Reading

A senior risk analyst works for a nation's sovereign wealth fund (SWF). She is attending an investment committee meeting in which a proposed investment in direct private equity is being discussed. Details of the investment are below:

- The SWF will take a 40% stake in unlisted foreign automobile manufacturer Dala Motor Group (DMG), based on the island nation of Modinica. The proceeds from the investment will be used to increase the automation and robotics of the company's plant and machinery. This investment should improve productivity, leading to an expected reduction in headcount of up to 40% of the current staff.

- DMG has benefitted historically from large tariffs on imported cars from large international automobile manufacturers. If the governing party in Modinica changes, it is expected these tariffs will be reviewed and potentially reduced or even removed. This could lead to a reduction in demand for DMG automobiles in favor of the now lower-priced imports.

- Existing DMG management will remain in place after the investment. Management has recently been issued a fine by the government of Modinica for inadequate waste disposal measures leading to the pollution of local wetlands.

The head of risk at SWF raises issues regarding currency risk, business competition risk, and risks relating to the quality of the existing management team with the head of private equity. The head of private equity makes the following comments in response:

- "With respect to currency risk, we shouldn't be too concerned here. The currency of Modinica is pegged to the USD, and this is expected to continue. Apart from a currency crisis in the late 1990s, which occurred prior to the peg to the USD, there has never been an issue with the currency of Modinica.

- With respect to business competition risk, we shouldn't be too concerned about the impact of the potential removal of tariffs—the domestic customers of DMG are very loyal to the brand, so international automobile makers are not really competitors to DMG.

- I don't see any risk with the existing management team—they've shown themselves to be tremendously effective cost-cutters in recent years. I'm sure they can go on to cut the staff by even more than our target and reduce all sorts of costs and perks for the staff!"

The head of risk is unimpressed by the responses of the head of PE and points out that none of the risks mentioned have been adequately assessed.

Question 1.1

Recommend how the risk management of the currency risk can be improved.

Question 1.2

Recommend how the risk management of the business competition risk factor can be improved.

Question 1.3

Discuss the major risk factor associated with working with the current management team at DMG.

Recommend how this risk factor can be best managed if the fund proceeds with the investment.

Reading

Ola Ramil is a senior risk analyst for a nation's sovereign wealth fund (SWF). Ramil is attending an investment committee meeting in which a proposed foreign direct investment in infrastructure is being discussed. Details of the proposed investment are as follows:

- The investment is a new toll bridge for a river crossing just outside a major foreign capital city. The fund will contribute 25% of the capital required, the local government will contribute 15%, and the rest of the project will be funded with fixed-rate infrastructure project bonds guaranteed by the foreign government.
- The agreement between the SWF and the foreign government states that the SWF is responsible for the construction and maintenance of the bridge. A pre-agreed fixed payment will be made by the government to the SWF in local currency for every month that the bridge is operational after a two-year construction period, regardless of the level of usage. The agreement in total covers the next 10 years.
- The river level has varied considerably over the last few years, and incidents of bursting of the banks have increased in frequency and impact. The local government has recently increased tax to raise revenue for a barrier system to prevent future flooding.

The SWF's Head of Infrastructure points out that the legal structure of the investment could be such that the SWF avoids paying any costs of constructing the flood barrier. The Head of Risk has warned against structuring the investment in this way.

The CIO says, "Our risk management process aims to identify and classify the risks of investments as insignificant, moderate, or significant." The CIO further categorizes the major risks of the infrastructure project into three classifications.

Insignificant risks:

- Usage of the bridge being lower than expected
- Default risk

Moderate risks:

- Currency risk
- Interest rate risk

Significant risks:

- Project delay costs
- Maintenance costs being higher than expected

In addition, the CIO notifies Ramil that the SWF is still conducting research to classify any political risk associated with the project.

Question 2.1

State the major risk to the SWF from structuring the infrastructure investment in such a way as suggested by the Head of Infrastructure. **Explain** why this risk factor is significant to the SWF.

Question 2.2

Justify why each risk classified as insignificant is correctly categorized.

Question 2.3

Recommend a method the SWF can use to hedge each risk classified as moderate.

Question 2.4

Describe how the risk management team could assess the political risk of the project.
