CARNEGIE COUNCIL for Ethics in International Affairs

Justin Harlow on Political Risk and Investment in Emerging Markets

Just Business

Justin Harlow, Julia Taylor Kennedy

Transcript

JULIA KENNEDY: Welcome to Just Business, a series of interviews on global business ethics.

Today I'm talking about political risk and investment in emerging markets with Justin Harlow, a managing partner at Tau Energy Partners.

Justin, it's a great pleasure to have you here on Just Business.

JUSTIN HARLOW: It's great to be here.

JULIA TAYLOR KENNEDY: You have made a priority of working in emerging markets. Even the so-called BRICs—Brazil, Russia, India, and China—are too mainstream for you. What drew you to this space, and why work in especially emerging markets?

JUSTIN HARLOW: Tau Energy Partners is an energy investment advisory business dedicated to the emerging markets. You probably know that the vast majority of energy resources are in the emerging markets, so it's natural to be there. Over 90 percent of the proven oil and gas reserves are in what are called the emerging markets.

BRICs—we don't focus on that much for a couple of reasons. One is competition. India and China tend to be a lot of the focus of private equity funds, which are the bulk of the businesses in which we advise. They also, from the oil and gas side, aren't the most resource-heavy nations in the world. Brazil is becoming increasingly important, and we do look at Brazil.

Russia has been very relevant for a long time. Obviously, with the whole privatization process, there has been a lot more investment there. But we just haven't focused on it. There's no real rationale for that. But I think there is a lot of investment to be made outside of the BRICs. I think there is a lot less investment competition in some of the other emerging markets. That's really why we focus on them.

JULIA TAYLOR KENNEDY: Justin, tell me how you got into this political risk/energy consulting space.

JUSTIN HARLOW: Sure. I have always been interested in emerging markets. My undergraduate degree is in Eastern European business. My master's is in developing economics, focusing on Asia and Africa. I started my career working for a small advisory firm, but was seconded to the Saudi Arabian Ministry of Foreign Affairs, where I advised them on my WTO [World Trade Organization] export strategy. So that gave me a really interesting flavor on the emerging markets. It also enabled me to travel to Saudi Arabia, which was a lot of fun and extremely fascinating, as you can well imagine.

I then moved to BP's trading group. I then moved to the United States. You can probably tell by my accent that I didn't start here. I joined a boutique consulting firm that was spun out of one of the big investment banks. I headed up some very interesting M&A [mergers & acquisitions] work, mainly for BP, in Indonesia, in Oman, in Kuwait. That gave me increased geographical knowledge of the energy space.

I was actually then hired by a client to head up global investment for Abu Dhabi National Energy Company, which was a startup company that is now at $20 billion, three or four years later. I headed up their global investment group and I headed up their global trading group. That gave me very useful levels of exposure, as you can probably imagine, being a national company of Abu Dhabi, to energy investments across the world.

From there is when I set up Tau Energy Partners.

JULIA TAYLOR KENNEDY: Why are you passionate about the energy sector?

JUSTIN HARLOW: One, I've always been intellectually curious. It's so varied. There are so many dynamics. The problems are so complex to solve and so interrelated. It's just a fascinating industry to work in. There aren't many industries where you can take technical risks, political risks, macroeconomic—trying to boil all these down and make an investment decision. I love traveling, so having a job where I have an excuse to travel—and especially to the places in the world where you wouldn't normally go on vacation. I don't think Saudi Arabia is that high on the vacationer's list, but it's probably the most interesting place I have ever been to.

JULIA TAYLOR KENNEDY: There is a bit of a preconception of risk in those emerging, developing markets. Talk about that risk and why you think it's not that much of a barrier.

JUSTIN HARLOW: Sure. There is risk in the emerging markets. A lot of people think that all the emerging markets are as risky as one another. I'll give you some examples. Maybe this is another reason why we haven't focused so much on India and China.

If you look at the World Bank's Ease of Doing Business as an example, in the 2009 statistics, India was ranked 133rd in the world. If you know how many countries there are in the world, that's pretty far down the list. If you look at Saudi Arabia, a country that most people in the West would think is not a place where we should necessarily do business, it's ranked 13th in the world. Japan is 15th.

When you look at the risks, you can talk about political risks, but there is business risk and everything else. If you look at corruption as an example, if you look at China, it's ranked 79th in the world. If you look at Qatar, it's ranked 22nd. That's better than France. France, I think, was ranked 24th.

So there are a lot of risks, but I think there is a lot of misconception about what those risks are. You really need to look at it on a country-by-country basis. It's not that the emerging markets are risky and the developed markets are not, that's for certain.

JULIA TAYLOR KENNEDY: Interesting. You do a lot of work in Latin America, too. What kinds of preconceptions are there with specific countries? Then maybe within countries they can be subverted.

JUSTIN HARLOW: Actually, one of the major projects that I'm working on at the moment is, I'm developing a private equity fund focused on Latin American oil and gas. My partner in this venture happens to be a Venezuelan investment bank. Venezuela is a very resource-heavy nation with respect to oil and gas, with the top two or three reserves in the world. It's difficult to extract, but they are there. But when you look at Venezuela, there has been a lot of political risk recently. There has been a lot of expropriation of assets.

But one thing I will say about political risk is that it's generally there in the emerging markets. It can be good; it can be bad. But it also differs on, depending on the entity that you are working in, how that risk can perhaps be managed.

My first real exposure to Venezuela was working with the Saudi sovereign wealth fund that was looking to go into Venezuela as everybody else was coming out. Why is that?

Saudi Arabia and Venezuela were founding members of OPEC [Organization of Petroleum Exporting Countries]. They have a long history of strong relations government to government. Therefore, this Saudi entity, which has very strong ties to the Saudi Arabian government, thought that they would be in a position to handle that political risk.

So even if there is political risk there, there are ways to manage it. Political risk insurance is one way, but government relations is another. Just because there's political risk doesn't mean you should necessarily stay completely out of those countries. It depends who you are a lot of the time.

With respect to Brazil, from a political risk perspective, that has been a real success story. Even though the regimes have been thought of as somewhat socialist in nature, they have adopted very pro-business policies. It looks as if that has continued with Rousseff. So from a political risk perspective, I think Brazil is great.

JULIA TAYLOR KENNEDY: And that's Dilma Rousseff, the new Brazilian president.

JUSTIN HARLOW: Exactly right.

In Colombia, a lot of the political risk has been historical, with entities such as FARC [Revolutionary Armed Forces of Colombia] and the guerilla movements. That has been very well-managed under Uribe. That continues to be well-managed. From the oil and gas side of things, which I work in, a lot of those guerilla movements have been pushed to the borders of Venezuela and Ecuador, which aren't as important in oil and gas. But as exploration continues to move out into the jungle areas, that will become more important.

Then Peru, which obviously has had a recent regime change—that seems to be heading in kind of a Brazil-type direction rather than a Chávez-type direction.

Argentina is somewhat important in energy, but those are the countries that I have tended to focus on.

JULIA TAYLOR KENNEDY: It seems like the energy space in particular has a lot of this political risk embedded in it. Why is that?

JUSTIN HARLOW: One of the major reasons is that a lot of these countries have dominant national oil companies. They are extensions of the government. Therefore, you have to deal with the government, and therefore you are naturally exposed to political risk. You can't get away from it. But they are highly strategic resources. Historically, I think, in the emerging markets, they have mainly been export-driven.

There has been a change in recent years to increasing value-add from your resources, developing businesses internally, creating jobs, et cetera, et cetera. A lot of the people are saying, "We have all these great oil resources. Why is our GDP [gross domestic product] per capita so low?"

It's all very political. Historically, it's just been that the regimes say what happens and that's what happens. But you are seeing people, through demonstrations and protests and everything else, becoming much more involved in the political process. You have seen that a lot in Peru in the energy space, where the indigenous groups are actually very organized and they have created some headaches for Peru's government with respect to new developments in the oil and gas space that are going deeper and deeper into the Peruvian jungle.

JULIA TAYLOR KENNEDY: It seems that the elements that investors have to worry about in the energy space are very complex. Walk me through a project and tell me where the risks come in.

JUSTIN HARLOW: We have talked about the political risks. They are well understood. There is the macroeconomic risk. If you are a U.S. company that is investing in a foreign country, you need to understand not only how the exchange-rate regimes work, but how you repatriate capital, what the tax regimes are, whether they are likely to change.

But there is also a lot on the social side as well. Historically, energy companies have done an okay job, I would say, in working with local communities. But it has been more of a case of charity rather than what we encourage, and that's actual investments in local communities. Dealing in these countries, which I have dealt with for a while, charity is okay, but what they really want is to be able to stand on their own two feet. So you have seen some pushes from the government perspective whereby they have encouraged domestic supply obligations and supply to the local community—

JULIA TAYLOR KENNEDY: And that's energy supply, right?

JUSTIN HARLOW: That's energy supply. Often with a big oilfield, there might be some associated gas. That gas goes to local power plants at a subsidized price that helps stimulate the local economy.

I would say that's a really big risk. I think the governments are starting to think about this. Companies are starting to think about this. It has caused more of an integrated approach to a project being developed, where you can't just look at it as purely an export project, in most countries.

Most countries in the emerging markets need power. They need energy to enhance their industrial base. I would say that's something that needs to be thought of well ahead of time, because it does impact economies because the energy is often supplied at subsidized rates. It has an impact on the overall viability of the project itself.

JULIA TAYLOR KENNEDY: But then the upside is that you have buy-in from the local community.

JUSTIN HARLOW: You have buy-in from the local community. It's not just something that's touchy-feely anymore. We have seen real examples of how that has seriously impacted project development.

You can't get past a project without all the other risks, which are the risks that investors in the United States are more familiar with—geological risk and production risk and transportation risk and all these other kinds of risks that the bulk of investors in the United States are familiar with. They may be more acute in the emerging markets, but they are the same problems they have been dealing with for 100 years.

But they haven't been dealing with political risk and economic risk and repatriating capital and dealing with local communities. In the United States the infrastructure is there. It doesn't tread on too many toes anymore. It still does. It's still controversial. But it's nothing like what you'll see in emerging markets.

JULIA TAYLOR KENNEDY: How do you keep investors calm?

JUSTIN HARLOW: A lot of the time we start working going in. So a lot of investors are relatively calm going in. The ones that are serious about going in have already thought a little bit about this and have made a decision. There isn't a whole lot of convincing we can do. Somebody is either interested in Brazil or Colombia or they're not.

The way we try and differentiate ourselves from, say, an investment bank is that we try and stay involved in the project on an ongoing basis. With investment banks and the M&A groups, it's often that you do the transaction and then that's it. But in the emerging markets there are so many problems that need management on an ongoing basis.

A lot of our clients haven't invested in the emerging markets before. How we keep them calm is, to be honest with you, having them very fully informed going in. There aren't any surprises. There are scenarios that they wish to happen and scenarios that they don't wish to happen, but there aren't that many surprises.

With that, you also have contingency planning. Again, to the extent that Chávez expropriates our asset in Venezuela, we already have an idea of the plan to realize the most value from that investment.

So a lot of planning, a lot of scenario analysis, a lot of what-ifs, but that's generally how we keep our clients calm.

JULIA TAYLOR KENNEDY: So then how do investors go about weighing the viability of a project? Risk is sometimes unquantifiable. How do you try and decide this is worth taking?

JUSTIN HARLOW: I agree, to a certain extent, it's unquantifiable. The way we approach it is through scenario analysis. You can't have 300 scenarios. You need to pick four or five. But if an election is coming up during your investment horizon, you need to think about the repercussions: Will there be an increase in taxation, et cetera, et cetera? With respect to currency uncertainty and the volatility around that, there are ways that you could build that into valuation through very sophisticated risk valuation-based methods.

A lot of the time people just value the project and take a punt on it, to be honest with you. It doesn't sound very sophisticated, but that's often what happens in the energy space. You're right, there are so many risks—a lot of the time, it's like, well, there are so many, and we can't perceive so many of them at all; let's just kind of cross our fingers and hope it happens. But that isn't the approach that we encourage our clients to take.

JULIA TAYLOR KENNEDY: Say your client believes the government where they are operating will expropriate their asset. What's a way you can mitigate that risk?

JUSTIN HARLOW: One of the ways in which we could help clients mitigate is that we have relationships throughout the world and we actually know companies that may want to come in. A lot of the contracts—you can handle some of it contractually by having the international arbitration clauses, et cetera, et cetera.

JULIA TAYLOR KENNEDY: And how do those work?

JUSTIN HARLOW: They work very slowly. I think a lot of them are based in The Hague. You go through an international arbitration and you request damages, if you know what the value of the property that was expropriated was. Time value of money, which is an economic concept—by the time you make your investment and you go through arbitration, you're years away.

How we help our clients is that we have built relationships throughout the world. We understand companies or institutions or investment funds that actually may be willing to step in. They're going to ask for a heavy discount, but it might be much more preferable than to go through a five-, six-, seven-year arbitration. Sometimes these projects can take that long.

So our advice would be, contractually, obviously well-designed contracts, which is generally the case. They have improved over the years. But when you're stuck in a bind, entities like ours can really add value by giving you options. You still may want to go through the international arbitration, but at least you'll have another data point to see that you could just go for a straight sale that could be done within a month; what is the haircut that we would have to take on that valuation?

JULIA TAYLOR KENNEDY: And that sale is contingent upon, okay, if we are expropriated, then the sale goes through? Is it a certain amount of time into the project?

JUSTIN HARLOW: It's a really good question. I actually was going through a similar process in Venezuela. I was not only targeting cases that were already in arbitration that were easy to find, but I was also targeting Venezuelan lawyers to find out which of their clients are starting to get concerned that their assets will be expropriated.

If it gets expropriated, then you go through international arbitration. The option is, if you think it's going to be expropriated, can you sell out prior to that event occurring? There's some gray area in the middle as well, where it's not clear who owns what and the government is saying one thing and you are saying the other.

But generally I would definitely encourage investors that are in these countries, that see these risks, to start thinking proactively about ways to get out, as opposed to just simply crossing your fingers and hoping, and then going through the international arbitration process.

JULIA TAYLOR KENNEDY: I also want to ask you while I have you here—we are at the Carnegie Council for Ethics in International Affairs, and there is a lot of talk in the energy space lately about clean tech, alternative tech. What do you think of those industries as an investment and from a sort of ethical investing perspective?

JUSTIN HARLOW: From the U.S. perspective, I think everybody is kind of clear on what needs to happen in the energy space in the next 20 to 30 years. Today we are reliant on foreign imports of oil and petroleum products. We can get into a debate on how hostile those suppliers really are. I think it's grossly overinflated. But I do fully recognize that in 20 to 30 years clean tech is going to take over. It just has to happen.

That being said, before I get on to my views on clean tech, I think the gap in the middle, which is the piece that I generally work in, is not talked about. That is, we are reliant. How do we manage those relationships in some of those countries? How do we ensure that the United States and everybody has continued supply in the presence of China investing greatly in some of these countries? What does that mean for supply, et cetera?

With respect to clean tech, my personal view is that it needs to happen, but I fear it's like the next Internet bubble. There are so many private equity funds, venture capital funds targeting this sector, and there are going to be very few winners. Not all those winners are going to be based in the United States either. As Obama says, China is playing the clean tech game to win. And they really are. Even in areas where America used to kind of lead, like solar, now Germany leads there.

JULIA TAYLOR KENNEDY: And now you're seeing a lot in Japan, too.

JUSTIN HARLOW: As part of my due diligence when I set up my company—I really wanted to see, in the energy space—and that encompasses conventional and renewable energy—how many investment funds are out there, how many venture capital funds are out there, et cetera, that concentrate on the various aspects of the energy chain. Emerging markets' private equity is dramatically underserved.

But when you go to clean tech, my main fear is that I see—I have not done an exhaustive check, but I would guess there are 300 or 400 at least private equity or venture capital funds involved in clean tech. As I said, there are going to be very few winners. There is a lot of money and a lot of investors chasing those.

Also the worrying thing, from my perspective, is that you are seeing a lot of funds go into clean tech that just do not have the people that can make credible investment decisions. So you'll see some private equity funds that historically have been in completely unrelated sectors—real estate—going into clean tech. There's just no justification for it. If you see private equity funds that have been in the scientific business, manufacturing business, I can understand how that process works.

I do fear that there is going to be a massive shakeout in the clean tech space. There are going to be a lot of people who lose a lot of money.

JULIA TAYLOR KENNEDY: Let's return to what you were talking about, the middle that you are thinking about and actively involved in, which is foreign markets that are emerging. It sounds like what you are describing is that there is a scramble going on that the United States is not very involved in for those resources. Is that what you see?

JUSTIN HARLOW: I've seen the start of it. There are still reliable suppliers to the United States, both at the government level and also in the free-market level. If you take the government level, Saudi Arabia has been a very trusted ally. I actually used to advise the Saudi Arabian government. I had a lot of time in that country—very misunderstood. They have been able to rely on Saudi Arabia.

The Exxons, the Shells, the BPs of the world generally rely on the market. The United States is still a very nice home for crude oil.

On the natural gas side, with shale gas, it's not so much of a concern anymore. But on the oil side it is a concern.

With respect to the kind of grabbing of resources, it has started to happen. It's often the case that China is stepping in. If you look at Iran as an example, the United States does not get its oil from Iran anymore. Who has stepped into that void? China has stepped into that void. I think Iran is the third-biggest supplier of crude oil and petroleum products to China.

If you look at Venezuela, America still sources a fair amount of its oil from Venezuela, I think 10 or 15 percent. But who has been stepping in recently, during the Chávez times, when the IOCs [International oil companies], mainly U.S.-based, have come out? The majority has been China, along with some Russian involvement.

What I will say is that a lot of people assume that if a Chinese company goes and invests, that oil is necessarily being directed to China and that oil company is completely governed by the Chinese state. It's difficult to get data on these things, but it seems like that's actually not the case.

How you would phrase it is that these Chinese companies are majority government-owned, but they are not government-controlled. They actually have more of a commercial outlook on resource allocation. PetroChina; CNPC [China National Petroleum Corporation], which is PetroChina's parent; Sinopec; Sinochem as well, which is a chemical company; and CNOOC [China National Offshore Oil Corporation]—

JULIA TAYLOR KENNEDY: Oh, I'm impressed.

JUSTIN HARLOW: Don't ask me what all those things stand for. They have made a huge amount of investment in foreign oil. I saw an estimate that it was something like, in the last two years, they have invested $40 billion in M&A transactions in foreign oil and gas assets.

But not all that oil—and I don't even know if the majority of that oil—goes to China. It's commercially driven. They are in it to make a profit. If prices are higher in the United States or Western Europe, they'll seek to transport that oil there, not necessarily to China.
That being said, these are long-term projects. Just because that oil is going on the market right now, it doesn't mean that that's going to happen forevermore. These deals tend to be 15-, 20-year types of transactions. I think it could be a problem in the longer term.

JULIA TAYLOR KENNEDY: I also was curious—every election cycle, we hear rhetoric about how the United States has to reduce its dependence on foreign oil. We have to look domestically. Then there is the debate on whether to look for traditional oil domestically or clean tech domestically. How frustrated do you get when you listen to politicians talking about energy?

JUSTIN HARLOW: It's great for me, because the longer they disagree, the less they're going to do and the more we'll be reliant on the emerging markets, which is my business.

The big sticking point, to me, is transportation fuel. What you have seen in the United States—and you see this in a lot of developed countries—is that they have moved towards more gas-fired power generation and other forms of generation, but they have reduced their use of oil and petroleum products for power generation, which is a great thing for pricing. It's a great thing for the environment.

Transportation is just a completely different beast. Of the petroleum products that get imported into the United States, I think about 70 percent—you have seen measures like increased vehicle efficiency standards coming in, and that's great, moving in the right direction. But it's barely going to keep up with demand.

JULIA TAYLOR KENNEDY: I guess another piece of that question is whether you think that the discourse is informed enough, if people are talking about issues in an intelligent enough way that they actually understand what is possible and what is not possible?

JUSTIN HARLOW: I think people are talking about it in an informed way. It's just this gap, this transition gap of the 20 years. I think people understand the situation now. A lot of business has been getting involved, not just through businesses investing, but business councils, et cetera, to help the government understand the future challenges in 20, 30 years' time. They are challenges now, but a lot of the prescriptions are just not going to be material in the next 10, 15 years or so. It's this piece in the middle that nobody seems to be talking about, which is the space that we're involved in.

JULIA TAYLOR KENNEDY: Great. These are fascinating issues, Justin. Thank you so much for making the time to talk to me about them.

JUSTIN HARLOW: No problem. It has been great.

Audio

Justin Harlow discusses investing in the energy sector in emerging markets. He is the founder and managing partner of Tau Energy Partners, an energy investment advisory firm dedicated to the emerging markets.

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