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Cash Flow | February 15, 2012 | CFO.com | US

Rx for Emerging-Market Investment: Lower Hurdle Rates for Growing Nations

Companies are often too conservative, setting their global investment hurdle rates too high: an approach that can lead to underinvestment and languishing share prices.

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There is little doubt that emerging markets are growing faster than the developed markets of North America and Western Europe. Companies that realize the importance of growth have been investing in such emerging economies as China and India for years.

But while some companies are more aggressive, others are decidedly less so. In some cases, companies are investing too little in emerging markets because of internal decision-making obstacles that stand in the way of approving these important growth investments.

To get a sense of the value creation that emerging-market growth is driving for shareholders, consider that an investment of $1,000 in the iShares MSCI Emerging Index Fund (EEM) when it began trading in April 2003 would have appreciated in value by more than $3,300 versus about $500 for a similar investment in the S&P 500. That's more than six times the value creation.

Companies like Domino's Pizza seem to really get it. Since 2005, 80% of Domino's revenue growth has come from outside the United States. During the period, its total shareholder return in the form of dividends and share-price appreciation has been 225%, which far exceeds the 12% TSR of the S&P 500. Domino's has more than 4,000 restaurant franchises internationally, with many in such places as Mexico, India, South Korea, Turkey, and Taiwan.

But for every company with a successful global-investment strategy, there seems to be quite a few with international endeavors that never really amount to much. They tend to underinvest because they exaggerate the risks, underestimate the growth potential, and — very importantly — set international investment rate-of-return hurdle rates that are simply too high. They examine international opportunities from a U.S.-centric viewpoint and seem to recognize only differences that are adverse without embracing those that are constructive.

Most companies set hurdle rates by determining their own weighted average cost of capital plus premiums for additional risk factors. The WACC is typically determined by weighting the after-tax interest rate on debt with the cost of equity, which is often calculated as the long-term government interest rate (taken as risk-free) plus a premium for market-specific and company-specific risk.

During the past eight years, the WACC of most U.S. companies has been in the 7% to 9% range, and the rate would be similar for investments they make in mature economies such as the United Kingdom. But when a company from a mature market invests into the emerging markets, they typically step up that hurdle rate to reflect “country risk” by looking at sovereign bond spreads and other factors.

Applying the traditional approach, we determined the average WACC for a U.S. company investing in China and India to be about 3% to 5% above its U.S. WACC. In practice, many companies are very concerned about international risk. Thus, it’s not uncommon to find U.S. companies using hurdle rates of 15% to 20% or higher for investments in China and India.

Along with our colleagues, we have developed a new approach that interprets the capital markets to determine the “Required Return.” Our analysis indicates that the typical hurdle rates are too high in comparison to what investors really demand. This creates an obstacle to investing in high-growth emerging markets.

The Required Return is applied like a cost of capital, but is forward-looking and more closely follows what investors demand from companies. The Required Return is the cash-on-cash return on capital required for a company to be viewed as being zero net present value. That is, it’s the return required by investors for a company to be valued equal to its gross asset base, no more and no less. Those generating higher returns usually create value and those delivering lower returns usually destroy value.

In the United States, industries and specific companies tend to have a lower Required Return when investors expect them to grow revenue faster. That is, investors do not demand as high of a current return when future growth is expected to be strong. This has important implications for international investment, since many emerging markets are growing faster.

We applied the Required Return methodology to China, India, the United Kingdom, and the United States over the 32 quarters through the third quarter of 2011. We included all nonfinancial companies with forward revenue and earnings before interest, taxation, depreciation, and amortization estimates, and a market capitalization of at least $500 million each quarter.

In contrast to the situation using a WACC approach, we found that investors actually demand a lower Required Return in India (median of 7% over 32 quarters) and China (9%) than they do in developed countries like the United States (10%) and the United Kingdom (11%).

Our analysis indicates the lower Required Return in emerging markets seems to be related closely to forward revenue growth. Median next-year revenue growth for companies in China and India has been 23% and 22% over the past eight years, while in the United States and the United Kingdom, it has been 9% and 8%. Investors appear to demand less current return in countries where future revenue growth is expected to be stronger. We have verified this relationship with a handful of other countries as well.

Some executives question whether emerging-market growth can be profitable. When first entering a market, developed or emerging, companies often experience low profitability while they establish a foothold. But high returns on capital are achievable in all of these markets as shown by the median cash-on-cash return on capital being between 18% and 21% in all four countries. The emerging markets are a bit lower in this range but all are well above the Required Return.

The strategic significance of this research is that many developed-market companies are evaluating emerging-market investments using hurdle rates that are too high. This is leading many companies to underinvest in these high-growth geographies.

By modifying a company's investment policies to use lower hurdle rates in high growth countries, it is more likely to pursue ample investments in countries where growth is strong. This strategy is likely to improve the revenue growth and share-price appreciation.

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