ON HIGH ALERT

With political unrest seemingly a given and former accords breaking down, for treasurers, rating agencies and corporates, it's very much business as usual. James Ashton reports

Words: **James Ashton** / Illustrations: **Nick Chaffe**

BREXIT might have been the straw that broke the camel's back. The shock vote to take the UK out of the EU spooked markets and business leaders, most of whom were rooting for the status quo.

Yet for much of the past decade, a string of events has created a heightened environment for risk. And since the credit crunch and banking crisis – problems manufactured in the corporate world and exported across the globe – most problems have been geopolitical. Corporate treasurers have learnt to cope by not being surprised by anything.

"The risk cycle seems to be quicker than it was a few years ago – it feels like a riskier place," says Neil Wadey, group treasurer at British American Tobacco (BAT). "All of these things are somewhat interconnected. The geopolitical situation is obviously something that provides a backdrop and generates instability, but it is commodities, oil and their effects on the FX market that are very real for the treasurer."

In a report last year, entitled *Why Politics Matters To Sovereign Ratings*, Standard & Poor's credit analyst, Moritz Kraemer, explained the reasons why an understanding of politics and geopolitics has become crucial in assessing sovereign credit risk.

The vast majority of ratings actions, positive or negative, are still based on factors such as economic and financial changes, and institutional and governance assessment is only one of five key ratings factors for S&P. However: "it is one factor that can change the underlying sovereign credit story faster and more fundamentally than the economic factors typically do. Sharpening our understanding of political and geopolitical tendencies, therefore, remains an indispensable task of sovereign credit analysts and investors alike," he says.

'Institutional assessment' analyses the effectiveness, stability and predictability of a country's policymaking and political institutions, debt payment culture and the transparency of its institutions. Domestic politics can be a drag on sovereign ratings in both advanced and emerging markets. Arab countries such as Egypt and Bahrain were downgraded because of the Arab Spring. The US's rating has suffered on the back of twice coming close to government shutdowns because of crises in debt management.

Situation under review

Geopolitical risk is harder to predict, such as taking an investment view on South Korea guided by the activities of its nearest neighbour, North Korea. The clearest recent example has been the Syrian war that has created a refugee crisis in Europe and could yet impact credit ratings unless the region collaborates to find a solution.

Kraemer adds: "S&P, therefore, monitors political strife at the national level and regional turmoils, and strives to understand and evaluate the implications for what superficially appear innocent bystanders."

For treasurers, dealing with higher risk has become part of life. The current environment – even without Brexit – is risky, but sadly familiar. "I think that financial markets and global economies are still in disequilibrium," says John Jackson, group treasurer at FTSE 100 water company Severn Trent. "You have low growth, interest rates are in many cases negative – certainly in terms of sovereigns – and a debt overhang that is not reducing. Collectively, the world has kicked the can down the road and not really addressed the fundamental issues,

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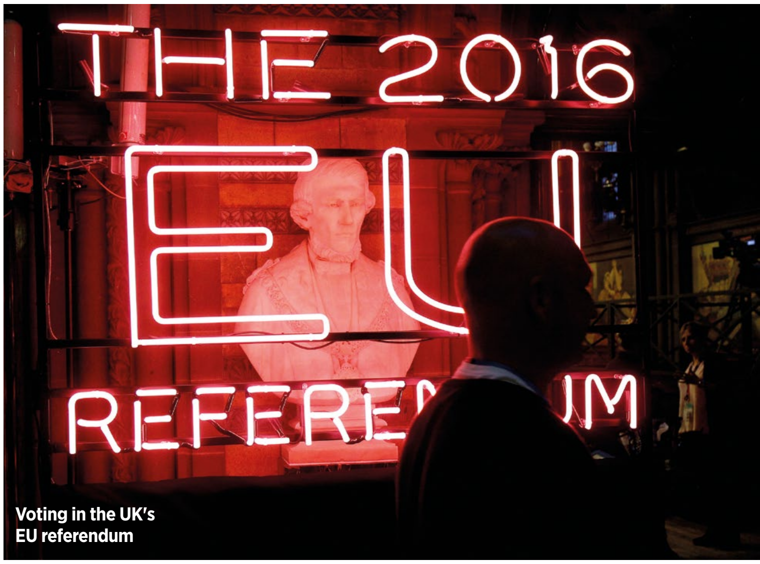
From a geopolitical point of view, there is nothing on the horizon that suggests the economic situation will improve any time soon. The upcoming US presidential elections, domestic tensions in Venezuela, the coup attempt in Turkey and ongoing conflict in Syria: all of these point to major political upheaval. But optimists, including Ana Boata, the European economist at trade credit insurer Euler Hermes, while not denying the risk these situations represent, suggests it is manageable. They point to a distinction between political instability and systemic risk.

In the case of Brexit, corporate treasurers must deal with specific issues it has thrown up. For instance, UK-focused companies must think about the impact that low rates for longer will have on pension liabilities. Healthy company profits appear to show that firms can cope.

"Underneath that, there are many zombie companies that are only alive because of the extremely low cost of finance," adds Jackson. "There has been little growth and that has been a problem for the UK, as well as low productivity. We weren't in a great place, but UK corporate profitability has held up pretty well."

Opportunities as well as knocks

So if treasurers are attuned to geopolitical risk, does that



Voting in the UK's EU referendum

mean they plan more carefully for every eventuality? Jackson and his team could only do so much ahead of the Brexit vote: "Quite frankly, in terms of what would happen from the Brexit outcome, the forecasting was all over the place. Would it be recession, would interest rates rise, would they fall?"

"I certainly think it means we turn our attention to those types of risks as they come on," says Wadey. "I wouldn't necessarily say we hedge more, but we are more focused on hedging opportunities to reduce risk, to match our trade flows better.

"If we can hedge in countries where there is significant FX volatility, for instance, then we will, but we have had recent examples

Shifting insurance ratings

Within days of the UK voting for Brexit, trade credit insurer Euler Hermes declared that the country would keep its AA1 rating for trade risk, despite the impending withdrawal from the EU, its largest trading partner, and the rocky two-year road to divorce. In looking on the bright side, Euler flagged the UK's supportive economic, fiscal and monetary policies, a healthy banking sector and a diversified export structure.

"Increased financial market volatility and economic uncertainty were the immediate global fallouts of the UK's decision to leave the EU," says Ana Boata, Euler Hermes' European economist. "The political vacuum created in its immediate aftermath makes political risks appear heightened globally, but [these factors] do not indicate systemic global political failures will ensue."

These days, it seems that political risk can bubble up anywhere on the planet. But, with little evidence that the UK had suddenly plunged down the risk charts, much of it gets taken in someone's stride. If anything, attitude to trade risk has flattened the Earth. For example, in its country risk assessment map, credit insurer Coface has assigned Indonesia and India the same 'acceptable' score as Portugal and Spain, illustrating the gap between emerging and emerged markets has narrowed considerably.

In its latest country risk barometer, Coface found that Europe was a source of good news for a change. Before the Brexit vote, its country assessments of France and Italy were revised upwards because of falling insolvencies, earnings that had stopped declining and more favourable lending conditions. Central and Eastern Europe have been benefiting from the eurozone recovery, too. That contrasts with the US and China, whose country ratings were both downgraded. While Chinese growth is stabilising, company insolvencies are sharply rising. In the US, corporate profitability is suffering even though the unemployment rate is still on the slide.

Post-Brexit, Coface is still enthused by the uptick in household consumption in Western Europe and improvement in construction activity in Spain, Germany and France, but thinks UK construction will be weighed down by rising import prices. Heavily exported UK pharmaceutical and automotive goods may be hit by new entry barriers, although in the short term, they will benefit from the weak pound. Europe compares favourably with Latin America, which is still associated with the highest risk in the world.

"Our understanding of current events also needs a historic perspective," adds Boata. "When compared with the three periods that developed into two world wars and the Cold War in the 20th century, we are not in a riskier place now. For Europe, history suggests that the continent is less prone to systemic political risk than in earlier times, and its political systems appear more developed and capable of meeting current challenges than in previous epochs."

War-torn Aleppo, in Syria

Turkey's coup attempt in July

REUTERS PICTURES

like Ukraine or Nigeria where you would like to be able to do more from the financial markets, but it is more about making sure your business is business ready to take the volatility."

BAT saw FX swings go against it in the past few years. The company reports in sterling, but only a tiny slice of its revenue comes from the UK. The weak pound means that international revenues will be worth more when converted. Wadey says, in that case, attention shifts from the translation of results to what is happening market by market on input costs.

Explosive growth rates in emerging markets persuaded some that investment in one-time, no-go areas was worth the risk. But the tapering of the US Federal Reserve's monetary stimulus saw many of these local currencies slump. Whereas some companies, selling packaged goods or services, can choose the markets in which they operate, explorations firms must go where the resources are.

Tim Lane, group treasurer at Premier Oil, an exploration and production company with oil and gas interests in the North Sea, Southeast Asia, Pakistan, the Falkland Islands and Latin America, explains how he looks to mitigate risk wherever possible. "The nature of our business means that we are predominantly US dollar-based and our functional and reporting currency is US dollars, so apart from the dollar-sterling exchange rate, the Brexit impact is not too significant for Premier; on a macroeconomic level, the effect on the oil price is more relevant.

"For Indonesia, Pakistan and Vietnam, the funding is in US dollars, so there is no real local currency risk. There are some local currency payments, but the majority of the capex and opex is in dollars. All the revenue is paid directly into London bank accounts; it is not paid locally.

"The recent move in the dollar-sterling exchange rate has meant we have been able to lock in approximately £110m of our GBP forecast expenditures for the rest of 2016. Furthermore, weaker sterling will help those projects in the North Sea that have a significant sterling cost element. We also hedge a portion of our forecast oil production in order to protect against potential future falls in oil price."

So although it may feel sometimes as though the world has been turned on its head, treasurers must put geopolitical risk in context and see through current crises to the market fundamentals.

Wadey concludes: "I think you have to take the long view on these types of opportunities or risks. At the end of the day, environments that are moving also create opportunities, so I wouldn't necessarily say Europe becomes less attractive versus emerging markets. They still have the same demographic characteristics. We are yet to see what happens with Brexit. I don't sit here with huge trepidation for Europe."

James Ashton is a freelance business journalist