

VALUATION

Discounted Cash Flow Methodology – The Country Risk Premium

In the Discounted Cash Flow (DCF) valuation approach, future expected unlevered free cash flows are discounted with the Weighted Average Cost of Capital (WACC) to estimate the present value of an investment proposition, the enterprise value. - When investing outside the domestic market, a Country Risk Premium (CRP) may be added to the WACC, reflecting additional risk assumed.

The concept of a CRP is often associated with emerging markets: These are usually characterized by weak regulatory frameworks, weak implementation through courts and administration, political instabilities or a lack of infrastructure, such as liquid capital markets. On top, the macro-economic environment in such markets can be challenging, often due to high inflationary pressure, not least resulting in high currency exchange rate fluctuations. – Positive attributes, such as growth momentum, anticipated economic transformation and an outlook for improvement of political and regulatory weaknesses could by far outweigh such potential risks.

When valuing an asset in an emerging market, one would in a first step view such asset on a stand-alone basis, entirely within its economic environment. This means that the DCF valuation approach would in principle be based on the local currency: Expected unlevered free cash flows would be forecast in local currency and the WACC would have to take into account local macro-economic and market characteristics, such as inflation - embedded in the local risk free rate - or the local market risk premium - the difference between the return of the local market and its risk free rate. In regards to the latter, one may assume that investors demand a relatively higher market risk premium for emerging markets to account for the higher risks in such regions.

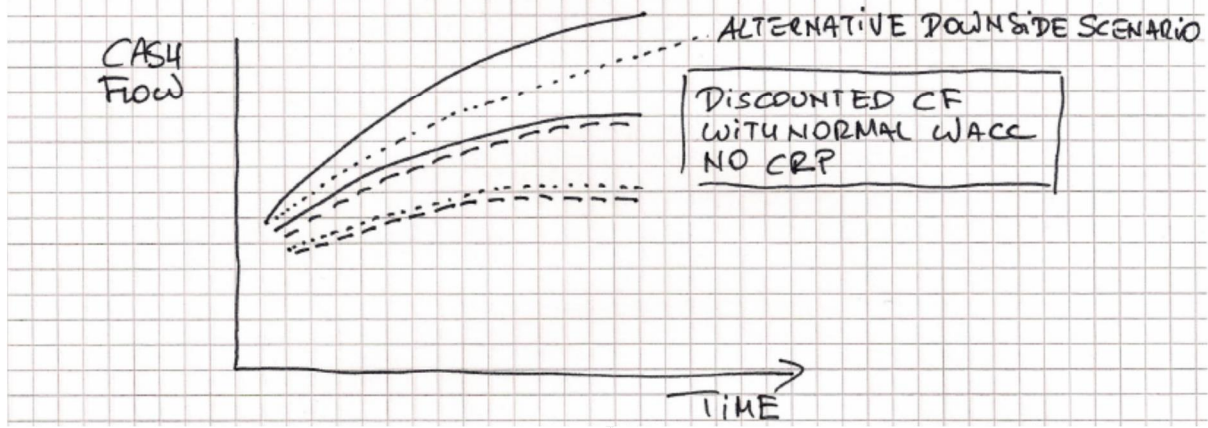
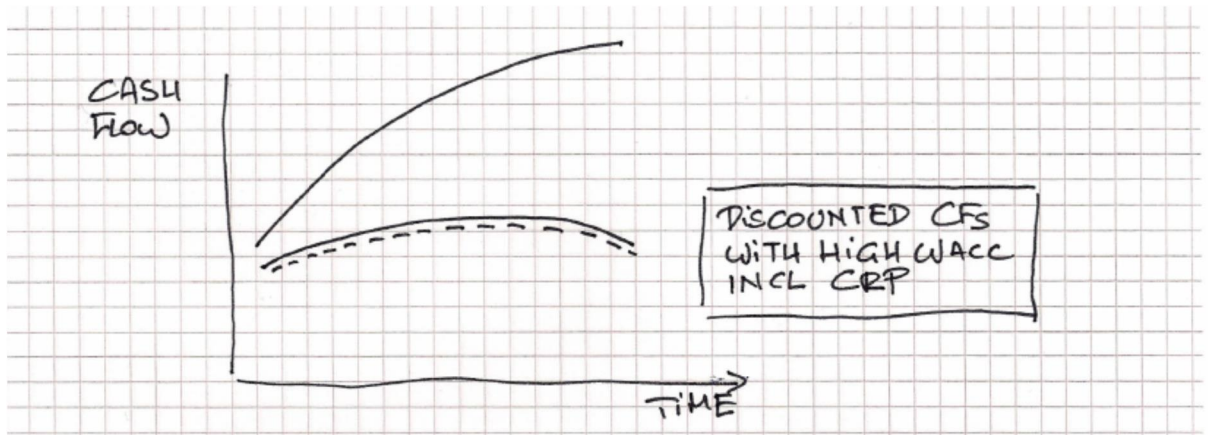
Here the practical issues begin: Emerging markets often have only a short capital markets history.

Therefore any estimation of a local market risk premium is difficult, by times outrageously high as well as wide in its range, driven by periods of high yields but also high levels of volatility. Therefore, some analysts apply first a market risk premium for developed countries, such as the United States, and then add a CRP to account for the higher risk profile of the target country.

This approach is questionable, because the fundamental issue is: How high should such a country risk premium be? – But this question opens a much broader debate: Is it fair to merely increase the WACC by some percentage points instead of mirroring the relatively higher risk through a set of different scenarios of future expected unlevered cash flows? Of course, latter approach would require assigning probabilities to each scenario. This is a challenging task, but probably worth it. Especially, when considering the fact that the whole DCF valuation approach is actually not only about valuing an asset, but –more so – undertaking due diligence on the target to better understand its potential, but also its issues.

A CRP could be derived from foreign bonds issued by an emerging country in a stable currency. The relatively higher yield on its foreign – let's say US\$ - bond compared to that of the US sovereign would indicate such a CRP. - Also, sometimes there are actually good reasons, when deviating from the general principle of modelling in the local currency of the emerging market may make sense: For example, if inflation in that country were unreasonably high, maybe above 15-20%, then future expected cash flows may be re-based and translated into a stable base currency, such as US\$ or EUR. In this case the spread of the emerging markets issuer's foreign bond vis-à-vis the stable base currency sovereign could be added as a country risk premium.

Having said this, frequently precisely such issuers suffering from high inflationary pressures may not have any foreign bonds in a stable base currency outstanding, or at least not with a maturity long enough to reflect the anticipated holding period of the investor. This would probably force the analyst to create spread approximations to reflect the specific local macro-economic challenges.



COPYRIGHT PROTECTED