

Spotify and SoundCloud

opening case

Numerous online music platforms exist today, with Apple Music, Google Play Music, Pandora, Spotify, SoundCloud, and YouTube as perhaps the most common ways people listen to music online around the world. What's popular, of course, can change rapidly. Numerous other music platforms exist or have existed (e.g., 8tracks, AccuRadio, Dash Radio, Deezer, Grooveshark, iHeartRadio, Incus Tunes, Jango, last.fm, Mixcloud, MusixHub, MySpace, RDIO, Slacker Radio, TuneIn Radio, The Sixty One, Xbox Music), and some of these will overtake the top platforms of today, some will be gone soon, and some already have very few users remaining. In this fierce competitive technology environment, Swedish entrepreneurs have made an incredible mark on the music industry.

It all begins, really, with the countless start-ups that Sweden has produced. The focus of this case is on Spotify and SoundCloud. However, to better understand the creation of companies and brands such as these, it's important to know how a tiny country like Sweden with a population of 10 million people and high government spending can be so innovative and entrepreneurial. Given its size, it should come as no surprise that companies from Sweden rely on exports for much of their sales. And the start-ups have become a cultural phenomenon in Sweden that has helped the economy grow in unimaginable ways from just a couple of decades ago.

Stockholm, the capital city of Sweden, produces the second-highest number of billion-dollar tech companies per capita, after Silicon Valley. The change happened in the 1990s when Sweden needed a boost to its economy. The country used to be heavily regulated and public monopolies dominated the market, but regulations have been eased since that time. Interestingly, while Sweden was making it harder for monopolies to dominate the market, the regulatory landscape in the U.S. was changed to favor big companies and established firms. Despite the global fascination with start-ups, only 8 percent of all firms in the U.S. meet that definition today, a remarkable drop from a few decades ago.

In Sweden, the trend has been reversed. The pace of new-business creation start-ups has been accelerating. Countries like Brazil, India, Romania, Germany, and Singapore have also seen an increasing trend of start-ups in recent years. These start-ups are critical to a country's economy. They create jobs, spur innovation, and foster the entrepreneurial spirit that drives economic growth. For example, in the United States, small- and medium-sized enterprises account for 98 percent of the country's exporters, and start-ups fall into this SME category (often as so-called "born globals"—companies that start selling internationally early on after inception). Spotify and SoundCloud fit all of these categories as start-ups—they were initially small, went international early on, and helped drive exporting numbers.

continued

Spotify is a Swedish entertainment company founded in 2008 by Daniel Ek and Martin Lorentzon that specializes in music, podcast, and video streaming. Spotify Technology SA is headquartered in Stockholm and listed on the New York Stock Exchange as SPOT. The company has more than 3,000 employees, 160 million users, and revenue of about \$5 billion. Spotify is available in most of Europe, the Americas, Oceania, and parts of Asia. Spotify gives users access to more than 30 million songs and has some 140 million active monthly users, with more than 70 million paying subscribers.

SoundCloud was founded in 2007 in Stockholm, Sweden, by Alexander Ljung and Eric Wahlforss, who almost immediately developed a headquarters for the company in Berlin, Germany. In effect, Alexander Ljung and Eric Wahlforss used the great infrastructure for start-ups in both Sweden and Germany to launch SoundCloud and build it into what it has now become—a company with 300 employees, 40 million registered users, and 175 million monthly listeners. With a different focus than Spotify, SoundCloud positioned itself as an online audio distribution platform that enables users to upload, record, promote, and share their originally created sounds.

Both Spotify and SoundCloud are service businesses that have entered into the global marketplace with music platforms that customers find valuable. Service exports are an important and increasing trend in global trade. Take, for example, the developed countries in the world, most of whose economies—around 75 percent—are service-based. If these economies, like Sweden and Germany, did not find an opportunity to export their services, they would likely fall behind in the trade balance (imports versus exports). Interestingly, the US has a relatively large trade surplus in services but a massive trade deficit in manufactured goods. If the US could reduce the deficit in products to have a neutral import-export ratio, the country's service economy would automatically create a trade surplus—which the country has not seen for some 50 years. Given that a service export is really any service provided by a resident in one country to people or organizations in another country, we know many countries can be successful, or at least have the opportunity to export more services like what Sweden and Germany are doing with Spotify and SoundCloud. ●

Sources: Stacy Fisher, "The Top 14 Places to Listen to Free Music Online," *The Balance Every Day*, April 3, 2018; Namrata Ahuja, "Spotify vs. Soundcloud: What Is the Best Platform for Music Lovers?" *Odyssey*, June 1, 2016; Alana Semuels, "Why Does Sweden Have So Many Start-Ups?" *The Atlantic*, September 28, 2018; "Spotify Makes Its Stock Market Debut," *The Economist*, April 4, 2018; "Having Rescued Recorded Music, Spotify May Upend the Industry Again," *The Economist*, January 11, 2018; and "SoundCloud Streaming Hones In On Creator Uploaded Content: CEO," *BusinessWeek*, April 23, 2018.

Introduction

Chapter 13 reviewed exporting from a strategic perspective as a part of the chapter's focus on entering foreign markets. We considered exporting as just one of a range of strategic options for profiting from international expansion. This chapter is more concerned with the nuts and bolts of exporting, along with tackling importing and countertrade. In some way, we can say that importing is exporting in reverse since the importing country and its companies buy from companies in other countries that are exporting. Unfortunately, the rules and regulations for importing and exporting are not always the same and, in fact, are often different in even the same country.

Exporting is a tremendously important mode of foreign market entry, preferred by more than 90 percent of all companies engaging in the global marketplace. The reason exporting is preferred by such a large portion of companies engaging in the global marketplace is that most small- and medium-sized enterprises (SMEs) prefer exporting as a relatively low commitment to getting their products or services out globally. Importantly, these SMEs also make up more than 80 percent of companies going international from almost every country in the world.

The volume of export activity in the world economy has increased as exporting has become easier from a large number of countries. Even countries now export themselves, such as France with its award-winning "Calling France" number. In a positive move for international trade, the gradual decline in trade barriers under the umbrella of the World Trade Organization (see Chapter 7), along with regional economic agreements such as the European Union (EU) and the North American Free Trade Agreement (NAFTA) (see Chapter 9), has significantly increased export opportunities.

Did You Know?

Did you know you can call Sweden and France and chat with a random person from those countries?

Visit your Instructor's Connect® course and click on your eBook or SmartBook® to view a short video explanation from the authors.

At the same time, modern communication and transportation technologies have alleviated the logistical problems associated with exporting. Over the last two decades, firms have increasingly used e-commerce and international air services to reduce the costs, distance, and cycle time associated with exporting. Still, more than 90 percent of products and component parts still logistically get shipped via large ships around the world. Consequently, it is not unusual to find thriving exporters among small companies. In fact, of U.S. companies that trade internationally, some 85 percent of them are SMEs, and they generally do so via exporting. Nevertheless, exporting remains a challenge for many firms. Take the United States as an example. Fewer than 1 percent of all U.S. firms trade across their country borders to other countries, and those companies that do engage in trade do so with typically only one other country (about 60 percent of all U.S. companies that export trade only with one other country). This means that knowledge, data, and experience often are lacking, and smaller enterprises, in particular, can find the exporting process intimidating.

Companies wishing to export must identify foreign market opportunities, avoid a host of unanticipated problems that are often associated with doing business in a foreign market, familiarize themselves with the mechanics of export and import financing, learn where they can get financing and export credit insurance, and learn how they should deal with foreign exchange risk. The process can be made more problematic by currencies that are not freely convertible. Arranging payment for exports to countries with weak currencies can be a problem. This is where countertrade comes in as a potential solution, and why we have made countertrade a focus in this chapter. Countertrade allows payment for exports to be made through goods and services rather than money. This chapter discusses all these issues, with the exception of foreign exchange risk, which was covered in Chapter 10.

In Chapter 13, we dealt with the scale of market entry and strategic commitments in going international. Essentially, our focus was on involvement and commitment when engaging in the international marketplace. What we find is that the first international level for both involvement and commitment was the exporting (outbound international activity) and importing (inbound international activity) options. The remaining options for involvement and commitment, although they overlapped in some areas, were a bit different (Chapter 13 discusses turnkey projects, licensing, franchising, joint ventures, and wholly owned subsidiaries—the latter also a production facility focus in Chapter 15). That places a lot of emphasis on exporting and importing as modes of operations for many companies, and we think that this area deserves more coverage; thus, this chapter is devoted to digging deeper into the knowledge of operations (“nuts and bolts”) of exporting and importing as well as the unique case of countertrade. This is, after all, the lowest level of involvement and the lowest level of commitment a company can make when going international: selling to foreign markets (exporting) or purchasing raw materials, component parts, or finished goods for operations (importing).

The bottom line is that as the global marketplace becomes more viable for many companies over time, companies must also adapt to this opportunity by strategically engaging in exporting (see Chapter 13) and operationally go about seeking opportunities globally. This could mean using suppliers from developing nations, importing products from new sources, or exporting products to new markets. Companies that have traditionally operated within national or regional trading groups may feel ill equipped to extend their market horizon. This may be as simple as feeling unable to select and manage a foreign supplier or not knowing how to sell products in a new country. But keep in mind that, by some accounts, 90 percent of the products and services that are needed locally are not produced locally; they are shipped in from somewhere else. And so, market opportunities are globally available everywhere and exporting and importing fill these voids.¹



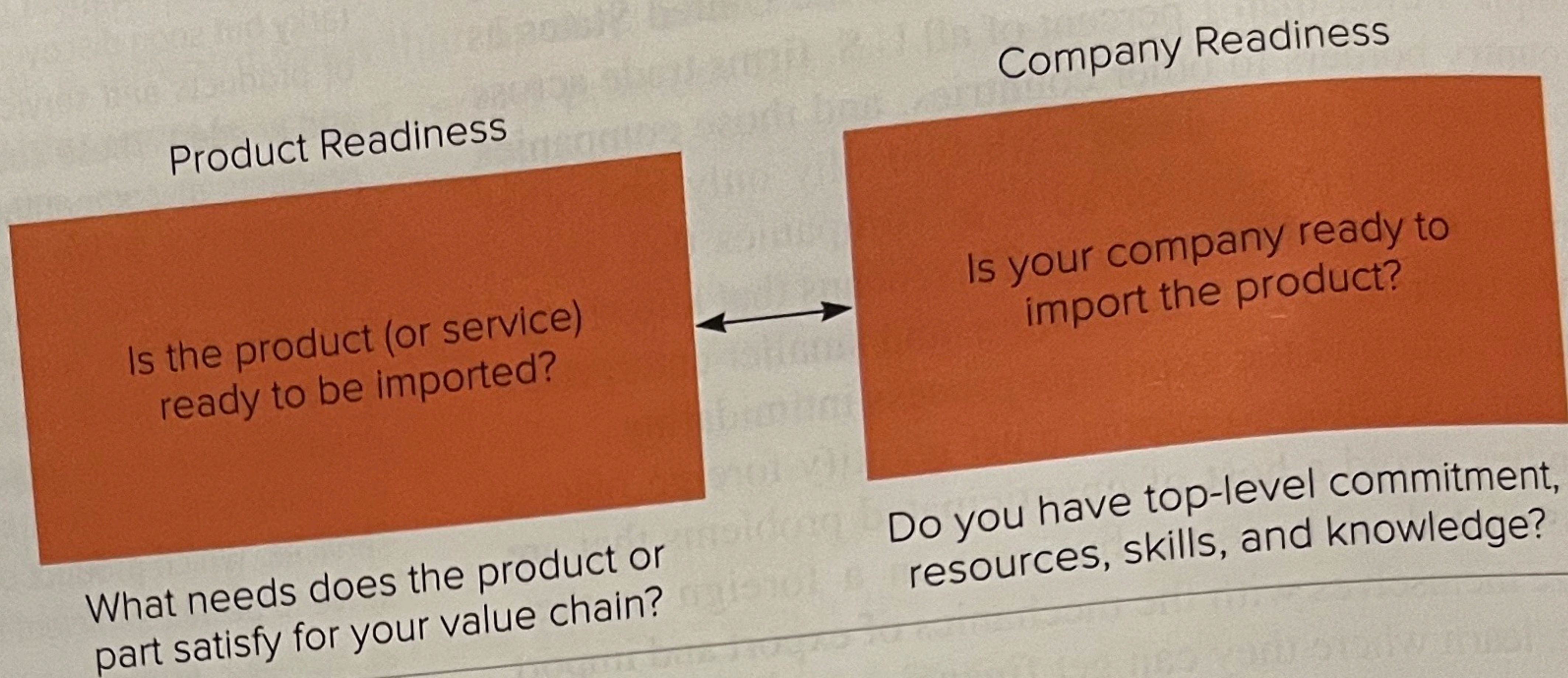
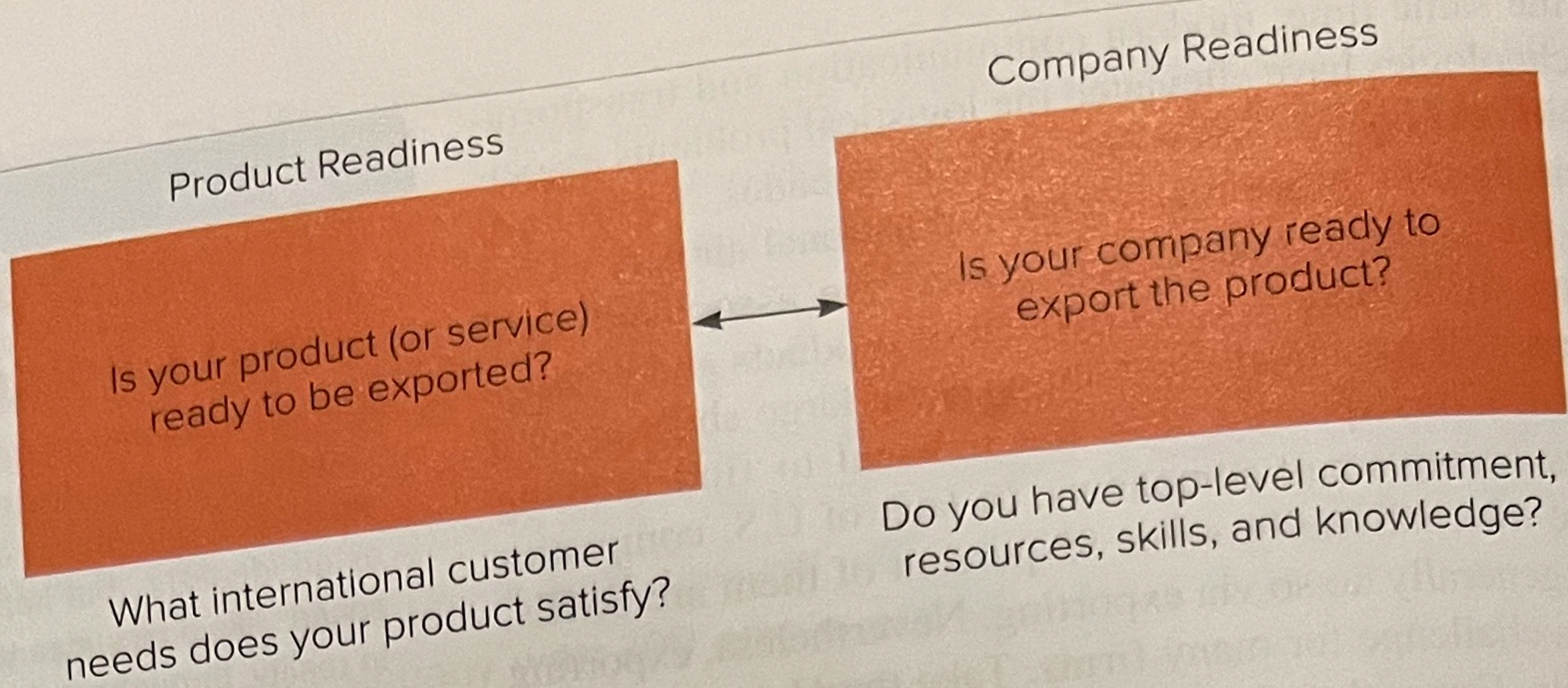
For Which Product Is Autarky a Good Choice for Countries?

The word *autarky* refers to the quality and belief that a country should be self-sufficient and avoid trade and/or external assistance with other nations. Many economists regard autarky as an idealistic, but impractical, goal of countries. Basically, it sounds like a nice idea to be self-sufficient and practice autarky. In reality, throughout history countries have tried to achieve autarky but soon discovered they could not produce the wide range of products and services customers in their population wanted and needed. These countries also found out that manufacturing products at competitive prices over the long term became a daunting task. In fact, those countries found themselves worse off economically than nations that engaged in international trade. So, a word to the wise; unless your country can efficiently produce everything it needs, the country needs to engage in international trade. A more logical and achievable possibility is to focus on being self-sufficient in certain areas, for certain products or services. Which product or service do you think a country should strive to be self-sufficient in?

Sources: “China Pursues Lithium Autarky,” *Strategic Risk*, March 27, 2018; J. Heathcote, Catherine Rampell, “The Dangerous New Age of Global Autarky,” *The Washington Post*, June 6, 2016; and Mahdi Amirisefat, “Autarky and Trade Wars: What Does Economic Theory Say?” *PressTV*, March 10, 2018.

14.1 FIGURE
Product readiness and company readiness to export or import.

Source: Adapted from T. Hull, D. Closs, and D. Frayer, *Global Supply Chain Management: Leveraging Processes, Measurements, and Tools for Strategic Corporate Advantage* (New York: McGraw-Hill, 2014).



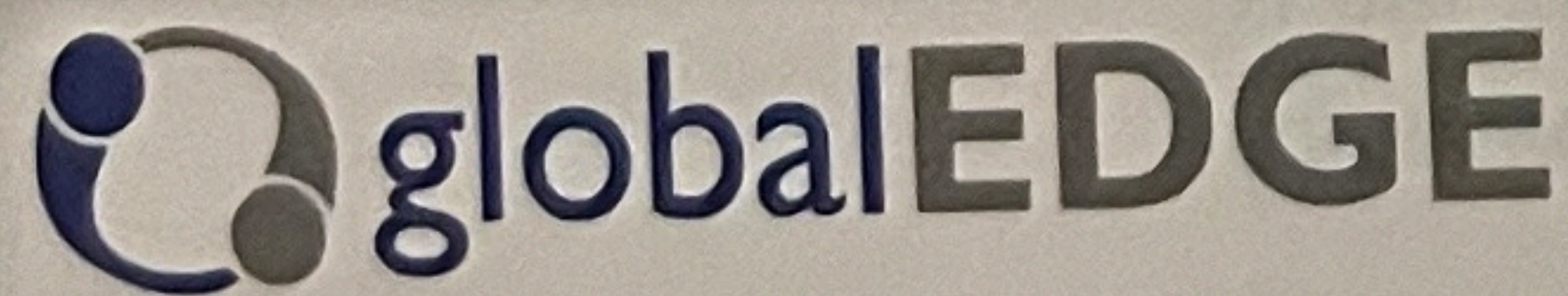
The chapter opens in the next section by considering the promise and pitfalls of exporting. The logic for both exporting and importing is very similar. Readiness to export and/or import is a large part of the story, as illustrated in Figure 14.1.²

The Promise and Pitfalls of Exporting

The great promise of exporting is that large revenue and profit opportunities are to be found in foreign markets for most firms in most industries. This was true for both Spotify and SoundCloud in the opening case to this chapter (as well as Tata Motors in the closing case). The international market is normally so much larger than the firm's domestic market that exporting is nearly always a way to increase the revenue and profit base of a company. By expanding the size of the market, exporting can enable a firm to achieve economies of scale, thereby lowering its unit costs. Firms that do not export often lose out on significant opportunities for growth and cost reduction.³

Consider the case of Marlin Steel Wire Products, a Baltimore manufacturer of wire baskets and fabricated metal items with revenues of about \$5 million. Among its products are baskets to hold dedicated parts for aircraft engines and automobiles. Its engineers design custom wire

LO 14-1
 Explain the promises and risks associated with exporting.



Export Tutorials

Exporting, importing, and countertrade are the focus areas of Chapter 14. The exporting entry mode choice, also discussed in Chapter 13, is the most often used way to conduct cross-border trade for companies. The vast majority of small- and medium-sized enterprises, for example, use exporting as their way to expand to international markets. But that begs the question of whether the company is ready to export and whether the product the company plans to export is ready to be exported. The "Export Tutorials" section of globalEDGE™ (globaledge.

msu.edu/reference-desk/export-tutorials) includes CORE as a diagnostic tool to assess "company readiness to export." The "Export Tutorials" section also has a lengthy set of questions and answers to the most common exporting-related questions in the categories of government regulations, financial considerations, sales and marketing, and logistics. For example, one question deals with whether a company needs a license to export. Assume you are based in the United States. How can you identify the relevant commodity jurisdiction for a product?

baskets for the assembly lines of companies such as Boeing and Toyota. It has a reputation for producing high-quality products for these niche markets. Like many small businesses, Marlin did not have a history of exporting. However, Marlin decided to engage globally in the export market, shipping small numbers of products to Mexico and Canada.

Marlin's president and CEO, Drew Greenblatt, soon realized that export sales could be the key to growth. In 2008, when the global financial crisis hit and America slid into a serious recession, Marlin was exporting only 5 percent of its orders to foreign markets. Greenblatt's strategy for dealing with weak demand in the United States was to aggressively expand international sales. Today, Marlin Steel has been exporting for eight years, with sales going to more than 20 countries. One-fourth of the company's 28 employees are employed as a direct result of its export success. By 2019, exports accounted for some 20 percent of sales, and the company set a goal of exporting half its output.

Despite examples such as Marlin Steel Wire Products, studies have shown that while many large firms tend to be proactive about seeking opportunities for profitable exporting—systematically scanning foreign markets to see where the opportunities lie for leveraging their technology, products, and marketing skills in foreign countries—many medium-sized and small firms are very reactive.⁴ Typically, such reactive firms do not even consider exporting until their domestic market is saturated and the emergence of excess productive capacity at home forces them to look for growth opportunities in foreign markets.

Many small- and medium-sized firms tend to wait for the world to come to them, rather than going out into the world to seek opportunities. Even when the world does come to them, they may not respond. An example is MMO Music Group, which makes sing-along tapes for karaoke machines. Foreign sales accounted for about 15 percent of MMO's revenues of \$8 million, but the firm's CEO admits this figure would probably have been much higher had he paid attention to building international sales. Unanswered e-mails and phone messages from Asia and Europe often piled up while he was trying to manage the burgeoning domestic side of the business. By the time MMO did turn its attention to foreign markets, competitors had stepped into the breach, and MMO found it tough going to build export volume.⁵

MMO's experience is common, and it suggests a need for firms to become more proactive about seeking export opportunities. One reason more firms are not proactive is that they are unfamiliar with foreign market opportunities; they simply do not know how big the opportunities actually are or where they might lie. Simple ignorance of the potential opportunities is a huge barrier to exporting.⁶ Also, many would-be exporters, particularly smaller firms, are often intimidated by the complexities and mechanics of exporting to countries where business practices, language, culture, legal systems, and currency are very different from those in the home market.⁷ This combination of unfamiliarity and intimidation probably explains why exporters still account for only a tiny percentage of U.S. firms, less than 5 percent of firms with fewer than 500 employees, according to the Small Business Administration.⁸

To make matters worse, many neophyte exporters run into significant problems when first trying to do business abroad, and this sours them on future exporting ventures. Common pitfalls include poor market analysis, a poor understanding of competitive conditions in the foreign market, a failure to customize the product offering to the needs of foreign customers, a lack of an effective distribution program, a poorly executed promotional campaign, and problems securing financing.⁹ Novice exporters tend to underestimate the time and expertise needed to cultivate business in foreign countries.¹⁰ Few realize the amount of management resources that have to be dedicated to this activity. Many foreign customers require face-to-face negotiations on their home turf. An exporter may have to spend months learning about a country's trade regulations, business practices, and more before a deal can be closed. The accompanying Management Focus, which documents the experience of Embraer, illustrates cultural barriers that sometimes can hinder both exporting and importing.

Exporters often face voluminous paperwork, complex formalities, and many potential delays and errors. Exporting to Brazil is a unique experience in and of itself that still to this day often requires more than just following the rules and regulations stipulated by the country. According to a United Nations report on trade and development, a typical international trade transaction may involve 30 parties, 60 original documents, and 360 document copies—all of which have to be checked, transmitted, reentered into various information systems, processed, and filed. The UN has calculated that the time involved in preparing documentation, along with the costs of common errors in paperwork, often amounts to 10 percent of the final value of goods exported.¹¹

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Embraer and Brazilian Importing

Embraer is a Brazilian company that manufactures commercial, military, executive, and agricultural aircraft and provides aeronautical services. It is headquartered in São José dos Campos, São Paulo State in Brazil. Importantly, Embraer is the fourth largest airplane manufacturer in the world, and its imports of various raw material and component parts to Brazil to make its airplanes constitute up slightly more than 1 percent of the Brazilian trade balance with all other countries, which is a relatively large portion of the Brazilian economy for just one importer.

Embraer has consistently been one of the top importers in Brazil since its founding in 1969. Today, the company has about 20,000 employees from 20 countries, revenue of more than R\$20 billion (Brazilian Real, BRL) or about \$6 billion, and more than \$300 million in net income. The company consists of three primary divisions: Embraer Defense and Security, Embraer Commercial Aviation, and Embraer Executive Jets. Across these divisions, the output is impressive. Embraer has served more than 90 airlines in more than 60 countries and delivered more than 5,000 aircraft to this clientele.

To be able to produce that many aircraft and achieve a top four position in its industry, Embraer has to import a lot of raw materials and component parts to Brazil to build the aircraft at the company's main locations at its headquarters in São José dos Campos as well as its other core plants in Brazil in Botucatu, Eugênio de Melo, and Gavião Peixoto. Some of these component parts are in reality finished products that are then inserted into the planes in a certain position, such as the PurePower Geared Turbofan engines from Pratt & Whitney to power its E-Jets. Embraer also collaborates with some of its competitors in the

industry, such as Boeing, in building its stretch civilian model of the KC-390 military transport/aerial refueler.

The list of suppliers to Embraer's operations is lengthy, with partnerships with Honeywell, Saab, UTC Aerospace, SNC, Flight Safety International, Goodrich, Eaton, Thales, Sierra, and Air France Industries, to mention some of the company's top suppliers. But the complete list of suppliers needed for Embraer planes is incredibly lengthy—even lengthier than most car manufacturers, which have a reputation for using a lot of suppliers (some 50,000 in the case of General Motors, for example). Though the number of suppliers for Embraer—or any aircraft manufacturer is somewhat fluid—we can certainly put the number of parts used at more than 300,000. This places incredible pressure on operating an efficient and effective global supply chain system and, most importantly, a well-structured importing operation into Brazil.

Importing into Brazil, some would say, is a difficult task for most companies and product categories. At the consumer product level, it was almost impossible to find imported products in Brazil before 1990. The Brazilian government used a number of protectionist measures and high taxes to discourage the importing of products. Bribing of officials that can facilitate the importing process is normal. Adding to the importing difficulty, the World Bank considers Brazil to be one of the most difficult places to start a business. Brazil's tax system has also been ranked as one of the most complex worldwide by analysts at PwC.

Sources: Jon Ostrower, "You Wait Ages for a New Airplane and Then Two Come Along," *CNN Money*, March 7, 2017; Dimitra DeFotis, "Embraer Flies Higher on Earnings," *Barron's*, March 9, 2017; Asif Suria, "Embraer: An Impressive Brazilian Jet Producer," *Seeking Alpha*, August 8, 2007; and Russ Mitchell, "The Little Aircraft Company That Could," *Fortune*, November 14, 2005.

LO 14-2

Identify the steps managers can take to improve their firm's export performance.

Improving Export Performance

Inexperienced exporters have a number of ways to gain information about foreign market opportunities and avoid common pitfalls that tend to discourage and frustrate novice exporters.¹² In this section, we look at information sources for exporters to increase their knowledge of foreign market opportunities, we consider a number of service providers, we review various exporting strategies that can increase the probability of successful exporting, and we illustrate the globalEDGE™ Diagnostic Tool called Company Readiness to Export (CORE) that can help exporters. We begin, however, with a look at how several nations try to help domestic firms export.

INTERNATIONAL COMPARISONS One big impediment to exporting is the simple lack of knowledge of the opportunities available. Often, there are many markets for a firm's product, but because they are in countries separated from the firm's home base by culture, language, distance, and time, the firm does not know of them. Identifying export opportunities is made even more complex because almost 196 countries with widely differing cultures compose the world of potential opportunities. Faced with such complexity and diversity, firms sometimes hesitate to seek export opportunities.

The way to overcome ignorance is to collect information. In Germany—one of the world's most successful exporting nations—trade associations, government agencies, and commercial banks gather information, helping small firms identify export opportunities. A similar function is provided by the Japanese Ministry of International Trade and Industry (MITI), which is always on the lookout for export opportunities. In addition, many Japanese firms are affiliated in some

MITI

Japan's Ministry of International Trade and Industry.

way with the *sogo shosha*, Japan's great trading houses. The *sogo shosha* have offices all over the world, and they proactively, continuously seek export opportunities for their affiliated companies large and small.¹³

German and Japanese firms can draw on the large reservoirs of experience, skills, information, and other resources of their respective export-oriented institutions. Unlike their German and Japanese competitors, many U.S. firms are relatively blind when they seek export opportunities; they are information-disadvantaged. In part, this reflects historical differences. Both Germany and Japan have long made their living as trading nations, whereas until recently, the United States has been a relatively self-contained continental economy in which international trade played a minor role. This is changing; both imports and exports now play a greater role in the U.S. economy than they did 20 years ago. However, the United States has not yet created an institutional structure for promoting exports similar to that of either Germany or Japan.

INFORMATION SOURCES Despite institutional disadvantages, U.S. firms can increase their awareness of export opportunities. The most comprehensive source of information is the U.S. Department of Commerce and its district offices all over the country (U.S. Export Assistance Centers, USEAC). Within that department are two organizations dedicated to providing businesses with intelligence and assistance for attacking foreign markets: U.S. and Foreign Commercial Service and International Trade Administration (ITA). ITA regularly publishes *A Guide to Exporting*. This is the United States' "Official Government Resource for Small and Medium-Sized Businesses" in their exporting quest.

The U.S. and Foreign Commercial Service and International Trade Administration are governmental agencies that provide the potential exporter with a "best prospects" list, which gives the names and addresses of potential distributors in foreign markets along with businesses they are in, the products they handle, and their contact person. In addition, the Department of Commerce has assembled a "comparison shopping service" for countries that are major markets for U.S. exports. For a small fee, a firm can receive a customized market research survey on a product of its choice. This survey provides information on marketability, the competition, comparative prices, distribution channels, and names of potential sales representatives. Each study is conducted on site by an officer of the Department of Commerce.

The Department of Commerce also organizes trade events that help potential exporters make foreign contacts and explore export opportunities. The department organizes exhibitions at international trade fairs, which are held regularly in major cities worldwide. The department also has a matchmaker program, in which department representatives accompany groups of U.S. businesspeople abroad to meet with qualified agents, distributors, and customers. Affiliated with the U.S. Department of Commerce and its USEAC offices is a set of District Export Councils (DECs; connected also via the National District Export Council). DECs are composed of some 1,500 volunteers appointed by the U.S. Secretary of Commerce to help U.S. business be more competitive internationally.

Another governmental organization, the Small Business Administration (SBA), can help potential exporters (see the accompanying Management Focus on exporting desserts for an example of the SBA's work). The SBA employs 76 district international trade officers and 10 regional international trade officers throughout the United States, as well as a 10-person international trade staff in Washington, DC. Among the SBA's no-fee services are Small Business Development Centers (SBDCs), the Service Corps of Retired Executives (SCORE), and the Export Legal Assistance Network (ELAN). The SBDCs and the Export Legal Assistance Network (ELAN). The SBDCs around the country provide a full range of export assistance to business, particularly small companies new to exporting.

sogo shosha

Japanese trading companies; a key part of the *keiretsu*, the large Japanese industrial groups.



Is Chinese Exporting the Next Edge for the Country?

With hundreds of television sets stacked high, Changhong Electronics' warehouse in Shunde resembles many other storage depots in southern China, but the TVs' destinations reveal an important shift in global trade patterns. While Changhong's smaller sets are headed for Europe, its 50-inch plasma screens, which dominate the warehouse, will be shipped to South Africa. Fast growth in developing countries and sluggish Western economies are prompting Chinese companies to abandon their obsession with the United States and Europe and to try to capitalize on rapidly growing markets in Asia, Africa, and Latin America. The so-called China price—a vastly lower price because of low labor costs and the low cost of capital for large government-owned companies—now applies to industrial goods, not just consumer goods. Experts believe that cheap Chinese exports could provide a boost to investment in the developing world, just as they once did to consumption in the developed world. Can China boost investment in the developing world and also boost its own economy?

Exporting Desserts by a Hispanic Entrepreneur

Taking basic ingredients and creating a myriad of flavors has led to worldwide exporting success for Lulu's Foods Inc. (lulus-foods.com). Started in 1982 in a 700-square-foot storefront in Torrance, California, followed by exporting to Mexico in 1992, the company is a gelatin dessert business with core customer target markets in the United States and Mexico but with exporting to several countries worldwide. Lulu is the nickname of the founder, Maria de Lourdes Sobrino.

Lulu thought of the idea of ready-to-eat flavored gelatin desserts when she was looking for the popular dessert in local stores. At the time, she was living in the United States, but originally she came from Mexico. The ready-to-eat flavored gelatin desserts were a staple in her native Mexico, but the concept was a novelty when she introduced it to American grocers. Today, Lulu's Foods Inc. can be found in a variety of well-known stores (e.g., Albertsons, Safeway, Walmart).

Back in the early 1980s, Lulu identified and recognized a need for gelatin desserts, filled it with what has now become 45 ready-to-eat products of different sizes and flavors, and transformed the food industry by creating the first ready-to-eat gelatin category based largely on her mother's recipes. The business concept has become quite a "spoon spectacular" since Lulu first began, with a catch line for the company of "More fun for your spoon."¹³

The party started out very small with just Lulu making her mother's gelatin recipe desserts, with an initial production of 300 cups of gelatin

per day. Ultimately, the party grew so big that Lulu could not handle it by herself and had to negotiate help from established markets and wholesale distributors. Lulu wanted everyone within reach to enjoy her festival of flavors. In going international, Lulu spent some 10 years trying to gain international sales but continued to run into all kinds of problems and issues. After the trial-and-error decade, she found assistance from the U.S. Export-Import Bank services and now has deeper confidence in her abilities to export products worldwide.

Over the years, Lulu has kept making more and more varieties of her gelatin desserts. A carnival of colors of three-layer gelatins, fruit parfaits, and festive containers of wild new colors and flavors have become identifying marks. This exporting innovation led Bill Hopkins of *USA Today* to call Maria de Lourdes Sobrino "the queen of ready-to-eat gelatins and a force in the surging number of Hispanic Entrepreneurs." Hal Lancaster of *The Wall Street Journal* also recognized her as an innovator and very successful entrepreneur in "getting out and selling customers your dream."

Today, with its exporting worldwide, but especially to Mexico, and sales across the United States, Lulu's Foods Inc.'s core focus is on gelatin cups, with flavors that include such exotic descriptors as Fruit Fantasia, Orange Blast, Creamy Vanilla with Cinnamon, and Sugar Free-De-Light.

Sources: D. Barry, "Maria de Lourdes Sobrino, Founder, LuLu's Dessert," *Exporters: The Wit and Wisdom of Small Businesspeople Who Sell Globally* (Washington, DC: U.S. Commerce Department, 2013); J. Hopkins, "Bad Times Spawn Great Start-Ups," *USA Today*, December 18, 2001; and Lulu's Foods Inc., www.lulus-foods.com.

Through SCORE, the SBA oversees some 11,500 volunteers with international trade experience to provide one-on-one counseling to active and new-to-export businesses. The SBA also coordinates ELAN, a nationwide group of international trade attorneys who provide free initial consultations to small businesses on export-related matters.

The United States has also established a set of 17 Centers for International Business Education and Research (CIBERs), which assist with exporting needs. The CIBERs were created by the U.S. Congress under the Omnibus Trade and Competitiveness Act of 1988 to increase and promote the nation's capacity for international understanding and competitiveness. Administered by the U.S. Department of Education, the CIBER network links the human resource and technological needs of the U.S. business community with the international education, language training, and research capacities of universities across the country. The 17 CIBERs, including the University of Washington and Michigan State University, where the authors of this text are professors (www2.ed.gov/programs/iegpscibe), serve as regional and national resources to businesspeople, students, and teachers at all levels. Many countries around the world are trying to replicate the U.S. CIBER initiative (e.g., the European Union).

Additionally, the vast majority of U.S. states, regions, and many large cities maintain active trade commissions whose purpose is to promote exports. Most of these provide business counseling, information gathering, technical assistance, and financing. Unfortunately, many have fallen victim to budget cuts or to turf battles for political and financial support with other export agencies.

A number of private organizations are also beginning to provide more assistance to would-be exporters. Commercial banks and major accounting firms are more willing to assist small firms in starting export operations than they were a decade ago. In addition, large multinationals that have been successful in the global arena are typically willing to discuss opportunities overseas with the owners or managers of small firms.¹⁴

SERVICE PR
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SERVICE PROVIDERS

Most companies that engage in international trade enlist the help of export–import service providers, but there are many choices. Let's look at the main ones: freight forwarders, export management companies, export trading companies, export packaging companies, customs brokers, confirming houses, export agents and merchants, piggyback marketing, and economic processing zones.

Freight forwarders are mainly in business to orchestrate transportation for companies that are shipping internationally. Their primary task is to combine smaller shipments into a single large shipment to minimize the shipping cost. Freight forwarders also provide other services that are beneficial to the exporting firm, such as documentation, payment, and carrier selection.

An **export management company (EMC)** offers services to companies that have not previously exported products. EMCs offer a full menu of services to handle all aspects of exporting, similar to having an internal exporting department within your own firm. For example, EMCs deal with export documents and operate as the firm's agent and distributor; this may include selling the products directly or operating a sales unit to process sales orders.

Export trading companies export products for companies that contract with them. They identify and work with companies in foreign countries that will market and sell the products. They provide comprehensive exporting services, including export documentation, logistics, and transportation.

Export packaging companies, or export packers for short, provide services to companies that are unfamiliar with exporting. For example, some countries require packages to meet certain specifications, and the export packaging firm's knowledge of these requirements is invaluable to new exporters in particular. The export packer can also advise companies on appropriate design and materials for the packaging of their items. Export packers can assist companies in minimizing packaging to maximize the number of items to be shipped.

Customs brokers can help companies avoid the pitfalls involved in customs regulations. The customs requirements of many countries can be difficult for new or infrequent exporters to understand, and the knowledge and experience of the customs broker can be very important. For example, many countries have certain laws and documentation regulations concerning imported items that are not always obvious to the exporter. Customs brokers can offer a firm a complete package of services that are essential when a firm is exporting to a large number of countries.

Confirming houses, sometimes called buying agents, represent foreign companies that want to buy your products. Typically, they try to get the products they want at the lowest prices and are paid a commission by their foreign clients. A good place to find these potential exporting linkages is via government embassies.

Export agents, merchants, and remarketers buy products directly from the manufacturer and package and label the products in accordance with their own wishes and specifications. They then sell the products internationally through their own contacts under their own names and assume all risks. The effort it takes for you to market the product internationally is very small, but you also lose any control over the marketing, promotion, and positioning of your product.

Piggyback marketing is an arrangement whereby one firm distributes another firm's products. For example, a firm may have a contract to provide an assortment of products to an overseas client, but it does not have all the products requested. In such cases, another firm can piggyback its products to fill the contract's requirements. Successful piggybacking usually requires complementary products and the same target market of customers.

There are now more than 600 export processing zones (EPZs) in the world, and they exist in more than 100 countries. The EPZs include foreign trade zones (FTZs), special economic zones, bonded warehouses, free ports, and customs zones. Many companies use EPZs to receive shipments of products that are then reshipped in smaller lots to customers throughout the surrounding areas. Founded in 1978 by the United Nations, the World Economic Processing Zones Association (wepza.org) is a private nonprofit organization dedicated to the improvement of the efficiency of all EPZs.

EXPORT STRATEGY

In addition to using export service providers, a firm can reduce the risks associated with exporting if it is careful about its choice of export strategy.¹⁵ A few guidelines can help firms improve their odds of success. For example, one of the most successful exporting firms in the world, 3M (originally, Minnesota Mining & Manufacturing Company), has built its export success on three main principles: enter on a small scale

export management company (EMC)

Export specialist that acts as an export marketing department for client firms.

management FOCUS

Two Men and a Truck

By some accounts, moving is ranked as the third-most-stressful event a person can experience, after death of a relative and divorce. Two Men and a Truck (<https://twomenandatruck.com>) started as an after-school business for two high school boys in Lansing, Michigan. As a small business focused on local moving services, the company began in 1985 with \$350, a hand-drawn logo, and an advertisement in a local community newspaper.

In 1989, Melanie Bergeron, the daughter of founder Mary Ellen Sheets, opened the first franchised office of Two Men and a Truck in her hometown of Atlanta, Georgia. Melanie is now board chair, with Brig Sorber as the chief executive officer and Jon Sorber as executive vice president. Randy Shacka, who joined the company as an intern in 2001, was promoted in 2012 to president. This is the first president of the company who did not come from the family.

Two Men and a Truck is no longer “two men and a truck.” The company has grown both domestically and internationally to most of the United States and some 380 locations worldwide. Two Men and a Truck is the fastest-growing franchised moving company in the United States (with more than 95 consecutive months of growth as of May 2018), with more than \$300 million in sales, 2,800 moving trucks, and some 6,000 workers. The average franchise grosses about \$1.5 million annually. Bergeron said that “we never imagined being in the moving business—that is, until my mom and my brothers Brig and Jon scraped together some money to buy a truck to help raise extra cash for college.”

Two Men and a Truck has remained branded as “Two Men and a Truck” in all parts of the world in which it operates franchises (e.g., Canada, Ireland, the United Kingdom). Names such as “Two Blokes and a Lorry” do not appeal to them! The company has decided to stick to

the core American brand name because “that’s what master franchisers and their investors want,” said Bergeron. “The customers are less interested in whether it’s a U.S. brand . . . the appeal is the opposite . . . it’s a local [franchise] company that will be available when I need them. . . . They want the U.S. brand power and mystique.”

In going international to new markets, Two Men and a Truck’s primary factors to evaluate are the size of the middle class in a country and the population’s mobility. They use software tools to help pinpoint income levels by neighborhood and whether the housing market is primarily based on single- or multifamily units. The market for Two Men and a Truck is best where there is a good mix of both. In addition, Bergeron said that two other key areas in determining locations in which to operate include obtaining accurate market research and identifying potential master franchisees.

In the case of Two Men and a Truck going international, the industry itself also represented a challenge. There are plenty of moving businesses worldwide; why should franchisees represent Two Men and a Truck? The company’s answer to this market differentiation problem is its exceptional focus on customer service and a sophisticated web-based tracking system. Quality control, labor costs, and cycle time to complete a move are core performance metrics in the system. In fact, the company has become known in its industry for faster and better analytics to run the business. It has installed a private cloud system to make its business operations more efficient, using business analytics to capture and identify growth opportunities worldwide.

Sources: D. Barry, “Melanie Bergeron, Chair of the Board of Two Men and a Truck,” *Exporters: The Wit and Wisdom of Small Businesspeople Who Sell Globally* (Washington, DC: U.S. Commerce Department, 2013); C. Boulton, “Moving Company Gets a Lift from Faster Analytics,” *The Wall Street Journal*, August 20, 2013; and A. Wittrock, “Two Men and a Truck Wins State Grant, Plans \$4 Million Expansion of Lansing-Area Headquarters,” *MLive.com*, February 27, 2013.

to reduce risks, add additional product lines once the exporting operations start to become successful, and hire locals to promote the firm’s products. Another company—Two Men and a Truck (profiled in the accompanying Management Focus)—has had global success with a franchising approach.

The probability of exporting successfully can be increased dramatically by taking a handful of simple strategic steps. First, particularly for the novice exporter, it helps to hire an EMC or at least an experienced export consultant to identify opportunities and navigate the paperwork and regulations so often involved in exporting. Second, it often makes sense to initially focus on one market or a handful of markets. Learn what is required to succeed in those markets before moving to other markets. The firm that enters many markets at once runs the risk of spreading its limited management resources too thin. The result of such a shotgun approach to exporting may be a failure to become established in any one market.

Third, as with Two Men and a Truck, it often makes sense to enter a foreign market on a small scale to reduce the costs of any subsequent failure. Most important, entering on a small scale provides the time and opportunity to learn about the foreign country before making significant capital commitments to that market. Fourth, the exporter needs to recognize the time and managerial commitment involved in building export sales and should hire additional personnel to oversee this activity. Fifth, in many countries, it is important to devote a lot of attention to building strong and enduring relationships with local distributors and/or customers. Sixth, as 3M often does, it is important to hire local personnel to help the firm establish

itself in a foreign market. Local people are likely to have a much greater sense of how to do business in a given country than a manager from an exporting firm who has previously never set foot in that country. Seventh, several studies have suggested the firm needs to be proactive about seeking export opportunities.¹⁶ Armchair exporting does not work! The world will not normally beat a pathway to your door.

Finally, it is important for the exporter to retain the option of local production. Once exports reach a sufficient volume to justify cost-efficient local production, the exporting firm should consider establishing production facilities in the foreign market. Such localization helps foster good relations with the foreign country and can lead to greater market acceptance. Exporting is often not an end in itself but merely a step on the road toward establishment of foreign production (again, 3M provides an example of this philosophy).

THE GLOBALEDGE™ EXPORTING TOOL

In Chapter 1, we introduced the globalEDGE™ website (globaledge.msu.edu), a product of the International Business Center in the Eli Broad College of Business at Michigan State University. globalEDGE™ has been the top-ranked website in the world for “international business resources” on Google since 2004. Some 10 million people now use globalEDGE™, with about 2 million active users. The site is free, including the “Diagnostic Tools” section. In that section of the site, the Company Readiness to Export (CORE) tool has become a frequently used option by a variety of small, medium, and large firms to assess (1) a company’s readiness to export a product and (2) the product’s readiness to be exported.

CORE (Company Readiness to Export) assists firms in self-assessment of their exporting proficiency, evaluates both the firm’s and the intended product’s readiness to be taken internationally, and systematically identifies the firm’s strengths and weaknesses within the context of exporting (see Figure 14.2). The CORE tool also serves as a tutorial in exporting and has been used by the U.S. Department of Commerce, U.S. District Export Councils, and other exporting facilitators to help companies succeed with their exporting.

Figure 14.3 shows the online interface of the CORE Results Report. The overall report includes a prediction by respondents of where they think their company is in terms of readiness to export, as well as the actual readiness (organizational and product) based on the 70-question CORE diagnostic tool assessment. The users also receive scores on all questions and various strengths and weaknesses associated with their exporting capabilities and capacities.

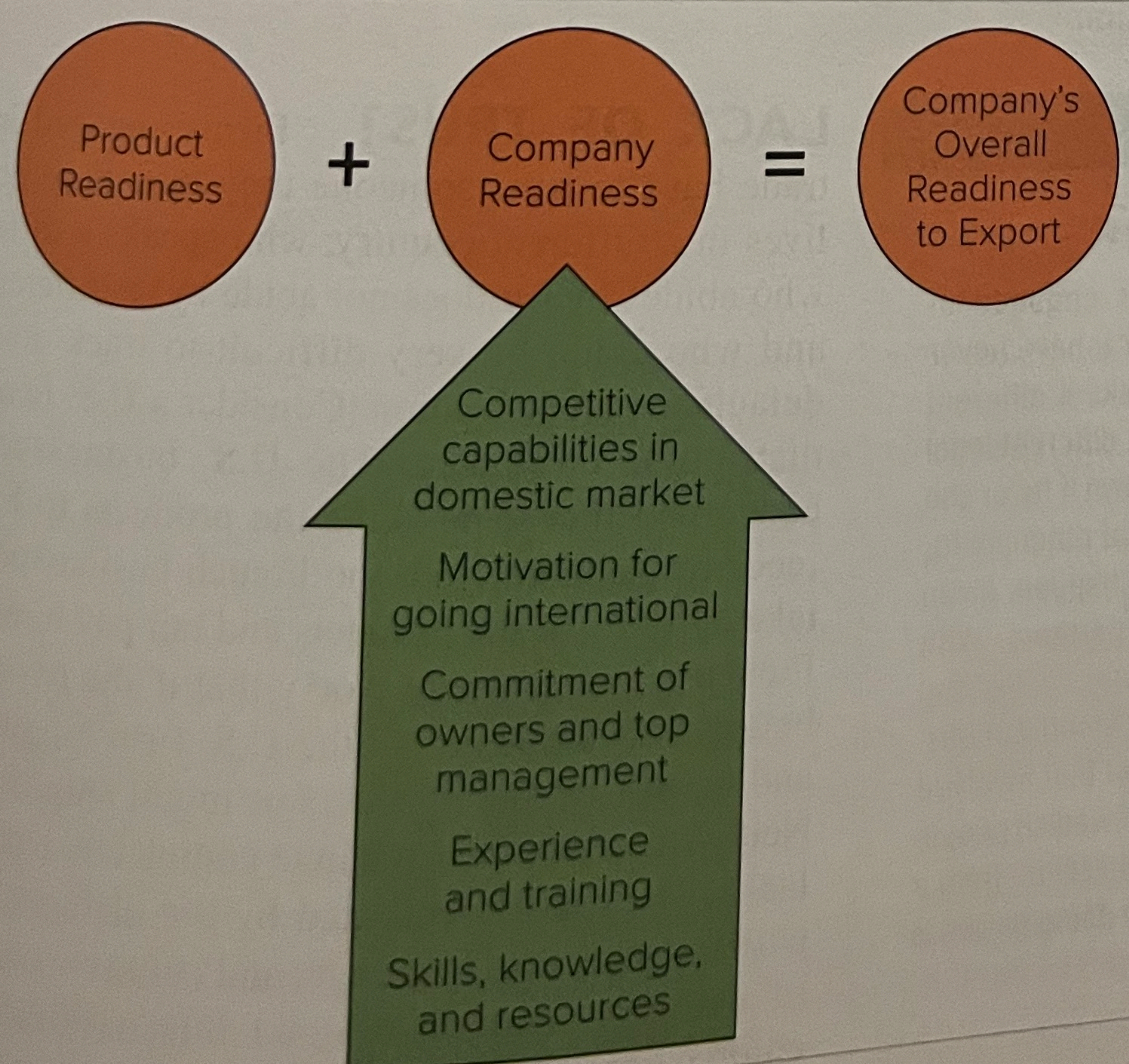
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Use SmartBook to help retain what you have learned. Access your instructor’s Connect course to check out SmartBook or go to learnsmartadvantage.com for help.

14.2 FIGURE

Company readiness to export.

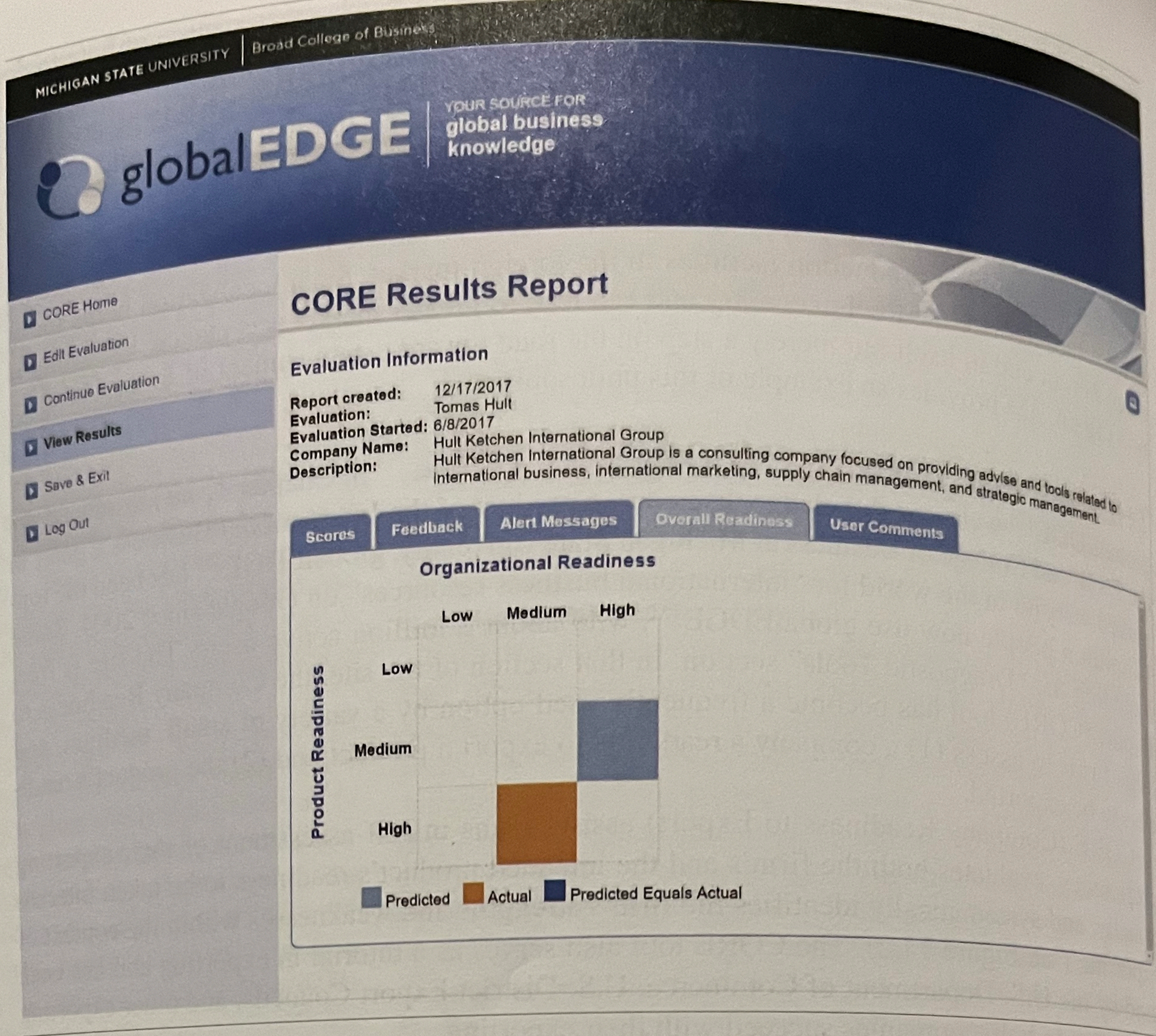
Source: C. W. L. Hill and G. T. M. Hult, *International Business: Competing in the Global Marketplace* (New York: McGraw-Hill Education, 2017).



14.3 FIGURE

A screenshot of select results from the globalEDGE CORE (Company Readiness to Export) diagnostic tool.

Source: Global Edge, Michigan State University.



LO 14-3

Recognize the basic steps involved in export financing.

Export and Import Financing

Mechanisms for financing exports and imports have evolved over the centuries in response to a problem that can be particularly acute in international trade: the lack of trust that exists when one must put faith in a stranger. In this section, we examine the financial devices that have evolved to cope with this problem in the context of international trade: the letter of credit, the draft (or bill of exchange), and the bill of lading. Then we trace the 14 steps of a typical export-import transaction.¹⁷



How Trusting Can You Be?

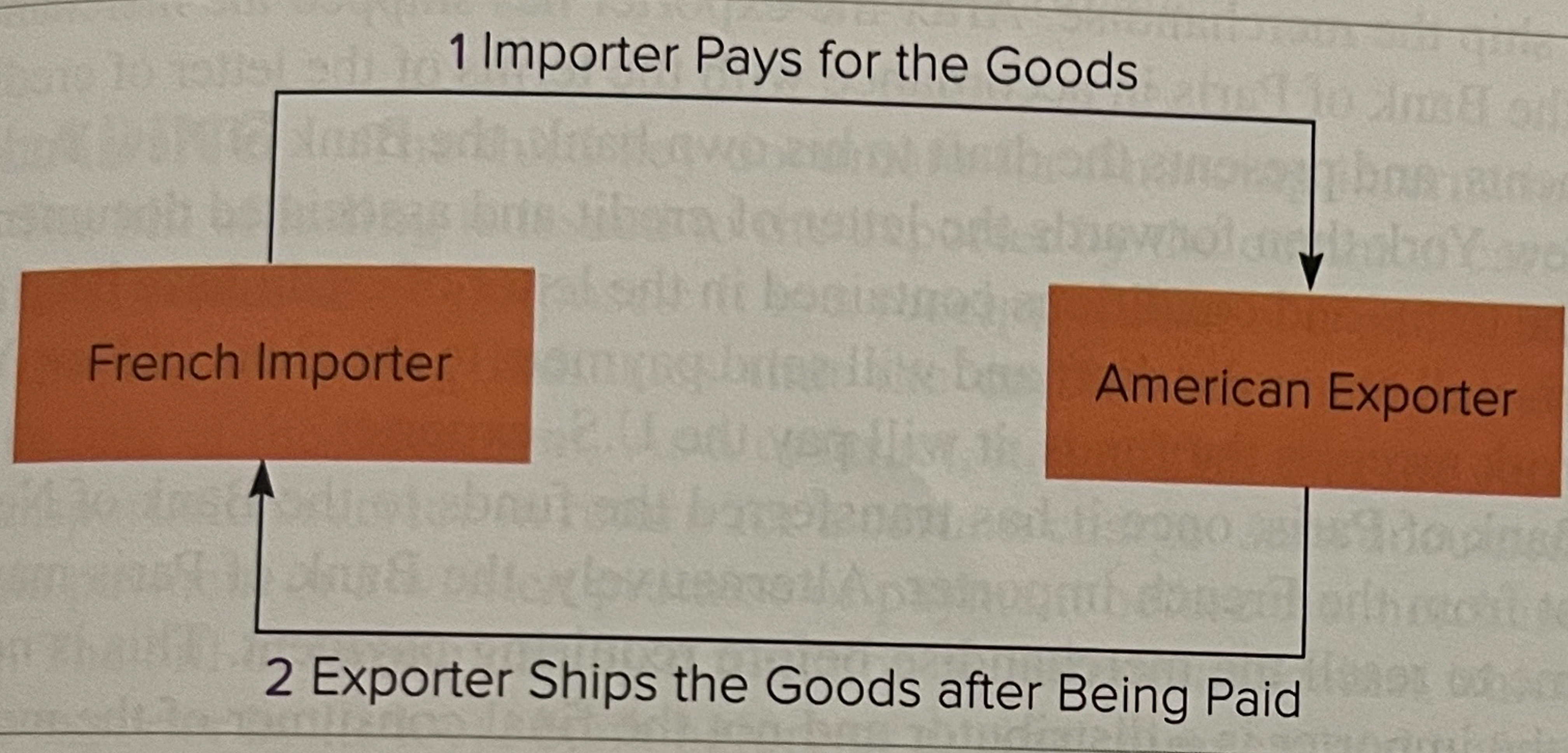
In Chapter 14, we discuss the fact that firms engaged in international trade have to trust someone they may have never seen, who lives in a different country, who speaks a different language, who abides by (or does not abide by) a different legal system, and who could be very difficult to track down if he or she defaults on an obligation. Basically, there is a lot of potential for unknown issues to arise and for complications to happen, given the lack of established trust between trading partners. With almost 200 countries in the world, lots of cultural values and beliefs, and many potential avenues to run into complications, how much trust would you place on a relationship that involved (1) an organization from a country like yours (e.g., Swedish people doing business with Danish people) or (2) an organization from a country very different from yours (e.g., a Canadian doing business with someone from Turkey)?

LACK OF TRUST

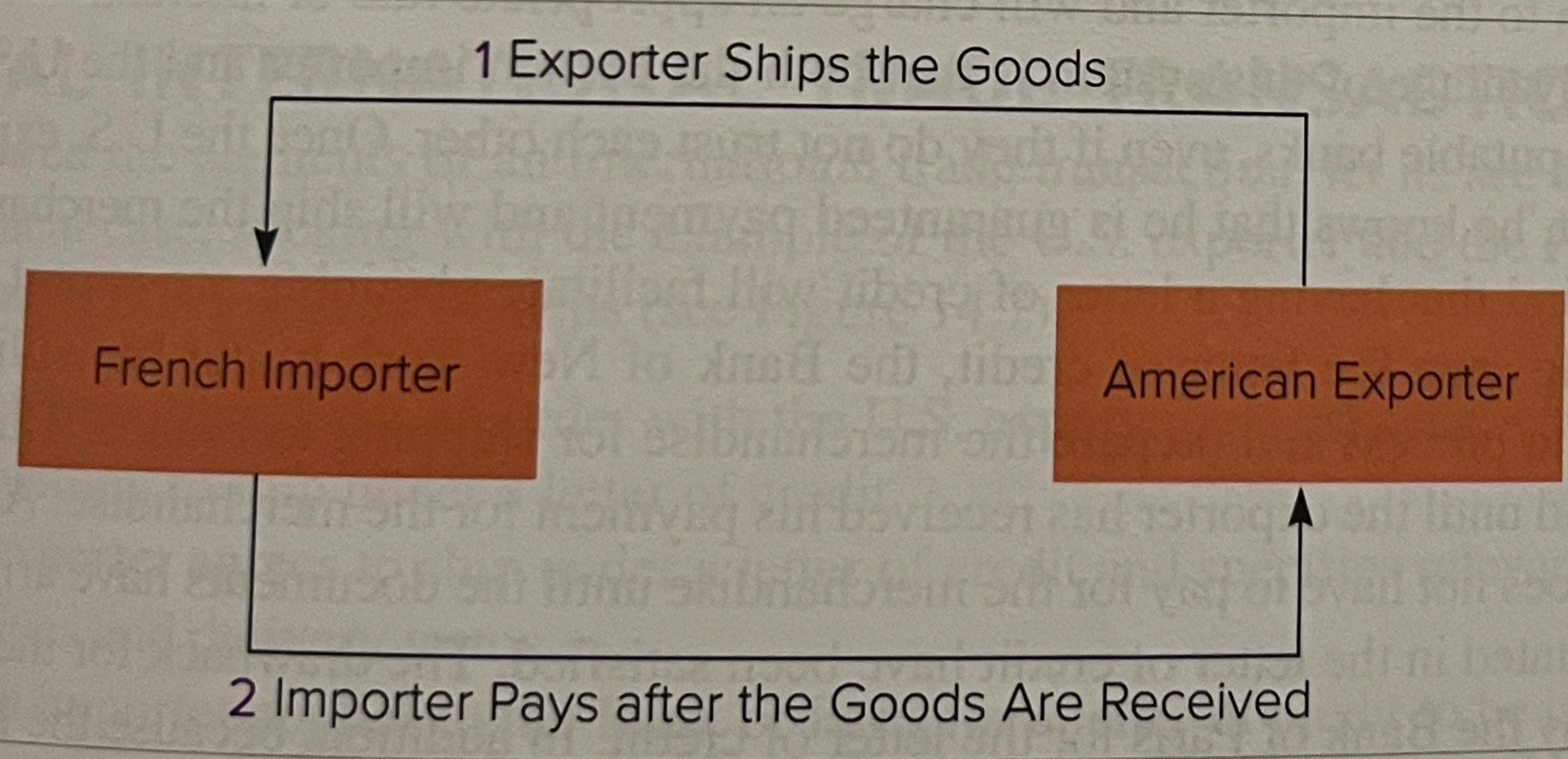
Firms engaged in international trade have to trust someone they may have never seen, who lives in a different country, who speaks a different language, who abides by (or does not abide by) a different legal system, and who could be very difficult to track down if he or she defaults on an obligation. Consider a U.S. firm exporting to a distributor in France. The U.S. businessperson might be concerned that if he ships the products to France before he receives payment from the French businessperson, she might take delivery of the products and not pay him. Conversely, the French importer might worry that if she pays for the products before they are shipped, the U.S. firm might keep the money and never ship the products or might ship defective products. Neither party to the exchange completely trusts the other. This lack of trust is exacerbated by the distance between the two parties—in space, language, and culture—and by the problems of using an underdeveloped international legal system to enforce contractual obligations.

Due to the (quite reasonable) lack of trust between the two parties, each has his or her own preferences as to how the transaction should be configured. To make sure he is paid, the manager of the U.S. firm would prefer the French distributor to pay for the products before he ships them (see Figure 14.4). Alternatively, to ensure she receives the products, the French distributor would prefer not to pay for them until they arrive (see Figure 14.5). Thus, each party has a different set of preferences. Unless there is some way of establishing trust between the parties, the transaction might never occur.

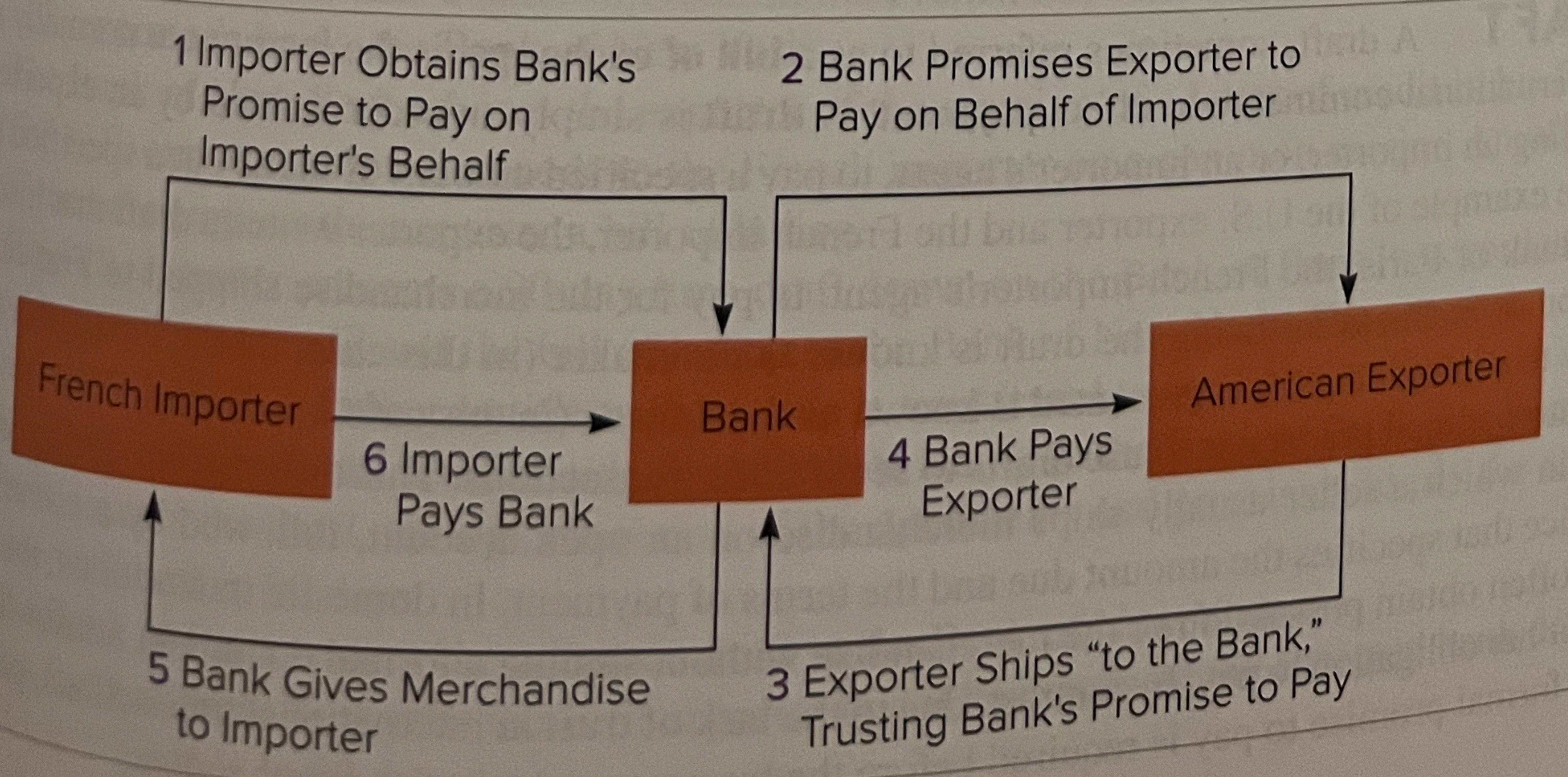
The problem is solved by using a third party trusted by both—normally a reputable bank—to act as an intermediary. What happens can be summarized as follows (see Figure 14.6). First, the French importer obtains the bank's promise to pay on her behalf, knowing the U.S. exporter will trust the bank. This promise is known as a letter of credit. Having seen the letter of credit, the U.S. exporter now ships the products to France. Title to the products is given to the bank in the form of a document called a bill of lading. In return, the U.S. exporter tells the bank to pay for the products, which the bank does. The document for requesting this payment is referred to as a draft. The bank, having paid for the products, now passes the title on to the French importer, whom the bank trusts. At that time or later, depending on their agreement, the importer reimburses the bank. In the remainder of this section, we examine how this system works in more detail.



14.4 FIGURE
Preference of the U.S. exporter.
 Source: C. W. L. Hill and G. T. M. Hult, International Business: Competing in the Global Marketplace (New York: McGraw-Hill Education, 2017).



14.5 FIGURE
Preference of the French importer.
 Source: C. W. L. Hill and G. M. T. Hult, Global Business Today (New York: McGraw-Hill Education, 2018).



14.6 FIGURE
The use of a third party.
 Source: C. W. L. Hill and G. M. T. Hult, Global Business Today (New York: McGraw-Hill Education, 2018).

letter of credit

Issued by a bank, indicating that the bank will make payments under specific circumstances.

LETTER OF CREDIT

A letter of credit, abbreviated as L/C, stands at the center of international commercial transactions. Issued by a bank at the request of an importer, the **letter of credit** states that the bank will pay a specified sum of money to a beneficiary, normally the exporter, on presentation of particular, specified documents.

Consider again the example of the U.S. exporter and the French importer. The French importer applies to her local bank, say, the Bank of Paris, for the issuance of a letter of credit. The Bank of Paris then undertakes a credit check of the importer. If the Bank of Paris is satisfied with her creditworthiness, it will issue a letter of credit. However, the Bank of Paris might require a cash deposit or some other form of collateral from her first. In addition, the Bank of Paris will charge the importer a fee for this service. Typically, this amounts to between 0.5 and 2 percent of the value of the letter of credit, depending on the importer's creditworthiness and the size of the transaction. (As a rule, the larger the transaction, the lower the percentage.)

Assume the Bank of Paris is satisfied with the French importer's creditworthiness and agrees to issue a letter of credit. The letter states that the Bank of Paris will pay the U.S. exporter for the merchandise as long as it is shipped in accordance with specified instructions and conditions. At this point, the letter of credit becomes a financial contract between the Bank of Paris and the U.S. exporter. The Bank of Paris then sends the letter of credit to the U.S. exporter's bank, say, the Bank of New York. The Bank of New York tells the exporter that it has received a letter of credit and that he can ship the merchandise. After the exporter has shipped the merchandise, he draws a draft against the Bank of Paris in accordance with the terms of the letter of credit, attaches the required documents, and presents the draft to his own bank, the Bank of New York, for payment. The Bank of New York then forwards the letter of credit and associated documents to the Bank of Paris. If all the terms and conditions contained in the letter of credit have been complied with, the Bank of Paris will honor the draft and will send payment to the Bank of New York. When the Bank of New York receives the funds, it will pay the U.S. exporter.

As for the Bank of Paris, once it has transferred the funds to the Bank of New York, it will collect payment from the French importer. Alternatively, the Bank of Paris may allow the importer some time to resell the merchandise before requiring payment. This is not unusual, particularly when the importer is a distributor and not the final consumer of the merchandise since it helps the importer's cash flow. The Bank of Paris will treat such an extension of the payment period as a loan to the importer and will charge an appropriate rate of interest.

The great advantage of this system is that both the French importer and the U.S. exporter are likely to trust reputable banks, even if they do not trust each other. Once the U.S. exporter has seen a letter of credit, he knows that he is guaranteed payment and will ship the merchandise. Also, an exporter may find that having a letter of credit will facilitate obtaining pre-export financing. For example, having seen the letter of credit, the Bank of New York might be willing to lend the exporter funds to process and prepare the merchandise for shipping to France. This loan may not have to be repaid until the exporter has received his payment for the merchandise. As for the French importer, she does not have to pay for the merchandise until the documents have arrived and unless all conditions stated in the letter of credit have been satisfied. The drawback for the importer is the fee she must pay the Bank of Paris for the letter of credit. In addition, because the letter of credit is a financial liability against her, it may reduce her ability to borrow funds for other purposes.

DRAFT

A draft, sometimes referred to as a **bill of exchange**, is the instrument normally used in international commerce to effect payment. A **draft** is simply an order written by an exporter instructing an importer, or an importer's agent, to pay a specified amount of money at a specified time. In the example of the U.S. exporter and the French importer, the exporter writes a draft that instructs the Bank of Paris, the French importer's agent, to pay for the merchandise shipped to France. The person or business initiating the draft is known as the maker (in this case, the U.S. exporter). The party to whom the draft is presented is known as the drawee (in this case, the Bank of Paris).

International practice is to use drafts to settle trade transactions. This differs from domestic practice in which a seller usually ships merchandise on an open account, followed by a commercial invoice that specifies the amount due and the terms of payment. In domestic transactions, the buyer can often obtain possession of the merchandise without signing a formal document acknowledging his or her obligation to pay. In contrast, due to the lack of trust in international transactions, payment or a formal promise to pay is required before the buyer can obtain the merchandise.

bill of exchange

An order written by an exporter instructing an importer, or an importer's agent, to pay a specified amount of money at a specified time.

draft

An order written by an exporter telling an importer what and when to pay.

Drafts fall into two categories, sight drafts and time drafts. A **sight draft** is payable on presentation to the drawee. A **time draft** allows for a delay in payment—normally 30, 60, 90, or 120 days. It is presented to the drawee, who signifies acceptance of it by writing or stamping a notice of acceptance on its face. Once accepted, the time draft becomes a promise to pay by the accepting party. When a time draft is drawn on and accepted by a bank, it is called a *banker's acceptance*. When it is drawn on and accepted by a business firm, it is called a *trade acceptance*.

Time drafts are negotiable instruments; that is, once the draft is stamped with an acceptance, the maker can sell the draft to an investor at a discount from its face value. Imagine that the agreement between the U.S. exporter and the French importer calls for the exporter to present the Bank of Paris (through the Bank of New York) with a time draft requiring payment 120 days after presentation. The Bank of Paris stamps the time draft with an acceptance. Imagine further that the draft is for \$100,000.

The exporter can either hold onto the accepted time draft and receive \$100,000 in 120 days or sell it to an investor, say, the Bank of New York, for a discount from the face value. If the prevailing discount rate is 7 percent, the exporter could receive \$97,700 by selling it immediately (7 percent per year discount rate for 120 days for \$100,000 equals \$2,300, and $\$100,000 - \$2,300 = \$97,700$). The Bank of New York would then collect the full \$100,000 from the Bank of Paris in 120 days. The exporter might sell the accepted time draft immediately if he needed the funds to finance merchandise in transit and/or to cover cash flow shortfalls.

BILL OF LADING The third key document for financing international trade is the bill of lading. The **bill of lading** is issued to the exporter by the common carrier transporting the merchandise. It serves three purposes: it is a receipt, a contract, and a document of title. As a receipt, the bill of lading indicates that the carrier has received the merchandise described on the face of the document. As a contract, it specifies that the carrier is obligated to provide a transportation service in return for a certain charge. As a document of title, it can be used to obtain payment or a written promise of payment before the merchandise is released to the importer. The bill of lading can also function as collateral against which funds may be advanced to the exporter by its local bank before or during shipment and before final payment by the importer.

A TYPICAL INTERNATIONAL TRADE TRANSACTION Now that we have reviewed the elements of an international trade transaction, let us see how the process works in a typical case, sticking with the example of the U.S. exporter and the French importer. The typical transaction involves 14 steps (see Figure 14.7).

1. The French importer places an order with the U.S. exporter and asks the American if he would be willing to ship under a letter of credit.
2. The U.S. exporter agrees to ship under a letter of credit and specifies relevant information such as prices and delivery terms.
3. The French importer applies to the Bank of Paris for a letter of credit to be issued in favor of the U.S. exporter for the merchandise the importer wishes to buy.
4. The Bank of Paris issues a letter of credit in the French importer's favor and sends it to the U.S. exporter's bank, the Bank of New York.
5. The Bank of New York advises the exporter of the opening of a letter of credit in his favor.
6. The U.S. exporter ships the goods to the French importer on a common carrier. An official of the carrier gives the exporter a bill of lading.
7. The U.S. exporter presents a 90-day time draft drawn on the Bank of Paris in accordance with its letter of credit and the bill of lading to the Bank of New York. The exporter endorses the bill of lading so title to the goods is transferred to the Bank of New York.
8. The Bank of New York sends the draft and bill of lading to the Bank of Paris. The Bank of Paris accepts the draft, taking possession of the documents and promising to pay the now-accepted draft in 90 days.
9. The Bank of Paris returns the accepted draft to the Bank of New York.
10. The Bank of New York tells the U.S. exporter that it has received the accepted bank draft, which is payable in 90 days.

sight draft

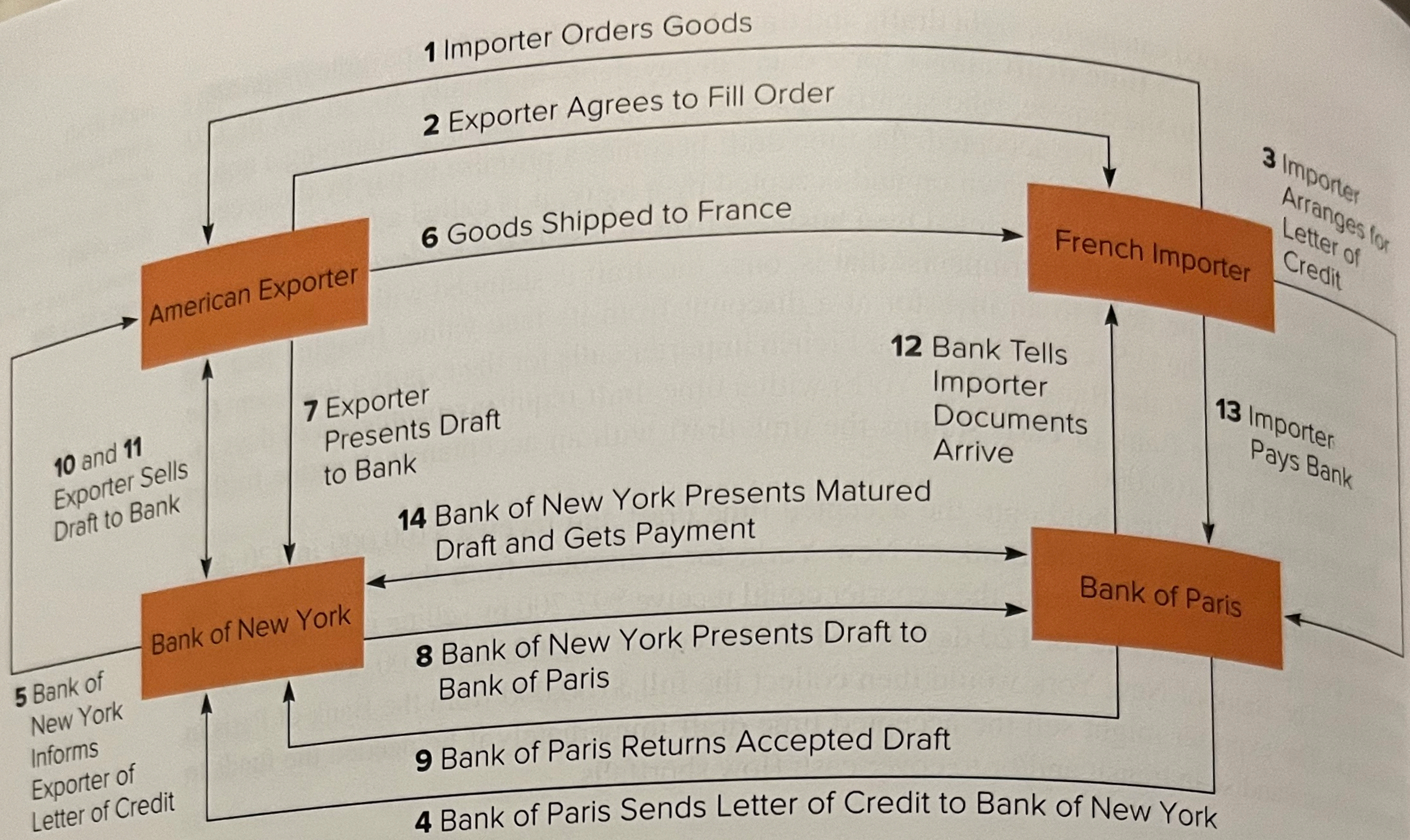
A draft payable on presentation to the drawee.

time draft

A promise to pay by the accepting party at some future date.

bill of lading

A document issued to an exporter by a common carrier transporting merchandise. It serves as a receipt, a contract, and a document of title.



14.7 FIGURE

A typical international trade transaction.

Source: C. W. L. Hill and G. M. T. Hult, *Global Business Today* (New York: McGraw-Hill Education, 2018).

11. The exporter sells the draft to the Bank of New York at a discount from its face value and receives the discounted cash value of the draft in return.
12. The Bank of Paris notifies the French importer of the arrival of the documents. She agrees to pay the Bank of Paris in 90 days. The Bank of Paris releases the documents so the importer can take possession of the shipment.
13. In 90 days, the Bank of Paris receives the importer's payment, so it has funds to pay the maturing draft.
14. In 90 days, the holder of the matured acceptance (in this case, the Bank of New York) presents it to the Bank of Paris for payment. The Bank of Paris pays.

test PREP

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LO 14-4

Identify information sources and government programs that exist to help exporters.

Export Assistance

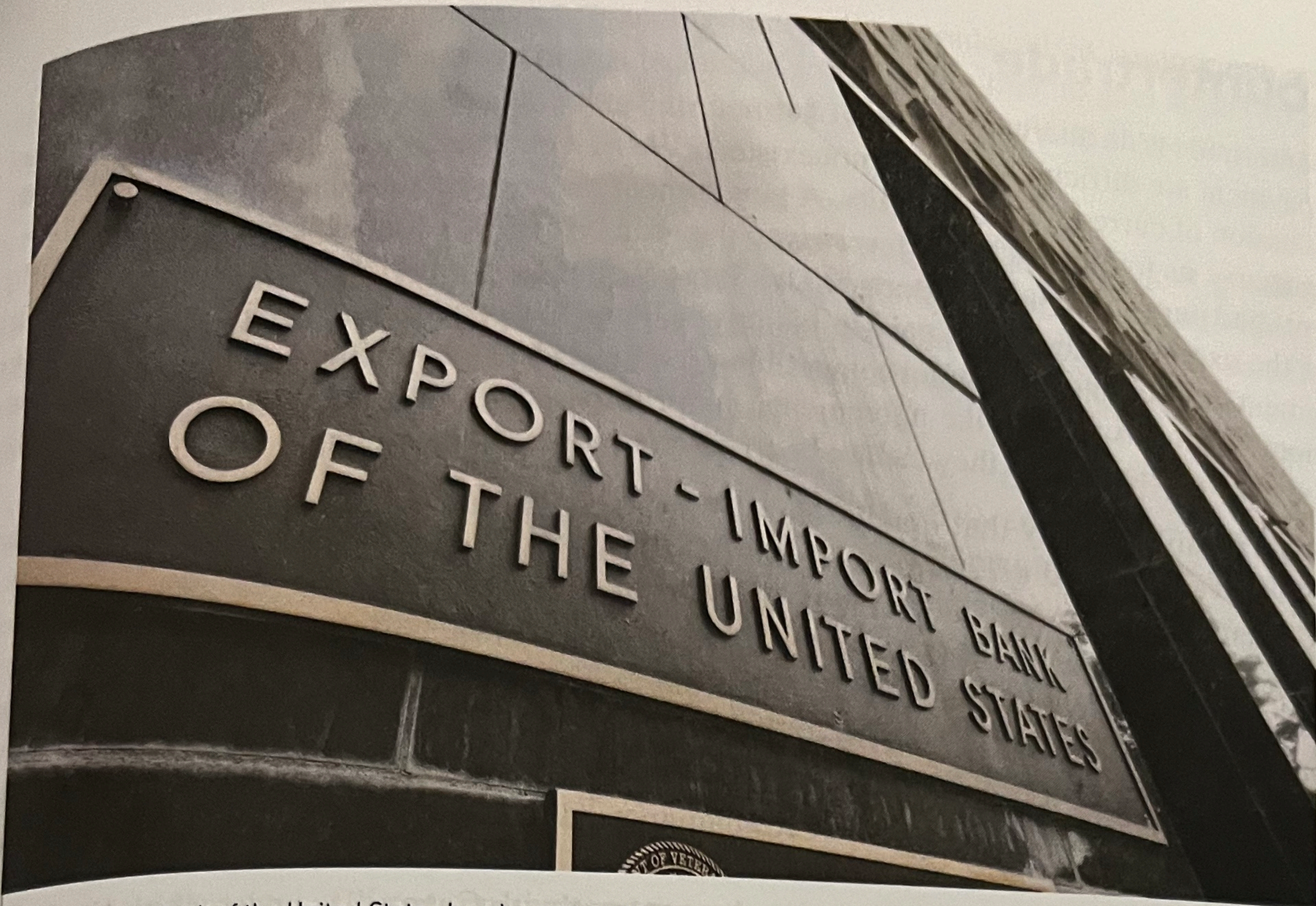
Prospective U.S. exporters can draw on two forms of government-backed assistance to help finance their export programs. They can get financing aid from the Export-Import Bank and export credit insurance from the Foreign Credit Insurance Association (similar programs are available in most countries).

EXPORT-IMPORT BANK

Export-Import Bank (Ex-Im Bank) is a wholly owned U.S. government corporation that was established in 1934. Its mission is to assist in the financing of U.S. exports of products and services to support U.S. employment and market competitiveness. Based on its charter and mandate from the U.S. Congress, the Ex-Im Bank's financing must have a "reasonable assurance of repayment" and should supplement, and not compete with, private capital lending. The Ex-Im Bank also follows the international rules for government-backed export credit activity under the Organisation for Economic Co-operation and Development (OECD). The Ex-Im Bank reported authorizing about \$20.5 billion for 3,746 transactions of finance and insurance to support some \$27.5 billion in U.S. exports and 164,000 U.S. jobs the last year it was fully operational (2014). The Ex-Im Bank's overall exposure was \$112 billion, below the \$140 billion statutory cap for its fiscal year. Interestingly, 2014 was the last year the Ex-Im Bank was fully operational due to a lack of quorum on the board of directors. But the Ex-IM Bank's financing of exports of U.S. goods and services still supported more than 50,000 jobs in the last year completed (2018), even with a smaller operation.

Export-Import Bank (Ex-Im Bank)

Agency of the U.S. government whose mission is to provide aid in financing and facilitate exports and imports.



Export-Import Bank of the United States headquarters - Washington, DC USA


©B Christopher/Alamy Stock Photo

Overall, the Ex-Im Bank pursues its mission with various loan and loan-guarantee programs. The agency guarantees repayment of medium- and long-term loans that U.S. commercial banks make to foreign borrowers for purchasing U.S. exports. The Ex-Im Bank guarantee makes the commercial banks more willing to lend cash to foreign enterprises. This facilitates cross-border trade by U.S. companies. About 85 percent of the banks' transactions support small businesses (under 500 employees).

Ex-Im Bank also has a direct lending operation under which it lends dollars to foreign borrowers for use in purchasing U.S. exports. In some cases, it grants loans that commercial banks would not if it sees a potential benefit to the United States in doing so. The foreign borrowers use the loans to pay U.S. suppliers and repay the loan to the Ex-Im Bank with interest. Using the structure of the U.S. Ex-Im Bank, many countries now have their own export-import banks to facilitate cross-border trade (e.g., China, India).

EXPORT CREDIT INSURANCE For reasons outlined earlier, exporters clearly prefer to get letters of credit from importers. However, sometimes an exporter who insists on a letter of credit will lose an order to one who does not require a letter of credit. Thus, when the importer is in a strong bargaining position and able to play competing suppliers against each other, an exporter may have to forgo a letter of credit.¹⁸ The lack of a letter of credit exposes the exporter to the risk that the foreign importer will default on payment. The exporter can insure against this possibility by buying export credit insurance. If the customer defaults, the insurance firm will cover a major portion of the loss.

In the United States, export credit insurance is provided by the Foreign Credit Insurance Association (FCIA), an association of private commercial institutions operating under the guidance of the Export-Import Bank. The FCIA provides coverage against commercial risks and political risks. Losses due to commercial risk result from the buyer's insolvency or payment default. Political losses arise from actions of governments that are beyond the control of either buyer or seller. Marlin, the small Baltimore manufacturer of wire baskets discussed earlier, credits export credit insurance with giving the company the confidence to push ahead with export sales. For a premium of roughly half a percentage of the price of a sale, Marlin has been able to insure itself against the possibility of nonpayment by a foreign buyer.¹⁹

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LO 14-5
Describe how countertrade can be used to facilitate exports.

countertrade
The trade of goods and services for other goods and services.

Countertrade

Countertrade is an alternative means of structuring an international sale when conventional means of payment are difficult, costly, or nonexistent. We first encountered countertrade in Chapter 10's discussion of currency convertibility. A government may restrict the convertibility of its currency to preserve its foreign exchange reserves so they can be used to service international debt commitments and purchase crucial imports.²⁰ This is problematic for exporters. Nonconvertibility implies that the exporter may not be paid in his or her home currency, and few exporters would desire payment in a currency that is not convertible. Countertrade is a common solution.²¹ **Countertrade** denotes a range of barterlike agreements; its principle is to trade goods and services for other goods and services when they cannot be traded for money. Some examples of countertrade are

- An Italian company that manufactures power-generating equipment, ABB SAE Sadelmi SpA, was awarded a 720 million baht (\$17.7 million) contract by the Electricity Generating Authority of Thailand. The contract specified that the company had to accept 218 million baht (\$5.4 million) of Thai farm products as part of the payment.
- Saudi Arabia agreed to buy ten 747 jets from Boeing with payment in crude oil, discounted at 10 percent below posted world oil prices.
- General Electric won a contract for a \$150 million electric generator project in Romania by agreeing to market \$150 million of Romanian products in markets to which Romania did not have access.
- The Venezuelan government negotiated a contract with Caterpillar under which Venezuela would trade 350,000 tons of iron ore for Caterpillar earthmoving equipment.
- Albania offered such items as spring water, tomato juice, and chrome ore in exchange for a \$60 million fertilizer and methanol complex.
- Philip Morris shipped cigarettes to Russia, for which it received chemicals that can be used to make fertilizer. Philip Morris shipped the chemicals to China, and in return, China shipped glassware to North America for retail sale by Philip Morris.²²



Is Countertrade an Appropriate Way of Trading Today?

Countertrade can take many forms, and there are several examples of how it works internationally. For instance, the Malaysian government recently bought 20 diesel electric locomotives from General Electric. Officials of the government said that GE will be paid with palm oil supplied by a plantation company. The company will supply about 200,000 metric tons of palm oil over a period of 30 months. No money changed hands, and no third parties were involved. As another example, in order to save foreign exchange reserves, the Philippine government offered some creditors tinned tuna to repay part of a state \$4 billion debt. In other examples, General Motors Corporation sold \$12 million worth of locomotive and diesel engines to Yugoslavia and took cash and \$4 million in Yugoslavian cutting tools as payment. Plus, McDonnell Douglas agreed to a compensation deal with Thailand for eight top-of-the-line F/A-18 strike aircraft. Thailand agreed to pay \$578 million of the total cost in cash, and McDonnell Douglas agreed to accept \$93 million in a mixed bag of goods, including Thai rubber, ceramics, furniture, frozen chicken, and canned fruit. To some, these types of trading contracts are strange, and to some they are normal, especially if we go back in time. But what about today? Should the global marketplace engage in these types of nonmonetary trades?

THE POPULARITY OF COUNTERTRADE

Countertrade emerged in the 1960s as a way for the old Soviet Union and the then-communist states of eastern Europe, whose currencies were generally nonconvertible, to purchase imports. The technique has grown in popularity among many developing nations that lack the foreign exchange reserves required to purchase necessary imports. Also, reflecting their own shortages of foreign exchange reserves, some successor states to the former Soviet Union and the eastern European communist nations periodically engage in countertrade to purchase their imports. Estimates of the percentage of world trade covered by some sort of countertrade agreement grew from 2 to 10 percent about a decade ago to, by most estimates, some 20 to 25 percent today.²³ The precise figure is unknown, but it is probably at the very low end of these estimates, given the increasing liquidity of international financial markets and wider currency convertibility. However, a short-term spike in the volume of countertrade can follow periodic financial crises (e.g., 1997, 2008). For example, countertrade activity increased notably after the Asian financial crisis of 1997. That crisis left many Asian nations with little hard currency to finance international trade. In the tight monetary regime that followed the crisis in 1997, many Asian firms found it very difficult to get access to export credit to finance their own international trade. Thus, they turned to the only option available to them—countertrade.

Given that countertrade is a means of financing international trade, albeit a minor one, prospective exporters may have to engage in this technique from time to time to gain access to certain international markets. The governments of developing nations sometimes insist on a certain amount of countertrade.²⁴

TYPES OF COUNTERTRADE With its roots in the simple trading of goods and services for other goods and services, countertrade has evolved into a diverse set of activities that can be categorized as five distinct types of trading arrangements: barter, counterpurchase, offset, switch trading, and compensation or buyback.²⁵ Many countertrade deals involve not just one arrangement but elements of two or more.

Barter Barter is the direct exchange of goods and/or services between two parties without a cash transaction. Although barter is the simplest arrangement, it is not common. Its problems are twofold. First, if goods are not exchanged simultaneously, one party ends up financing the other for a period. Second, firms engaged in barter run the risk of having to accept goods they do not want, cannot use, or have difficulty reselling at a reasonable price. For these reasons, barter is viewed as the most restrictive countertrade arrangement. It is primarily used for one-time-only deals in transactions with trading partners who are not credit-worthy or trustworthy.

barter

The direct exchange of goods or services between two parties without a cash transaction.

Counterpurchase Counterpurchase is a reciprocal buying agreement. It occurs when a firm agrees to purchase a certain amount of materials back from a country to which a sale is made. Suppose a U.S. firm sells some products to China. China pays the U.S. firm in dollars, but in exchange, the U.S. firm agrees to spend some of its proceeds from the sale on textiles produced by China. Thus, although China must draw on its foreign exchange reserves to pay the U.S. firm, it knows it will receive some of those dollars back because of the counterpurchase agreement. In one counterpurchase agreement, Rolls-Royce sold jet parts to Finland. As part of the deal, Rolls-Royce agreed to use some of the proceeds from the sale to purchase Finnish-manufactured TV sets that it would then sell in Great Britain.

counterpurchase

A reciprocal buying agreement.

Offset An offset is similar to a counterpurchase insofar as one party agrees to purchase goods and services with a specified percentage of the proceeds from the original sale. The difference is that this party can fulfill the obligation with any firm in the country to which the sale is being made. From an exporter's perspective, this is more attractive than a straight counterpurchase agreement because it gives the exporter greater flexibility to choose the goods that it wishes to purchase.

offset

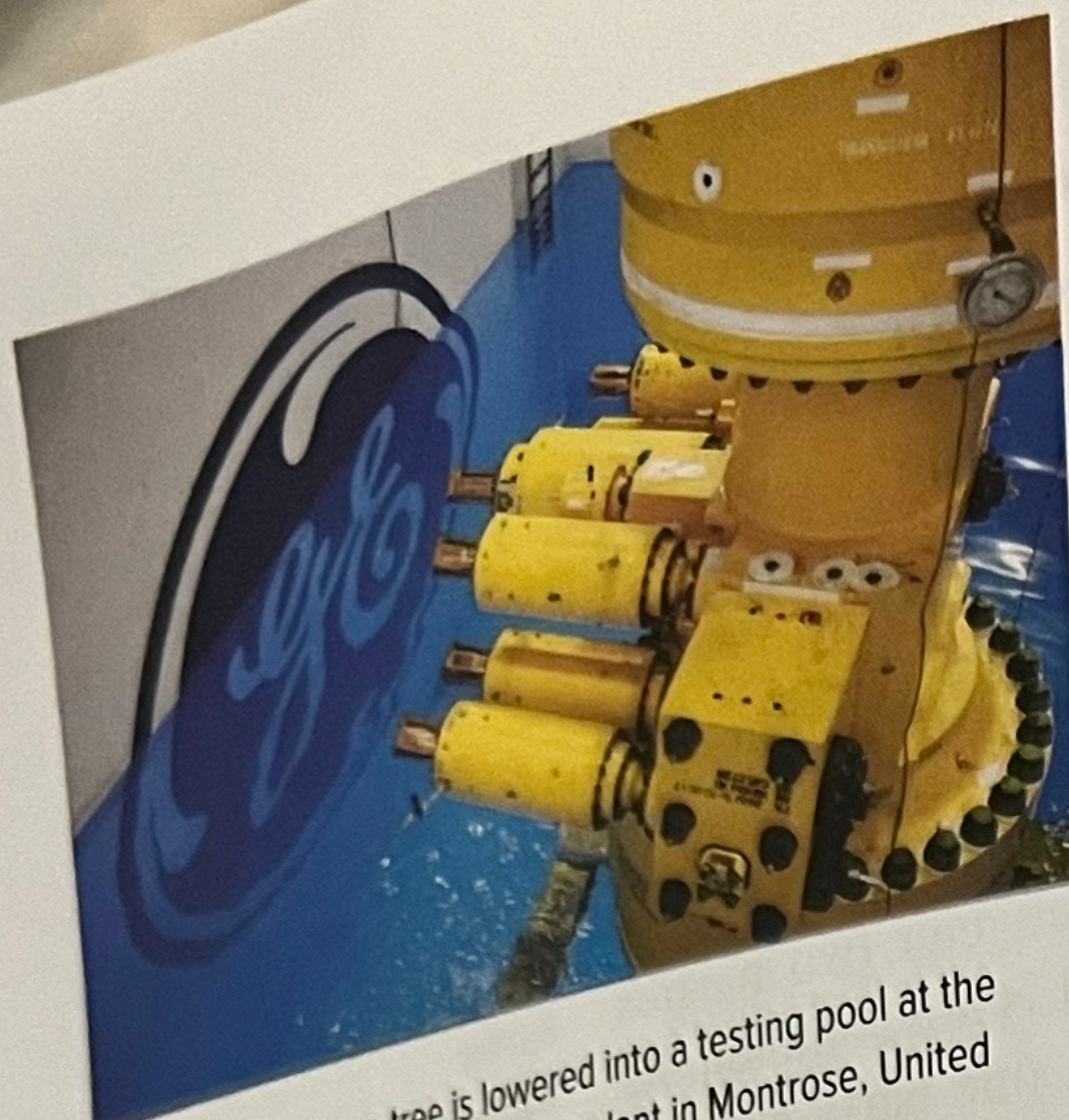
Agreement to purchase goods and services with a specified percentage of proceeds from an original sale in that country from any firm in the country.

Switch Trading The term **switch trading** refers to the use of a specialized third-party trading house in a countertrade arrangement. When a firm enters a counterpurchase or offset agreement with a country, it often ends up with what are called counterpurchase credits, which can be used to purchase goods from that country. Switch trading occurs when a third-party trading house buys the firm's counterpurchase credits and sells them to another firm that can better use them. For example, a U.S. firm concludes a counterpurchase agreement with Poland for which it receives some number of counterpurchase credits for purchasing Polish goods. The U.S. firm cannot use and does not want any Polish goods, however, so it sells the credits to a third-party trading house at a discount. The trading house finds a firm that can use the credits and sells them at a profit.

switch trading

Use of a specialized third-party trading house in a countertrade arrangement.

In one example of switch trading, Poland and Greece had a counterpurchase agreement that called for Poland to buy the same U.S.-dollar value of goods from Greece that it sold to Greece. However, Poland could not find enough Greek goods that it required, so it ended up with a dollar-denominated counterpurchase balance in Greece that it was unwilling to use. A switch trader bought the right to 250,000 counterpurchase dollars from Poland for \$225,000 and sold them to a European sultana (grape) merchant for \$235,000, who used them to purchase sultanas from Greece.



A subsea oil and gas tree is lowered into a testing pool at the General Electric Co. manufacturing plant in Montrose, United Kingdom.

©Simon Dawson/Bloomberg/Getty Images

buyback

Agreement to accept a percentage of a plant's output as payment for contract to build a plant.

Compensation or Buybacks A **buyback** occurs when a firm builds a plant in a country—or supplies technology, equipment, training, or other services to the country—and agrees to take a certain percentage of the plant's output as partial payment for the contract. For example, Occidental Petroleum negotiated a deal with Russia under which Occidental would build several ammonia plants in Russia and as partial payment receive ammonia over a 20-year period.

PROS AND CONS OF COUNTERTRADE Countertrade's main attraction is that it can give a firm a way to finance an export deal when other means are not available. Given the problems that many developing nations have in raising the foreign exchange necessary to pay for imports, countertrade may be the only option available when doing business in these countries. Even when countertrade is not the only option for structuring an export transaction, many countries prefer countertrade to cash deals. Thus, if a firm is unwilling to enter a countertrade to cash deals. Thus, if a firm is unwilling to enter a counter-

trade agreement, it may lose an export opportunity to a competitor that is willing to make a countertrade agreement.

In addition, a countertrade agreement may be required by the government of a country to which a firm is exporting goods or services. Boeing often has to accept counterpurchase agreements to capture orders for its commercial jet aircraft. For example, in exchange for gaining an order from Air India, Boeing may be required to purchase certain component parts, such as aircraft doors, from an Indian company. Taking this one step further, Boeing can use its willingness to enter into a counterpurchase agreement as a way of winning orders in the face of intense competition from its global rival, Airbus. Thus, countertrade can become a strategic marketing weapon.

However, the drawbacks of countertrade agreements are substantial. Other things being equal, firms would normally prefer to be paid in hard currency. Countertrade contracts may involve the exchange of unusable or poor-quality goods that the firm cannot dispose of profitably. For example, a few years ago, one U.S. firm got burned when 50 percent of the television sets it received in a countertrade agreement with Hungary were defective and could not be sold. In addition, even if the goods it receives are of high quality, the firm still needs to dispose of them profitably. To do this, countertrade requires the firm to invest in an in-house trading department dedicated to arranging and managing countertrade deals. This can be expensive and time-consuming.

Given these drawbacks, countertrade is most attractive to large, diverse multinational enterprises that can use their worldwide network of contacts to dispose of goods acquired in countertrading. The masters of countertrade are Japan's giant trading firms, the *sogo shosha*, which use their vast networks of affiliated companies to profitably dispose of goods acquired through countertrade agreements. The trading firm of Mitsui & Company, for example, has about 120 affiliated companies in almost every sector of the manufacturing and service industries. If one of Mitsui's affiliates receives goods in a countertrade agreement that it cannot consume, Mitsui & Company will normally be able to find another affiliate that can profitably use them. Firms affiliated with one of Japan's *sogo shosha* often have a competitive advantage in countries where countertrade agreements are preferred.

Western firms that are large, diverse, and have a global reach (e.g., General Electric, Philip Morris, and 3M) have similar profit advantages from countertrade agreements. Indeed, 3M has established its own trading company—3M Global Trading Inc.—to develop and manage the company's international countertrade programs. Unless there is no alternative, small and medium-sized exporters should probably try to avoid countertrade deals because they lack the worldwide network of operations that may be required to profitably utilize or dispose of goods acquired through them.²⁶

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Key Terms

- MITI, p. 388
- sogo shosha*, p. 389
- export management (EMC), p. 391
- letter of credit, p. 391
- bill of exchange, p. 391

Summary

This chapter establishes the following points:

1. One big market opportunity.
2. Neophyte exporters often encounter frustrated customers.
3. The way to success in the U.S. market is through importation. Commerce and industry can also match.
4. Many countries avoid services if it adds to their trade deficit.
5. Firms with products that are difficult to sell in their home market due to trade barriers can use the countertrade system.
6. The countertrade system is an export strategy.
7. A letter of credit is an important part of the countertrade system.

Critical Thinking

1. A firm's financial performance can be affected by the export market.