Financial Considerations on Exporting Products

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Financial Considerations of Exporting Products

- Selecting a Currency to Invoice
- Getting Paid
- Other Considerations
- Tax Implications

Selecting a Currency to Invoice Customers

- Customers currency
  - Stability in pricing for customers who operate in the foreign currency
  - Incur currency exposure if USD strengthens
  - Incur currency benefit if USD weakens
  - Hedging

- USD
  - Stability in pricing for supplier
  - Matches cost of products (assuming costs are in USD)

- Either side may be request price concessions if currencies move.

Euro vs USD Example

5 Year Exchange Rate View

Local Currency vs the USD

Impact of a Change in Exchange Rates

- If you price in US Dollars (constant dollar) over time
  - You will have no currency impact
  - If the USD strengthens the distributor will suffer (it will cost the customer more).
    - Euro/USD exchange rate goes from $1.15/Euro to $1.00/Euro
  - If the USD weakens the distributor will benefit (it will cost the customer less)
    - Euro/USD exchange rate goes from $1.15/Euro to $1.35/Euro

- If you price in local currency (constant local currency) overtime
  - The customer will have no currency impact
  - If the USD strengthens you will suffer (you will receive less)
    - Euro/USD exchange rate goes from $1.15/Euro to $1.00/Euro
  - If the USD weakens you will benefit (you will receive more)
    - Euro/USD exchange rate goes from $1.15/Euro to $1.35/Euro

Euro vs USD Example: Invoice in Dollars

Assumptions:

- Assume you start selling to a Euro based customer January 1, 2014 when the exchange rate was ~1.375 $/€
- Assume your revenue is $1,000 from the foreign customer and cost is $500 per unit.
- Assume your foreign customer is reselling the product at €1,500.
- Assume and annual 2% price increase to the customer and the customer also gets a 2% annual price increase

The US Supplier

	Invoice Customer in USD				
	2014	**2015**	**2016**	**2017**	**2018**
Revenue	$ 1,000	$ 1,020	$ 1,040	$ 1,061	$ 1,082
% Growth		**2.0%**	**2.0%**	**2.0%**	**2.0%**
Cost of Goods Sold	500	510	520	531	541
% Growth		**2.0%**	**2.0%**	**2.0%**	**2.0%**
Gross Profit	$ 500	$ 510	$ 520	$ 531	$ 541
Gross Profit Percentage	**50.0%**	**50.0%**	**50.0%**	**50.0%**	**50.0%**

The Euro Based Distributor

	Purchase from Supplier in USD				
	2014	**2015**	**2016**	**2017**	**2018**
Revenue	€ 1,500	€ 1,530	€ 1,561	€ 1,592	€ 1,624
% Growth		**2.0%**	**2.0%**	**2.0%**	**2.0%**
Cost of Goods Sold	727	864	946	884	935
% Growth		**18.9%**	**9.4%**	**-6.5%**	**5.7%**
Gross Profit	€ 773	€ 666	€ 615	€ 707	€ 689
Gross Profit Percentage	**51.5%**	**43.5%**	**39.4%**	**44.4%**	**42.4%**

The customer has the risk and with a strengthening dollar, the customer margins suffer

Euro vs USD Example: Invoice in Euros

Assumptions

- Assume you start selling to a Euro based customer January 1, 2014 when the exchange rate was ~1.375 $/€
- Assume your revenue is $1,000 from the foreign customer and cost is $500 per unit.
- Assume your foreign customer is reselling the product at €1,500.
- Assume and annual 2% price increase to the customer and the customer also gets a 2% annual price increase

The US Supplier

	Invoice Customer in Euro				
	2014	**2015**	**2016**	**2017**	**2018**
Revenue	$ 1,000	$ 875	$ 832	$ 926	$ 911
% Growth		**-12.5%**	**-4.9%**	**11.3%**	**-1.6%**
Cost of Goods Sold	500	510	520	531	541
% Growth		**2.0%**	**2.0%**	**2.0%**	**2.0%**
Gross Profit	$ 500	$ 365	$ 312	$ 396	$ 370
Gross Profit Percentage	**50.0%**	**41.7%**	**37.5%**	**42.7%**	**40.6%**

The Euro Based Distributor

	Purchase from Supplier in Euro				
	2014	**2015**	**2016**	**2017**	**2018**
Revenue	€ 1,500	€ 1,530	€ 1,561	€ 1,592	€ 1,624
% Growth		**2.0%**	**2.0%**	**2.0%**	**2.0%**
Cost of Goods Sold	727	742	757	772	787
% Growth		**2.0%**	**2.0%**	**2.0%**	**2.0%**
Gross Profit	€ 773	€ 788	€ 804	€ 820	€ 836
Gross Profit Percentage	**51.5%**	**51.5%**	**51.5%**	**51.5%**	**51.5%**

The US supplier has the risk and with a strengthening dollar, the supplier margins suffer

Currency Conclusions

- Exchange rates fluctuate over time
- You cannot entirely isolate your company from the impact of exchange rates
- Better to price in USD assuming your costs are in USD and over the short term it is more predictable
- Be transparent on currency and consider exchange rate repricing based on a currency index.
    - Allows you to benefit if the USD weakens if you price in USD
        - Frequently you will be required to give price concessions if the USD strengthens
    - Clarifies the exchange rate situation and sets expectations

Hedging

- What is hedging:
  - A **hedge** is an investment position intended to offset potential losses or gains that may be incurred by a companion investment. In simple language, a **hedge** is a risk management technique used to reduce any substantial losses or gains suffered by an individual or an organization.
- If you have a predictable history of foreign currency transactions you can enter into hedges (e.g. forward contracts or options) as you forecast the sales.
- If you do not have a predictable history you can enter into hedges as you enter into foreign currency sales
- Talk with your accountant/auditor to understand the parameters and documentation requirements which can be onerous

Getting Paid

- Terms
  - Cash in advance
    - Cash paid in advance of product shipment.
  - Open terms (e.g. net 30)
    - Providing credit to the customer.
  - Letters of Credit
    - A letter of credit is a letter from a bank guaranteeing that a buyer's payment to a seller will be received on time and for the correct amount upon the seller fulfilling predetermined conditions (e.g. shipping product).
  - Stand By Letters of Credit
    - A stand by letter of credit is a letter from a bank guaranteeing that a buyer's payment to a seller will be received on time and for the correct amount upon the seller fulfilling predetermined conditions (e.g. shipping product). In the event that the buyer is unable to make payment on the purchase, the bank will be required to cover the full or remaining amount of the purchase.

Getting Paid: Terms

- Cash in advance
  - Most desirable state to get cash in advance or on shipment, but can be difficult to achieve.
- Open terms (e.g. net 30)
  - Granting open terms or credit can facilitate the sale, but evaluating customer credit status can be difficult.
    - Financial statements in language other than English
    - Differing accounting standards
    - Audit rigor in Statutory Financial Statements is not robust
    - Legal remedy may be unavailable

Getting Paid: Terms

- Letters of credit
  - Secures your receivable
  - Need to understand the (customers) issuing bank credit status
  - Need to negotiate the terms of the letter of credit. What triggers payment
  - Can be expensive to use for both parties
  - Manually intensive. Banking systems are available if you are receiving multiple letters of credit
  - Secured by buyers credit so buyers do not like to issue letters of credit
  - Get your bank involved
    - You will need a high quality international bank with experience as your bank
    - The bank will check the documents and pay if documents are complete
  - Can borrow against the customer LOC if terms are fulfilled and the right counter party. Allows you to grant longer terms and get paid.

Getting Paid: Terms

- Stand By Letters of Credit
  - Secures your receivable, but typically paid in cash and LOC is used in the event the customer does not pay
  - Need to understand the issuing bank credit status
  - Manually intensive. Banking systems are available if you are receiving multiple letters of credit
  - Need to negotiate the terms
  - Get your bank involved
    - You will need a high quality international bank with experience as your bank
    - The bank will check the documents and pay if documents are complete
  - Can be expensive to use
  - Secured by buyers credit so buyers do not like to issue letters of credit

Other Considerations

- Risk of loss while the product is in transit. Who pays for damage product in transit.
  - Shipping terms do not always determine who is at risk. Customers may expect replacement product for damage in shipment
  - Best to clarify and insure the customer understands the risk and/or has cargo insurance

- Customs and duties (typically paid by the party moving the product through customs).

Tax Implications

- Foreign Derived Intangible Income (FDII)
  - 2017 Tax Act created a new preferential tax rate for income derived by domestic corporations from serving foreign markets.
  - A corporation pays an effective rate of 13.125% (rather than 21%) on it above-routine income arising from foreign markets from 2018 to 2025 and 16.406% on years after 2025
  - Detailed calculation based on income above 10% of the corporations qualified business asset investment (QBAI).
  - Best case scenario for a company will all foreign based income and no QBAI, the tax rate would drop from 21% to 13.125%
  - See your tax preparer for assistance

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