Bringing back the cash

ROB KELLER AND **ALAIN SMITH** EXAMINE THE STRATEGIES FOR COPING WITH INHERENT RISKS WHEN EXPANDING OVERSEAS.

As the UK economy continues to deal with the challenges of an adverse economic backdrop, the appeal of overseas markets remains an attractive opportunity for UK businesses. Organisations, now more than ever, are hoping to take advantage of the attractive opportunities that expansion can offer. Recent research* shows that over two-thirds of businesses believe that now is a good time to increase overseas trading. However, an equal number also believe that businesses are deterred from exporting due to the perceived complexity and risk.

As UK companies look for new international markets for their products and services, they are confronted with the very real challenges that go hand in hand with growing a business overseas. These include managing cashflow effectively, but also being aware of the specific risks relating to non-payment for goods or services provided and issues around foreign currency transactions.

These challenges notwithstanding, there is much that can be done to manage such risks. Provided companies are well prepared and well equipped with the appropriate tools and information, doing business in international markets need not be as daunting as it can often seem. Financial institutions and banks can be helpful in providing trade solutions which can manage your cashflow more effectively and reduce the risk of not getting paid, as well as supporting your strategies to be efficient with the management of your resources.

A HEALTHY CASHFLOW: FEEDING YOUR BUSINESS Finding available funds to fulfil your next contract when you have not yet received payments for existing contracts is an issue that companies face every day, whether they are doing business domestically or internationally. However, when dealing with customers overseas, payments can take longer.

Very few companies can command payment upfront from their customers, but there are alternative ways to obtain the money you are owed more quickly.

One way is to arrange pre-shipment financing. Pre-shipment finance provides cash to purchase the materials that you need to fulfil your next orders, but it can also cover the costs of manufacturing, packing, transportation and shipping your goods. Lending can be provided against a letter of credit (LoC) arranged by the

buyer with you as the beneficiary, or an acceptable purchase order.

Other forms of financing include export invoice discounting (also called export receivables finance). This provides you with immediate access to up to 90% of the value of the invoices you have issued to your customers. It works in a simple and straightforward way: you issue your invoice as usual and send a copy to your bank and, in most circumstances, you can draw up to 90% of the value of the invoice within 24 hours.

The need for cash isn't always at the point of order. Sometimes, your customers may insist on having a longer period to pay you following delivery – maybe 90 days when you can only afford to give 60 days, for instance. In this case, a bank may be able to assist with a post-shipment financing solution.

CONTROLLING RISKS RELATED TO PAYMENT As well as ensuring sufficient funding, managing payment risks is a key part of keeping your export activity healthy. Working with new customers/suppliers or companies you have done relatively little business with can raise questions such as: "Will I receive payment on time?" and "Will my suppliers deliver the materials to the specification I need?"

You may also be concerned not just about the company you intend to work with, but also the country it resides in. For example, there are very attractive opportunities for UK companies in the world's emerging markets. However, the flip-side of this is the relatively higher risks inherent in transacting with emerging-market countries.

Again, this is where various financial export solutions can help businesses which buy and sell internationally to make these risks more acceptable.

Letters of credit and documentary collections are two such services that can add certainty to getting paid and being paid on time. The former involves the importer asking its bank to guarantee the payment to the exporter, providing certain conditions are met. It will involve the importer agreeing to a credit facility with its bankers.

A documentary collection works in a similar way, but is not a guarantee of payment by the importer to the exporter. It is simply a way of the payment being controlled – i.e. until the importer's bank receives documentary confirmation that the shipped goods have been received, it will not release payment from the importer.

On occasion, importers and exporters may want to guarantee other aspects of their trading activities, apart from payment. As an importer you may wish to ensure that the goods or services you have ordered are produced to the agreed specification and arrive on time. Alternatively, as an exporter bidding for a contract, you may be asked to provide a guarantee that you will deliver what you promise. All these risks have an associated bond or guarantee available that can be arranged by your banking provider.

TRADING INTERNATIONALLY BRINGS NEW SOURCES OF CUSTOMERS AND REVENUES. HOWEVER, IT ALSO BRINGS SPECIFIC FINANCIAL RISKS THAT NEED TO BE CONTROLLED.

THE GLOBALISATION OF FOREIGN EXCHANGE MARKETS AND ITS IMPLICATIONS Trading internationally brings new sources of customers and revenues. However, it also brings specific financial risks that need to be controlled. Here again, there are many financing solutions available to address those risks. No two businesses, or their attitudes towards foreign exchange (FX) risk, are the same – which means that flexibility and creativity are key to building a range of potential risk management solutions.

Recent statements from the People's Bank of China regarding gradual currency liberalisation and threats from the central bank of Brazil are just two examples of the growing truly global nature of the currency markets, which has been led by the robust expansion of these economies, and by an ongoing search for diversification by many investors.

Comparing the strength of growth in Asia, where non-Japan Asia grew by 9.5% in 2010, and Latin America, where growth was 7% for the three largest economies (and over 7.5% in Brazil) with the euro zone (1.7%), the UK (1.7%) and the US (2.8%), it is not difficult to see why these currencies are looked upon with greater and greater interest. Official central bank interest rates in China are 6%, while in Brazil they are 11%, which compares very favourably with the 0.1-1% rates in the US, the UK and the euro zone. Moreover, China could be set to overtake the US in terms of economic size within the next 15 years, while India will be the third largest economy within 10 years on current projections.

This not only threatens to marginalise current major currencies, but could have an effect across a broader spectrum of currencies/financial markets, potentially leading to greater, rather than less, volatility in all markets. As the UK slips further down the GDP rankings, this could mean sterling could get pushed around more by how the US dollar is viewed versus the likes of the Chinese renminbi, Indian rupee, Brazilian real and the euro, rather than bilateral economic differences between the UK and the US.

This argument is less powerful in the bilateral sterling/euro relationship because of larger trade flows and also because the euro zone economies are expected to suffer difficulties over the coming years as the euro zone deals with ongoing sovereign debt issues.

We should prepare ourselves for a changing landscape in terms of FX markets, one where businesses are dealing in more countries and in more currencies than they have been used to recently.

HOW CAN YOU MANAGE FOREIGN EXCHANGE UNCERTAINTY? With relatively high market volatility expected to continue, market moves can ultimately have a large impact on the cost of raw materials or goods imported and also on the value gained from selling goods and services overseas. For many businesses, it is the uncertainty of future exchange rate movements that they wish to avoid and the

knock-on effect that these could have on profitability. Increasingly, businesses are adopting formal exchange rate hedging policies which form part of their key financial controls. These policies state how the exchange rate risk should be managed and what financial products should be considered. This then drives the decision to hedge.

AS FORMER US SECRETARY OF DEFENSE DONALD RUMSFELD FAMOUSLY SAID: "THERE ARE KNOWN KNOWNS AND KNOWN UNKNOWNS." CURRENCY FLUCTUATIONS DEFINITELY FALL INTO THE LATTER CATEGORY.

For other businesses without formal policies, it often comes down to a need for greater certainty in cashflow planning and budgeting and the need to protect against a critical level of rates, where profitability becomes marginal.

In considering its overall position, the business should assess the likely sizes of its FX exposures, when these are expected to materialise, and how certain it is about the flow being created from its anticipated income or cost base.

In all circumstances, the importance of considering a range of hedging alternatives should be stressed, as no single approach will suit all cases. The individual mechanics of a company's cashflow may well rule out some alternatives while making others more attractive.

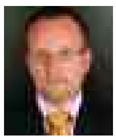
Most financial institutions can give you strong support in this field. When discussing an FX solution with your banking provider, the key is to formulate a hedging policy that has the ability to adapt to unknown future events. As former US Secretary of Defense Donald Rumsfeld famously said: "There are known knowns and known unknowns." Currency fluctuations definitely fall into the latter category. The solution simply lies in being well prepared and well equipped with the right tools.

MANAGING YOUR MONEY: BE SMART AND EFFICIENT

Finally, a large part of trading outside the UK comes down to your available cash – those monies you pay to others and that you take in revenue. Connected to this is managing the payment risks and FX risks. Ensuring sufficient cashflows in different currencies across different countries can seem difficult, but using services which "pool" this money could allow you to benefit from a favourable return on available funds and also enable you to utilise your cash by making your payments cost-efficient.

In summary, trading internationally for the first time or expanding operations abroad can bring great rewards for UK companies, but as with any type of trading, risks exist which need to be considered. Talking to a bank which has a proven track record in helping and supporting firms that expand overseas, or investigating what solutions are available to help you by speaking with your financial provider, can help maximise your success.

** According to a survey commissioned by RBS, entitled RBS B2B Export Research Study. The study interviewed 518 businesses of various sizes across a range of sectors. The report was prepared on behalf of RBS by IDC Research, October 2010.*



Robert Keller is head of business development and commercialisation for the UK & Ireland region for Global Trade Finance at RBS.
Rob.keller@rbs.com

Alain Smith, RBS FX Corporate Solutions.
Alain.smith@rbs.com

www.rbs.co.uk