed to Houston-based Enron's decision to abandon a power-generation project last winter.

Also, there are no guarantees that a company will be able to capitalize on an emerging market's potential. Enron, for example, has decided to move away from developing countries. "We are no longer focusing on emerging markets. We have made a strategic decision to get out of emerging markets, because the returns in those markets versus returns available in developed markets are not comparable," says company representative John Ambler.

China's gradually opening economy, low-cost labor and 1.3 billion population constitute huge untapped markets. But reports of politically motivated violence are on the rise in China, and foreign companies are struggling against an ever-changing regulatory environment, serious copyright infringement problems and unmet profit targets. "Right now, over 350,000 multinational corporations are operating in China, but less than 30 percent have made a profit," says **Dr. Usha Haley, an expert on Asian business and professor of business management at the University of Tennessee, Knoxville.**

Quantifying the risks

Before locating in a troubled area, company executives can take precautions to assess the potential for success as well as trouble. An examination of a government's economic and regulatory policies can help gauge a country's stability. An unclear or inconsistent public policy environment can translate to a higher cost of doing business.

To quantify the risk-reward scenario, consulting firm PricewaterhouseCoopers has created a rating system that measures the strength of a nation's economic, regulatory and legal infrastructure.

The PwC Opacity Index measures five criteria—government corruption, transparency of the legal system, fiscal and monetary policy, transparency of accounting systems and the regulatory environment—to assign an overall score. The tool enables companies to quantify the added expense associated with a venture in a developing country. Countries with the highest scores, including China, Russia and Indonesia, would require a greater return on the investment. "Opacity translates into a higher corporate tax burden. For example, in Russia, the score means adding 34 percent to the corporate tax rate and a return that needs to be 12 percent higher than it would be in a less risky country," explains Bob Frederickson, of PwC's business location strategies practice.

A manufacturer looking for lower labor costs might be less concerned about macroeconomic risks, according to developmental economist Kim Staking. Therefore, a country experiencing severe currency devaluation may look attractive to a company seeking low-cost labor to manufacture goods for export. However, a company establishing a local market for its products would be affected by a decline in a country's buying power, says Staking, author of Financial Risk Management, and a senior economist with the Inter-American Development Bank.

Furthermore, companies selling locally may experience currency transfer difficulties when a country undergoes economic hard times. "Depending upon a country's monetary policy, you may have problems converting currency," says Peter Jones, manager of finance and syndications for the World Bank's Multilateral Investment Guarantee Agency (MIGA) division. Companies manufacturing for export may be less exposed to such risk, he says, "unless the government insists that you repatriate the proceeds into the country."

Anthony Herrmann, CFO of DVI Inc., says that his company carefully examined Brazil's monetary policies before establishing operations there. DVI finances the purchase and lease of imported diagnostic medical equipment. He carefully monitors Brazil's economic stability because of the transfer issue. "They could easily put restrictions on the flow of dollars, given their current debt situation," says Herrmann.

Be savvy about relationships

One of the best ways to ensure the success of a business venture in a frontier market is to bring in a business the government really wants, says Jones. "You can greatly mitigate project risk, depending on how important your business is to the country," he says. If the company is introducing new technology, bringing in needed equipment or enabling local suppliers to benefit from expanded business opportunities, the government will have a vested interest in ensuring smooth operations.

When Dutch dairy cooperative Campina Melkunie established a yogurt factory near Moscow several years ago, the Russian government strongly supported this project. Although Russia's post-communist bureaucracy has often made doing business difficult, the government cooperated with the company to ease the process, because the project involved linkages with local dairy farmers to supply raw materials.

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By contrast, governments have the potential to make life very difficult if they perceive that a foreign company will compete with a local operation. “Before going in, make sure you understand the dynamics of the business environment,” cautions Jones.

Expropriation is a primary concern when evaluating an investment in a country with a history of political instability. Jones advises company strategists to investigate a government’s record in this area. He distinguishes between two types of expropriation: the total seizure of assets and the more common “creeping expropriation,” a series of gradual actions that ultimately results in an inability to do business. “Creeping expropriation is when a government basically makes life difficult for the company. They impose discriminatory tariffs; they prevent workers from getting to work,” Jones explains. Governments may also impose burdensome regulatory requirements, such as frequent on-site inspections or an extensive permitting process that may disrupt the regular flow of business operations.

Executives should also make sure that the project makes commercial sense and is sustainable and that the company’s own internal systems function well. “If a project is badly structured and employees are not being paid, there could be a greater risk of expropriation,” says Jones. A government would view such a seizure of assets as a way to protect its citizens, he explains.

Companies venturing into the world’s political hot spots can add a level of comfort with political risk insurance. MIGA handled security for DVI’s operations in Brazil, for example. Other public insurers include the U.S. government agency OPIC, the Overseas Private Investment Corp. Private insurers include AIG, Lloyds of London, Zurich US and Chubb and Son. Coverage includes compensation for loss or damage resulting from transfer restrictions, expropriation, breach of contract and war or civil disturbance.

Small steps are safer

Company executives interested in pursuing opportunities in emerging markets should begin slowly. “It makes sense to take small steps first, while you learn, and your risks are smaller as well,” recommends Herrmann. Importing may be a way of beginning operations before making a direct investment in real estate.

Working with a local team will also give the company much needed expertise. “If you plunge in like gung-ho Americans, you will get frustrated very quickly,” Herrmann says. Local experts who understand the idiosyncrasies of the local and national government and speak the language will help move the process along.

In addition, PwCs’ Frederickson recommends a thorough examination of utility and transportation infrastructures. Unreliable power supplies and logistics nightmares resulting from clogged highways could erode any savings gained from the lower cost of materials or labor, says Frederickson.

“You also need to be worried about the comfort and safety of your expat employees,” he says. “Does your fringe benefit package need to include an armored car for executives?” Private insurers such as AIG offer kidnap insurance to protect senior executives in dangerous locations.

Who has 'Opacity'?

The more opacity a country has, the more it lacks clear, accurate, formal and widely accepted practices, according to research by PricewaterhouseCoopers. O ratings are determined by:

(1) corruption in government bureaucracy

2) laws governing contracts or property rights

3) economic policies (fiscal, monetary and tax-related)

4) accounting standards

5) business regulations

O-factor	
China	***87***
Russia	***84***
Indonesia	***75***
Turkey	***74***
South Korea	***73***
Czech	***71***
Romania	***71***
Kenya	***69***
Ecuador	***68***
Thailand	***67***
Guatemala	***65***
India	***64***
Poland	***64***
Venezuela	***63***
Pakistan	***62***

Argentina	***61***
Brazil	***61***
Taiwan	***61***
Colombia	***60***
Japan	***60***
South Africa	***60***
Egypt	***58***
Lithuania	***58***
Peru	***58***
Greece	***57***
Israel	***53***
Uruguay	***53***
Hungary	***50***
Italy	***48***
Mexico	***48***
Hong Kong	***45***
UK	***38***
Chile	***36***
USA	***36***
Singapore	***29***

SOURCE: PricewaterhouseCoopers