Political Risk Considerations in Global Planning

Insight paper by Harmattan Risk

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Political risk is often associated with spectacular events, such as expropriation, terrorist attacks, strikes, corruption scandals and shareholder rebellions based on unethical business practices. As such, it seems remote from day to day planning, and regarded as a concept that covers "black swans" that fall outside conventional commercial considerations. However, given the ubiquity of the socio-political context (the sea we swim in) and the inevitable linkages between an international company and its political environment, a consideration of political risk is not only beneficial, but when dealing with diverse global operations or when emerging markets form a significant part of the global portfolio, it can be indispensible to long-term business resilience.

The aim here is to elucidate the potential contribution of a consideration of political risk to effective global business planning. As an introductory illustration, this is confined to corporate global planning (Following from this will be future pieces on new market entry and operational sustainability).

Corporate global planning

The subtitle might not always be applied, but it refers to planning that necessarily takes into account the relevant attributes of different geographies, and which also aims at coordination across geographic activities. This is often an element of corporate planning (which would consider coordination across a matrix structure) and the greater a firm's international spread, the more explicit the global perspective. For example, some companies conduct corporate planning with an emphasis on business units and their markets and competitors, downplaying the cross-border and transnational character of the company. Others, however, bear sufficient global exposure and geographic diversity that the cross-border / transnational character of the firm is an explicit consideration. For such companies, global planning, how geographic exposure and opportunity can be managed, is a substructure for the usual "company, customer, competitor" planning process. Of course the business basics matter, but the fact that these basics are spread between multiple cultures and jurisdictions matters just as much.

The following are some ways in which a political risk perspective can contribute to global planning and help to result in a more resilient overall global organisation. To know what to expect, the following elements comprise the rest of the paper:

- Geopolitical portfolio balance
- Scenario planning
- Supply chain risk
- Sustainability planning

Geopolitical portfolio balance

A company (X) has 12 operations spread between 10 countries, five of those emerging markets. Business development in one key business unit suggests bidding for a 13th operation in yet another emerging market, perhaps in Central Asia or the Middle East. The business proposition in itself is more or less sound. So, is it a good idea? The question needs to be considered in the context of the geopolitical portfolio, i.e. the overall degree of exposure to political volatility in and across markets, and how any changes might adjust an acceptable risk-reward balance.

The planning team takes corporate risk appetite into consideration, using it as a rough "red line" – what could the company live with in terms of challenges to personnel security and duty of care compliance, reputation, and loss? The usual immediate answer is "we have no tolerance for any of that" but if that were true, many firms would be in perpetual paralysis. Risk appetite is a hard call, but when it comes to geographies, it is handy to define it as the most volatile place one might consider operating in. For example, a less experienced international company with a focus on Western Europe might regard Morocco as just within risk appetite. For an experienced oil and gas, mining or infrastructure firm, even parts of Somalia might be under consideration. Country risk benchmarks shift over time, but can be useful indicators of corporate red lines.

Having established international risk appetite, the planning team maps global operations. One axis is political risk, an aggregated derivation of:

- potential for harmful regulatory / tax change / resource nationalism
- weak governance / corruption / red tape (bureaucratic hassle)
- violence / conflict / terrorism / organised crime

- disruptive regime transition and consolidation (even if apparently democratic)
- ethical track record (regime and human rights, past negligent investors – there would be some transference, e.g. anyone taking up blocs in South Sudan)

Usually one can take a country risk rating from international insurers or research publications like the Economist EIU. Country risk intelligence providers also provide “risk maps”. Such ratings are based on intelligence and analysis at least at the macro level, so they are safe for deriving a political risk scale. Additionally many also incorporate some baseline economic risk, such as the risk of currency / capital controls, currency volatility or sovereign default. Using such a scale, planners can map their current exposures according to political risk. This could be the X axis on a matrix, perhaps not exactly going from Canada to Syria, but using a reasonable spread that captures both ends of the company’s potential risk exposures and some stretch on either side where direct competitors are operating.

There is merit in using publication risk ratings for the X axis – it has been researched, it covers more or less what we need to cover. But there are pitfalls too. For example, the company might get used to a particular scale provided by a risk intelligence company, and then the company goes out of business. Or, no particular risk intelligence provider or trade credit agency captures the most relevant risks in its definition of country or political risk – maybe the factors they consider are more appropriate to institutional investors, not to those with a direct presence.

This is when having an in-house approach and team yields value. The in-company analyst team develops relevant ratings and indicators, and uses whatever sources are optimal at the time, not relying on generic third party inputs. They can justify their scale to decision makers, and back it up with hard intelligence, but they are not beholden to one external resource that might have variations in quality and which might not last. Internal approaches and benchmarks will adjust too, but upon mutual agreement, based on a reading of the global and competitive landscape (e.g. when competitors start to go into harder environments, it can be an indication that the game has shifted).

Either way, we already have our X axis, as derived from the above factors. We have our dots on the map scattered along the X axis. Now we move them up to the level that represents their strategic relevance. This is an aggregate of:

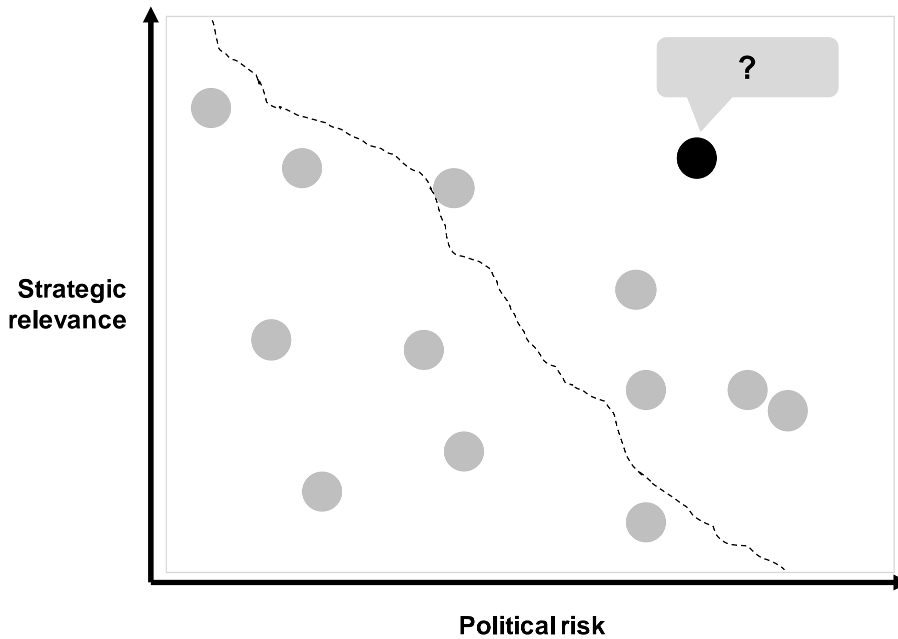
- exposed personnel, both expatriate and local (and families as per policy – is there a policy, for example for evacuation priorities if ever came to that? That's another story, but thought-worthy)
- overall competitive and cost advantage of the presence (pure business relevance)
- exposed physical and financial assets (stay behind assets, but one also needs to consider and account for what is necessary burn bin material – i.e. if you had to leave in 30 minutes, would you manage to take all of your intellectual property with you? Practice makes perfect)
- reputational stake on the endurance of the presence or operation

Just as an aside, any analyst would probably know that we can derive a rating system for each factor, then normalise scores out of our preferred number, be it high-medium-low (one to three) or the more standard one to five, or one to 10. Whichever scale and normalisation one chooses, it needs to be well explained and quite basic, and backed up by explanation.

Now we have our geopolitical portfolio map. If we were firm X, considering where and how the proposed operation fit into this portfolio, we would know how much our risk-reward equation was already stretched, and if we could afford to take on the new proposed operation. Is it going to add one more major dot to the right hand corner of the map, thereby making our long term resilience and returns even more tenuous? Does it help to extend a rather limp risk-reward equation?

Some of these questions are dependent on the specifics of the opportunity, but without a geopolitical portfolio map, it is hard to even know where to start. This is a useful tool not just for new proposition assessment, but also for taking stock of a current portfolio, and if aligned to global scenario planning, it can indicate where a firm needs to adjust exposure to retain an optimal risk-reward balance.

An illustration is below. This can be more nuanced with scales and even colour coding, and could even use a world map using operational dots against a country colour code for degree of risk (basic to most risk maps). This is basic but it suffices for an example:



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Global scenarios

Shell has cornered the market for corporate global scenario planning, at least in terms of public literature (the CIA has done okay too, and writings from ex-analytical executives are somewhat easier to digest). Their process begins with a diagnosis of business challenges, and a high-lighting of key swing factors in global oil and gas supply and demand, and market / supply access. Key questions are derived, then the planning team holds internal workshops with relevant executives and external experts to derive at least two global energy market scenarios. From the outcomes, the planning team develops indicators of either scenario arising, and contingency plans for Shell's strategic response.

Given that Shell operates anywhere from the US and Canadian Arctic to the Niger Delta, and that political events can have a huge impact on energy supply and markets, the process involves a consideration of relevant global political and economic trends. Decision-makers obtain invaluable intelligence in terms of what to plan for under what contingencies, i.e. strategic options. They can then help the firm to position for different outcomes. It is noteworthy that Shell does not attach probabilities to scenarios, and maybe this makes sense – scenarios after all consider long term and

"beyond horizon" possibilities. The indicators will tell which one, or which variation of one, seems to be playing out and hence what to prepare for.

Shell's model is fine for Shell, but for smaller firms there is still an opportunity to derive scenarios that help to guide planning and investment emphasis. Indeed, scenario analysis works at nearly any level, including country operation. The author recalls one project in which the client posited the question "How might the investment climate change when the president dies? Assuming his direct advisors and sons are next in line – who might assume the title and what would it mean for our operation?" That was a scenario question (So far that president has refused to die, though there have been some close calls. The question remains relevant, though the factors have varied). This kind of question is especially relevant to small one-off mining operations and oil wildcatter operations premised on a single country. Indeed scenario planning is relevant at various levels, whenever the relevant future period is uncertain.

How does scenario planning work? There are different models. Shell's is somewhat more intuitive, using hard trend data but balanced by group interpretation and expertise. Other models derive categories of factors, weigh and link them based on initial research, then cram them into a software programme that spits out myriad contingencies, then the top three are taken forward as baselines for planning.

Harmattan has often used variants of scenario analysis, from competing hypotheses models to full blown alternative futures analysis. Our approach is more on the intuitive side, and we have not used the Monte Carlo method nor resorted to software, yet. The following has been applied in scenario analysis elements of our work.

We begin by defining the relevant question. Then we use a matrix, with importance and uncertainty as axis labels. We derive and plot all relevant change factors, aggregate where feasible, and then focus on those in the upper right quadrant, while taking into account their causal linkages to other, less important / uncertain factors. We look behind each immediate causal factor to see which broad trends in governance, economics, regional relations, and the global environment are relevant to the story, as potential macro-level forces.

We usually set out four potential plots, ranging from very negative to very positive, and four means that there is no middle ground, as that is often a thought trap in scenario analysis (people tend to latch onto more of the same).

Then we connect the dots, and see how each of the four might play out. The resulting four stories will have implications for the company, ranging from very damaging to more or new opportunity. Once we do this, we also have a good idea of how robust each plot line is, given the causal linkages we had to make, and the potential change triggers we had to assess. So we can assign a degree of plausibility, although we do so with a cautionary note because the more volatile the market, the more unpredictable, and the element of pure surprise can never be discounted (e.g. Asian crisis 1997, Iranian Revolution 1979, 9-11, Arab Spring starting in Tunisia 2011...).

Each scenario will have indicators, i.e. what to look for to see if it is moving from:

- latent
- partial
- emerging
- manifesting

We then work with a company to help derive options in terms of how they might position and manoeuvre to make the most of emerging opportunities and mitigate risk under each of the broad four, with emphasis on the most plausible positive and negative futures.

When it comes to one country it is not that difficult. Global scenarios take in a broader array of factors and can be a challenge. For example, the subtle but escalating power contest between the US and China with respect to control over resources and transit in the Pacific has implications on nearly all global trade, as does Russia’s aspirations to regain great power status, but how do we factor these in to a particular company’s concerns? It depends partly on the timeline, and in some cases, such as oil and gas, where contracts are sometimes written for 10-20 years and business horizons are long, the bigger global variables matter. For smaller or more near-term problems, for example for a construction or private equity company specialising in African real estate, a shorter horizon with more known variables makes it a bit easier.

But we can afford to get it wrong and we probably will – that is the nature of estimating beyond the horizon. The most important element is the derivation of indicators and contingent options, then whichever way it plays out, the company is ready to prepare itself and adjust course. Even the "implausibles" cannot be discounted.

There are a variety of futures analysis tools, and scenario analysis is just one. Others, like competing hypotheses for example, are better aimed at shorter term problems. The take away from this section is that in a global company, the socio-political variable matters, and it is perhaps the most volatile or rapidly evolving factor in defining a future business landscape. Whether a separate scenario analysis on the socio-political environment is conducted and then integrated into a wider set of contingencies, or is included up-front, scenario analysis on relevant futures and contingencies is critical intelligence in long term planning.

Supply chain risk

Supply chains for even smaller retail firms can extend well beyond borders. For an international firm (or TNC – transnational corporation) it is not just about supply, but about a global spread of critical organisational capabilities.

There are essentially two kinds of supply chain risk:

- A key hub or link shuts down and deprives other links in the value chain of its inputs, severely affecting promised delivery
- A link in the supply chain is found to be using unethical practices to achieve its quotas and margin, this is discovered and results in scandal and liability

Political risk, in terms of conflict, strikes, or new unfriendly regulations, can cause stoppages. For example, a mining company in Mauritania relies heavily on rail transport to get processed ore to the port for shipping, but either Al Qaeda-government conflict or labour issues lead to a halt in rail services. Or, a PC manufacturer based in Taiwan needs chips from the Philippines, but a diplomatic dispute causes a halt on commercial trade permits, and the Taiwan operation is paralysed. Trade wars, conflict, and diplomatic standoffs can have a huge impact on supply chains, as can terrorism, usually not because it is targeted at a specific company, but because it leads to crackdowns and transport hassle.

Harder to assess is unethical practice along the supply chain, but it is critical not just to the corporate brand, but also to compliance and liability avoidance. The average hammer, to name one basic example, might be sourced from both China and an African country, then assembled in Guatemala. Then it is delivered to the branded hardware (for those in the UK, DIY) shop and sold to consumers. Those consumers would like to think that their purchase was legitimate and helped to fund a job somewhere.

When corruption, slave labour / worker compulsion / unfair labour practices, political collusion of suppliers with dictatorial regimes, or outright fraud using a supply operation to launder illicit gains are discovered, the ultimate branded firm which contracted suppliers faces ethical criticism and legal liability, and needs to remove and replace that link. Especially for branded manufacturers, this can have a huge impact on sales and market share. The public might have a short memory, but investors and public relations contacts will remain wary long after issues are corrected.

Political risk research and analysis helps on both levels. The more transparent challenges, such as assessing relative corruption or conflict risk, feed into business continuity planning at a local level, and supply chain resilience on a global level – if this is the risk, then where else can divert or source this input, and when do we activate this contingency? Do we diversify now and use 2 – 3 suppliers? Maybe that is a good bet given the risk.

The level of supplier integrity is harder to address, but well feasible (whether or not this is a "political risk" is up for grabs – it can be and it is often an issue that is addressed at the same time as assessments of the political terrain since it falls outside ordinary business concerns). Analysts and experts can cross check public records to see what might be amiss. The reputation of a supplier can be assessed though discrete interviews, discrete visits and observation, and media analysis. Contracts can and should stipulate compliance with the buyer's standards, and include a permission for independent audit.

On the question of whether or not supplier criminality or negligence is a political risk, we suggest that ultimately a company can get away with nearly anything if public and political oversight can be bought off or is indeed in collusion. Where public corruption is prevalent, one can almost expect lax and abusive labour standards and attempts to manipulate the accounts. Hence another benefit of

political risk analysis is pointing out where public corruption is rife, so that internal controllers and operations can tailor their own more detailed research accordingly.

One can look at a map and see logistical issues, for example during the wave of Somali piracy in the Indian Ocean, or in SE Asian waters contested between China and the Philippines. Going behind that map and into specific links is another corollary analysis in assessing supply chain risk.

Supply chain risk is bigger one that mentioned here, and we do not deign to be supply chain experts, but for global or even partly internationalised firms, it is a significant issue, and political / socio-political risk is often a major variable thereof.

NOTE: What has not been explicitly mentioned in supply chain risk is labour issues. We will leave that for a later follow on piece on country operation resilience, but often strikes are coordinated by political actors and are hence dealt with as a political risk. The effect on supply is obvious, but strikes, especially if they involve violence by the security forces or government sanctioned vigilantes, can lead to a major dent not just in business continuity but also reputation and perceived company value.

Input into global sustainability approach

Sustainability is the new catch word and big international firms have had to get on board, partly to comply, and partly because it is good marketing.

A 30 second definition? Possible so here goes: A company will leave a society and its host communities (those in proximity to company operations) at at least the same standard of living as before its operation, and will ensure no lasting damage to the natural environment.

That was hard, and it misses some points of emphasis that companies put on "sustainability", for example the final product is wrapped up in recycled paper and is itself biodegradable.

Putting a definition to "sustainability" is a serious pain in neck, but it generally means compliance with the E and S in ESG (environmental, social, governance) standards, at both national and global levels, and some governments actually stipulate a "social account" to be included in the usual returns of a public firm.

There is much room for hyperbole and "green wash" in presenting one's sustainability credentials, yet many companies have welcomed the trend, tired of being vilified and with many staff actually hoping to see a positive contribution to society through their work. Plus it does wonders for the brand.

There are at least two angles to sustainability:

- Environmental – processes are as clean as possible (balanced against the value of the product)
- Socio-economic impacts are taken into account and the firm strives to leave affected communities better off (or at least no net change)

An example of poor sustainability, to help capture the concept as it applies to political risk: A global agriculture firm under the auspices of a major national donor goes to Africa to start industrial crop production. It displaces tens of thousands of local subsistence farmers in the process, and if they complain then they get threatened by the authorities. The relevant national ministry is fine with helping to generate export revenues and has no issue with the local impact – the local region was mainly full of opposition sympathisers after all. Local NGOs based in the capital recognise the problem and bring it to light, and it goes to major international NGOs and then also global media. Investors and advisors are repulsed. The firm has to withdraw before their market image is tarnished and before they incur liability with their home government, who has compliance standards on ethical investment. The would-be donor is also chastised and reconsiders the merits of industrial farming in the country.

Political risk analysis in this context is partly about environmental effects, but only in so far as they affect livelihoods and potential political opposition. It is more about stakeholder analysis (a major element of political risk assessment) to discern who wins and loses from an operation and how they will respond, and linking that response to actors with meaningful degrees of attitude and influence, and how potentially responsive groups are formed (networks).

This kind of assessment obviously would help a local operation to benefit from targeted actions (or changes to an operation) to gain more favourable local attitudes, but it is also indispensable at a global level. Given the kinds of social hardship that a typical operation incurs, what kinds of fallout or

feedback does the company have to be ready for, how can it best circumvent issues, and how should it best deal with issues when they arise? All of this is towards a positive brand image a socially aware and sustainable company, but beyond the image, how a firm conducts itself in sensitive environments is also a factor in how it is treated – i.e. strikes, protests, attacks versus sliding in and forging a symbiotic relationship with the host communities most affected.

Nearly every foreign operation has to undergo an SEIA or Social Environmental Impact Assessment, whether for home or host country compliance. But compliance is the key word. Reports resulting from compliance-centric initiatives (often off loaded to third party consultants who apply a template) are weighty, hard to read, full of technicalities, and seldom applied since many recommendations are off the shelf and not positioned in context.

A suggestion is that a company forges its own internal standards on host community and ecological impact, commissions independent and hard hitting reports and advice, and on that basis lives up to expectations and even more. One should expect an audit, but one should also expect shareholder / stakeholder concern and interest, and the latter is the better benchmark.

Done on a global level, a solid, meaningful (fluff-free) and actionable definition of sustainability, and compliance with one's own promises, can only help the brand. While "big companies hold all the power these days", the Internet and international NGO and media collaboration have more than kept pace. Knowing international and local expectations (via consultations and committed study) and working them into a contract and project plan / budget, with follow up audits, helps a company to "keep its nose clean", and to augment the brand as a socially responsible player. This might seem like an ambiguous gain, but when it comes to the next negotiations with a ministry in a weakly governed country, a track record for responsible business is a trump card. Similarly if a company faces pressure and has to call in its chips, a reputation for ethical business can only help. In the meantime, security issues are attenuated by a better social relationship.

Conclusion

More could be added to this and whole books have been written on global political risk management. They reader can peruse and think about what applies to their organisation. Some of this seems like big business stuff, but Harmattan has had discussions with small social enterprises

and NGOs on these and related issues. Simply put, if one crosses jurisdictions and especially if one directly engages in emerging markets, then political risk is an important planning element.

We plan on coming up with two more papers one on political risk planning in new market entry, the other on political risk planning for country presence / operational sustainability. So stay tuned. There are other considerations that might be addressed in time, for example, the degree to which a transnational corporation is a political actor and the relative merits of acting as such.

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