

# Geomarket Risk Management: How to Balance Risk Holistically, Globally



SOUTH AMERICA



AFRICA



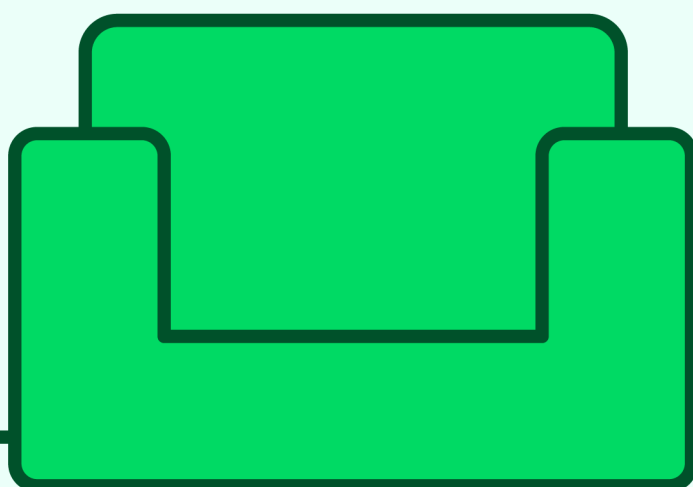
SOUTHEAST ASIA



MIDDLE EAST



EASTERN EUROPE



For many large corporations, forays into foreign markets have delivered mixed results. Gains in developing economies have been subpar even in periods of remarkable growth. Today, even those returns increasingly are threatened by heightened geopolitical risk, protective nationalistic economies and constrained capital markets. Consequently, management teams are being placed under the microscope when proposing new capital expenditures, and, in extreme cases, managers are being asked to justify their very presence in emerging markets.

**S**everal automobile manufacturers have been negatively affected by the hit the Venezuelan economy has taken due to declining global oil prices and repeated devaluations of Venezuela's currency leading to the implementation of controls preventing companies from taking dollars out of the country.

But globalization is here to stay, and avoiding these markets is not an option for most companies. Instead, corporations need to evolve their game plan. A portfolio approach to participating in global economies should provide high returns and a competitive advantage, and this model should be an integral component of any multinational's corporate strategy.

Business leaders need to understand the risk dynamics within each market and

use an adaptive decision-making process to ensure that expected returns justify taking on these risks.

### Globalization is not static

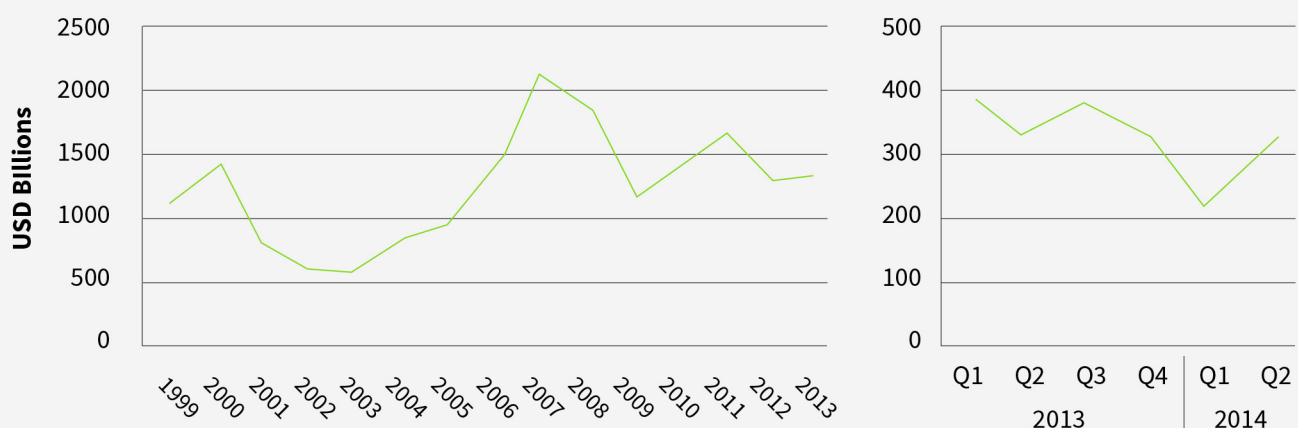
The globalization of the world's economies and cross-border investment has been one of the hottest topics in business over the last two decades. Measures of global economic activity such as foreign direct investment and capital flows showed unprecedented growth during this period. But the past four years have produced little to no growth in these metrics, raising concerns that globalization has stalled (Figure 1).

The global financial crisis of 2008 forced managers to take a less optimistic view of the potential for rapid international expansion and to take stock of their performance in developing markets.

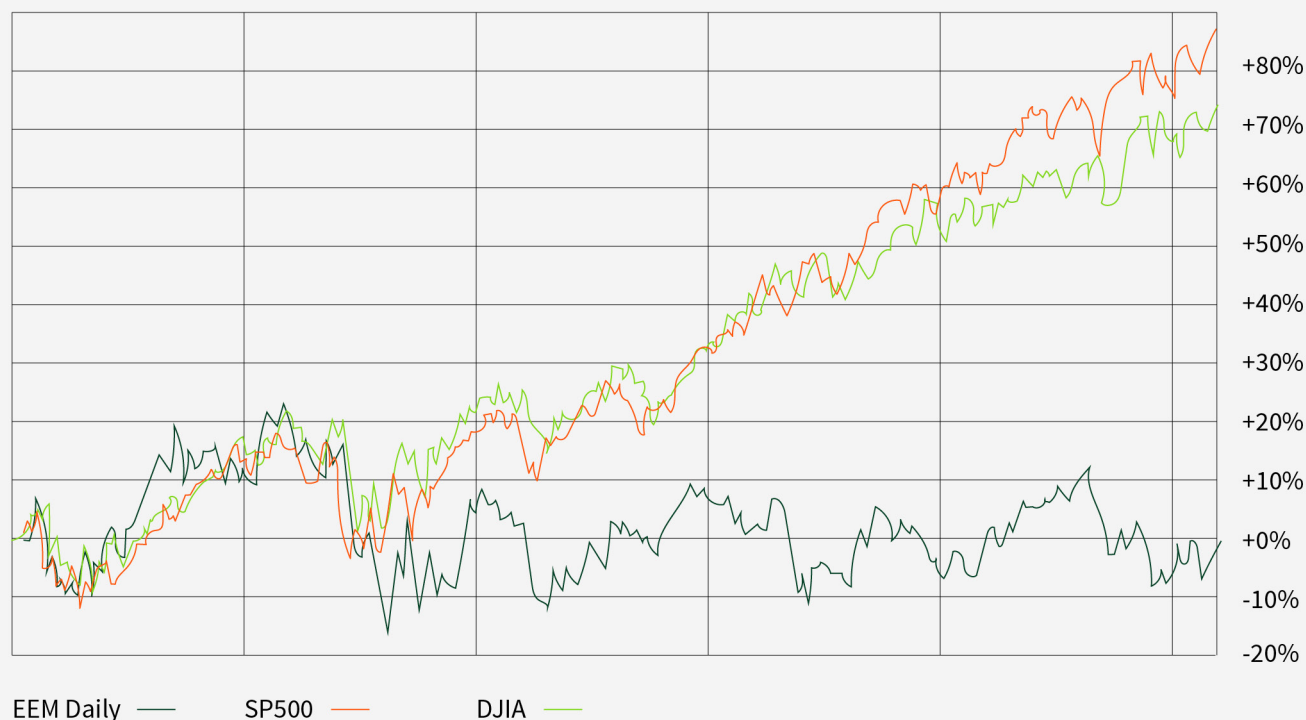
Many players realized that they were not reaping the expected benefits. A report submitted by [The Economist](#) outlined the difficulties in producing a significant return on investment ("ROI") in emerging markets. Investors have begun to take note of this fact, reflected in the stark underperformance of emerging market indices compared with the S&P 500 ("SPX") and the Dow Jones Industrial Average ("DJIA") (Figure 2), most dramatically in the oil and gas industry.

This underwhelming performance is due in no small part to the fact that these markets are host to a variety of unavoidable and complex risks. Still, managers mostly have not deployed tools and processes adequately robust to fully integrate geopolitical and commercial risk considerations into market strategies and decision making.

**Figure 1.** Historical Global Foreign Direct Investments



Source: "FDI in Figures: International Investment Continues to Struggle."  
[Organization of Economic Co-operation and Development \(OECD\)](#) Dec. 2014.

**Figure 2.** Emerging Returns Compared to Dow Jones and S&P 500 Indices

Corporate decisions to make medium-to-long-term investments in emerging markets projects mostly are made on a one-off basis, and approval is granted with a point-in-time consideration of market risk and on the standalone merit of the project. This approach fails to take into account that the risk profile of any market is dynamic and that, for most companies, a portfolio of projects competes for dollars and resources.

An integrated approach to business performance risk management can help managers better understand the elements of a market's risks that can lead to improved decision making.

### A better way to understand geopolitical and commercial risk

When operating in emerging markets, it is imperative that managers acquire a deep understanding of a market's operating conditions and the drivers of geopolitical and industry-specific commercial risks.

Geopolitical risks typically are grouped in categories such as political, judicial and

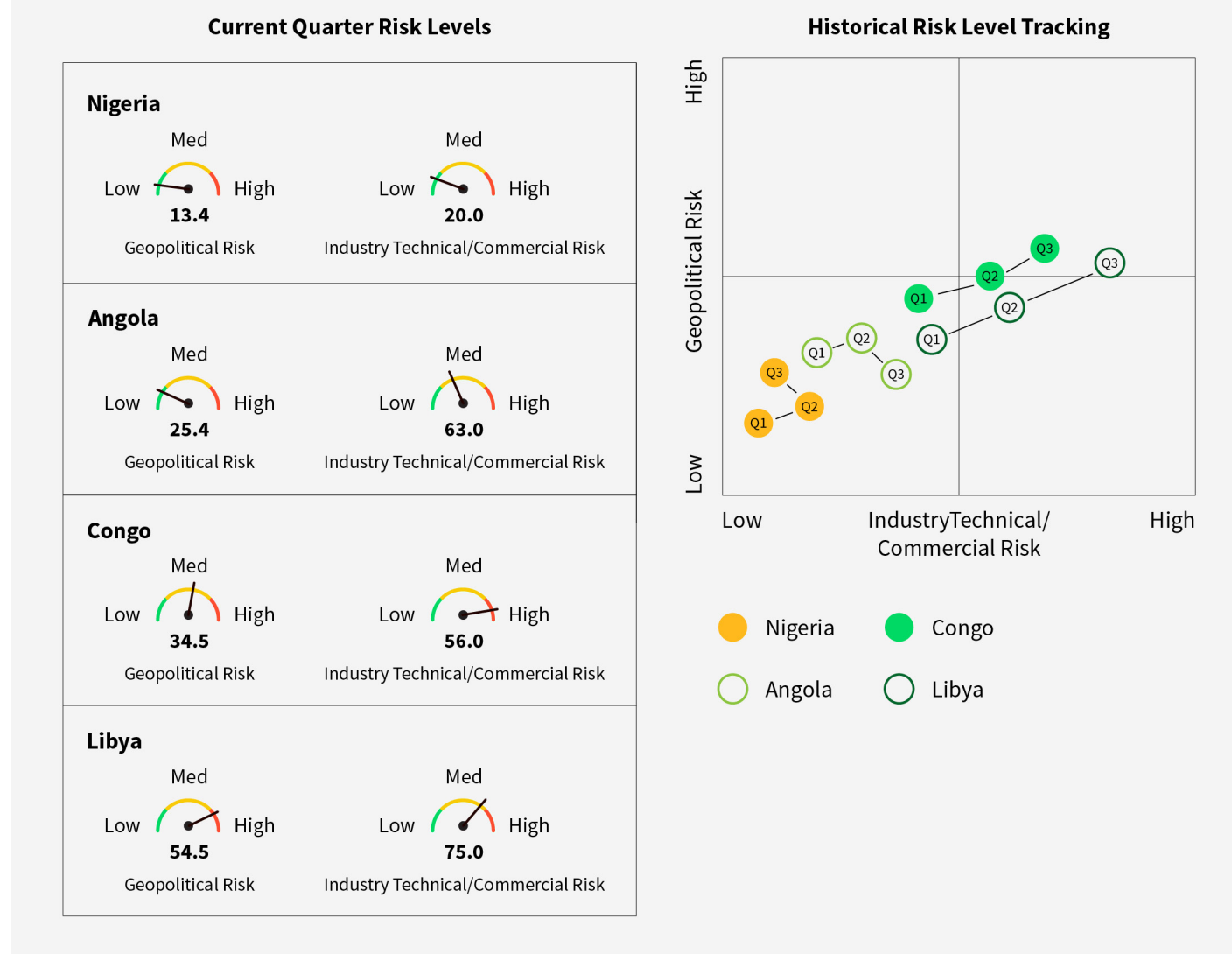
regulatory, economic, financial system, and social and environmental. Contained in these larger groupings are more discrete risk factors, including political stability, rule of law and government control.

Commercial and technical risks are uniquely specific to an industry and include factors such as labor, education, industrial relations, the competitive environment, currency stability, import-export regulations and infrastructure readiness.

In the traditional approach to business decision making, a corporation runs quantitative ROI models for projects, superimposing market and industry risks to create scenarios for go/no-go decisions. A company buys market and industry research materials from third-party sources to inform its decisions. However, once approval is granted, an organization rarely revisits its decision unless it finds itself in a catastrophic situation. And the company repeats this cycle for projects in other geographies or countries within the same region.

This methodology ignores the fact that even a good decision made at a particular point in time later may become a liability. As market conditions change, management teams spend excessive time generating explanations for multiple project variance reports. As the variance reports created for every project in each country mount up, one-off course corrections become the corporation's dominant operating model. Ultimately, this results in chaos.

Instead, we recommend establishing a learning environment for risk management where market risks are understood both at a single point in time and over a period of time. This approach greatly enhances the ability of algorithms to convert qualitative data on risk drivers to quantified models. Profiling market risk over a period of time, and correlating its impact on project performance variance, makes the model self-correcting. Over several quarters, business managers can develop a realistic and actionable window into the risks of the markets in which they operate and prepare for taking a portfolio approach. Figure 3 describes the risk profile trajectory of countries in

**Figure 3.** Representative Geomarkets and Oil and Gas Industry Technical / Commercial Risk Snapshots and Trends

the portfolio for an oil and gas industry services corporation. For one country, demanding multiple new investments, the risk profile had changed rapidly, with growing political instability and currency devaluation. At the same time, another country had demonstrated stability on geopolitical, as well as industrial, risk frontiers. Therefore, future investment decisions need to be made in light of these marketplace portfolio dynamics.

Viewing performance holistically on a global canvas vs. a narrow local perspective also allows a corporation to break down country silos and manage investments in an integrated manner that is in the best interest of the business as a whole.

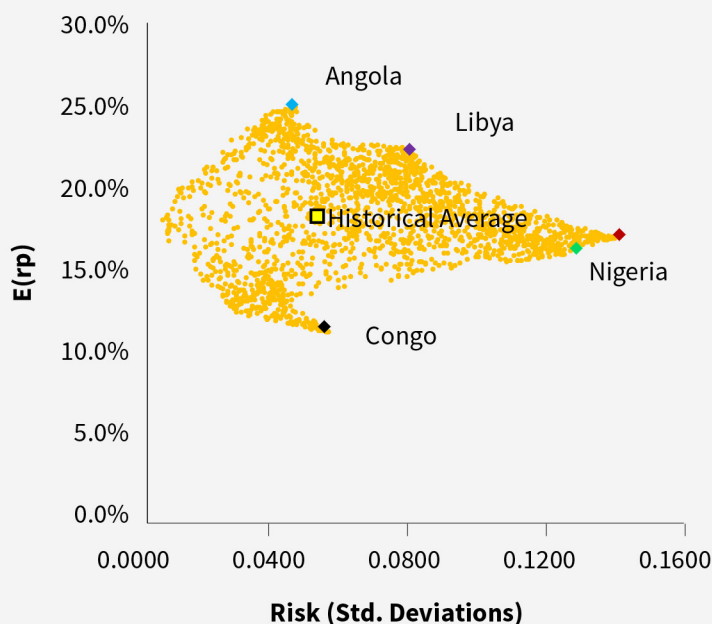
### A portfolio approach to managing investments in a global setting

Managers of product or service lines that cross national boundaries often are tasked with making resource allocation decisions. Typically, these decisions will be made within the context of a corporation's capital budgeting guidelines. A manager will project revenues, costs and cash flows expected to result from entering or continuing in a market and then apply the firm's weighted cost of capital ("WACC") to calculate net present value ("NPV") or use the cash flows to determine an internal rate of return or, still yet, use

payback period (the length of time required to recover an initial investment or savings) as a benchmark. To ensure that a measure of risk has been included in the analysis, managers perform sensitivity analyses to determine the accretive or dilutive effects of controllable and uncontrollable variables. In our experience, this process creates confusion, as it is too shortsighted for managing across multiple markets and lines of business.

For managers tasked with making resource allocation decisions across multiple markets, the process of plotting the risk-return profile of the operations should help answer two key questions:

**Figure 4.** Risk and Return Profile Simulation for Active Geomarkets



### Mapping market risks and returns

Markets Angola and Congo had similar risk profiles but considerably different historical returns. Conversely, Markets Libya and Nigeria offered similar returns but had significantly higher risk profiles than Angola and Congo. When the business managers had the opportunity to view their operations in this light, it enabled the managers to see that there was significant room to improve their market allocations and move closer to the efficient frontier. The business managers also found that certain service lines had positive relationships between risk and return while others had no relationship or even negative relationships, helping managers better identify areas for concern and improvement.



How much risk is the product/service line incurring in each market and in aggregate as a portfolio?



Is the return commensurate with the level of risk assumed?

We suggest using return on assets (“ROA”) as the preferred measure because it includes all forms of financing, equity or debt, to provide the resources required to generate a return to the parent organization and can be run across multiple assets in the portfolio. This measurement of return allows for a comprehensive evaluation of the market’s performance by including the profit and loss (“P&L”), as well as total balance sheet effects. However, a variety of return metrics, including operating income, return on equity and return on investment, also can be used. This can be plotted against the risk as a measure of variation (standard deviation) to the ROA historically expressed in a given market.

This fact-based risk-return profile provides valuable insights into the operational dynamics of the product or service line, including whether taking on more risk necessarily translates into greater returns. Armed with this

information, the management team can adjust the level of activity in various markets to optimize the portfolio and move it to the efficient frontier. Figure 4 describes a risk-return profile for a multiple country portfolio for an industry leader client.

### Adapting and enhancing decision making for smarter management

From the risk-return plots for a given product or service line, managers have a number of opportunities to improve the performance of a portfolio. Managers can alter their exposure to select markets in order to create an optimal portfolio of markets in which to operate with a longer term strategic focus vs. knee-jerk, tactical reactions. In a financial market, an investment manager can sell a security in an exchange to reduce a portfolio’s exposure; it is much harder for an operational manager to close an office or move equipment out of a market. Accordingly, we do not recommend a quarterly focus for managing portfolio risk; operational managers must manage the weight of markets in their portfolio of business and make decisions for the long run.

There are two ways an operational manager can use the risk-return profile to improve returns from the portfolio:



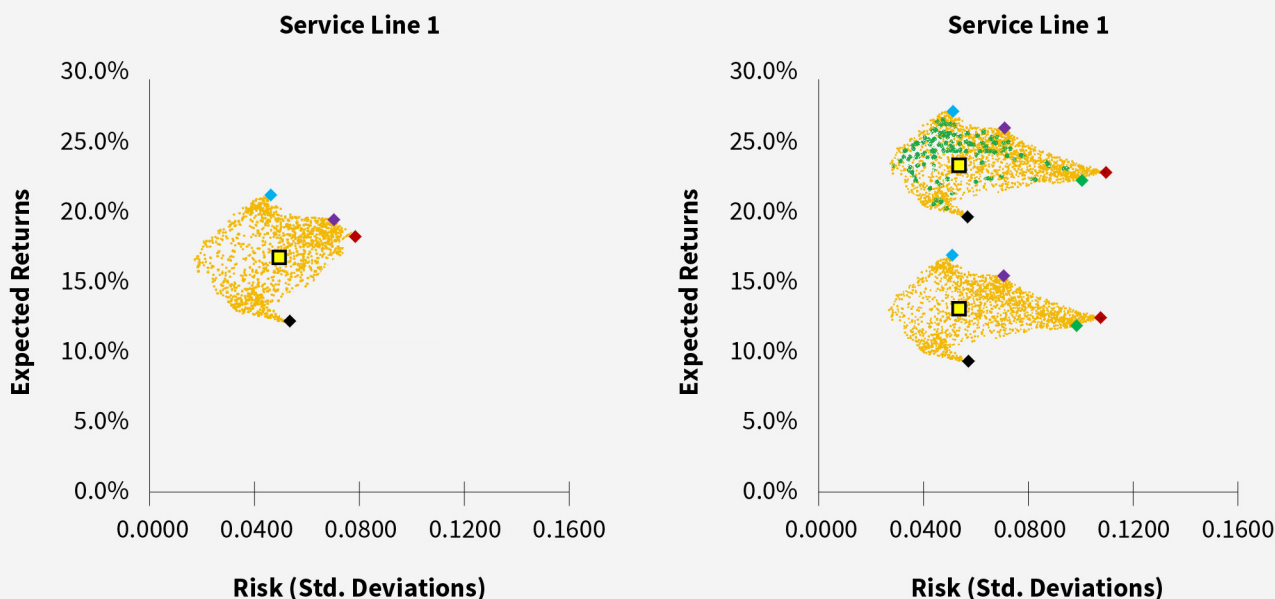
Profile management



Profile shifting

The goal in profile management is to identify underperforming markets and institute market-specific performance improvement projects. Management teams can do this by changing the ROA and by managing the risks of specific markets. Managers can shift market performance on the risk-return profile vertically by instituting a variety of performance improvement initiatives. Because the measure is ROA, managers can affect top-line performance through price increases or bottom line P&L performance through cost savings initiatives. Additionally, managers can implement local asset efficiency programs that will decrease the denominator (total assets) in the ROA equation.

Risk variables can be slightly more difficult to manage, but they still can be

**Figure 5.** Managing Geomarket Risk by Initiating Performance Improvement Programs for the Portfolio

improved in various ways. If managers determine that the market has a short-term cyclical aspect to its activity level, they can work on the underlying cost structure supporting the market. Another option is to work with customers to smooth demand peaks and valleys for products or services. Both of these options will reduce period-to-period variations in the ROA metric and also the standard variation; that is, the risk factor. Finally, to control the level of risk, one of the most powerful tools available to management teams is contract management. Ensuring favorable terms in contracts can help reduce variations in ROA that are not necessarily a result of activity. For example, negotiating for payment in the parent company's currency can reduce currency fluctuation risk.

Profile shifting is the second option available to managers to improve the performance of their product or service line. Profile shifting is similar in concept to profile management except that it requires equal improvement opportunities across all markets in the portfolio. This has the effect of shifting the entire risk-return profile vertically or horizontally without changing the

shape of the profile, as seen in Figure 5. In this example, the client team had the opportunity to raise the overall performance of the portfolio by rolling out universal process improvement projects across the countries in the portfolio.

### Why you need an integrated approach to business risk management

As projects and opportunities present themselves, managers need a way to ensure that, in accepting a project, they are being properly compensated for its risks. The traditional way to do that is to use NPV or another method of discount rates. NPV uses the WACC as the discount rate. The logic is that any project that is accepted will add value for shareholders of the parent organization. However, this will allow managers merely to verify that a project is good enough, not that they are being fully compensated for the project's risks. Accordingly, some management teams have been modifying the WACC specifically for certain markets. This is known as country WACC adjustments.

#### How static risk assessment leads to missed opportunities

A global oil and gas services company in Latin America had consistently underperformed compared with the industry despite the fact that the region itself had registered significant growth during the same five-year period. The company pursued mid- to long-term projects using the traditional approach of a one-off quantitative market risk assessment. This led to suboptimal returns of the company's overall portfolio as market conditions changed in subsequent periods and tactical decisions to correct projects were made on the fly.

At the same time, new investment requests were being reviewed with negative bias filters (due to the drop in the portfolio's performance), and the corporation was missing out on real opportunities to turn the portfolio around. Caught in a downward spiral, headcount reduction and frequent leadership changes had become the norm, creating an environment of mistrust, fear and low morale.



Using the WACC as a basis, managers can modify the discount rate used for project acceptance decisions based on qualitative factors in the contract, as well as by the quantified risk of the specific market. Managers can create discount rate adjustments for a variety of qualitative factors, including fixed pricing without price adjustment clauses, the transaction currency and contract length. This allows management teams to influence tactical acceptance decisions to reflect strategic direction, as well as to encourage contract terms that will reduce performance variance during the execution phases. This type of analysis permits managers to view quantitative factors — like price and cost — independent of qualitative factors such as payment currency and contract length, thus leading to enhanced risk mitigation and profitability.

An analysis of a contract's value addition should take place prior to project acceptance and be part of the go/no-go decision. As part of this process, managers should have the opportunity to influence contract terms, as well as revenue and cost assumptions, to allow a project to exceed its hurdle rate and, thereby, optimize return.

Corporations that have large medium- to long-term projects in developing economies can benefit from this integrated approach. Projects with both large capital expenditure entry points and ones with significant recurring operating budgets can use this model to better manage business performance.

Industries such as oil and gas, petrochemicals, mining, metals, engineering construction, infrastructure, and capital-intensive building product operations such as cement and steel, forestry, shipbuilding, aerospace and defense, hospitality projects, and large conglomerates and real estate investment trusts with diversified portfolio investments will be the prime beneficiaries of adopting an integrated business performance risk management methodology.

### Accepting the permanence of risk

The recent history of economic globalization thus far does not reflect Thomas L. Friedman's utopian vision in *The World Is Flat* in which business rules around the world converge. Rather, as Nader Mousavizadeh, Partner and Co-founder of Macro Advisory Partners, told a recent meeting of FTI Consulting senior

managing directors, it appears the world will remain more like an archipelago — a group of small islands, each with its own politics, protectionist measures and ways of doing business. Turmoil here, there and everywhere most likely will continue to exist, and managers will need an integrated approach to business performance risk management to navigate and make progress in choppy waters.

In addition to understanding the market-specific risks inherent in developing economies, managers need to measure the true level of risk their international market portfolio is incurring, as well as determine if they are being properly compensated for this risk level. The analysis presented here can be a tool to provide a comprehensive view of risk and profitability that can help management teams improve the performance of their portfolio.

Although the challenges of operating in developing markets will continue to multiply, there still are opportunities to gain sustainable competitive advantage by maintaining a presence in emerging markets. Management teams that adapt to marketplace risks by managing a portfolio proactively and holistically will generate better shareholder returns. ■

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