BEING AWARE OF THE RISKS AND DEVELOPING A CLEAR FRAMEWORK TO ABIDE BY BEFORE ENTERING AN EMERGING MARKET IS KEY TO SUCCESS, SAYS HSBC'S **FREDERIC JEANPERRIN**.

RISK-TAKING HAS ITS REWARDS

For many industries emerging markets represent huge opportunities, whether it be through access to new customer bases, cheaper production processes or natural resource pools. However, having identified such potential opportunities, treasurers need to assess and understand the many risks associated with investing in emerging markets, such as the development of clear entry and exit strategies in order to mitigate potential sovereign, currency and interest rate risks, to name but a few. Treasurers will then be able to support the business with a clear risk profile on the opportunities offered by the sector.

At the recent inaugural ACT conference on *Reducing Risk in Emerging Markets Investments*, sponsored by HSBC, delegates had the opportunity to hear different, but complementary, views on the sector and pose questions regarding the practicalities of financing acquisitions and doing new business in emerging markets.

The panel was chaired by Frederic Jeanperrin, Managing Director, Corporate Risk Managements Sales, HSBC. It included Harry Koppel, Corporate Risk Manager, BP Finance; Martyn Smith, Director of Tax and Treasury, Dyson; Robert Williams, Group Treasurer, Allied Domecq; and Keith Richardson, Treasury Operations Director, Tesco. The panellists talked through the approaches they took, and why, and the problems they faced in guiding their companies into new emerging market opportunities.

The discussion began with each person highlighting the main reasons their respective companies had for entering various emerging markets. Harry Koppel explained that the very nature of BP's global business involved having key operations in emerging markets where a substantial portion of the natural resources and growth opportunities lie.

Allied Domecq, which has more than 50 businesses worldwide, invested in South Korea to target and develop a market with international premium spirits, as well as support the growth of an existing local whisky. Dyson, the privately-owned manufacturer of domestic appliances, identified the opportunity to move its manufacturing operations to a lower cost base, and more flexible set-up as why it entered Malaysia.

Tesco, meanwhile, saw the opportunity to access new business, and to complement its complete footprint of the UK market, by establishing hypermarket retail operations in Asia Pacific and Central Europe. There were interesting parallels between the four panellists. Although they operate in different industries, each of these companies have a centralised treasury function that manages the financial issues generated in the emerging markets.

Furthermore, although each company had different motives driving their decision to enter emerging markets, the panellists were unanimous in agreeing that group treasurers need to be involved early in the process, when generating initial cashflow projections, and deciding on aspects such as hedging strategies and banking structures. A failure to do so might expose the company's operations to undue financial risk. Examples include the purchase price of companies in a local currency, not taking into account the cost of illiquidity of the local currency market.

The panellists also agreed that treasurers need to develop a clear and thorough framework by which to enter these markets. Each agreed that understanding and tackling the following issues in the planning stages were imperative to a successful entry into emerging markets:

- ownership and business plan;
- regulatory and tax issues;
- funding strategies (both upon entering and exiting the market), cash and banking; and
- risk management

OWNERSHIP AND BUSINESS PLAN. As Dyson's Martyn Smith put it, in emerging markets, "expect the unexpected". However, clear planning for the business is a vital element in success when considering entering. A business plan, together with cashflow projections, will enable the treasurer to measure what their funding needs are and which financial risks (in foreign exchange (FX), interest rates or in taxes) will have to be tackled. It also helps the company to decide whether the investment is financially viable or not.

Obviously, the weighted average cost of capital (WACC) used to discount the cashflows has a major impact on the present value calculation. Conference attendees were keen to hear the views of the panellists on whether the same WACC should be used across the board for a given company or if a specific WACC incorporating a specific country risk premium should be used when looking at a project in a given emerging market. Interestingly, the answers differed, depending on the nature of the business in which the companies are involved. BP's Harry Koppel explained that the group uses the same WACC irrespective of the country it is operating in but applies it to 'risked' cashflows. One could argue this is because BP's product is priced in US dollars, with financing structures put in place for the operations being sheltered from the country risk. However, that is not the case necessarily. BP uses a single WACC more due to 'simplicity' and efficiency. It is hard to compute accurately WACCs for BP's different business and projects. Therefore, instead of 'risking' the discount factor, BP 'risks' the cashflows to capture the different levels of risk found in projects.

Allied Domecq, on the other hand, could apply different WACCs according to location. Robert Williams explained that the South Korean joint venture operates domestically and is, therefore, subject to local financial risks, including sovereign risk. Ownership structures for the subsidiary in emerging markets depend on the environment and the desired objectives. For example, Allied Domecq, on deciding to do business in South Korea, used a local partner in a 70/30 joint venture, unlike Dyson, which decided upon 100% equity ownership but with very close operational integration with its local prime contractors.

REGULATORY AND TAX ISSUES. All the treasurers agreed that having the right structure to mitigate tax and regulation risks was essential. This is particularly important with the potential problems associated with changing political regimes mid-project, which may negate any existing investment agreements that may have influenced investment decisions, for example, tax breaks/grants, subsidies and the like. This is where sovereign risk can be costly for corporates. As BP's Harry Koppel explained, even an identified risk in this context might not be hedgeable. Although BP has a robust experience in dealing with crisis in emerging markets, it could not mitigate the 'tax on exports' put in place by the Argentine authorities during the economic crisis in early 2002.

Tesco's Keith Richardson raised the point that withholding tax on cross-border financing or the thin capitalisation rule (meant to prevent foreign companies from funding their local operations with little equity and too much debt) would have a major impact on the way the local operation is funded.

Regulations on profit repatriation was also a key topic of interest for the audience. Robert Williams described how Allied Domecq decided on a capital structure in order to facilitate a more efficient repatriation of profits.

FUNDING STRATEGIES, CASH AND BANKING. As Keith Richardson explained, when investing in emerging markets, Tesco, like other corporates, has the following funding decisions to make: debt vs equity, as well as central vs local funding. The decision for debt vs equity is a function of several factors: first, what the business can support; second, the regulatory and tax framework; and finally, how developed the domestic financial markets are. The corporate's long-term plan will also have an influence on the way the business is financed.

Cash management is an integral part of the financing strategy. Irrespective of the country in which it operates, Tesco manages a system of three accounts that clearly segregates receipts from payments and enables central treasury to control the funding. For example, in Thailand, all receipts are paid into one of three onshore banks, which are subsequently paid into an HSBC receipt account.

REDUCING RISKS IN EMERGING MARKETS:

This article is based around one of the seminars at the ACT conference, held on 18 February 2004.

The conference was chaired by David Creed (second from right), Chairman of The Housing Finance Corporation and speakers included Noreen Doyle, First Vice President, European Bank for Reconstruction and Development (right), and John Boles, Head of Corporate Finance, E.ON Energie (far right).

NOREEN DOYLE, FIRST VICE PRESIDENT, EBRD AND DAVID CREED, CONFERENCE CHAIRMAN

‘DIFFERENT BUSINESSES, WITH DIFFERING PRODUCTS, NEEDS, STRUCTURES AND POTENTIAL GEOGRAPHIES WILL ALL ADOPT DIFFERENT APPROACHES’

These are then passed onto the central Tesco operation in Thailand. No flows are netted, and the local Tesco Finance Team then makes requests to Central Treasury as to how much money it needs, which is then paid from the Group Treasury Account with HSBC in Thailand to the local payment account.

The audience was interested in what the panellists’ views were on local financing. When the local financial market enables it, Tesco issues commercial paper (CP) to fund its working capital needs. BP uses a similar approach by netting excess cash from one BP entity with another one which needs funds in the same currency. This approach minimises cross-border inter-company financing, therefore reducing cross-border risk. Upon entering South Korea, Allied Domecq set up a bank facility to fund its working capital requirements.

RISK MANAGEMENT. Risk management is perhaps the most important consideration for a group treasurer when deciding whether to enter an emerging market. FX, interest rate, cross-border and sovereign risks are all issues that need to be managed. How successfully this is done depends on how liquidity problems can be overcome, and how knowledge of the domestic financial markets, as well as the financial instruments, can be applied. Harry Koppel explained how BP has developed an ‘early warning system’, enabling the group to evaluate and monitor financial risk, in particular FX, in emerging markets. Best practices, based on previous experience, are shared within the group. In case of crisis, BP’s main action is to reduce working capital to a minimum.

Market availability and liquidity of financial instruments determine what corporates can do to mitigate their risks. Keith Richardson recommended dealing at the time of greatest liquidity in the market concerned, and always being aware of local economics and politics. Allied Domecq hedges the FX transaction risk of its Korean operations onshore, without any language problems via a London interface. Dyson treats its Malaysian operation as being essentially a US dollar operation, since most of its costs and all of its revenues are in US dollars.

FLEXIBILITY IS THE KEY. As we can see, it is hard to say that there is a one-size-fits-all solution to mitigating the risks that may confront anyone, not just corporates, when deciding to invest in emerging markets. Different businesses, with differing products, needs, structures and potential geographies will all adopt different approaches upon entering such potentially rewarding markets. However, one factor they all share at the outset is the necessity to develop a clear framework to abide by well before the decision to proceed is made.

The aim is not to completely protect the operation from all potential issues that may arise, as this will serve to erode the potential benefits that may be achieved, but to do enough to ensure that, should things go wrong, the ability to manage these problems has been discussed with potential solutions at hand.

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