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Abstract

Emerging market companies typically have lover values than their counterparts in developed markets. In order to account for this practitioners typically use an ad hoc premium in discount rate in their DCF models – so called country risk premium. Approaches for this premium calculation do not have adequate theoretical basis in the literature. There is an alternative to premium which is in accounting for a country risk through scenario approach. However it is difficult to implement practically because of the calibration problem. Thus there is a problem of a country risk.

The concept of country risk premium has to be abandoned. We propose following procedure in emerging company DCF valuation.

1) Calculate theoretical discounted value as if the business is from developed country.

2) Account for the risk of an emerging market applying the discount. The discount can be obtained through analysis of differences between emerging and developed stock market multiples. As a result the problem of an emerging country risk stops being «black box» and becomes clear, observable and verifiable.

This paper proposes critical analysis of the theory and practice of discount rates. In addition paper gives a theoretical basis for country risk from the prospective of New Institutional Economics.

Key words: sovereign premium, country risk premium, emerging markets, valuation, value, discounted cash flow

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