Two problems with these approaches..

- Focus just on revenues: To the extent that revenues are the only variable that you consider, when weighting risk exposure across markets, you may be missing other exposures to country risk. For instance, an emerging market company that gets the bulk of its revenues outside the country (in a developed market) may still have all of its production facilities in the emerging market.

- Exposure not adjusted or based upon beta: To the extent that the country risk premium is multiplied by a beta, we are assuming that beta in addition to measuring exposure to all other macro economic risk also measures exposure to country risk.
A Production-based ERP: Royal Dutch Shell in 2015

<table>
<thead>
<tr>
<th>Country</th>
<th>Oil &amp; Gas Production</th>
<th>% of Total</th>
<th>ERP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Denmark</td>
<td>17396</td>
<td>3.83%</td>
<td>6.20%</td>
</tr>
<tr>
<td>Italy</td>
<td>11179</td>
<td>2.46%</td>
<td>9.14%</td>
</tr>
<tr>
<td>Norway</td>
<td>14337</td>
<td>3.16%</td>
<td>6.20%</td>
</tr>
<tr>
<td>UK</td>
<td>20762</td>
<td>4.57%</td>
<td>6.81%</td>
</tr>
<tr>
<td>Rest of Europe</td>
<td>874</td>
<td>0.19%</td>
<td>7.40%</td>
</tr>
<tr>
<td>Brunei</td>
<td>823</td>
<td>0.18%</td>
<td>9.04%</td>
</tr>
<tr>
<td>Iraq</td>
<td>20009</td>
<td>4.40%</td>
<td>11.37%</td>
</tr>
<tr>
<td>Malaysia</td>
<td>22980</td>
<td>5.06%</td>
<td>8.05%</td>
</tr>
<tr>
<td>Oman</td>
<td>78404</td>
<td>17.26%</td>
<td>7.29%</td>
</tr>
<tr>
<td>Russia</td>
<td>22016</td>
<td>4.85%</td>
<td>10.06%</td>
</tr>
<tr>
<td>Rest of Asia &amp; ME</td>
<td>24480</td>
<td>5.39%</td>
<td>7.74%</td>
</tr>
<tr>
<td>Oceania</td>
<td>7858</td>
<td>1.73%</td>
<td>6.20%</td>
</tr>
<tr>
<td>Gabon</td>
<td>12472</td>
<td>2.75%</td>
<td>11.76%</td>
</tr>
<tr>
<td>Nigeria</td>
<td>67832</td>
<td>14.93%</td>
<td>11.76%</td>
</tr>
<tr>
<td>Rest of Africa</td>
<td>6159</td>
<td>1.36%</td>
<td>12.17%</td>
</tr>
<tr>
<td>USA</td>
<td>104263</td>
<td>22.95%</td>
<td>6.20%</td>
</tr>
<tr>
<td>Canada</td>
<td>8599</td>
<td>1.89%</td>
<td>6.20%</td>
</tr>
<tr>
<td>Brazil</td>
<td>13307</td>
<td>2.93%</td>
<td>9.60%</td>
</tr>
<tr>
<td>Rest of Latin America</td>
<td>576</td>
<td>0.13%</td>
<td>10.78%</td>
</tr>
<tr>
<td>Royal Dutch Shell</td>
<td>454326</td>
<td>100.00%</td>
<td>8.26%</td>
</tr>
</tbody>
</table>
Approach 3: Estimate a lambda for country risk

- Country risk exposure is affected by where you get your revenues and where your production happens, but there are a host of other variables that also affect this exposure, including:
  - Use of risk management products: Companies can use both options/futures markets and insurance to hedge some or a significant portion of country risk.
  - Government “national” interests: There are sectors that are viewed as vital to the national interests, and governments often play a key role in these companies, either officially or unofficially. These sectors are more exposed to country risk.

- It is conceivable that there is a richer measure of country risk that incorporates all of the variables that drive country risk in one measure. That way my rationale when I devised “lambda” as my measure of country risk exposure.
A Revenue-based Lambda

- The factor “$\lambda$” measures the relative exposure of a firm to country risk. One simplistic solution would be to do the following:
  
  $$\lambda = \frac{\text{% of revenues domestically}_{\text{firm}}}{\text{% of revenues domestically}_{\text{average firm}}}$$

- Consider two firms – Tata Motors and Tata Consulting Services, both Indian companies. In 2008-09, Tata Motors got about 91.37% of its revenues in India and TCS got 7.62%. The average Indian firm gets about 80% of its revenues in India:
  
  $$\lambda_{\text{Tata Motors}} = \frac{91\%}{80\%} = 1.14$$
  $$\lambda_{\text{TCS}} = \frac{7.62\%}{80\%} = 0.09$$

- There are two implications
  - A company’s risk exposure is determined by where it does business and not by where it is incorporated.
  - Firms might be able to actively manage their country risk exposures
A Price/Return based Lambda

\[ \text{Return}_{\text{Embraer}} = 0.0195 + 0.2681 \times \text{Return}_{\text{C Bond}} \]
\[ \text{Return}_{\text{Embratel}} = -0.0308 + 2.0030 \times \text{Return}_{\text{C Bond}} \]
Assume that the beta for Embraer is 1.07, and that the US $ riskfree rate used is 4%. Also assume that the risk premium for the US is 5% and the country risk premium for Brazil is 7.89%. Finally, assume that Embraer gets 3% of its revenues in Brazil & the rest in the US.

There are five estimates of $ cost of equity for Embraer:

- **Approach 1:** Constant exposure to CRP, Location CRP
  - $E(\text{Return}) = 4\% + 1.07 \times (5\%) + 7.89\% = 17.24\%$

- **Approach 2:** Constant exposure to CRP, Operation CRP
  - $E(\text{Return}) = 4\% + 1.07 \times (5\%) + (0.03 \times 7.89\% +0.97 \times 0\%) = 9.59\%$

- **Approach 3:** Beta exposure to CRP, Location CRP
  - $E(\text{Return}) = 4\% + 1.07 \times (5\% + 7.89\%)= 17.79\%$

- **Approach 4:** Beta exposure to CRP, Operation CRP
  - $E(\text{Return}) = 4\% + 1.07 \times (5\% +( 0.03 \times 7.89\%+0.97 \times 0\%)) = 9.60\%$

- **Approach 5:** Lambda exposure to CRP
  - $E(\text{Return}) = 4\% + 1.07 \times (5\%) + 0.27 \times (7.89\%) = 11.48\%$
Valuing Emerging Market Companies with significant exposure in developed markets

- The conventional practice in investment banking is to add the country equity risk premium on to the cost of equity for every emerging market company, notwithstanding its exposure to emerging market risk. Thus, in 2004, Embraer would have been valued with a cost of equity of 17-18% even though it gets only 3% of its revenues in Brazil. As an investor, which of the following consequences do you see from this approach?

  a. Emerging market companies with substantial exposure in developed markets will be significantly over valued by equity research analysts.

  b. Emerging market companies with substantial exposure in developed markets will be significantly under valued by equity research analysts.

Can you construct an investment strategy to take advantage of the misvaluation? What would need to happen for you to make money of this strategy?
**Implied Equity Premiums**

- Let’s start with a general proposition. If you know the price paid for an asset and have estimates of the expected cash flows on the asset, you can estimate the IRR of these cash flows. If you paid the price, this is what you have priced the asset to earn (as an expected return).

- If you assume that stocks are correctly priced in the aggregate and you can estimate the expected cashflows from buying stocks, you can estimate the expected rate of return on stocks by finding that discount rate that makes the present value equal to the price paid. Subtracting out the riskfree rate should yield an implied equity risk premium.

- This implied equity premium is a forward looking number and can be updated as often as you want (every minute of every day, if you are so inclined).
We can use the information in stock prices to back out how risk averse the market is and how much of a risk premium it is demanding.

Between 2001 and 2007 dividends and stock buybacks averaged 4.02% of the index each year. Analysts expect earnings to grow 5% a year for the next 5 years. We will assume that dividends & buybacks will keep pace.. Last year’s cashflow (59.03) growing at 5% a year

After year 5, we will assume that earnings on the index will grow at 4.02%, the same rate as the entire economy (= riskfree rate).

If you pay the current level of the index, you can expect to make a return of 8.39% on stocks (which is obtained by solving for \( r \) in the following equation)

\[
1468.36 = \frac{61.98}{1 + r} + \frac{65.08}{(1 + r)^2} + \frac{68.33}{(1 + r)^3} + \frac{71.75}{(1 + r)^4} + \frac{75.34}{(1 + r)^5} + \frac{75.35(1.0402)}{(r - .0402)(1 + r)^5}
\]

Implied Equity risk premium = Expected return on stocks - Treasury bond rate = 8.39% - 4.02% = 4.37%

Aswath Damodaran
A year that made a difference.. The implied premium in January 2009

<table>
<thead>
<tr>
<th>Year</th>
<th>Market value of index</th>
<th>Dividends</th>
<th>Buybacks</th>
<th>Cash to equity</th>
<th>Dividend yield</th>
<th>Buyback yield</th>
<th>Total yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>1148.09</td>
<td>15.74</td>
<td>14.34</td>
<td>30.08</td>
<td>1.37%</td>
<td>1.25%</td>
<td>2.62%</td>
</tr>
<tr>
<td>2002</td>
<td>879.82</td>
<td>15.96</td>
<td>13.87</td>
<td>29.83</td>
<td>1.81%</td>
<td>1.58%</td>
<td>3.39%</td>
</tr>
<tr>
<td>2003</td>
<td>1111.91</td>
<td>17.88</td>
<td>13.70</td>
<td>31.58</td>
<td>1.61%</td>
<td>1.23%</td>
<td>2.84%</td>
</tr>
<tr>
<td>2004</td>
<td>1211.92</td>
<td>19.01</td>
<td>21.59</td>
<td>40.60</td>
<td>1.57%</td>
<td>1.78%</td>
<td>3.35%</td>
</tr>
<tr>
<td>2005</td>
<td>1248.29</td>
<td>22.34</td>
<td>38.82</td>
<td>61.17</td>
<td>1.79%</td>
<td>3.11%</td>
<td>4.90%</td>
</tr>
<tr>
<td>2006</td>
<td>1418.30</td>
<td>25.04</td>
<td>48.12</td>
<td>73.16</td>
<td>1.77%</td>
<td>3.39%</td>
<td>5.16%</td>
</tr>
<tr>
<td>2007</td>
<td>1468.36</td>
<td>28.14</td>
<td>67.22</td>
<td>95.36</td>
<td>1.92%</td>
<td>4.58%</td>
<td>6.49%</td>
</tr>
<tr>
<td>2008</td>
<td>903.25</td>
<td>28.47</td>
<td>40.25</td>
<td>68.72</td>
<td>3.15%</td>
<td>4.61%</td>
<td>7.77%</td>
</tr>
<tr>
<td>Normalized</td>
<td>903.25</td>
<td>28.47</td>
<td>24.11</td>
<td>52.584</td>
<td>3.15%</td>
<td>2.67%</td>
<td>5.82%</td>
</tr>
</tbody>
</table>

In 2008, the actual cash returned to stockholders was 68.72. However, there was a 41% dropoff in buybacks in Q4. We reduced the total buybacks for the year by that amount.

Analysts expect earnings to grow 4% a year for the next 5 years. We will assume that dividends & buybacks will keep pace..

Last year’s cashflow (52.58) growing at 4% a year

After year 5, we will assume that earnings on the index will grow at 2.21%, the same rate as the entire economy (= riskfree rate).

\[
903.25 = \frac{54.69}{(1+r)^1} + \frac{56.87}{(1+r)^2} + \frac{59.15}{(1+r)^3} + \frac{61.52}{(1+r)^4} + \frac{63.98(1.0221)}{(1+r)^5}
\]

Expected Return on Stocks (1/1/09) = 8.64%
Riskfree rate = 2.21%
Equity Risk Premium = 6.43%

A year that made a difference.. The implied premium in January 2009
The Anatomy of a Crisis: Implied ERP from September 12, 2008 to January 1, 2009

Aswath Damodaran
An Updated Equity Risk Premium: January 2016

Base year cash flow (last 12 mths)
- Dividends (TTM): 42.66
- Buybacks (TTM): 63.43
- Cash to investors (TTM): **106.09**

<table>
<thead>
<tr>
<th></th>
<th>Last 12 mths</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>Terminal Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends + Buybacks</td>
<td>106.09</td>
<td>$111.99</td>
<td>$118.21</td>
<td>$124.77</td>
<td>$131.70</td>
<td>$139.02</td>
<td>142.17</td>
</tr>
</tbody>
</table>

Expected growth in next 5 years
- Top down analyst estimate of earnings growth for S&P 500: **5.55%**

S&P 500 on 1/1/16 = 2043.94

\[
2043.94 = \frac{111.99}{(1 + r)} + \frac{118.21}{(1 + r)^2} + \frac{124.77}{(1 + r)^3} + \frac{131.70}{(1 + r)^4} + \frac{139.02}{(1 + r)^5} + \frac{142.17}{(r - .0227)(1 + r)^5}
\]

\[r = \text{Implied Expected Return on Stocks} = 8.39\%\]

Minus

Risk free rate = T.Bond rate on 1/1/16 = 2.27%

Equals

Implied Equity Risk Premium (1/1/16) = 8.39% - 2.27% = **6.12%**
Implied Premiums in the US: 1960-2015


Aswath Damodaran
A Buyback Adjusted Version of the US ERP

Base Year Earnings = 104.48
Base Year ROE = 14.18%

Base year cash flow (last 12 mths)
Dividends (TTM): 42.66
+ Buybacks (TTM): 63.43
= Cash to investors (TTM): 106.09
Payout Ratio = 101.54%

104.48 growing @ 5.55% a year

Payout Ratio adjusts in linear steps to sustainable payout

Expected growth in next 5 years
Top down analyst estimate of earnings growth for S&P 500: 5.55%

Payout Ratio in stable growth
Growth rate = 2.27% a year forever
ROE = 14.18%
Sustainable Payout = 1 - .0227/.1418 = 83.99%

Last 12 months
<table>
<thead>
<tr>
<th></th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5 Terminal Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings</td>
<td>104.48</td>
<td>110.29</td>
<td>116.41</td>
<td>122.88</td>
<td>136.91</td>
</tr>
<tr>
<td>Payout Ratio</td>
<td>101.54%</td>
<td>98.03%</td>
<td>94.52%</td>
<td>91.01%</td>
<td>87.50%</td>
</tr>
<tr>
<td>Cash Paid out</td>
<td>106.09</td>
<td>$108.12</td>
<td>$110.03</td>
<td>$111.83</td>
<td>$113.49</td>
</tr>
</tbody>
</table>

S&P 500 on 1/1/16= 2043.94

2043.94 = \[
\frac{108.12}{(1 + r)} + \frac{110.03}{(1 + r)^2} + \frac{111.83}{(1 + r)^3} + \frac{113.49}{(1 + r)^4} + \frac{114.99}{(1 + r)^5} + \frac{117.60}{(r -.0227)(1 + r)^5}
\]

r = Implied Expected Return on Stocks = 7.43%

Minus

Risk free rate = T.Bond rate on 1/1/16= 2.27%

Equals

Implied Equity Risk Premium (1/1/16) = 7.43% - 2.27% = 5.16%
Implied ERP and Risk-free Rates

Implied Premium (FCFE) versus Risk Free Rate

Expected Return on Stocks = T.Bond Rate + Equity Risk Premium

Since 2008, the expected return on stocks has stagnated at about 8%, but the risk free rate has dropped dramatically.
Equity Risk Premiums and Bond Default Spreads

Aswath Damodaran
Equity Risk Premiums and Cap Rates (Real Estate)

Figure 18: Equity Risk Premiums, Cap Rates and Bond Spreads

Aswath Damodaran
Why implied premiums matter?

In many investment banks, it is common practice (especially in corporate finance departments) to use historical risk premiums (and arithmetic averages at that) as risk premiums to compute cost of equity. If all analysts in the department used the arithmetic average premium (for stocks over T.Bills) for 1928-2015 of 7.92% to value stocks in January 2014, given the implied premium of 6.12%, what are they likely to find?

a. The values they obtain will be too low (most stocks will look overvalued)

b. The values they obtain will be too high (most stocks will look under valued)

c. There should be no systematic bias as long as they use the same premium to value all stocks.
Which equity risk premium should you use?

### If you assume this
- Premiums revert back to historical norms and your time period yields these norms
- Market is correct in the aggregate or that your valuation should be market neutral
- Marker makes mistakes even in the aggregate but is correct over time

### Premium to use
- Historical risk premium
- Current implied equity risk premium
- Average implied equity risk premium over time

<table>
<thead>
<tr>
<th>Predictor</th>
<th>Correlation with implied premium next year</th>
<th>Correlation with actual return - next 5 years</th>
<th>Correlation with actual return – next 10 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current implied premium</td>
<td>0.750</td>
<td>0.475</td>
<td>0.541</td>
</tr>
<tr>
<td>Average implied premium: Last 5 years</td>
<td>0.703</td>
<td>0.541</td>
<td>0.747</td>
</tr>
<tr>
<td>Historical Premium</td>
<td>-0.476</td>
<td>-0.442</td>
<td>-0.469</td>
</tr>
<tr>
<td>Default Spread based premium</td>
<td>0.035</td>
<td>0.234</td>
<td>0.225</td>
</tr>
</tbody>
</table>

Aswath Damodaran
Inputs for the computation
- Sensex on 9/5/07 = 15446
- Dividend yield on index = 3.05%
- Expected growth rate - next 5 years = 14%
- Growth rate beyond year 5 = 6.76% (set equal to riskfree rate)

Solving for the expected return:

\[
15446 = \frac{537.06}{(1 + r)} + \frac{612.25}{(1 + r)^2} + \frac{697.86}{(1 + r)^3} + \frac{795.67}{(1 + r)^4} + \frac{907.07}{(1 + r)^5} + \frac{907.07(1.0676)}{(r - .0676)(1 + r)^5}
\]

Expected return on stocks = 11.18%
Implied equity risk premium for India = 11.18% - 6.76% = 4.42%
Changing Country Risk: Brazil CRP & Total ERP from 2000 to 2015

Aswath Damodaran
The evolution of Emerging Market Risk

<table>
<thead>
<tr>
<th>Start of year</th>
<th>PBV Developed</th>
<th>PBV Emerging</th>
<th>ROE Developed</th>
<th>ROE Emerging</th>
<th>US T.Bond rate</th>
<th>Growth Rate Developed</th>
<th>Growth Rate Emerging</th>
<th>Cost of Equity (Developed)</th>
<th>Cost of Equity (Emerging)</th>
<th>Differential ERP</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>2.00</td>
<td>1.19</td>
<td>10.81%</td>
<td>11.65%</td>
<td>4.25%</td>
<td>3.75%</td>
<td>5.25%</td>
<td>7.28%</td>
<td>10.63%</td>
<td>3.35%</td>
</tr>
<tr>
<td>2005</td>
<td>2.09</td>
<td>1.27</td>
<td>11.12%</td>
<td>11.93%</td>
<td>4.22%</td>
<td>3.72%</td>
<td>5.22%</td>
<td>7.26%</td>
<td>10.50%</td>
<td>3.24%</td>
</tr>
<tr>
<td>2006</td>
<td>2.03</td>
<td>1.44</td>
<td>11.32%</td>
<td>12.18%</td>
<td>4.39%</td>
<td>3.89%</td>
<td>5.39%</td>
<td>7.55%</td>
<td>10.11%</td>
<td>2.56%</td>
</tr>
<tr>
<td>2007</td>
<td>1.67</td>
<td>1.67</td>
<td>10.87%</td>
<td>12.88%</td>
<td>4.70%</td>
<td>4.20%</td>
<td>5.70%</td>
<td>8.19%</td>
<td>10.00%</td>
<td>1.81%</td>
</tr>
<tr>
<td>2008</td>
<td>0.87</td>
<td>0.83</td>
<td>9.42%</td>
<td>11.12%</td>
<td>4.02%</td>
<td>3.52%</td>
<td>5.02%</td>
<td>10.30%</td>
<td>12.37%</td>
<td>2.07%</td>
</tr>
<tr>
<td>2009</td>
<td>1.20</td>
<td>1.34</td>
<td>8.48%</td>
<td>11.02%</td>
<td>2.21%</td>
<td>1.71%</td>
<td>3.21%</td>
<td>7.35%</td>
<td>9.04%</td>
<td>1.69%</td>
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<td>2010</td>
<td>1.39</td>
<td>1.43</td>
<td>9.14%</td>
<td>11.22%</td>
<td>3.84%</td>
<td>3.34%</td>
<td>4.84%</td>
<td>7.51%</td>
<td>9.30%</td>
<td>1.79%</td>
</tr>
<tr>
<td>2011</td>
<td>1.12</td>
<td>1.08</td>
<td>9.21%</td>
<td>10.04%</td>
<td>3.29%</td>
<td>2.79%</td>
<td>4.29%</td>
<td>8.52%</td>
<td>9.61%</td>
<td>1.09%</td>
</tr>
<tr>
<td>2012</td>
<td>1.17</td>
<td>1.18</td>
<td>9.10%</td>
<td>9.33%</td>
<td>1.88%</td>
<td>1.38%</td>
<td>2.88%</td>
<td>7.98%</td>
<td>8.35%</td>
<td>0.37%</td>
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<tr>
<td>2013</td>
<td>1.56</td>
<td>1.63</td>
<td>8.67%</td>
<td>10.48%</td>
<td>1.76%</td>
<td>1.26%</td>
<td>2.76%</td>
<td>6.02%</td>
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<td>1.48%</td>
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<td>2014</td>
<td>1.95</td>
<td>1.50</td>
<td>9.27%</td>
<td>9.64%</td>
<td>3.04%</td>
<td>2.54%</td>
<td>4.04%</td>
<td>6.00%</td>
<td>7.77%</td>
<td>1.77%</td>
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<tr>
<td>2015</td>
<td>1.88</td>
<td>1.56</td>
<td>9.69%</td>
<td>9.75%</td>
<td>2.17%</td>
<td>1.67%</td>
<td>3.17%</td>
<td>5.94%</td>
<td>7.39%</td>
<td>1.45%</td>
</tr>
<tr>
<td>2016</td>
<td>1.89</td>
<td>1.59</td>
<td>9.24%</td>
<td>10.16%</td>
<td>2.27%</td>
<td>1.77%</td>
<td>3.27%</td>
<td>5.72%</td>
<td>7.60%</td>
<td>1.88%</td>
</tr>
</tbody>
</table>