IS PROTECTIONISM ON THE RISE IN AUSTRALIA?

Could Australia become riskier and, if so, how much of a loss could investors reasonably expect? And, as the march to protectionism continues, will it all end in tears? Leadenhall investigates.

Introduction

As investors find it easier to access opportunities abroad, and with the risks varying from country to country, it's worth understanding the causes and effects of "sovereign risk" – and how it could impact the Australian market.

What is sovereign risk?

Traditionally, as part of country risk, sovereign risk relates to the risk of default by a country on its debt to banks and other countries. Today, it more broadly describes a number of additional risks of government intervention in business, and this paper is based on them:

- **Political / Regulatory environment** – includes adverse policy changes, legislation, and decisions that may adversely impact certain sectors or businesses.
- **Legal rights for investors** – such as access to and enforcement of property rights, and appropriation of privately-owned assets by governments.
- **Economic structure** – refers to key asset dependency (such as oil) which may result in indirect or unintended exposure to another asset class.

Globally…

Recent economic turmoil in the Eurozone and a rise in protectionism may be contributing to heightened sovereign risk for certain countries, due to:

- The election of Donald Trump, whose election campaign was underpinned by an emphasis on protectionist policies.
- European protectionism. For example, with Brexit and the emergence of other political figures with protectionist rhetoric.

What's causing the growing fear about Australia?

Foreign investors in Australia may well have their fears triggered by:

- The debate around the implementation of restrictions on LNG exports in order to address the gas shortage – and high prices of LNG affecting the Australian East Coast. The argument is that such quotas and restrictions increase the cost of doing business in Australia and divert funds to less costly and risky investments.
- A recent proposal by the WA state government to raise the gold royalty rate. This has sparked sovereign risk concerns in the industry with gold miners asserting that a royalty increase would impact expenditure on exploration and development.

NOW YOU KNOW SOVEREIGN RISK

- The high-profile blocking of two foreign investments in 2016 by the Federal government when it barred the sale of a 50.4% holding in Ausgrid to State Grid Corp (the Chinese state-owned utility company) and the blocking of the acquisition of the Kidman cattle empire by a Chinese-led consortium. Without doubt, these raised the spectre of rising sovereign risk.
- The cancellation of the East West Link infrastructure project in Victoria in 2015 which involved a consortium of companies including large global construction companies, Acciona and Bouygues. Cancelled due to a change of state government, this led to substantial termination costs of approximately $1.2 billion offset by $320 million in sales of assets acquired for the project – and official complaints by the ambassadors of France and Spain.
- And, on the horizon, the recently announced Royal Commission into the banking sector.

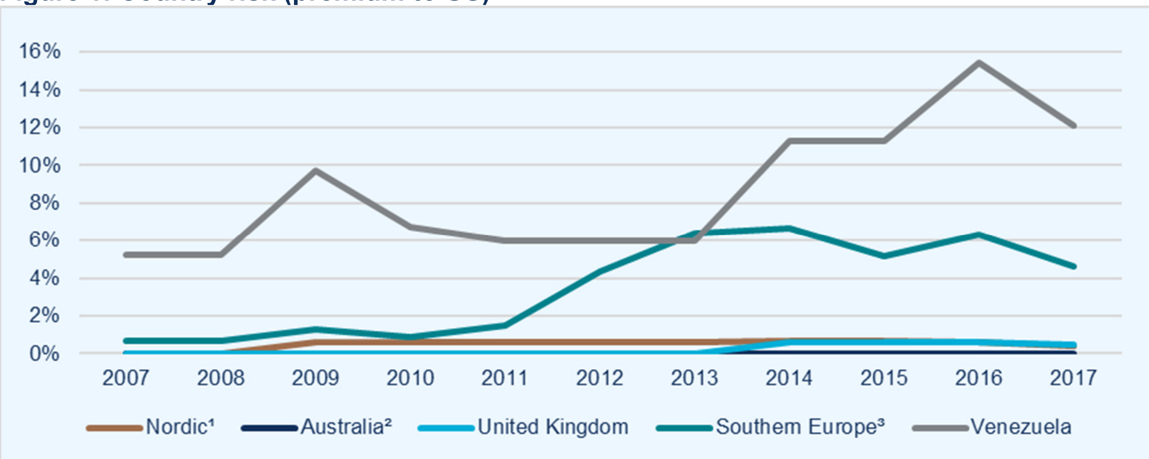
But, from a valuation perspective…

Investors need to allow for any additional sovereign risk when pricing or valuing assets in different countries – either by amending cash flows to factor in these risks or including an additional premium in determining the required return/discount rate to apply to an investment. But measuring country risk can be tricky, because:

- Risks can vary by sector even within one jurisdiction.
- Risks may vary amongst investors as investor perception is not homogenous.
- Countries with higher degrees of sovereign risk are typically emerging and third world countries – where financial data and its quantitative analysis is limited.
- There are no generally accepted models or methodologies.

Worse, measuring sovereign risk is even more subjective, but for the purpose of our analysis Leadenhall has considered the data on country risk provided by Aswath Damodaran, Professor of Finance at New York University.

Figure 1: Country risk (premium to US)



Source: Aswath Damodaran and Leadenhall analysis

Notes:

1. *The Nordic countries comprise Sweden, Denmark, Norway, Finland and Iceland. The mean country risk premium increased in 2009 due to the economic difficulties faced by Iceland during the global financial crisis. Excluding Iceland, the mean would have been nil throughout most of the period.*
2. *The country risk premium for Australia is nil throughout the period as Commonwealth Government bonds have a Aaa credit rating.*
3. *Southern Europe, in this analysis, is the median spread calculated for Italy, Spain, Portugal and Greece.*

NOW YOU KNOW SOVEREIGN RISK

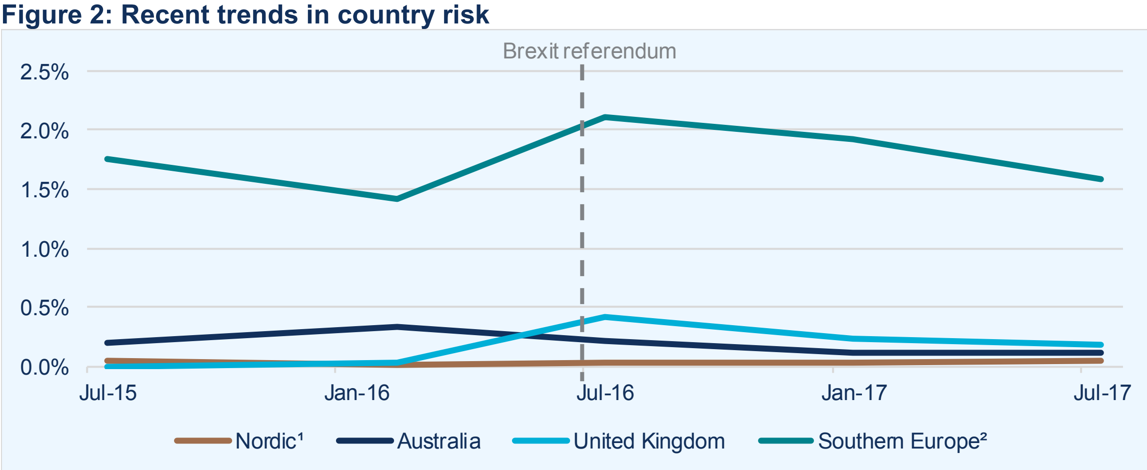
You will observe that:

- Venezuela, which is an oil reliant economy, was highly affected by the oil price crash in 2014/2015 and currently has the highest country risk premium at 12%. It has a high level of intervention by the government in business, nationalisation of private assets and industry sectors, plus economic and political instability – all contributing to the high overall country risk premium.
- The Nordic countries generally have some of the lowest country risk premiums in the world (except for Iceland), likely due to their stable political environments and high levels of social welfare.
- The economies of the Southern European countries of Italy, Spain, Portugal and Greece suffered during the Eurozone debt crisis with their governments unable to repay their sovereign debt.

Brexit effect

The following chart presents more recent trends in estimated country risk:

Figure 2: Recent trends in country risk



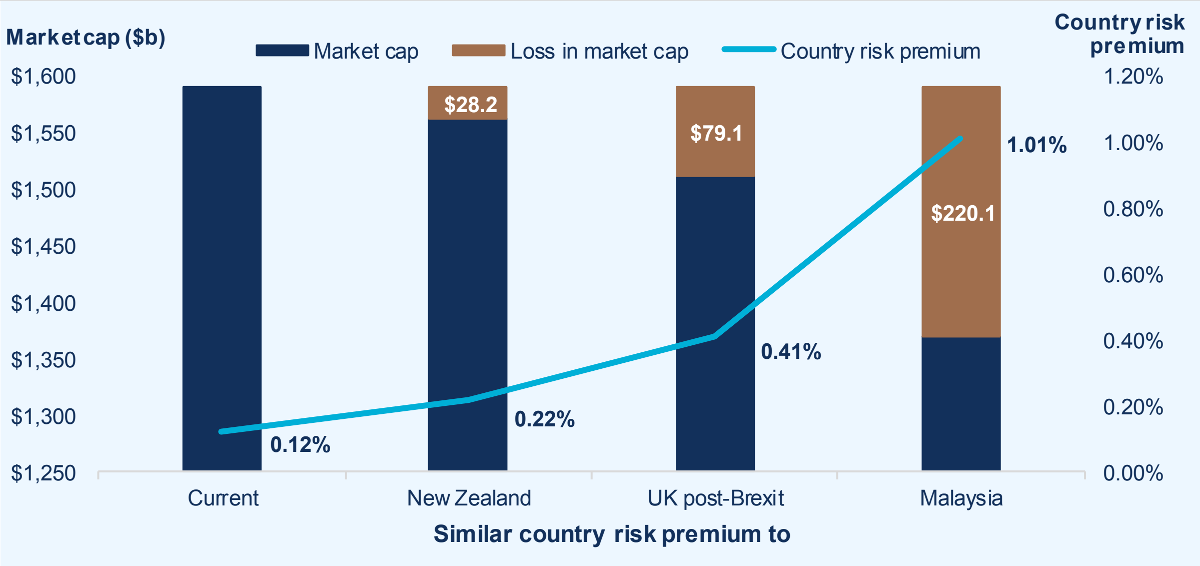
Source: Aswath Damodaran and Leadenhall analysis
Notes:
1. *The mean for the Nordic countries excludes Iceland.*
2. *Southern Europe excludes Greece.*

You will observe that:

- **UK pre Brexit:** The pre-Brexit country risk premium in February 2016 was 0.03%.
- **UK post Brexit:** Post-Brexit referendum, in July 2016, it was 0.41%. Currently (July 2017) this is at 0.18%.

Leadenhall estimates a loss…

Notwithstanding the domestic issues discussed earlier in this paper, there has been no significant country risk premium attached to Australia to date. However, if investors do begin to apply a country risk premium as a result of future decisions, the market response could be significant. The potential impact of increases in Australia's country risk premium on the market capitalisation of the ASX 200 is as follows:



Source: Leadenhall analysis

Conclusions…

- Based on the above, a 10 basis point increase in Australia's country risk premium does not appear to be unreasonable.
- This would make Australia similarly risky to New Zealand.
- A change of this magnitude would result in an approximate $28 billion loss in market cap for the ASX 200, an average decline of $140 million for each company.