Managing Political Risk in Emerging Markets

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"Growth is happening where political risk is most challenging. So, meticulous monitoring and mitigation now will enable business to flourish and benefit from the opportunities presented by the future growth economies of the BRICs and Next 11."
— Jim O'Neill, Chairman of Goldman Sachs Asset Management

Introduction

Analysts predict that emerging markets will continue to experience rapid growth with anticipated annual growth rates in the medium term ranging from 5.5% (in Sub-Saharan Africa) to over 8.5% (in emerging Asia). It is this rapid growth and other attractive features such as increasing domestic demand, improved infrastructure and investment environments, technological advancement and innovation that continue to attract private equity investors into these previously untapped markets, at a time when global FDI remains generally subdued.

However, political risk continues to be perceived as a significant challenge to investment in emerging markets, a view that has been accentuated by recent events in the MENA region. The global economic fragility has also heightened investors' perceptions of risk, and surveys seem to indicate that political risk will remain one of the most important concerns for investors into emerging markets in the medium term.

This article seeks to build a deeper understanding of political risks likely to be encountered by private equity investors in emerging markets by examining a number of key risks, suggesting appropriate mitigants for such risks and looking at some of the practical implications of using these solutions.

Definition and Overview of Key Political Risks

Broadly defined, political risk is the probability of disruption of the operations of companies arising from acts of governments and political institutions as well as minority groups and separatist movements. It includes the following:

1. **Expropriation including creeping expropriation:** Historically, expropriation entailed the seizure by a host state of a company's ownership or control of its assets. It is however evolving into a more gradual form of expropriation (commonly referred to as "creeping expropriation") which is effected by way of increased regulations, confiscatory taxes, limits on the repatriation of currency, changes in exchange rates and forced re-negotiation of contracts.

2. **Change of law:** Changes in the legal, regulatory, fiscal, or judicial frameworks of a host state, usually made by host governments to take advantage of peaks in prices of commodities in a particular industry, can result in increased costs or a reduction in ownership rights, ultimately resulting in losses or significantly lower returns to investors.

3. **Currency convertibility and transferability risk:** This arises from the inability of investors to legally convert local currency into foreign currency and to make offshore payments or transfer foreign currency out of the host state due to legal/regulatory restrictions.

4. **Depreciation:** This occurs when the host state's currency significantly reduces in value relative to strong currencies.

5. **Government breach of contract:** This is the risk of failure of a host state or state entity to honor its contractual obligations.

6. **War/terrorism/riot/nationwide strike:** These and other similar acts can result in damage to assets or business interruption.

7. **Business practice:** Illegal practices such as fraud and corruption usually result in contracts or licenses and related insurance policies becoming void.

Brief Description of Political Risk Mitigants

There are a number of protective measures that could be employed in order to manage or mitigate political risks. The most common and effective risk mitigants include:

1. **Contractual Protection/Local law:** This is usually achieved by requiring host governments to give transaction agreements (or certain provisions of it) the force of law by legislative enactment or requiring special laws to be enacted for a particular project. Stabilization agreements (or stabilization clauses in agreements) with host states can also be applied to prevent the host states from making adverse changes to the legal or regulatory environment.

2. **Structuring for Bilateral Investment Treaties ("BITs"):** BITs are agreements entered into between two States providing for the mutual promotion and protection of

investments made by investors in the two States. BITs usually prescribe certain minimum protections including protection from expropriation, and cancellation of licenses/concessions, guarantees against foreign exchange controls, "most favoured nation" protection; and dispute resolution by neutral international arbitration for disputes between host states and private investors.

3. **Political Risk Insurance ("PRI"):** PRI is available for a wide variety of projects and investments. Potential political risk insurers include government agencies (such as OPIC), the World Bank (MIGA) as well as private insurers. Products tailored for private equity investment have been developed by MIGA and OPIC and recent trends indicate that we are likely to see an increased use and/or increased availability of such products in the medium term.

4. **Upfront due diligence and continuous monitoring:** Conducting extensive due diligence and risk analysis prior to investment and continuous monitoring after investment can help investors manage risks particularly those for which there are no obvious structural solutions (e.g. corrupt business practices).

Analysis of Mitigants for Particular Risks

It is clear that different risks apply to different types of deals/investments. Likewise, some risk mitigants may be more appropriate for certain specific risks and not for others. The table below seeks to analyze the relevance of mitigants to the risks identified above by looking at examples of where such mitigants have been successfully applied.

Sampling of Political Risks and Appropriate Mitigants

Expropriation/Creeping Expropriation	
Relevance of Risk to Deal Type	Relevant for all deal types
Appropriate Mitigants	• Contractual protection • BIT • PRI
Examples	**Libya nationalization of oil concessions (1970s)** A number of oil companies (including BP) successfully enforce stabilization provisions against Libya following its nationalization of oil concessions. **MidAmerican Energy Holdings, Indonesia (2000)** MidAmerican Energy Holdings obtained compensation from OPIC in the sum of US$217,500,000 for losses arising from certain expropriatory acts of the government of Indonesia (including abrogation of its contractual obligations) in connection with its investment in two geothermal projects in Indonesia.

Change of Law	
Relevance of Risk to Deal Type	Relevant for all deal types
Appropriate Mitigants	• Contractual protection • BIT
Examples	**Goetz v Burundi (1995)** Antoine Goetz and other Belgian nationals successfully enforced a BIT against Burundi in 1995 following revocation of a tax free license issued in connection with their investment in a silver mine in Burundi. **Caterpillar Financial Services Corp, Venezuela (2006) (see below)**

Currency Inconvertibility and Transfer Restriction	
Relevance of Risk to Deal Type	Relevant for all deal types
Appropriate Mitigants	• PRI
Examples	**Caterpillar Financial Services Corp, Venezuela (2006)** OPIC issued a determination that Caterpillar Financial Services Corp. was unable to legally convert currency following an amendment to the law of the Central Bank of Venezuela to impose certain convertibility restrictions. OPIC paid Caterpillar's claim (in the sum of US$2,644,989).

Depreciation	
Relevance of Risk to Deal Type	Very relevant to infrastructure deals.
Appropriate Mitigants	• None. However: • Can generally be managed through investment structuring by ensuring that an appropriate proportion of the tariffs are linked to the appropriate investment currency. • It might also be possible to reduce risk by obtaining IFC/AfDB products that extend local debt tenors. Most power generation tariffs will have a USD-linked equity provision and USD-linked cost components. • Export-related ventures can also provide mitigants through sales to other markets. • Also possible to obtain Local Currency Guarantee Facilities (for example GuarantCo) for projects in low or middle income countries.

Breach of Contract/Payment Default	
Relevance of Risk to Deal Type	Relevant for all deal types, but most likely to apply to infrastructure deals.
Appropriate Mitigants	• BIT • PRI
Examples	**Ponderosa Assets LP, Argentina (2005)** OPIC issued a determination that the Government of Argentina violated international law by abrogating key provisions of the license that it had granted for the operation of the major natural gas pipeline in southern Argentina. As a result, OPIC decided to pay a $50 million political-risk-insurance claim filed by Ponderosa Assets L.P., which owned 35% of the licensee. **MidAmerican Energy Holdings, Indonesia (2000) (see previous page)**

War/Terrorism/Riot/Nationwide Strike	
Relevance of Risk to Deal Type	Relevant for all deal types, but most likely to apply to infrastructure deals.
Appropriate Mitigants	• PRI • For infrastructure deals it may be possible to lay-off this risk on the Government or a relevant state-owned entity.
Examples	**Sector Resources Ltd, Colombia (2002)** Sector Resources Ltd obtained compensation in the sum of US$2,369,736 from OPIC following losses arising from guerrilla threats which led to the shutting down of its Las Animas mine in Colombia. **Kibos Sugar and Allied Industries Ltd, Kenya (2009)** MIGA settled a war and civil disturbance claim (in the sum of US$491,100) to Kibos Sugar and Allied Industries Ltd following losses arising out of public protests allegedly caused by trucks ferrying sugarcane to Kibos sugar factory.

Business Practice	
Relevance of Risk to Deal Type	Relevant for all deal types.
Appropriate Mitigants	• Corrupt business practice monitoring and upfront due diligence. This is particularly important in light of the provisions of the U.K. Bribery Act 2010, the U.S. Foreign Corrupt Practices Act 1977 and the OECD Anti-Corruption Guidelines extending risk to investors. None of the other mitigants highlighted will help.

Practical Implications for Private Equity Investors

In determining the appropriate mitigant, investors must also assess the pros and cons as well as the practical implications of employing the available mitigants. The table below highlights some of the issues to bear in mind.

Strengths and Weaknesses of Selected Political Risk Mitigants

PRI	
Pros	• Products available for private equity investments • Can improve access to finance or lower cost of borrowing
Cons	• Covers new projects only • Does not cover all risks (e.g. currency depreciation, corrupt practices) • Policies will have a time and claim limit. • MIGA/OPIC open only to "eligible" investors/countries. • Investor must establish an insurable claim prior to payment. • High cost, but pricing becoming increasingly competitive.
Other onsiderations	• Lenders may require PRI as a condition to funding. • Process of obtaining PRI can be time consuming and may delay the timing of the project/investment.

Contractual Protection/Local Law	
Pros	• Binding on host states
Cons	• Not likely to obtain for short-term investments or where host state/state entity is not involved in the project/investment. • Covers a limited number of risks (does not include risks such as political instability and currency inconvertibility/transfer restrictions) • Reliant on host state's ability and willingness to comply with its contractual obligations • Laws can be amended.
Other Considerations	• Negotiations with host states or legislative enactment can be time consuming and may delay the timing of the project/investment.

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BIT	
Pros	• Binding on host states • Not affected by changes in local law • Covers a wide range of political risks across all investments therefore suitable for short-term investments • Free of charge.
Cons	• Certain requirements need to be satisfied (e.g. proper nationality – see next column)
Other Considerations	• Structuring for BIT needs to be undertaken either before or soon after investment – do not wait until a claim has arisen as a claim can be dismissed for lack of proper nationality. • All BITs are different, need to review terms of the BITs to ensure the relevant risks are covered. • Need to check that BIT is not just signed but also ratified by both states. • Need to constantly monitor the status of the BITs (e.g. amendments, termination, etc.)

Conclusion

When it comes to political risk mitigation, there is no "one size fits all" solution. Investors are recommended to undertake upfront due diligence and risk analysis in order to identify potential risks and put appropriate mitigants in place prior to investment. This will involve undertaking host state risk assessment including social, political and economic factors and measuring its current performance against past performance and that of other countries. Investors will also need to understand the specific risks associated with the sector in which investments are to be made. Selection of mitigants should be based on a cost-benefit analysis taking into account the impact of employing the identified mitigants to the investment/project.

From a private equity perspective, portfolio diversification across different sectors and geographical locations could also limit the fund's overall exposure to political risk. Continuous vigilance and monitoring of investments will also enhance investors' ability to alleviate or manage the risks during the life of the investment.