Oxford Analytica

How are leading companies managing today's political risks?

2018 Survey and Report

A report produced for Willis Towers Watson

Willis Towers Watson

About this report

Oxford Analytica is providing this survey report for Willis Towers Watson.

Oxford Analytica is a global analysis and advisory firm which draws on a worldwide network of experts to advise its clients on their strategy and performance. Our insights and judgements on global issues enable our clients to succeed in complex markets where the nexus of politics and economics, state and business is critical.

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ABOUT THE RESEARCH

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It has been another tumultuous year in geopolitics since the last edition of this study was released in September 2017. The US has become locked in an escalating trade war with China and imposed new sanctions on Russia and Turkey. Rising oil prices have led to severe riots, strikes and protests in Jordan, Brazil, and Mexico. Several sub-Saharan African countries have defaulted on their sovereign debts. The "cold war" in the Middle East has continued to escalate – with, as in the case of the original US-Soviet cold war, distinct hot patches, particularly in Yemen. Emerging markets more generally have been pummelled by adverse economic conditions and outflows of footloose portfolio capital. As of this writing, Turkey is beset by a currency crisis that is rapidly becoming a debt crunch.

At a glance

Note: For details including sample sizes see the main text of this report

Proportion of companies with $1bn+ revenues that have suffered a political risk loss

55%

Proportion of political risk losses suffered that exceeded $100mn

43%

Country where political risk losses were most frequently reported

Russia

Have scaled down operations in a country as a result of rising political risk concerns

68%

Source: Oxford Analytica

How are the world's leading companies managing such challenges? Last year, Willis Towers Watson and Oxford Analytica conducted a series of twenty structured interviews with panellists representing some of the world's leading firms. Their geopolitical concerns were prescient: they mentioned threats from protectionism and trade wars, US sanctions policy, and tensions with a rising China as top concerns.

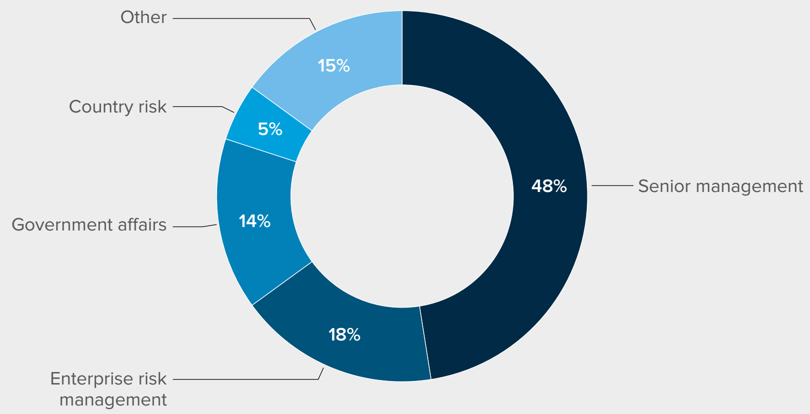
This year, we have expanded our study to include a formal survey of 40 leading companies, backed by in-depth follow-up interviews with 10 of the participants. We have focused on the clients of Willis Towers Watson and Oxford Analytica. As a result, this sample should not be seen as representative of companies worldwide, but rather of a leading group of firms that both face significant political risk exposure and invest significantly in political risk management.

We have expanded our study to include a formal survey of 40 leading companies

For that reason, the sample is biased towards large firms, with the greatest proportion of respondents (40%) having annual revenues of $10 billion or more. The participants represented a wide range of industries, from consumer products to telecoms to mining, with the largest proportions, approximately 20% in each case, from energy and real estate. In terms of job function, the largest number were in senior management (48%), with enterprise risk management second (18%).

Job functions of respondents

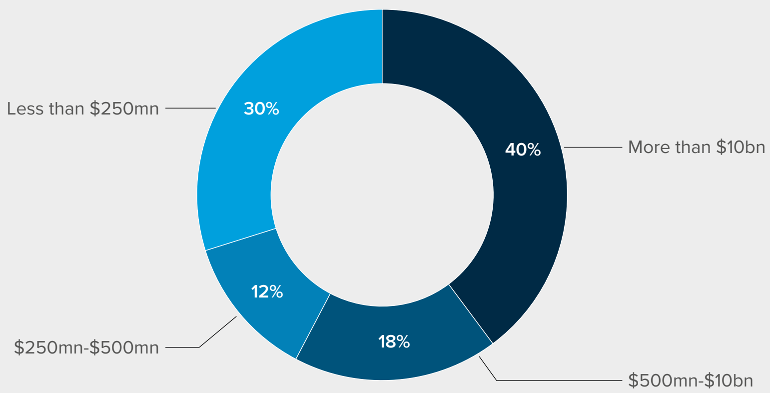
Note: All respondents; n = 40



Source: Oxford Analytica

Annual revenues of respondents' companies

Note: All respondents; n = 40



Source: Oxford Analytica

1. POLITICAL RISK LOSSES

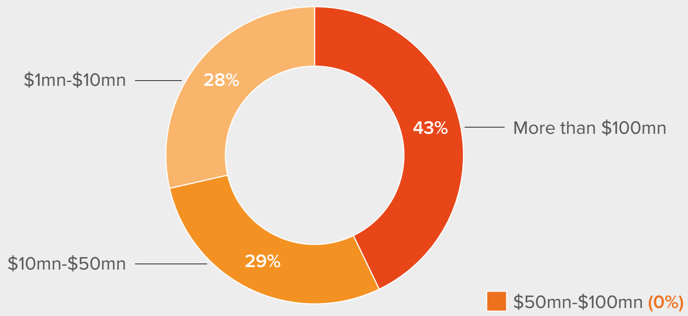
The term "political risk" can mean different things to different people, so we started our survey with several case examples of actual political risk losses – losses that may potentially have been addressable via political risk insurance (see callout). We asked the survey participants to read the cases and let us know if they had suffered similar losses; the scale of these losses; and where these losses had occurred. The results were striking.

Although these were companies with substantial competence in political risk management, and in many cases decades of experience operating overseas, more than 1 in 3 (35%) had suffered political risk losses in recent years. Indeed, a majority (55%) of companies with annual revenues in excess of $1 billion had suffered such a loss. It is often said that political risk losses are infrequent but catastrophic. However, while this remains true, our survey also highlights the extent to which exposure to political risk has become a reoccurring and material cost of doing business. The largest portion of losses, 43%, were in the highest category of financial impact, at $100 million or greater. One mining sector respondent noted that losses relating to political risk had, over the past three years, averaged $700 million per year. Companies with annual revenues in excess of $1 billion were significantly more likely to have experienced such large losses. Indeed, 70% of companies with revenues greater than $10 billion and had experienced at least one political risk loss reported that their loss or losses exceeded $100 million in value.

One respondent noted that losses relating to political risk had, over the past three years, averaged $700 million per year

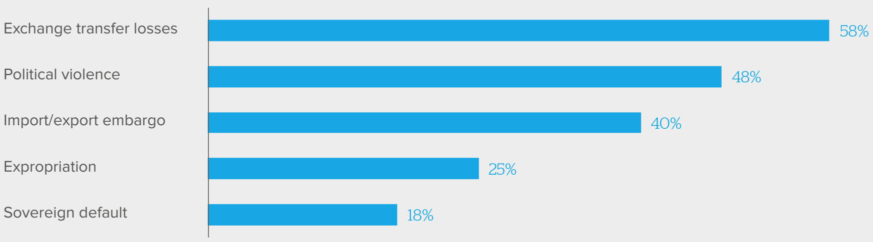
What was the financial impact of the political risk loss or losses?

Note: Respondents that had suffered losses; n = 14



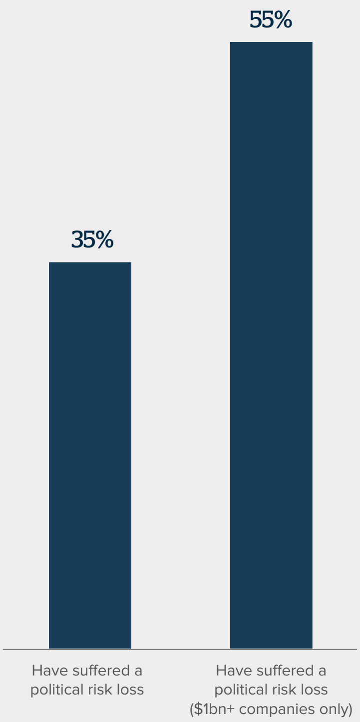
What types of political risk events caused the losses?

Note: Respondents that had suffered losses; n = 14



Political risk losses

Note: All respondents, n = 40;
for $1bn+ companies n = 22



Source: Oxford Analytica

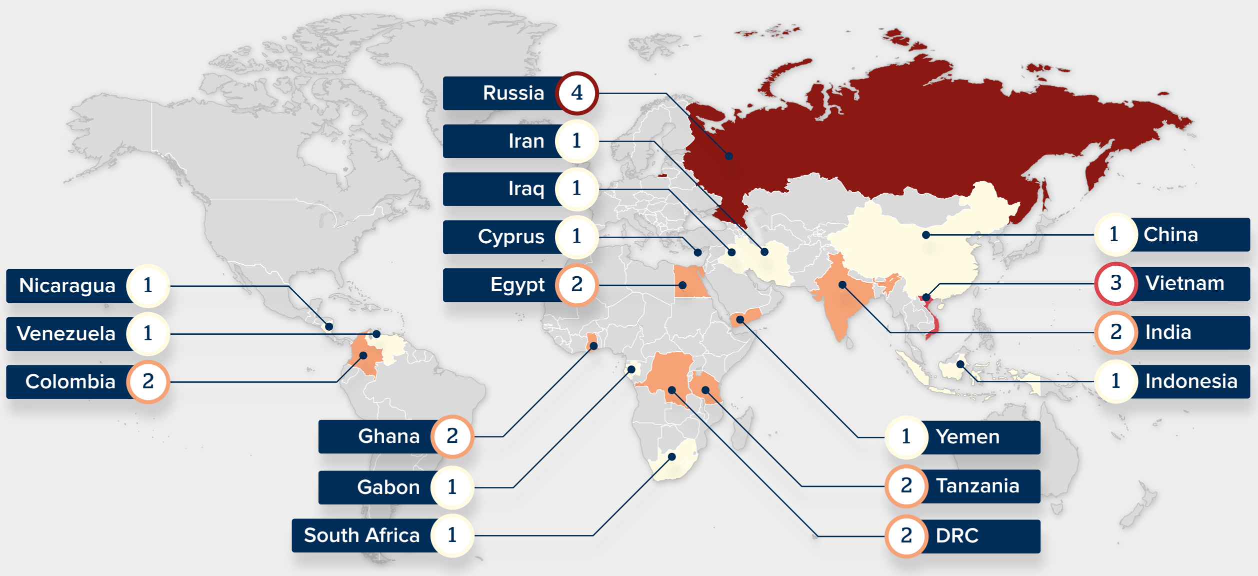
Larger companies were significantly more likely to report losses arising from expropriation, political violence and trade embargoes

What events caused these catastrophic levels of loss? The most frequently-reported loss event was exchange transfer, impacting nearly 60% of those experiencing losses. Exchange transfer losses tend to be smaller, impacting contracts and repatriated earnings rather than corporate assets. That said, in Venezuela in particular, many US corporations have reported large inconvertibility losses.

The second-most commonly experienced loss event was political violence. One respondent noted ongoing civil wars in Yemen and Syria as a source of such losses. Larger companies, with annual revenues in excess of $1 billion, were significantly more likely to report losses arising from expropriation, political violence and trade embargoes. A mining sector respondent noted that while most companies were concerned about import embargoes or trade sanctions, they had recently suffered losses from an export embargo on their product – because they were unable to export, they were incurring ongoing "costs [that] were not being funded through income generation."

In which countries did you experience political risk losses?

Note: Companies experiencing political risk losses only; ranked by number of mentions



Source: Oxford Analytica

Asked about the countries where recent losses have occurred, Russia was most frequently mentioned, followed by Vietnam. These results are not entirely surprising, as the Berne Union association of political risk insurance underwriters reports that, over the past five years, the countries generating the largest value of political risk investment insurance claims are Russia, Turkey, Venezuela and Vietnam (in that order). In the past, Russia saw numerous expropriation events, particularly in the natural resource sector. More recently, as one energy sector respondent noted, "the financial impact of political risk has increased, specifically because of the increased use of sanctions against Iran and Russia, and the development of tariff wars."

EXAMPLES OF POLITICAL RISK LOSSES

Expropriation

General Motors (GM), Venezuela

In April 2017, the Venezuelan Judicial Authorities seized GM's manufacturing facilities. As a result, the company was forced to write off the plant and recognise a $100 million charge against profits.

Sovereign risk

Carillion, Qatar

The construction company collapsed in January 2018 due to, in large part, the refusal of the Qatari government to pay for contracts worth a reported $200 million. The failure of the Qataris to pay the contract was apparently linked to increasing international controversy around labour practices being used in the construction of World Cup sites and contract disputes stemming from currency fluctuations.

Creeping expropriation

Kingsgate, Thailand

In 2016, the Thai government forced Australian miner Kingsgate Consolidated to close its gold mine in Thailand, allegedly due to environmental and public health issues. In 2017, Kingsgate announced it was taking legal action, demanding compensation of $750 million.

Sovereign default

External creditors, Barbados

In June 2018, Barbados sought to restructure the country's public debt by suspending payments due to external commercial creditors. This decision followed the discovery by the incoming government that previously undisclosed financial liabilities increased the country's overall debt from 137% of gross domestic product to more than 175%. The business implications included requiring many Barbadian businesses to pay upfront for imports.

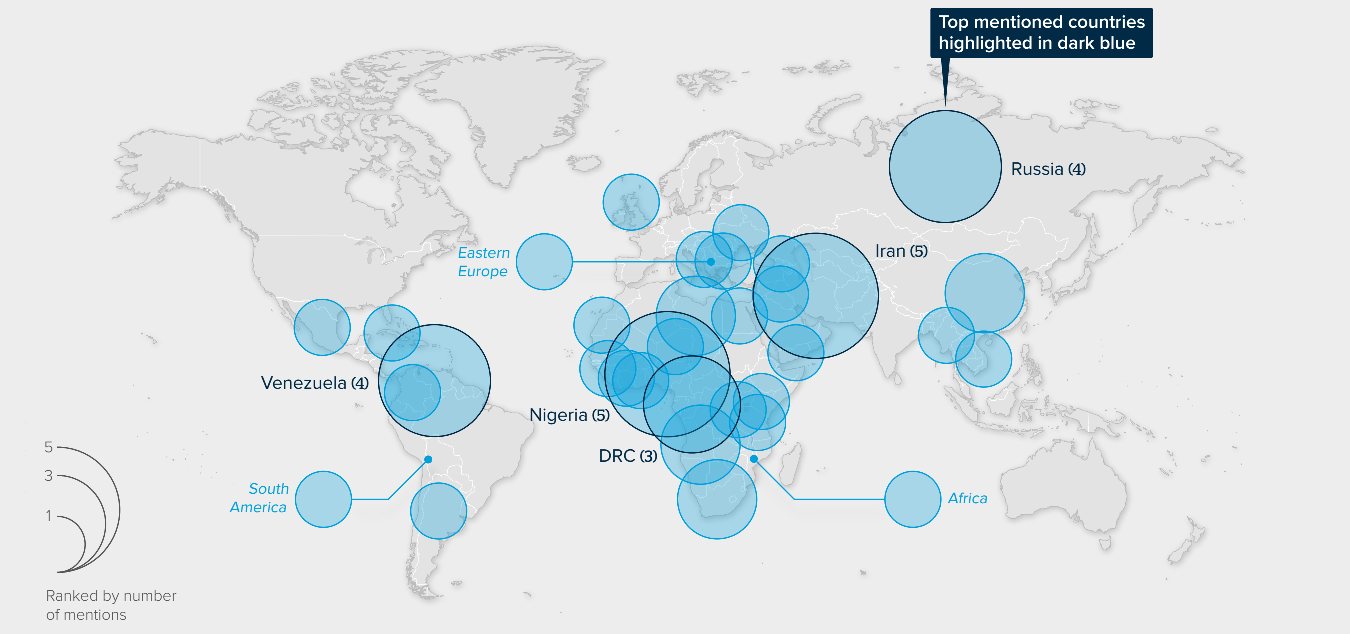
2. THE IMPACT OF POLITICAL RISK ON CORPORATE DECISIONS

Nearly 70% of respondents stated that they had scaled back operations in a country as a result of political risk concerns

Perhaps inevitably, losses on such a scale – and concerns about such losses – have had a significant impact on corporate decision-making. Of our respondents, 60% reported that political risk levels had increased since last year, and nearly 70% stated that they had scaled back operations in a country as a result of political risk concerns or losses. "When concern reaches a certain point we withdraw assets, shuffle supply chains, prepare to move money out of local banks," noted one industrial products respondent.

Companies also reported adopting avoidance strategies: more than 70% reported holding back from planned investment as a result of political risk concerns. In our panel interviews last year, "exposure minimisation" was a popular strategy for mitigating risks; it remained so this year. Notably, larger companies were more likely to report taking both types of avoidance strategies – among companies with more than $1 billion in revenues, 82% stated that they had scaled back investments, and 86% had avoided future investments. Companies most frequently reported scaling back investments in Nigeria, Iran, Russia and Venezuela.

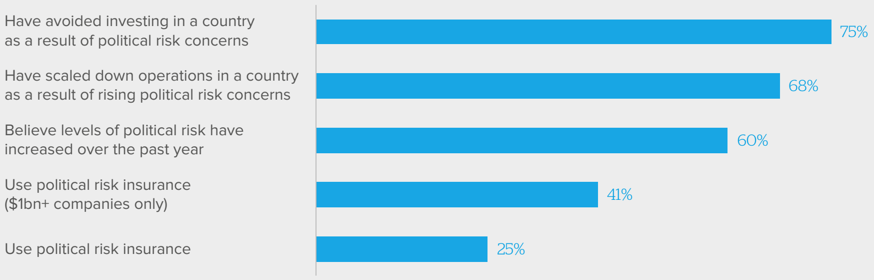
Scaled down operations in a country as a result of rising political risk concerns



Source: Oxford Analytica

Responding to political risk

Note: All respondents, n = 40; for $1bn+ companies only n = 22



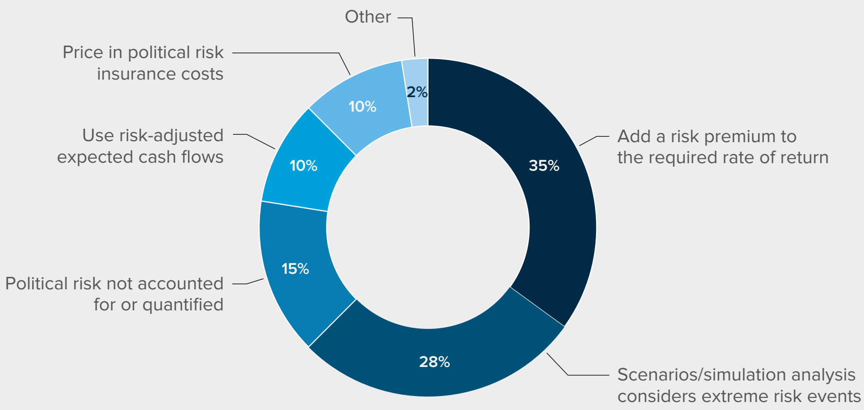
Source: Oxford Analytica

We asked companies how they make such difficult decisions, about when to scale back and when to invest. There was, of course, a substantial minority that used ad hoc approaches: 15% said political risk was not accounted for or quantified. For most others, however, use of risk premia was popular, including adding a political risk insurance premium (whether insurance was purchased or not) and the more sophisticated approach of using risk-adjusted cash flow estimates. Taken together, variations on these valuation approaches were reported by the majority (55%) of respondents. A significant minority of nearly 30% used simulations or scenarios. “Outputs of the Country Risk team are reviewed and circulated by the Geopolitical Committee, which is one of the committees of the Board,” noted one energy sector respondent.

Quite a few respondents expressed dissatisfaction with their company’s decision-making on geopolitical risk. “ERM [enterprise risk management] is not well-tailored to address complex geopolitical and social issues,” said one mining sector respondent, noting that “at many companies, risk is an afterthought,” and “securing optimal outcomes is impossible if you’re at the end of the decision-making process.”

How companies value political risk when making decisions

Note: All respondents; n = 40



Source: Oxford Analytica

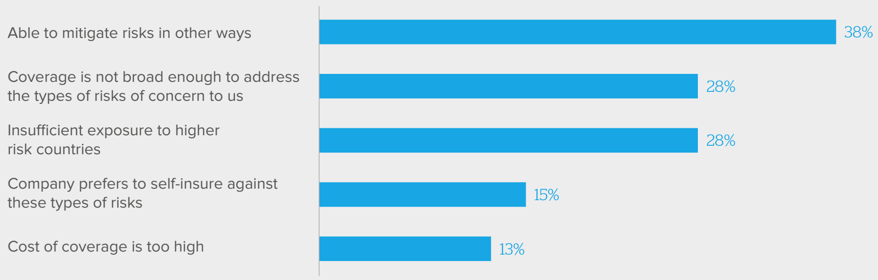
> The choice to scale back an investment entails a "loss of opportunity," even if it avoids a balance sheet loss

However the decision is made, the choice to scale back or withhold from investment – even if it avoids a balance-sheet loss – entails a "loss of opportunity" (a point made by a respondent in the real estate sector). Avoidance sacrifices the revenue enhancement or cost reduction that global operations can produce. There is, of course, a large marketplace of consultancy services and financial products available to help companies mitigate such losses and thus seize the opportunities afforded by global expansion. A quarter of the survey respondents said they used political risk insurance – a figure that rose to 40% among companies earning more than $1billion in annual revenues.

Still, that left a majority who had not purchased insurance. We asked why. The most popular answer was that the respondent relied on other means to mitigate risk. One respondent with business revenues divided nearly equally among Europe, the Americas and Asia reported taking a "portfolio approach," so that "problems in one area do not upset the overall situation." There was a tie for the second-most popular answer (respondents could select as many answers as they wished). About 30% said coverage was not broad enough; the same proportion said that exposures were not high enough (perhaps as a result of an "avoidance" approach). One respondent, joining the 15% who stated they preferred to self-insure, noted that a "healthy treasury allows us to handle our current level of risk internally."

Why not use political risk insurance?

Note: All respondents; n = 40



Source: Oxford Analytica

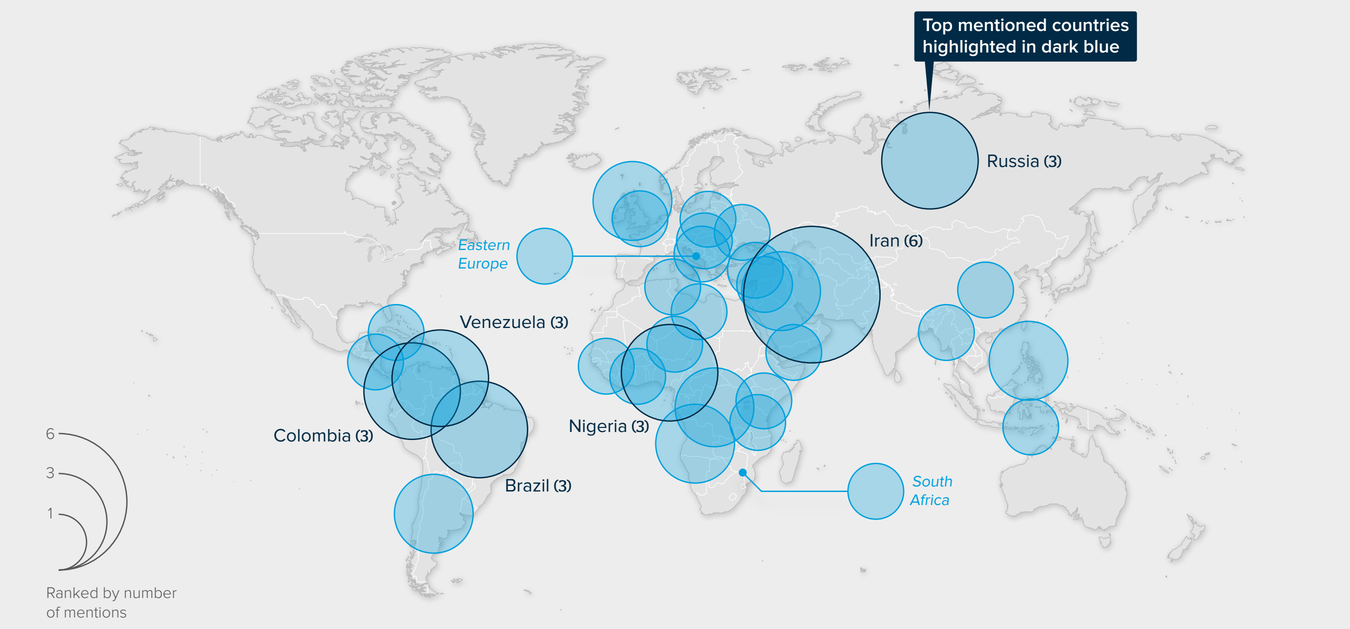
3. RISKS AND REGIONS OF CONCERN IN THE FUTURE

The panellists who participated in our 2017 study were prescient in identifying key sources of political risk. Their top concerns were US sanctions policy and rising trade protectionism. In the year that followed, both issues escalated dramatically. Will they be as prescient in the year ahead? And what are their concerns as we look towards 2019?

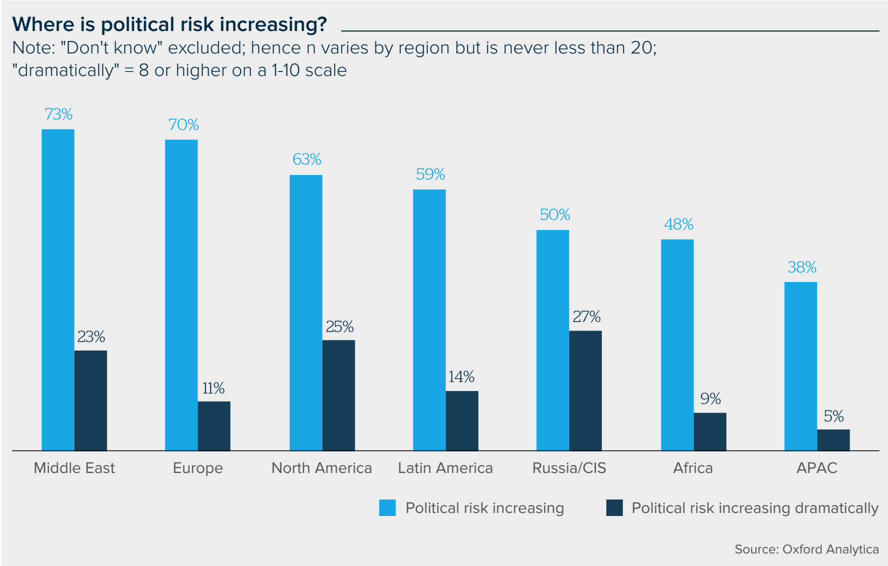
We asked our survey respondents where they were curtailing future investments and, more generally, in what regions political risk levels were rising. Many of the countries where respondents were curtailing investment were predictable: Iran had by far the highest number of mentions, in part as a result of an increasingly hard-line sanctions policy by the US government. Russia, Venezuela, Nigeria, and Brazil were also mentioned frequently; each of these countries is under substantial economic (and in some cases political) pressure. Other countries and territories were more surprising: Colombia, which had recently been on an improving trend; and Scotland.

The panellists who participated in our 2017 study were prescient in identifying key sources of political risk

Avoiding investment because of political risk concerns



Source: Oxford Analytica



On that theme, one of the top two regions where survey respondents felt political risk was rising was Europe – presumably in large part due to the "populist" governments in power in Italy, Greece, Hungary and Poland. In addition, "foreign investors are increasingly bypassing the UK [for Western Europe] as a result of Brexit uncertainty," noted one real estate sector respondent.

That said, few respondents (only 11%) felt that risk in Europe was rising dramatically. The world regions that most often fell into the dramatically-rising category were Russia and North America. Several respondents mentioned the US government's trade and sanctions policies – although whether those policies will lead to rising risk in North America itself, in other regions, or both, remains to be seen.

Investors in India and China are experiencing varying levels of retaliation

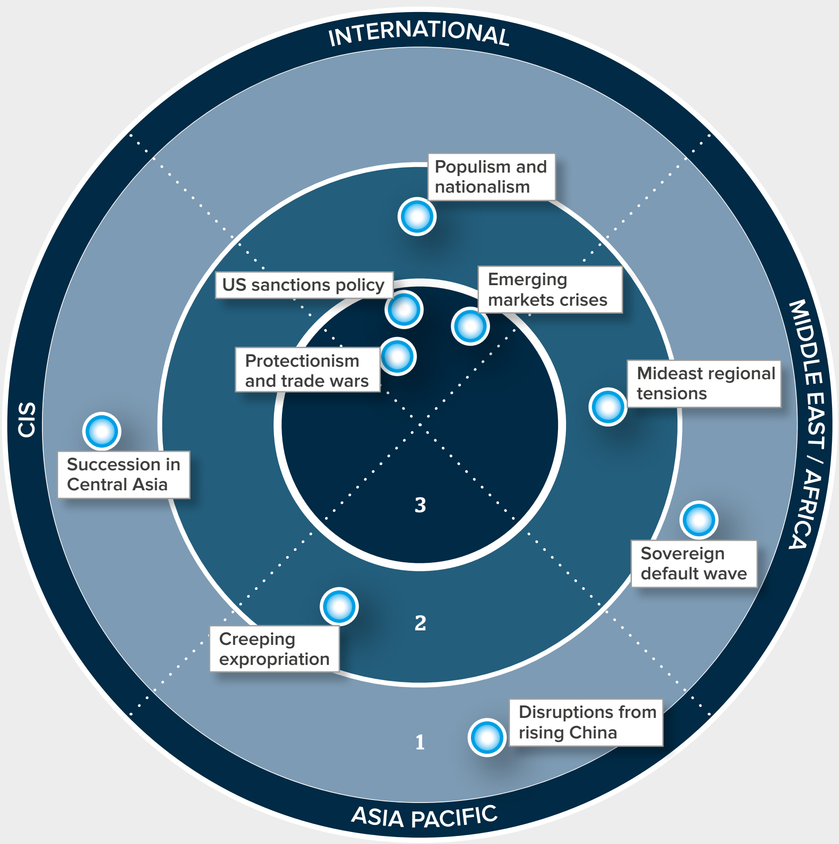
Lastly, we asked the panellists who participated in extended interviews an open-ended question: what is the geopolitical threat of greatest current concern? As with last year, we endeavoured to aggregate the results by identifying common themes in their answers. At the top of the risk radar produced by this exercise, there were a number of threats common to last year: US sanctions policy, protectionism, populism, and tensions in the Middle East. One top threat was new: the political risk implications of emerging markets economic crises, like that in Turkey (a related peril, the sovereign default wave that has started in Sub-Saharan Africa, appears at number seven). One panellist noted that "political upheaval could lead to regulatory changes."

Protectionism has broadened out to include trade war, as well as more explicit concerns about the potential corporate implications of protectionism. Panellists expressed concern that increasingly influential local competitors would abuse their political influence to force foreign investors out of markets. “Investors in India and China are experiencing varying levels of retaliation,” said one respondent in the food and beverages sector. “In emerging markets, there are those that want to compete and those that want government action when things do not go their way.”

Towards the bottom of the radar, there were a number of other new perils. Creeping expropriation enters in sixth place, as a bump up in oil prices gave rise to concerns about a possible return of resource nationalism. “Governments are less hesitant to demand more or change the rules,” noted one mining respondent, “and we expect resource nationalism to continue to rise in Africa (broadly) and Asia, specifically Indonesia and Malaysia.”

Risk radar

Note: Ranked by number of mentions



Source: Oxford Analytica

CONCLUSION

The past few years have been extraordinary in terms of geopolitical risk – particularly because much risk has originated in advanced economies, for instance in sanctions policies, even if investors in the “traditionally risky” emerging markets have thus far felt the brunt of the losses. There can be little doubt that political risk has been rising, and that in recent years many companies have experienced large – even catastrophic – political risk losses.

As geopolitical risk levels have risen, investors have turned to strategies of avoidance, drawing down investments in crisis-hit locations and foregoing planned investments in countries that appear to be becoming riskier. To a certain degree, such reactions are both inevitable and prudent, but they have their own costs. Rising risk perceptions have the potential to produce a period of reduced global investment by leading companies. Recent research suggests that corporate efforts at risk reduction could produce a period of moderated returns in the medium term. And thus, for those companies that can continue to effectively operate in environments of rising risk and associated high returns – and can manage political risk effectively – a competitive advantage awaits.

We would like to thank the survey participants and interview panellists for their time and insights.

Imagine if you could quantify the cost of political risk events
Willis Towers Watson, as a leading political and credit risk insurance broker, can help you mitigate the political risks associated with operating overseas. Our innovative insurance solutions, supported by our sophisticated risk modelling, can assist you when considering investment options.
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