THOUGHT LEADERSHIP
RESEARCH

HOW TO THINK ABOUT POLITICAL & SOCIAL RISK IN EQUITY INVESTING

A framework for assessing political and social risk.

MASSIF CAPITAL

Executive Summary

- Political/social risks will increase going forward if our belief that the trend of greater integration of global markets across diverse territories over the last two decades is waning.
- Political/social risk is idiosyncratic to a business model, its operations and how a company engages with its operating environment.
- An investor's goal in assessing political/social risk is not a forecast of events that *may* occur but rather high conviction that management can deal with political/social events when *they* occur.
- Political/social risks are hard to understand because they are people risks. As such risk management by a corporation is an ongoing bargaining relationship between the company and stakeholders.
- Political mastery by management can be a source of competitive advantage.

The Present Landscape

A sophisticated understanding of political/social risk and how to assess it has never been more important for an investor. The rule-based political order, and its associated trading system, in place since the end of WW2, is rapidly evolving and can no longer be taken for granted. Furthermore, well-established firms with lengthy operational histories now operate supply chains that stretch across the globe.[1] New firms can often find themselves operating in more countries then they have initial employees (internet firms can grow to tremendous size and reach before they have the staff to complement their new international exposure).[2] The frequency with which firms now operate on a global scale is unprecedented.

POLITICAL/SOCIAL FACTORS HAVE ALWAYS BEEN IMPORTANT TO THE MARKET; AFTER ALL, IT HAS ONLY EVER BEEN IN THE MINDS OF A FEW STUBBORN ECONOMISTS THAT MARKETS WERE ISOLATED FROM POLITICS.

Political/social factors have always been important to the market; after all, it has only ever been in the minds of a few stubborn economists that markets were isolated from politics. Markets, especially in this modern era of excessive operational regulation and populist politics, are created, shaped and constrained by the rules, norms, and institutions of the political world. The playing field on which companies operate is determined, in many respects by the decisions of participants that do not operate within a narrowly defined industry descriptor. That political/social risk matters to investors is not in question; the best approach for understanding it, on the other hand, is.

The Usual Approach and its Shortcomings

For most, understanding political/social risk comes in the form of a third-party report that articulates "country risk", which is to say a report with numerical rankings of qualitative factors, a broad summary of the political/social environment in a country at a high level and the obligatory near-term forecast, usually a mix of a general economic outlook and a political op-ed. In short, sometimes an interesting read but little else, and of very limited use to an investor. (See the sidebar below for more: Forget Country Risk Rankings)

The reason this approach fails is that political/social risks are **company specific, not country specific.** Some may protest this claim, and there certainly exist a few issues, such as interstate war or civil war, that impact everyone, but most political/social risks are company specific.[3] **Political/social risk is idiosyncratic to a business model, its operations and how the company engages with their operating environment.** The risks are not generalizable from a countries political or social structure. And, just as the toolbox an investor uses to assess a mining firm is different than the toolbox necessary to assess a retailer, so too are the tools an investor must use to assess political/social risk.

Increasing Political/Social Risk

Although the integration of the global economy during the 1990s and 2000s appeared to create a landscape that increased the need for political/social risk analyses, that was a false need, created only by the growing exposure of foreign markets to individuals daily. More new places cropped up in the newspaper every day with greater frequency, exposure increased, creating an impression of increased complexity on the political stage.[4] The reality is that the 1990s and 2000s were a period of increased integration of global markets and increased harmonization of rules across diverse territories. More places looked increasingly similar, not increasingly different.

As it turns out, the unwinding of that order, a process that appears (emphasis on appears) to currently be underway, led by the rise of illiberal governments and populist drives for increased sovereignty, now make political/social risk assessment an even more essential part of business analysis. The world we see today is driving towards less integration and less consistency in rulemaking, increasing political/social risks. More national and sub-national governments are making rules guided by their narrow self-interest and identity at the same time as individuals are increasingly capable of utilizing the internet as a force multiplier, turning minor grievances into the “cause celebre” of the moment. In short, an increasingly fractious, individualized, and seemingly petty political landscape has amplified the need for political/social risk analysis to levels not experienced since the 1970s.

What is an Equity Analyst to Do?

The first step towards a better understanding of political/social risk and its assessment is a definition. At Massif Capital we employ a simple one:

Political Risk is the probability that political/social events could significantly affect a company’s business over a defined period.

This definition is a combination of a definition put forward by Condoleezza Rice and Amy B. Zegart in their recent book Political Risk, and a time element, which we consider essential for investors. We believe this to be an appropriate and workable definition for investors because it guides one’s research towards the considering the right variables (discussed below), the right type of analysis, scenario analysis, and guides the investor to select the right scenarios to study, those with the most impact on a company's business within the timeframe of their investment.

This definition of political/social risk also establishes the four key variables for any investor concerned with political/social risk:

1. Likelihood
2. Magnitude
3. Time
4. Political/Social Events

The simplest variable to define is time. Depending on the time horizon of the investment, you can adjust your areas of concern. An investment with an expected catalyst in the next two years may not need to consider elections. A longer time horizon may require an evaluation of multiple transitions of power and a very shorter-term investment may only need to consider social unrest (these are just examples). After the time variable, it is necessary to consider the types of political/social events you are concerned with, and here we believe you can combine likelihood, and magnitude to create a framework of political/social events to consider.

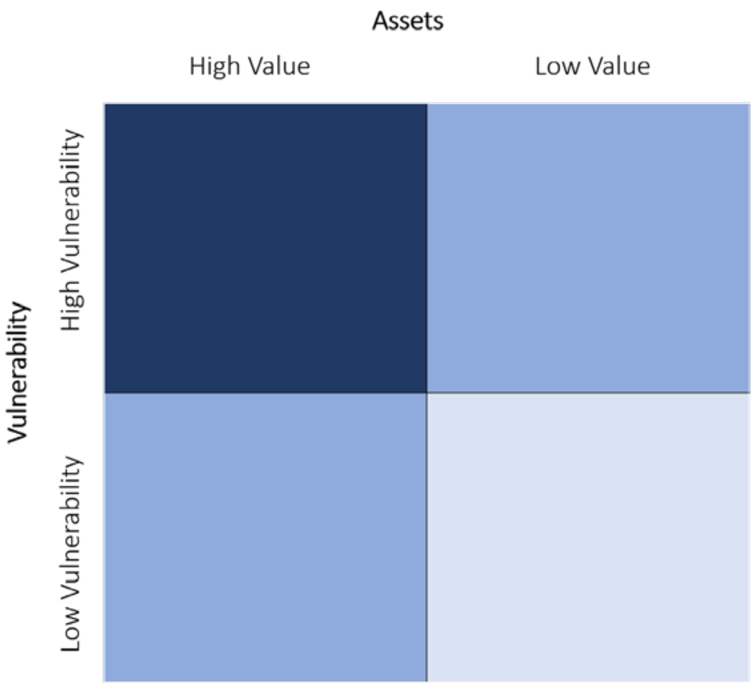
There are two flavors of political/social events: low probability-high impact events, and high probability-uncertain impact events. While both flavors are almost always present, they are also challenging to deal with. There is little in the way of surety or conviction regarding the occurrence of events that can arise from the study of either. **Luckily, as an investor, our goal is not calculating the probability of the occurrence of an event, but rather seeking to generate high conviction that a company's management team can deal with a political/social event when it does occur. This is worth repeating; we are not seeking to forecast the events that may occur; we are seeking a high conviction that management can deal with political/social events when they occur. If an investment is made with a medium to long term expected holding period, a political/social event that will impact company operations is almost certain to occur. As such, the ability to handle the fallout from such event is an essential skill of management.**

THERE ARE TWO FLAVORS OF POLITICAL/SOCIAL EVENTS: LOW PROBABILITY-HIGH IMPACT EVENTS, AND HIGH PROBABILITY-UNCERTAIN IMPACT EVENTS. WHILE BOTH FLAVORS ARE ALMOST ALWAYS PRESENT, THEY ARE ALSO CHALLENGING TO DEAL WITH.

The only sure thing about political risk is that many risks can and will result in a complete loss for a business if a management team is not prepared. Within the above categorization, there are many specific types of risks. The most common of which for the industries we at Massif Capital look at (basic materials, energy, industrials) are to be found in the table below. While the probability and impact of a specific type of political/social risk can change, the division below is based on our experience and the types of assets we look at:

Low Probability – High Impact
Geopolitical Events
Laws, Regulation and Government Policy
Breaches of Contract

High Probability – Uncertain Impact
Corruption
Social Activism
Terrorism



The definition of political/social risk we use, combined with this understanding of political/social events allows us to narrow our analytical focus by asking three questions:

- What assets are most valuable to Company X in Place A?
- What assets does Company X own that are most vulnerable to political/social events in Place A?
- Where is the overlap of high value and high vulnerability assets?

We often look at these questions graphically and try to assign a company's assets or operations to quadrants in the table to the left.

Another important aspect for an investor to consider is their orientation to the question. Unlike some financial analysis, in which a keen outsider perspective strengthens the analysis, political/social risk analysis requires the investor to put themselves in the shoes of a company's management team. **It is not enough to think like owners; we need to understand the situation and operations of the business as owners would, i.e., from an operational perspective. Once again, the reason for this is because we need to understand not only what the political/social risk is but if the company's management can address the risk.** Political/social risks are first and foremost operational risks; they impact the operations of a business and can almost always be prudently managed and prepared for.

As investors, we cannot hedge political/social risk. It is an idiosyncratic risk that we can choose to accept or reject as part of our portfolio. **The most useful analysis thus lays out both a clear understanding of the risks and the future managerial contingences that address such risks. Thus, an understanding of the risks and an understanding of how to address the risks are equally important.**

Identify the Stakeholders

After defining the high-risk assets, an investor must define the relevant sets of people within an operating environment that may hold the keys to avoiding that risk or may be the cause of the risk. **Political/social risk is hard because they are people risks. As such risk management by a corporation is an ongoing bargaining relationship between the company and stakeholders.** Keep your high-risk stakeholders happy, and a company will often avoid political/social risks. So, who are the primary stakeholders? It differs for every country and every asset, but the following list covers the general categories:

Forget Country Risk Rankings

Most political risk analysis boils down to a country risk ranking. Every major consulting firm, whether they be a generalist or political risk specific firm, has them, yet they are as close to useless as possible.

Country Risk Rankings don't work because they fail to consider the fact that political risk is always idiosyncratic and different not only for every firm in a country, but even for every project a firm might have in a single country. The ratings are also, by their very nature, backward looking. Finally, even if a broad, high level assessment of country risk is what you are looking for, the country risk ranking does a poor job of this.

Take for example the latest Euler Hermes Country Risk Rating, which puts the United States in the same category as Thailand. Both countries are perceived as having low risk, but one is a subject to multiple military coups in the last decade and the other is the oldest functioning democracy in the world. One has multiple bickering political parties, the other laws that make it easy for the military junta in charge to jail political activists and journalists they might dislike.

An even better way to think about it is to put yourself in managements shoes. Let's say you wanted to build an oil and gas pipeline from Canada to the Gulf of Mexico, is the political risk in the US low? The answer is no, on the other hand if you lay the ground work for a good working relationship with the Thai military, you will never have the issue of protesters delaying your oil and gas pipeline, the government just won't let it happen. So which country has greater political risk, that's a great question, telling me what you are doing, and I will get back to you with an answer.

- Government Officials
  - Federal Level (In-Power and Out-of-Power)
  - Local Level (In-Power and Out-of-Power)
- International Institutions (World Bank, The UN)
- Transnational Organizations (Amnesty International, Green Peace)
- National Organizations (The NRA, American Bankers Association)
- Local organizations
- Individuals

Agendas for the various stakeholders are not difficult to ascertain. The easiest place to start is at the top, defining who in the government is in power and who is not. Outline political agendas and then divvy up International Institutions, Transnational Organizations, National Organizations, and Local Organizations according to political philosophy under the federal level stakeholders that are in power and those that are not. The local level is where things get tricky, and the reality is the local level is also the most dangerous because it has the highest levels of uncertainty.

Issues at the federal level are often clear, companies usually have policy risk or expropriation risk, and although expropriation risk gets headlines and is likely the first thing people think about when one mentions political risk, it is also a very low probability event (see "The Hidden Risks in Emerging Markets, Harvard Business Review April 2010). It is worth noting that while expropriation risk has largely disappeared, it is largely the result of stronger international law and synchronicity of developing and developed economies. What we see as an ongoing break down in the international rules-based order may signal a return of exportation as not only a headline-grabbing risk but a very real risk. Our skepticism is rooted in a belief that most governments (or more specifically most politicians) are looking out for themselves, and far more value can be extracted from foreign investment and business via subtle policy means than through the outright seizure of assets. For this reason, an investors primary concern when considering federal level political risk should still be policy risk.

Policy risk is tricky to understand and harder for businesses to manage, but they must do so because the cost is so high:

- A 2001 PriceWaterhouseCoopers study concluded that an opaque policy-making environment is equivalent to at least a 33% increase in taxation.
- A 2004 World bank Study found that 15% to 30% of public-private infrastructure contracts, worth approximately $371 billion, in the 1990s were subject to government-initiated renegotiations or disputes.

Because these costs are high, investors must assess the policy risk environment not only to have an idea of potential losses but also because **political mastery by management can be a source of competitive advantage.** Some companies have a knack for operating in difficult environments, much of this can be chalked up to having the right people on the ground capable of understanding the political/social context in which they are operating. The clearest case of this is developed markets where companies spend millions on lobbying. This is a prime example of active political risk management and speaks to our previous comment that our primary concern is less the existence of political risks than in a company's ability to manage them. In this regard, two key questions for the investor to ask are: **how management is framing the debate around its company in the country and is that narrative accepted by stakeholders.**

In developed countries framing the debate is a complex and multifaceted task; understanding the framing is even more so. In emerging markets, framing the debate is less about clever political spin or PR and more about the company's *actions* in the country. ENI, the Italian oil company provides a suitable example. Eni has long had a Kazakhstani subsidiary called Agip KC. To frame the debate in the country, Eni has made sure that the company responds to the specific economic and social needs of a developing former Soviet state. **The key is not to act as a good corporate citizen in a generic way, but in a geographically, politically and socially specific way.**

For example, whenever the company needs equipment, and it can be sourced domestically, Eni sources domestically. This is much more effective than providing aid, and it leverages the existing manufacturing industries of former Soviet states. ENI melds their business needs with the existing economic infrastructure. When Eni needs industrial equipment that cannot be sourced locally due to a lack of knowledge but not a lack of necessary machine tooling equipment, the firm engages in a knowledge transfer. They have cleverly observed the landscapes strengths and are building on them for easy wins. This does not mean ENI has not also done the usual stuff a "good corporate citizen" does when investing in an emerging economy. They have funded public works including libraries, schools, and housing, but they have also done so in a way that has created a relationship of mutual dependence between Kazak politicians and Eni, principally by allowing more credit to accrue to the politicians then themselves. A firm's good works are easily overlooked and forgotten, but a well-placed politician can always provide cover.

Eni has also avoided the use of "foreign influence" by in essence taking a page from Theodore Roosevelt's foreign policy manual, "walk softly and carry a big stick." Foreign influence, for example, assistance from a company's home government, is one of the quickest ways a company can stoke nationals' fervor. This appears especially true in today's political/social environment.

Identifying the key stakeholders does not include only the groups that may pose a negative risk to the company though. Investors should also identify the groups, coalitions, or potentially supportive institutions and individuals and attempt to understand how a company is working with them or including them in their political/social risk management efforts. Locals and other foreign entities may become the best friends a management team can have in the country.

The key question for an investor after identifying key stakeholders must be: **is the management team of company X engaging in a sophisticated political**

campaign or are they leaving the politics to chance. A company should never leave it to chance.

How to Determine if a Company is Leaving it to Chance

We recently invested in a company called Nevsun, which owned a mining operation in Eretria and was developing a mine in Serbia. Following our initial analysis, initial investment and several conversations with management we went out to Serbia to get a sense for the operating environment and how difficult it was going to be for Nevsun develop a billion-dollar open pit mine. It quickly became apparent that it was not going to be as difficult from a regulatory and policy perspective as we had thought. Why was that? It turns out Nevsun management helped the government rewrite the mineral extraction laws that they were now subject to.

IN MOST CASES COMPANIES ARE NOT ABLE TO HELP REWRITE/WRITE LAWS BUT DOING SO IS A CLEAR INDICATION OF A HIGH LEVEL OF SOPHISTICATION IN A POLITICAL CAMPAIGN.

In most cases companies are not able to help rewrite/write laws but doing so is a clear indication of a high level of sophistication in a political campaign. Despite how difficult it may sound, it is rarely difficult to get a sense for what a company is doing to minimize political/social risk as management teams always want to trumpet what they are doing locally to get projects done. The value of this information is less in what the company is doing though then it is in being able to identify what they are *not* doing and what stakeholders are *not* being addressed. Those are the stakeholders that could cause a political/social event that investors need to be aware of and concerned about.

If a company is not talking with politicians at the federal level, or not partaking in town hall meetings at the local level or did not consult Green Peace before commencing construction of an oil rig near a coral reef, they are leaving things up to chance. The political/social risk for that organization is high.

Integrating Political/Social Risk into the Research Process

As an investor your research should seek to answer the following questions:

1. Does management understand the political/social risks they are exposed to?
2. Does management analyze political/social risk as an ongoing issue, or as a one-off issue when they first make a capital allocation decision?
3. Does management have strategies to mitigate their political/social risk?
4. Does management have strategies to respond to political/social risk events after they occur?

We have found a few of the following questions helpful to ask management when searching for answers and an understanding of how they think about and handle political/social risk:

1. **What is your appetite for political or social risk?** Just be direct, most management teams will never have been asked the question. It is often very clear from the answer whether management has thought about these risks. Most management teams tell us that they have little or no appetite,

regardless of the business. These management teams have not thought about the risks.

2. **How much political or social risk do you believe you are currently exposed to and how do you update your risk perspective?** Most management teams have a static understanding of their political/social risk, and few if any have a process for updating understanding. An example of a firm that appears to do this very well is Marriot. The hotel chain is principally exposed to security risks via their extensive global physical footprint, as such they have a team of two (so continues monitoring does not cost much) with one person based in Asia and one in the US who monitor news flow and update the security risk level of each hotel in their region daily. They have a process for taking in information, updating operating plans and working to prevent political/social risk impacting operations. You can read more about Marriot in the previously mentioned book Political Risk by Condoleezza Rice and Amy B. Zegart.

3. **How do you integrate political and social risks into your investment decisions?** Most management teams consider political and social risk when investing these days, but many do not have a clear process for integrating such complex and difficult variables into their capital allocation process. It is essential to ask how they do it, there is no right way, but because of its complexity, it does require a process.

4. **Do you have a strategy for mitigating and managing political risks?** As we have previously stated, political/social risks are operational risks that will occur over a long enough time horizon. As such a management team needs to have a plan for managing them after they have happened, not just a plan for trying to prevent them.

5. **Can you provide me an update on your thinking regarding X risk in country Y?** This has been the most telling question in our experience of a management teams' sophistication when it comes to political/ social risk. If a management team can thoughtfully and intelligently update you on their exposure and thinking on a political/social risk, they likely have a process for management and are updating their views via the integration of new information.

Those interested in learning more are encouraged to contact us to discuss or read the following:

- For a high-level overview: Political Risk by Condoleezza Rice and Amy B. Zegart
- For an operator's perspective: Managing International Political Risk by Theodore Moran
- For an industry specific perspective: Oil and Natural Gas - Political Risk in the International Oil and Gas Industry by Howard Lax

Footnotes

[1]It is worth noting that the more focused on 'just in time' operations a company with global supply chains is the more susceptible that company is to political/social risks. 'Just in time' supply chains focus on minimizing inventory through just in time delivery, yet a lack of inventory increases susceptibility to supply chain disruption and makes a company more sensitive to political/socials risks at any point in the supply chain. 'Just in time' should often be read as operating with no 'margin of safety'. As with all things, too much of a good thing is not as good as it may at first seem.

[2]A prime example of this would be Facebook, who despite its size, lacks the employees it needs to understand the extent to which its social network has reached. We are specifically thinking of the issues the firm is currently having in Myanmar where they have struggled to find employees with the appropriate language skill sets to address their problems.

[3]It is worth noting that even in case of war, some companies still figure out how to operate. The following three examples are presented in a World Economic Forum Article entitled 6 Lessons from Companies Operating in War Torn Communities, well worth reading if you are invested in a company that operates in or may operate in a war zone: Chevron in the Niger Delta, Nespresso in the South Sudan, Roshan in Afghanistan.

[4]Multiple explanations for this are possible, a combination a hindsight bias, recency bias and narrative spinning by various "experts" and "forecasters" at organizations such as IHS and Eurasia Group.

MASSIF CAPITAL

Massif Capital runs a long/short equity strategy focused on global opportunities in liquid real assets and industrials. We prioritize downside risk management by investing in business we understand operating in the Basic Materials, Energy and Industrial industries.

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