**SPECIAL TOPICS**

## The Obsession with a Country Risk Premium for Russia may ultimately lead to Flawed Investment Decisions

Since the early 1990s, Russia has been a roller-coaster ride for both, portfolio as well as strategic investors, especially – but not only – for international ones. Whilst the country has undergone a massive transformation process over a period of almost 3 decades, in regards to some aspects this seemingly did not go as fast or far as (maybe wrongly) anticipated or hoped for. Numerous reasons have been cited why, for example, Russian stocks have traditionally been trading at a discount to international peers: Inflation, currency volatility, lack of industrial diversification, corruption, lack of governance, trust in authorities and courts, just to mention some. Today, in the final quarter of 2018, not least various types of sanctions imposed on Russia confirm its comparably enhanced investment risk.

As a matter of fact, the term “risk” is often associated with potential losses: And, such shall ideally be avoided, even if their probability may be small. – In finance, however, risk is viewed abstractly from a neutral, a balanced perspective: Therefore, risk is about the unknown, the uncertain. And eventually either gains or losses may materialize. Hence, risk is nothing else than the degree of volatility of possible outcomes. – Now, that Russian stock have over the years indeed been a sequence of sky-highs and crushing lows is not necessarily a bad thing: There are plenty of investors actually seeking such volatility, hoping to buy low and eventually sell high … - But this enhanced level of volatility has definitely impacted and depressed share price levels.

Various tools and approaches exist that can be applied to narrow down the approximate value of an investment opportunity: Next to benchmarking a proposition with share prices paid for comparable peers on the stock market, also publicly disclosed acquisitions or mergers can serve as useful indications, once corrected for control premiums paid. However, to estimate an investment opportunity´s fundamental value (i.e. its upper price limit), the discounted cash flow valuation approach (DCF) is nowadays universally accepted.

Before introducing the concept of a country risk premium (CRP), let´s take a quick look at the basic mechanics of a DCF: Thereby, and in its most simple form, future expected cash flows anticipated to be generated by an asset are discounted and summed up to estimate the asset´s today´s, its present value. Now, the discount factor applied in this approach is a quite delicate and complex component: It is composed of a number of factors which ideally should reflect the long-term stable funding structure of an asset, in principle a mix of its cost of equity and cost of debt. – The mathematics of a DCF is actually straight-forward, though: The higher the discount factor (driven by the asset´s funding structure), the lower the value of the asset will be.

In the case of a local investment or acquisition - alas: one which has no cross-border or international angle -, all relevant input parameters of a DCF will only and exclusively be of domestic origin. Imagine a Moscow-based food manufacturer who considers acquiring another one in Tomsk: In assessing the target´s value, future cash flows the target is expected to generate will be forecasted in Russian Ruble. And the input parameters of the discount factor will be based on data derived from the Russian banking and capital markets. - If, however, a German-based food manufacturer intended to pursue this same target, then the intended transaction has a cross-border element: In this case, the valuation approach will have to be adapted, and this is the moment the concept of a country risk premium (CRP) kicks in.

Two aspects are important to appreciate a German acquirer´s perspective: First, it assesses investments - also such outside Germany - in its domestic currency, Euros. Second, in a cross-border transaction with the target located in Russia, the firm aims for an exposure towards a region associated with a somehow higher risk compared to Germany, its sound and stable home-base. – Therefore, whilst cash flow assumptions for the Russian-based target may still be based in Euros, just relying on Euro-/German capital markets and banking input parameters to come up with an appropriate discount factor will not work any longer: Instead, as per theory, a CRP for Russia would have to be added. - As a consequence, the target´s value will - because of the increased discount factor – decrease, reflecting the enhanced country risk. (Needless to say, positive attributes, such as a higher growth momentum, further economic transformation and a potential improvement of regulatory weaknesses could by far outweigh such potential risks.)

So, what may be an appropriate CRP figure for Russia? – The disappointing answer is: It all depends and its determination is by no means straightforward. Actually, one may confidently ask the question: Does the concept of a CRP make sense at all?

One set of analytical approaches towards estimating a CRP assesses debt capital-related components, such as credit ratings, sovereign bonds or credit default swaps: For example, Standard & Poor´s BBB- credit rating for Russia is weaker than Germany´s AAA. And, therefore BBB-corporate and sovereign issuers have to offer higher yields than AAA issuers. This is, for example, reflected in Russian Eurobonds carrying higher yields than such issued by the German sovereign. Or one may compare Germany´s and Russia´s credit default swaps, in essence an insurance premium an investor pays to protect against a possible default on obligations. - Currently, this set of approaches point towards CRP estimates in a range of low- to mid-single digit figures, depending upon assumptions and currency base, somewhere around 1.5-3.5%.

A quick glance over some equity capital markets-related components provides a quite different picture, though: Like everywhere, also in Russia shareholders demand a premium over creditors and bondholders for making an investment in a stock. This is, because shareholders will be compensated last in the liquidation of a bankrupt corporate: Creditors always rank first, shareholders at the bottom. Now, the difference between the return expectations of shareholders and the return achieved by making an investment in a (quasi) risk-free asset, such as a domestic government bond is referred to as equity market risk premium. In the United States or Germany, for example, this premium has over the last century fluctuated around 3.5-7.5%, depending on assumptions made. This is for stable, well-regulated, reasonably transparent and efficient equity capital markets with a long track record. – Way too few studies have been undertaken in this regards for Russia: Here, we are among others dealing with the challenge of a quite short capital markets history which – on top - has been impacted by numerous internal as well as external shocks over the last 3 decades. Now, depending on one´s holding period, studies´ results have pointed us towards an equity market risk premium for Russia in a range of between 5-30% … - and that for domestic investors only. – Needless to say, this does not seem like a workable proposition, and even lesser (or scary) so from the perspective of an international investor.

Therefore, one may rightly challenge both, the concept and applicability of a CRP, especially from a strategic investor´s point of view. So tempting the simplicity of the concept may be, the approach does not appear to be the most sophisticated one: Hence, is a CRP an appropriate tool for a strategic investor to assess non-macroeconomic related risks, such as, for example, potential political upheavals, expropriations, sanctions or new adverse regulatory regimes, and this by times in "real" emerging markets regions, such as Africa or the Middle East? – Probably no! And one cannot help feeling that a relatively arbitrarily chosen lower or higher CRP – such as, but not only, for Russia - is rather serving as a sort of dumping ground for any type of risk imaginable when considering a cross-border investment.

Now, the good news is , though, that a DCF – creativity provided - allows building different scenarios of future expected cash flows, so likely or unlikely they may be. Spending time on creating such alternatives, transforming these into numbers, and reflecting about their respective consequences is utilizing a DCF for what it should actually be: A tool of due diligence. – At the same time, this much more sophisticated approach helps shifting certain sets of risks away from the discount factor (and therefore the CRP) and towards the business, its strategy and operations, which all deserve to be analyzed and assessed thoroughly and in-depth.

Today, this approach seems even more appropriate, as geopolitical risks are definitely on the rise. It will not come to a surprise then that different scenarios will frequently result in quite diverse, possibly even extreme outcomes. But this is not necessarily a bad omen, as these outcomes will make an internal debate and thorough preparation ahead of an investment decision even more relevant. And; regardless whether probabilities have been attached to individual scenarios or not, the ultimate questions to resolve will always be the following: First, do we believe in the business case? And, what do we believe may happen?

Will this approach entirely eliminate the discussion surrounding an appropriate CRP for Russia? No, as the inclusion of specific generally accepted and by the markets assumed macroeconomic-related risks in a CRP actually do make sense. However, the wide range of non-macroeconomic-related risks has no place in a CRP: They have to be dealt with separately. – Beware, though, this conclusion may rather confirm than reject relatively lower pricing levels for Russia.