Political Risk and Emerging Market Private Equity Impact Investing

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Introduction

Impact investing is a significant theme within emerging market private equity (EMPE). Underpinning it is a belief that private capital and businesses can be a major contributor to international development, augmenting official donor, TNO, NGO and government efforts with socially beneficial private sector innovation, professionalisation and growth. For investors, funds and managers, it holds the prospect of being able to earn returns while alleviating hardship in developing regions and ultimately contributing to global sustainability.

Impact is greatest where the needs are most acute. Therefore, much impact investing has focused on regions and countries with significant social and economic challenges, which in turn are driven at least in part by factors of state fragility. Thus, much impact investing occurs in complex socio-political environments characterised by degrees of weak official governance, social divisions, low-level conflict and political instability.

International companies that operate on the ground in complex environments often have an explicit notion of political risk, by various labels, and of political risk management. Impact investing tends not to. One reason for this could be an assumption that investee companies are well accustomed to local socio-political eccentricities and manage pressures as a matter of routine. Additionally, fund managers and general partner companies are themselves usually based in stable, well governed regions, with little direct corporate exposure to complex environments. This might put political risk somewhere on the mental back burner. However, in political risk terms there is little structural distinction between a foreign operation and a country-level impact investment project. Both expose people, reputation and capital, and investee companies are directly exposed to local socio-political dynamics on the ground. Explicit political risk awareness and management help foreign operators to sustain a healthy presence, and impact investing too stands to gain from stronger political risk knowhow.

The aim of this paper is to provide readers in the impact investing community, including investees, with a sense of how political risk can be relevant to their aims and operations, and of how political risk can be managed. This is a nuanced and complex topic and for brevity we will remain at a relatively high level of abstraction, but hopefully this will at least be helpful in kickstarting further discussion and exploration.

The rest of the paper is structured as follows.

- Political risk in this context – a conceptual introduction to political risk
- The relevance of political risk in –
    - Investment targeting and selection
    - Foreign management
    - Investee company
- Political risk management
    - Big picture
    - On the ground
    - An overlooked opportunity: Investee political risk management capabilities
- Conclusions

Political risk in this context

At the highest level of abstraction, political risk can be defined as the potential effects of the behaviour of governments and non-official political entities on a business' performance, security and reputation. This can apply at different geographic levels, from global right down to a given host community. For purposes here this is a starting point but it needs refinement for an impact investing context.

First, we can put aside conventional notions of risk as currently conceptualised in enterprise risk management (ERM). There are crossovers, but political risk is less about specific one-off events, errors and actions, and more about the systemic relationship between the socio-political and business domains (or indeed one company when we examine political risk to a specific organisation). In developed, well institutionalised environments, the relationship between business and the socio-political realm is largely guided by institutionalised rules of interaction. The relationship is therefore relatively predictable and can be tacitly managed within routine management activities.

In more fragile and complex environments, weaker institutionalisation and rule of law, along with a greater overlap between social and official-political groups and affiliations, mean that the socio-

political domain can impinge on business well beyond just regulatory compliance and taxation. This matters because socio-political rationality and imperatives can be very distinct from those of businesses. Socio-politics is about ideologies, values, power contention, social / subnational identities, authority and inter-state relations. Business is about legitimate profit. When socio-politics intrudes on business beyond institutionalised interaction, the results for a company can range from mildly distracting to severely disruptive and even dangerous. Likewise, a company can impinge on socio-political interests, inadvertently or otherwise, and this in turn can shape specific socio-political responses to the company.

If we see political risk as arising from the interaction of two domains, and more specifically about the interaction between the socio-political domain and one organisation, political risk management is about managing the relationship between them. This is very distinct from the ERM approach to risk management, which tends to lead to piecemeal "control" initiatives. Political risk management needs some specific controls, but it is more about navigating the socio-political milieu and environment, using as a map an intelligence picture of the current and potential future socio-political context and how dynamics and interests within it could affect the organisation and its ambitions.

There are other perspectives on political risk, but the one sketched here is apt for impact investing. That is ultimately about trying to help an investee in a complex environment to achieve better business performance, and in so doing to support development. This is very different from simply investing money at arm's length, which would focus on political dynamics that could affect financial markets, or managing global supply chains, which would consider geopolitical risk and its potential to affect a global network. Impact investing is intimately bound to the socio-political environments where investees operate, and hence a relationship-centric picture of political risk is the most relevant. However, other perspectives matter too, particularly at the fund level where an appropriate degree of diversification is itself a form of political risk management.

Investment targeting and selection

Having characterised political risk, we can move onto how it can affect impact investing, both at the fund level and with respect to specific investment projects in developing or transitional countries. Starting with the level of an investment fund, political risk is relevant in the targeting and selection of investment prospects, because if overlooked it can lead to the selection of excessively risky or indeed unviable prospects, and it can unbalance the global portfolio of investment projects.

For an impact investor with an ambition to make a difference in deprived societies while earning strong returns, there is a sweet spot in terms of country characteristics. This can be characterised as a balance of the following:

- High development needs;
- High growth potential / market immaturity;
- A minimum acceptable level of legal protections of private property, and currency conversion and transfer; and
- A reasonable possibility of investing without abrogating sustainability and ESG principles, nor the "do no harm" imperative as it relates to conflict and human security (a strand of this is being able to meet reasonable duty of care standards for direct employees).

The first two of these actually require a degree of political fragility, since it is a significant factor in under-development, and a characteristic of early growth-stage economies. The second two require a certain level of political development, since they rely on a degree of institutionalisation, rule of law and respect for human and civil rights. Thus, the investor seeks a fine balance, and if one does not carefully examine the socio-political variable it is easy to get this balance wrong.

First, an investor can inadvertently target prospects in countries that are prone to significant decline in governance standards and stability. In practice, this has partly been a result of a tendency in the larger finance sector to hype frontier prospects that have appeared to become much more viable after a period of turmoil or which were previously hard to access (with a classic case being the enthusiasm about Russia in the 1990s, where "cowboy capitalism" and mafia racketeering went hand in hand).

For example, Myanmar became a much touted EMPE prospect during its political and economic reforms which started in 2011. It seemed that after years of military dictatorship, the country was finally becoming investable. This widespread view failed to take into account that in order for reforms to succeed, the military would ultimately need to shed its considerable economic and business stakes, and indeed its hold on power, and for those familiar with the regime these were very unrealistic expectations. After a decade of continued civil-military friction and continued subnational discrimination, the 2021 military coup and subsequent conflict again made the country unviable for impact investors, partly because of a lack of robust legal frameworks and partly because of ethical and security concerns.

Sri Lanka is another example. After the end of its civil war in 2009 the country showed considerable promise as an investment target, and it too was hyped. It only took a few more years before it was

clear that the country's problems were not just about post-war recovery. Weak governance was a major contributor to the country's economic crisis and instability from 2019. In addition, recent years have seen serious official and politically instigated discrimination against minorities, largely to boost Sinhala nationalism which underpins the little legitimacy the government retains. Unlike Myanmar, Sri Lanka has become investable again, but not without some serious caveats. These are only two examples in which an under-reading of the political variable would have led investors to take on more risk than they had intended to.

Even when a country remains relatively stable overall, a lack of political risk insight can lead to a failure to perceive tendencies that could undermine governance standards, and thereby challenge the upholding of ESG principles which most impact investors strongly identity with. For example, in 2018 Burundi's government reinforced an ethnic quota system in public sector and NGO jobs. Quotas were devised as an aspect of national reconciliation following the end of the country's civil war in 2005, but particularly from 2018, human rights groups have regarded them as discriminatory and as a tool of government ethnic surveillance. While quotas are mainly aimed at the public sector, for private sector firms, straying too far from quotas would very likely incur official hassle. Thus, investing in a local company in Burundi could mean accepting that an investee maintains discriminatory hiring policies, a situation that presents serious challenges to the "S" in ESG. Likewise, the relatively recent wave of anti-LGBTQ laws in east African countries makes it difficult for local firms to hire without discriminating, again posing the question to investors about how committed they are to the "S", and presenting a difficult trade off between upholding the full ESG package versus achieving nett positive socio-economic impact.

Political risk also applies to specific sectors. The ones most exposed to government interference, crony manipulation and public scrutiny tend to be those with significant socio-economic development potential, since these are linked to political leverage and high social expectations. This varies by context, but energy, health, telecoms and finance, along with natural resource extraction, are often politically sensitive. A well known case of political risk involved AES in Georgia in 1998 to 2003. Georgia was among the newly independent states hyped as an up and coming investment destination, and in fact cautious foreign investors were seeing returns. Incautious by contrast, AES bought the Tbilisi electricity distributor and quickly found itself at the centre of a multi-sided stakeholder reaction against the effects of rationalised and equitable electricity pricing. Electricity was not just an essential commodity, but a significant lever of clan and factional influence and competition. AES had failed to recognise this, and was unprepared for the ensuing backlash. While this was not a case of private equity impact investment, in structural terms it was similar: a foreign investor took a stake and sought to professionalise and rationalise a local company. A sector's

political sensitivity and the potential for spoiling activity by vested interests certainly does not preclude an investment, but when searching for investment prospects it should be a significant consideration. If an investment still proceeds, then awareness of the downsides can help to prepare to avoid and manage responses.

Moving on, political risk can also affect the overall risk-reward balance of an investment portfolio. Clearly, if a fund specialises in one or a few countries, then deteriorating conditions in even one of them could imbalance the portfolio. But even in the last decade or so there have been significant political changes and trends which have affected entire subregions.

West Africa provides an example, and is germane to a significant number of impact investment funds which see Africa as holding considerable long-term potential. Prior to 2013, west Africa, including the significant Nigerian market, was a complex environment, but the long-term prognosis was continued political development. Algerian jihadists had operated in the Sahel since the end of Algeria's civil war, but they had had negligible subregional appeal. The collapse of Libya in 2011 led to the spread of arms and armed groups in the subregion, and jihadism became a viable course of action for Muslim northerners in Sahel states, which were largely led by, and to some extent for, southerners. Fast forward to 2024 and the Sahel has been riven by interconnected insurgencies, coups, and repression backed by Russian mercenaries. Instability is spilling southwards in the wider west African region. Thus, from the sparse remnants of Algerian groups haunting remote corners, we see a number of countries facing new centrifugal pressures, and street-level challenges to governments who appear to be unable to manage them. A fund with a west African emphasis that was once able to sustain reasonable diversification between countries in the region would be seeing a significant risk-ward skewing of its entire portfolio.

Currently there are several regional issues with a potential to upend a balanced regional or even global portfolio. These include competing territorial claims in the South China Sea, Chinese designs on Taiwan, Iran-Israel tensions, India-Pakistan tensions, and the potential for Russian aggression in its near-abroad either alongside or following a resolution of the war in Ukraine. Diversification works to spread and control risk, but it needs to be guided by a reading of the political terrain, or a fund can find itself facing far higher overall risk than it had bargained on and was prepared to bear.

In summary, political risk can undermine sound investment targeting and selection in several ways. An investor can focus on a country which on the surface appears stable and fit for business, but which in fact is fragile and prone to instability. Governance can appear to support global investment ethics but be prone to tendencies, such as subnational discrimination, which could make meeting ESG commitments very difficult. Specific sectors can be particularly politically sensitive and unless

known beforehand an investor could commit to a prospect which is subject to interference and manipulation. Finally, regional issues can escalate and spread, and unbalance the risk-reward trade off in an investment portfolio. Political risk management as an aspect of targeting and selection would examine the medium to long-term potential for each of these issues upfront prior to commitment, and either steer the focus to less risky prospects, or enable a project to proceed with intelligence-based plans to avoid or manage plausible potential challenges and turns towards higher fragility.

Foreign management

Even when a fund or general partner upholds the position that investees should largely own their own transitions and retain significant autonomy, impact investing almost always requires an element of foreign expertise and guidance. This brings in new ideas and better practices, technology, and experienced-based advice to support the investee in moving towards stronger business performance and higher developmental impact.

As we will also see in the section on investee companies, political risk has a two-way relationship with management. Political risk can present hazards and challenges to foreign managers, and in turn their attitudes and judgements can increase the vulnerability of the investment project to political risk. We will examine both angles.

Beginning with political risk to foreign managers, expatriate personnel and experts can face security hazards when travelling to and working in complex environments. A common aspect of political fragility is weak national consensus, subnational or sectarian rivalry, criminality driven by deprivation and low social mobility, and relatively weak (and weakly governed) security institutions which can be repressive. This combination lends itself to low-level socio-political violence which, while short of civil war, can seriously affect human security. Expats are broadly exposed to same security hazards as national citizens in a given environment. Additionally, if their foreignness is apparent, they can be regarded by criminal groups as potentially lucrative targets, and depending on their nationality they can be seen by extra-legal political groups as a symbolic target.

Expat staff among foreign operators also face the above challenges, but there is a difference. When an international company establishes its own presence in a country, it sets up a routine security umbrella that safeguards its personnel and facilities. Most foreign managers in impact investment are travelling or working individually or in small teams, and lack an established local security infrastructure. The investee company could extend theirs, but local companies often manage security partly through long-standing socio-political relationships, and their staff likewise partly rely on their

innate knowledge of the environment and personal networks to stay secure. Thus, the investee's security is seldom tailored for foreign managers who, as noted above, tend to have distinct profiles from the perspective of potential threat actors. Thus, in the absence of a tailored security programme, foreign managers in impact investing can have relatively high vulnerability.

It is possible to keep individual expat staff safe in high-risk environments, but only with a robust understanding of the local socio-political context and threats within it. Generic security policies can widely miss the mark in terms of staff target profile in the local context, and the degree and types of hazards they face. One could play hard on the side of protection and deterrence, using armed escorts and guarded safehouses, but depending on local socio-political sensitivities such methods could backfire, incurring local suspicion and hostility, and actually increasing the subject's target profile. Thus, best practice expat staff security management can easily become bad practice without adjusting for context, and making that adjustment is the political risk management aspect of the security function.

Moving onto how foreign management can affect political risk for the investment project, we start with a problem related to the above one of security hazards for expat staff. This is that foreign managers and experts can have too little presence in the host environment, and too little time with the investee company, to build trust, provide robust guidance and to ensure reasonable ESG and integrity adherence. This is related to expat security because an obvious risk management measure is avoidance – if a place is dangerous, then minimise one's exposure there. That is indeed one reason why some EMPE firms spend too little time with investee companies after the initial investment. Managers with relatively less experience in developing countries can also simply be unaware of the extent of the challenges that investees can face when trying to meet international standards, and this can contribute to the problem of inadequate time on the ground.

As already alluded to above, a patchy and light foreign management presence can increase the investment project's, and indeed investor's, political risk vulnerability. After a deal is done and initial direction is set, the investee is supposed to proceed with the plan, which will have an ESG and integrity element. However, in most complex environments, it is far easier in the short term to focus on maintaining the breathing space to operate as a business than it is to implement changes in how a company conducts itself. Independent businesses in complex environments have a number of tried and tested breathing space strategies, most of which focus on maintaining friendly connections with the right official and factional influencers, and balancing different local socio-political expectations of the company. Favours are traded, palms are greased, and business plans and execution are adjusted so as not to annoy the wrong interests. In this context, ESG and integrity standards can look like a

nice-to-have, and even a disadvantage given that they seem to undermine the old survival strategies. Thus, despite what could be the best of intentions, unless checked upon and guided in how to reform without sacrificing performance, investees can easily lapse into paying lip service to international standards while carrying on with business as usual, somewhat unbeknownst to the fund and general partners who dip in and out from their offices abroad.

On a basic level, having ethical and integrity standards but barely adhering to them is worse than not having them in the first place for the reputation of the project and its stakeholders. Standards set investor, public and market expectations, and when an investee's compliance is only skin deep, there is a serious risk of disappointment. On a deeper level, this also makes life more complicated for the investee company. It begins to develop a split identity, one side of which is connected to international principles through a foreign fund's stake, and the other of which is still playing the old socio-political survival game. Managing this split is time consuming and distracting, and it increases the scope for mistakes in dealing with local socio-political challenges. The split also hurts the investee's local socio-political standing. Both actors who feel that the investee should remain committed to the old game of favours, and those who were hoping for positive change from the investee's new commitment to ethics, can start to suspect the investee of playing a double game. Its credibility on both sides erodes, along with the socio-political support and cooperation which the investee relies on to manage challenges.

It is far better to have both feet in one camp and to be known as such. If this is on the side of taking international standards seriously, it might disappoint actors who benefited from the old game of give and take, but a company can find new, legitimate ways to appeal to old interests, and also gain credibility simply by showing commitment to its principles. Making the transition to ethics and integrity while sustaining business performance is not something the company would have done before. But experienced general partners and international experts probably have done it before a number of times, albeit perhaps in different contexts. Their on-the-ground support is critical in convincing a local company that it can make the transition, and in guiding it through the process of doing so. On-the-ground oversight is also critical, to ensure that investees are sticking to commitments and not sliding back into old habits born of perceived necessity. Thus, a simple lack of foreign management presence can be a factor in political risk, affecting the reputation of all stakeholders in the investment project, and the local credibility of the investee company.

The final problem that we will touch on here is a lack of pragmatism on the part of foreign managers, and an over-insistence on their way of doing things This is roughly the converse of the above problem whereby foreign management is too hands-off (we say roughly because in that instance a

lack of presence can come from personal risk aversion or ignorance of the complexities, rather than an overly ardent belief that an investee is best positioned to manage its own transition). It is worth pointing out that in examining the problem of over-insistence, we are in effect setting up a balance. Yes, foreign management needs to be present for support and oversight, but if it fails to consider the socio-political reality in which the investee operates, and does not take advantage of the investee's better local knowhow, the result can be just as deleterious in terms of political risk vulnerability as not being there enough. We will examine two areas where an over-insistence on the foreign manager's way of doing things can be problematic: ESG and efficiency.

While ESG and integrity standards are important for an eventual sustainability and developmental impact, ESG in particular has become something of a mantra. The full and actionable meaning of each component, E, S and G, remain underexplored, as does the relationship between them. The confusion and inconsistency around how to measure ESG performance is a symptom of this. Additionally, it is worth bearing in mind that ESG, although endorsed by the UN, largely derives from the cultural values present where the biggest official and corporate influencers of international business standards are based, namely in western countries. There are other cultural concepts which can guide a company towards the same end of doing good for society, but these have not been wrapped up in a marketable, standardised package. Thus, when someone takes ESG very literally and insists that following nuts and bolts, published ESG guidance is the only way that a business can be socially responsible, they are over-relying on underbaked premises and discounting the possibility of achieving the same ends through other, if ethically similar and complementary, perspectives. This is especially important given that ESG adoption and compliance is seldom straightforward in complex socio-political contexts where there are often a range of distinct cultural sensitivities, and as previously noted, practical challenges in trying to operate cleanly and transparently.

If a foreign manager is an ardent ESG enthusiast and uses the investment stake in the investee to push for quick adoption, several things can go wrong. One is that the company sheds its previous socio-political network approach to risk management because it is not wholly compatible with the full ESG package, while at the same not having had time to develop alternative, ESG-compliant approaches. This can leave the company without important allies who in the past helped by sharing information about relevant socio-political changes and machinations, and by directly wielding their influence to help the company out of the odd complication. The investee is holding the ESG flag but in political risk management terms not much else. Second, not every aspect of pureplay ESG is compatible with every cultural and political landscape, at least not until there has been a process of gaining acceptance or at least toleration. Gender and LGBTQ rights and non-discrimination thereon, for example, is one which is unlikely to fly in conservative patriarchal cultural contexts, or where

governments have a policy of discrimination. Perhaps the investment should not have occurred if it is not feasible to meet minimum ESG standards without incurring traditional or official wrath, but once committed one cannot charge ahead in the face of entrenched barriers to the full ESG package. Finally, we noted that the strict conceptualisation of ESG discounts other cultural perspectives and values that also support a transition to social responsibility. If compelled to take on ESG and only “ESG”, the investee will discount these other potential sources of positive influence, and rely only on the imported concept with which they are less familiar and thereby with which they are more likely to make mistakes.

The above is not meant to suggest that a laissez-faire approach is better than guiding the adoption of ESG and related ethics (that approach might be fine for an investor looking for short-term gains but it would not work in impact investing). It does, however, suggest that foreign management needs to carefully assess how quickly such adoption can move in the investee’s context, and what elements of ESG might need to be replaced or complimented by broadly equivalent local cultural values in order to ease the transition and perhaps even make it more sustainable (in terms of duration, not “sustainability”). This requires a careful reading of the socio-political context, and a trusting relationship with the investee, who can use their local knowledge to guide foreign managers in how best to solidify ethics and integrity while maintaining business performance. The flip side of contextualisation and patience is increased vulnerability to political risk as outlined in the above paragraph.

The other thing that foreign managers need to be careful about over-insisting on is achieving higher efficiency, which some would have a tendency to fixate on since it is after all what creates margins. In developing countries, even a moderately successful business can have a variety of social obligations stemming from its social and cultural links and status. This is especially so for family businesses. To needy people in their social network, companies provide jobs, informal loans, and sometimes free or discounted goods and services. For influential members of their network, they provide socio-political support on local issues. Competitive advantage can be deliberately mitigated so as not to leave competing businesses and business families at risk of losing status or indeed their livelihoods. Treading carefully and sustaining allies is a survival strategy, but it can also simply be a cultural imperative. A well known case of political risk, Sainsbury’s in Egypt in 1999 to 2001, illustrates what can happen when one discounts this imperative in the interests of efficiency. After a difficult start, Sainsbury’s supermarkets started to do very well, but in so doing they were wrecking livelihoods among local shopkeepers in neighbourhoods where stores were located. The grassroots backlash drove the company out, but before that the company found that while it was gaining customers, it was losing friends, and no one was willing to stand up for it when it faced a concerted campaign.

The impact investing paradigm is in some ways about managing the balance between business and social performance. Usually, though, impact investing holds that as long as the company's core business is appropriate, business performance will lead to developmental benefits. This view does not directly account for the non-business social roles and obligations that investees can have and which, prior to investment, might have constituted its social performance, not to mention which are important to its socio-political resilience. Thus, again, while not advocating for an investee company being a gravy train for friends and allies, it is important that foreign managers work with the investee to carefully assess the pace at which it can move to efficiency, and how it can continue to have local social value as it becomes a better business performer. If there is a push to rapid efficiency, the investee could become socio-politically isolated and even incur new friction.

To reiterate, political risk and foreign management is a two-way street. In impact investing in developing countries, foreign managers can be directly affected by violent dynamics and threat actors in the host environment, and security management needs a strong dose of socio-political contextualisation. Foreign managers can be vulnerable to political risk, but their attitudes and behaviour can also affect the vulnerability of investees, by either being too hands-off during a delicate transition, or by insisting on a quick uptake of ESG and on efficiency without considering the effects on the investee's socio-political resilience. Note in this section how we moved from big picture, macro considerations in prospect targeting and selection, to foreign management as the link between a fund and the investee on the ground. The next section takes us all the way to the ground level and examines the relevance of political risk to the investee company in its immediate socio-political context.

Investee company

We have already mentioned some of the challenges that a reasonably successful, relatively independent company can face in complex environments, and in this section we build a more comprehensive picture. We need at least a general profile of company for illustration here. A micro business, for example a family-run neighbourhood repair workshop, is by far the most common type of company in developing countries, but it would not be a clear EMPE impact investment target (it would be a target for micro-finance initiatives aimed at developmental impact, but that is not our focus here). We also want to avoid the other end of the scale: successful larger companies tend to be owned by tycoons or oligarchs who are very enmeshed with regime cliques and local politicos, and usually owe a good part of their success to their roles as regime cronies. Thus, a useful profile would be a small to medium-sized, likely family-owned, business leveraging rare expertise, as opposed to political connections, to try to build a more substantial business. The company likely already has at

least some vision of its eventual social impact, and this has probably gained it some government champions who share a vision of legitimate, sustainable growth through innovation (government champions might not be especially influential, but without them it can be very hard to get beyond start-up stage). Being an investee, we can now add that the company has exchanged some management control for both financial investment and expert guidance towards stronger business performance and developmental impact, and its socio-political identity is now partly associated with the foreign fund.

For parsimony, we will examine only three broad areas of political risk to this hypothetical investee. One is the reactions of socio-political stakeholders who perceive the investee's success as a threat to their own interests or values. A second is losing appeal among socio-political networks on whom the company relies for a sustainable fit and for support with political risk management. Finally, we have exogenous political risk, in other words dynamics in the environment which could harm the company but which are not responses to it. This includes low-level violence, corruption, and instability. Just as we had to define a type of investee for illustrative purposes, we also need a type of country in terms of fragility and complexity. We will assume a broad middle-of-the-road degree of complexity which would roughly lie between Turkey or Indonesia on the more robust side, and Pakistan or Nigeria on the more complex end. The following will be very general, but it suffices as an introduction to some common potential challenges.

To start with, then, a good political risk question to ask of any business initiative in a complex environment is, "If we succeed, who would see it as their loss and how might they respond?" Prior to foreign investment, an investee has probably survived and moved beyond a micro size partly because it has not rocked the socio-political boat. The business-political elite, among whom are oligarchs and tycoons with regime factional connections, do not see the company's emergence as a threat because it is not eating into their market share, and it is not touting its clean business credentials and thereby making them look somewhat tawdry. The regime does not see the company as carrying values that are associated with anti-corruption and social justice, and hence the investee is not associated with challenges to the regime's legitimacy. The company has no particular association with western, colonial, or "crusader" values, so it is left alone by insurgent groups, for example jihadists loosely affiliated with Islamic State or Al Qaeda, or subnationalist groups who see the state as propped up by ex-colonial powers. The company is not especially wealthy and criminal groups have bigger fish to fry for extortion attempts. Once investment and a change programme ensue, the investee's profile changes, and it can cease to be innocuous to socio-political interests. In other words, they can start to think that if the investee and its investors succeed, they could lose at least something, or, conversely as in the case of criminal groups, they could have a new predatory opportunity.

In most real cases, not all of the above interests would notice or care about the investment project, and / or not to the same extent. Nonetheless it is useful to examine some potential reactions once the company's profile starts to change after investment. If the company does begin to threaten business-political elites, it can expect some hassle. Major business families can use their regime links to orchestrate bureaucratic obfuscation and unwarranted regulatory scrutiny. Many also own press outlets and these can be used to spread rumours or fake news about the investee. Access to sources of domestic capital can be constrained as bosses activate their links in the finance sector. Ties to security agencies can be used to threaten the company with unsubstantiated but nonetheless serious charges, and this is not difficult in more repressive states where national security laws are quite sweeping. Finally, links to political parties and traditional authorities could be applied to orchestrate local protests or boycotts. A government and regime concerned about the investee's impact on its perceived legitimacy could enact some of these measures itself, in addition to asking crony friends to increase their pressure. And criminal and insurgent groups (sometimes connected to business-political elites) could respond to a change in profile by targeting the company for extortion or outright attack. Again, it would be quite exceptional if an investee faced all of these pressures, but even a few of them partially enacted would be disruptive.

Even domestic companies with no foreign investment and no shift towards international ethical standards can trip over socio-political interests, or simply spark the wrong socio-political interest. For example, in countries where the military is involved in business, such as Egypt, it is not uncommon for successful entrepreneurs to eventually run up against the military. An up and coming firm can be made "an offer you can't refuse" and get absorbed by a military-owned conglomerate. As another example, in conflict-prone environments, insurgent groups often tax successful local businesses and punish "tax dodgers" with kidnapping (a way of getting immediate tax payment with interest). Investees share exposure to these problems, but the very fact that they are investees is a very significant shift in socio-political profile and as outlined above can lead to very different stakeholder perceptions. Thus, impact investors need to be aware that their engagement with a domestic company can be a factor in the socio-political stakeholder risk which it faces.

We already indirectly considered the problem of an investee losing local socio-political appeal and support because of its shift to ESG standards and towards efficiency. This can lead to a company disconnecting from socio-political allies if relationships had been maintained through what could be construed as corruption, nepotism or patronage, leaving the company with fewer friends to help it manage challenges, and potentially incurring a hostile reaction from disappointed ex-allies. A focus on quick efficiency can make a company seem disinterested in its traditional or cultural benefactor roles and can likewise alienate members of a previous support network. Strictly speaking, losing ties

is not a political risk in itself, but it certainly increases vulnerability to political risk, and if disappointed ex-allies act on their frustration, then new hassles and impediments could manifest.

Finally, we come to exogenous risk, or that which derives not from reactions to the company, but from dynamics in the environment which could affect any organisation exposed to them. There could be a number of relevant dynamics, but we consider only three for illustration. Low-level violence is a common challenge in complex environments, deriving from friction between subnational groups, between subnations and governments, and between segments frustrated with the pace of socio-economic and political reform and governments with tenuous legitimacy but still a grip on the security apparatus. Terrorism is a well known form of low-level violence and it can affect urban centres in fragile states. More common, however, are violent protests and police responses, subnational conflagrations, state repression which goes well beyond legitimate law and order, and organised criminality benefiting from official susceptibility to bribery. Levels and types of violence significantly vary, but a combination of relatively weak governance, low national cohesion, and socio-economic anxiety is a formula for a degree of hazard that would be considered exceptional in Europe or other developed regions.

Aside from basic security measures, most domestic organisations and even individuals tend to at least partly rely on socio-political relationships to manage hazard, for example maintaining ties to unofficial, traditional authorities who constrain violence in their areas of influence. That kind of connection is one which could suffer with a rush to meet off-the-shelf ESG standards, thereby increasing an investee's vulnerability to violent dynamics.

We move onto corruption, which tends to be significantly more pervasive in complex environments because of: overall scarcity and low pay in the civil service, convoluted and underperforming bureaucracies which create a market for bureaucratic facilitation, and weak governance at the top which sets a bad example and under-incentivises integrity oversight. There is considerable evidence that when it is routinised and predictable, corruption can be a cost but it is not necessarily an impediment to businesses. Companies can cultivate relationships with particular bureaucrats to increase the predictability and efficiency of bribery transactions. However, it is a matter of degree. Costs can become a serious drag on margins and growth, and predatory officials can change the rules. We consider instability below, but it is pertinent here too. Factional infighting in a regime can lead to anti-corruption campaigns which are actually used to purge a rival faction, including its liaisons in the bureaucracy. A corrupt relationship with a targeted official can paint a company as subversive, making it susceptible to state security investigations. Thus, corruption can range from a minor drag and hassle to being costly and even dangerous.

For a small to medium-sized independent company, playing the corruption game can be hard to escape unless there are influential officials who share an interest in legitimate business and innovation. If that is the case, then once the company becomes an investee, it might actually gain more legitimate official support, since its socio-economic performance is likely to increase. However, garnering official support to help avoid bribery pressure relies on a detailed understanding of the official stakeholder domain and time to engage with the right actors. In the meantime, in very short order one cannot expect a company to be a strong business performer *and* to keep its hands clean. Investors need to be patient and anticipate a period of bureaucratic drag, otherwise an investee will feel compelled to cut corners and end up paying bribes while trying to keep it covered up. We previously noted that playing that kind of double game is a risk factor in itself.

Finally, we come to instability, which means the fragility of a particular regime or even a whole government including its institutional framework. It does not necessarily mean regime change, revolution, or state collapse / failure. Those are potential outcomes that lie on the far end of the instability spectrum. That said, "unstable" is not just a category label either. Instability has tangible manifestations which can be very problematic for businesses and citizens alike. We briefly examine the two main types of the phenomenon, bottom-up and regime-level.

Bottom-up instability refers to widespread discontent with a government or ruling regime, and a perception that it is losing its legitimacy, or rightful claim to authority. When discontent reaches a certain threshold, either gradually or through triggering events, it can lead to protests and in some cases strikes. The specific dynamics, variations and outcomes are nuanced. For purposes here it suffices to note that this kind of unrest can be very disruptive, and potentially dangerous. Protests and consequent police action can make major parts of a city no-go zones. Governments often shut down communication networks, and can set up checkpoints throughout affected areas, both of which hinder local logistics. If protest-related strikes affect public services, there can be gaps in the provision of public utilities and transport. Finally, in countries where the ruling regime has a stark fear of revolutionary change, any significant manifested dissent can lead to a crackdown not just on dissidents, but also anyone vaguely suspected of having some link to them, however tenuous or historical. Periods of street protest often fizzle out after a government makes some concessions and people get tired of tear gas, but in the more repressive cases the regime's vengeful reaction can continue for some time and have lasting effects on specific people, groups and businesses.

Regime-level instability is competition by cliques or factions which constitute the regime. Factional splits can occur on family / clan / ethnic lines, on ideological axes, and between civilian and military elements. All three types of schism can intertwine. Institutionalisation helps to prevent rivalries from

becoming violent, because people play by the rules and know that they are protected by the rules. When institutions are weak, mutual threat perception intensifies. Factional moves can lead to bloodless coups, violent coups, coup attempts and purges, but short of these potential outcomes, rivalries often involve competition for control over different ministries and state companies, and efforts to undermine someone else's networks therein. One common form of sabotage is alleging corruption and, ideally, kicking off an anti-corruption campaign as a way to remove factional opponents, although such campaigns can become a double-edged sword. In any event, while regime instability short of existential violent contests seldom plays out on the street, it can have a severely deleterious effect on governance standards, policy-making, and bureaucratic performance, all of which make the business environment more confusing, uncertain, and prone to obstacles. More dangerously, a business could be associated with the "wrong side" in a rivalry because of its political connections, and become a target of factional sabotage.

From the standpoint of an office in a relatively well governed, democratic country, it is easy to regard instability of either kind as a rare and extreme dynamic. However, at any one time approximately half of all countries are suffering from serious forms of one or the other, or even both, types. Again, they do not necessarily lead to dramatic, newsworthy events, but they do make legitimate business performance in a country challenging, and investees are no less affected by instability than any other domestic enterprise.

In this section we have covered: potential harmful socio-political responses to an investee; the potential erosion of an investee's socio-political network as it undergoes its transition; and some of the main forms of political risk that an investee can face from environmental dynamics. The last, environmental, or exogenous, political risk is less directly relevant for purposes here, because while it is more acute where impact investing is most valuable, it is not linked to a company's investee status. Stakeholder-related challenges, on the other hand, are. Any successful domestic company will face degrees of stakeholder interest, for better or worse. But becoming an impact investee is a significant shift in profile, bringing not just a better financial position, but also an association with foreign investors and foreign values. Funds and expat managers need to be acutely aware of this and plan for it, or the investee could face bigger problems than had it just been left to its own devices.

Political risk management

We have covered the relevance of political risk to EMPE impact investing at three levels, a fund's prospect targeting and selection, foreign management, and the investee on the ground. At each level there have been indications for political risk management, and readers can likely extrapolate their own considerations after becoming more aware of political risk in this context. Thus, we will not be very prescriptive in this section, and in any case how political risk is managed, using what organisational models, can be very specific to an organisation's culture, exposures and the expectations of its immediate stakeholders. Instead, we will focus on a few key big picture and on-the-ground considerations. This will conclude with some thoughts on an investee's own political risk management capability.

Big Picture

For a fund and general partners specialising in emerging markets, strategies and guidelines on political risk management would make considerable sense in a range of decisions and processes. Here we will only focus on a few which we covered in the section on fund-level issues and foreign management.

One concerned the possibility of inadvertently committing to prospects in countries that were, under the surface, more fragile and risky than a fund had intended. Not only could this be problematic if political risk did manifest for a given project, but it could unbalance the risk-reward equation of an investment portfolio.

It can be very difficult to estimate how a country's political dynamics, or a wider regional issue, might evolve over the medium to long term. Unlike conventional business or economic trends in stable environments, which can be a numbers game, politics is ultimately driven by social psychology and risk-taking behaviour, often in relation to other entities. Deliberate deception also clouds the direction of change. Thus, forecasts and predictions are not reliable. However, political risk analysis aimed at testing assumptions and developing a picture of plausible change directions can help to get a sense of a prospect country's longer-term viability. This should be exploratory rather than just looking at indicators of instability. A country can manifest such indicators for a long time before showing any signs of significant change, and hence a simple status report is not particularly useful for getting a sense of a time window of opportunity. Scenarios are not prediction, but if well informed and well reasoned, they at least enable intelligent risk-taking.

As an aside, the question could arise if an investment is still worth it even though the host country might be headed to serious political unrest and disruptive change. An impact investment could well

still be worth it. First, most cases of political regression are resolved in a few years, and the country returns to a degree of functional stability. Second, impact investing can contribute to a country's socio-political resilience, and actually help it to recover from a period of decline. A profitable exit might be delayed, but eventual profit would still be feasible. However, if scenario analysis indicated that very stark turns for the worse, such as state failure or the rise of an ethnically discriminatory authoritarian regime, were plausible, then it could be time to shelve the prospect.

Another challenge at the fund and management level was the trade off between ESG adherence and accessing societies most in need of the developmental benefits that would come from impact investing. If we were very concerned about sustaining a record for ESG compliance, we might as well just focus on places that already have a reasonable standard of living by global standards. On the other hand, we would not want to be associated with, or somehow benefit, corrupt or abusive actors just on the narrow chance that our investment might do more overall good than harm.

For many countries which would benefit from impact investing, we might need to take ESG as a general guide in terms of what we are eventually trying to achieve, rather than an investment hurdle. This could mean conceptualising "impact" in broader terms, as well as developing an unfettered sense of what would constitute overall nett developmental benefit, as opposed to simply an ESG compliant investment. If there were serious hurdles to achieving nett benefit, then an investment might not be appropriate. If a prospect makes it past initial selection, a more nuanced analysis would examine realistic pathways towards ESG-compatible impact in the socio-political context. Subsequent planning would take a pragmatic, gradual approach, rather than a headlong rush to ESG proselytising and audits. The same holds for achieving efficiency: we would need to examine how margins could be increased without sacrificing the investee's existing socially beneficial roles, and if this were feasible then subsequent planning would balance the two imperatives.

Two more considerations could be regarded as on-the-ground questions, but given that they would influence fund and management-level policy we can deal with them now. One concerns prospect due diligence. EMPE firms carry out robust due diligence on prospective investees, but the process is often standardised and is not adapted for socio-political context. Where institutionalisation is robust and there is a clear separation between business and socio-politics, company due diligence can be quite standardised and still catch relevant insights. In complex environments, business and socio-politics are usually intertwined, and how and to what degree varies between cultures and levels of political development. A standard due diligence checklist could fail to pose the right questions and fail to provide relevant interpretive guidelines. Thus, as a matter of policy, due diligence for prospects

in more fragile environments should be contextualised, and not done using a one-size-fits-all template.

The second policy matter is security for expatriate personnel. Given the relatively high security hazard in complex environments, as well as the very nuanced distinctions between threat landscapes, security policies should also be contextualised for different locations. Additionally, security procedures should not be left to the whim of individuals on deployment. Sometimes “old hands” equate their past good luck with personal security proficiency, and can become quite cavalier. That makes them more vulnerable and also makes less experienced staff feel like they need to keep up. HQ, the country office, and individual staff should all bear accountability for adherence to procedure in higher risk locations.

On the ground

We noted two potential issues for an investee arising from its investee status: a shift to ESG compliance could undo socio-political networks which have enabled it to survive as a company, and a shift to efficiency could incur disappointment or friction with actors who benefitted from the company’s social and cultural benefactor roles. These are linked to exogenous political risk, since support networks are a significant enabler of managing risk, for example through the provision of insights and warnings, direct support with specific pressures, and simply moral support in hard times.

It is at the level of the investee on the ground where the rationale for our earlier conceptualisation of political risk and political risk management becomes clear. That positioned political risk as lying at the intersection of an organisation and the socio-political domain and milieu, and political risk management as guiding the relationship between these.

When one considers geopolitical risk, or macro political risk (overall country-level risk as used for pre-entry prospect screening), broad political dynamics and their potential problematic contortions are a reasonable focus. On the ground in a complex environment, these matter, but for almost any organisation, from a foreign multinational to a small local NGO, stakeholders are a more direct and tangible consideration. Stakeholder reactions to an organisation might not make the evening news, but they can add up to be the most significant source of overall pressure on an organisation. Thus, stakeholder analysis and engagement planning are important across the board, and for an investee they would rightfully constitute the preponderance of political risk analysis and management planning.

A potentially useful exercise is to conduct two analyses. One examines the stakeholder landscape and attitudes therein towards the company prior to it becoming an investee. This sets a baseline, and

also reveals socio-political interests that remain relevant in the investee phase. Then we change the company's socio-political profile, projecting forward a year or so in time when it will have clear attributes of an investee receiving foreign investment, having some foreign control, and being partly guided by foreign management and principles. A stakeholder analysis would examine how previous interests and attitudes would shift in this adjusted profile, and which new ones would develop. From this we can discern sources of friction and wary, predatory or hostile attitudes, as well of new or more positive attitudes. This exercise would yield a clear sense of how the shift to investee status would affect socio-political relationships and positioning, and how the investee could shape relations to minimise negative interest and build on positive perspectives. Bearing in mind the tensions between ESG and efficiency on the one hand, and socio-political survival mechanisms and benefactor roles on the other, engagement planning would be guided by the aim of achieving a balance between these.

The fund and foreign management would also need to examine their own profile and roles within the wider socio-political stakeholder equation, and adjust these for optimal effect. In some cases a visible connection, or even a degree of co-branding, with foreign interests and values could be beneficial for the investee. For example, it could help to convince relevant government officials that the company could have a concrete contribution to policy objectives concerning national innovation and competitive capacity based on global best practices. In turn, they could help to ensure that the company was not plagued by bureaucratic hurdles or corruption pressure. The converse is easy to imagine: a foreign aspect could incur more suspicion, predatory interest or hostility than positive interest, in which case that aspect should be minimised. There are nuances between these positions and not every actor will see the investee's foreign aspect the same way, but being aware of sensibilities will help the foreign side to tailor its profile for best effect. Even it needs to keep a low profile, it can still closely work with the investee behind the scenes to help it through its transition.

An investee will be even more exposed to twists and turns in exogenous political dynamics than foreign on-the-ground projects, since foreign firms have the option of leaving, and can call on significant corporate support structures in the meantime. Yet an irony is that few local companies in complex environments have a political risk intelligence capability, partly because they grow accustomed to a degree of volatility and, like the proverbial frog in a pot, only ever perceive change in minor increments even when the water in the pot starts to get very hot. It would be beneficial, and sometimes even essential, for the investee to have a capacity to read political dynamics which could affect it, and to build contingency plans and security procedures for the more serious potential challenges. This does not need to consume much management focus, as long as it were well on the

mental radar of investee managers and accounted for in periodic reviews of risk intelligence and preparedness.

In the above vein it would be helpful if foreign managers clarified up front the extent to which they would assist the investee in managing the effects of harmful dynamics. For example, should the foreign side help to evacuate investee staff in the event of violent turmoil, or ensure that particularly exposed investee managers had kidnap insurance and access to kidnap response consultants? More broadly, do the fund and foreign management have a duty of care towards the investee, and if so, to what extent? The answer to this and related questions would vary by context, but upfront consideration ensures that roles and responsibilities are clear for the time when action could be needed.

Much more could be said about on-the-ground political risk management in this context. We did not go into experience-based lessons, the political risk management roles that might need to be shaped, or the options for addressing different common issues and challenges. As with the rest of this paper, we can only provide an introductory snapshot without having a specific case to delve into. Hopefully, though, this suffices for at least a sense of what political risk management involves at the ground level.

An overlooked opportunity: investee political risk management capability

Many investees could be well positioned to lead on their own political risk management, because of their intrinsic awareness of the environment and of the socio-political relationships on which they rely, and which could affect them. We noted above that there is seldom an explicit political risk intelligence capability in firms based in complex environments, but that does not mean that they are not already managing political risk, specifically through networks and alliances which they nurture and balance as a matter of routine. That said, there is a world of difference between doing something habitually, as tacit adaptation, and taking a strategic perspective to control for priority potential issues, challenges and scenarios.

In the author's experience with local organisations in complex environments, people can be very receptive the notion that socio-political risk can be understood and strategically managed. All it takes to unleash latent capacity is a new perspective and the relevant frameworks. For example, in local NGO training in Lebanon, and during policy analyst training in Afghanistan, once ideas and tools were in hand, training participants suddenly grasped that they were personally sitting on a wealth of socio-political intelligence. That, along with finally having a channel and forum to discuss and shape

previously amorphous but pressing issues that had been on people's minds, led to very quick and ready adaptation to thinking strategically about political risk.

A fund and foreign managers should not just provide training and guidance and consider investee political risk management to be a ticked box. There is still much to do in terms of structuring the capacity as a collaborative thread within the firm, and the foreign side, as a significant stakeholder, needs to retain some oversight, including on the alignment between political risk management and business ethics and integrity. But the investee owning its own political risk management not only empowers it, but makes the most of cultural awareness and experience in the given context.

EMPE impact investing seeks to make a difference, and that difference is most needed where political risk is highest, namely complex emerging markets where weak governance, low national cohesion, conflict and instability hinder prosperity and socio-economic justice. It stands to reason that a capability to have an impact in that context would be strengthened by an awareness of how political risk could affect an investment, and knowhow in estimating and managing socio-political challenges. In this paper, we have only scratched the surface of a nuanced and varied topic, and there is much left to explore to see what makes sense for a particular fund, and its managers and investees. Hopefully this provides some initial direction for undertaking that exploration. Perhaps the single most important takeaway would be that once a company becomes an investee, its socio-political profile significantly changes, and a fund and foreign managers need to understand how this affects the company, and be patient and pragmatic in helping it to make a transition.

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