

## USING LETTERS OF CREDIT AS AN EXPORT MARKETING TOOL

You're relatively new to the exporting game. Sure, you've had a few nibbles, sent a couple of little shipments off by courier and taken payment by credit card. But now it's time to get into "real" exporting and you'll need to work out, amongst other things, your payment policy. Of course you'll want payment up front before you despatch the goods, or even before you accept the customer's order. That policy though will immediately put the brakes on your export success. How would you feel, sending someone you don't know in another country your hard-earned cash on the hope and promise that you'll one day eventually get the goods in exchange? Not thrilled? And that's probably how your potential customer will feel too.

Maybe you'd consider accepting say 25% deposit up front and 75% before shipment. But if the 75% never comes then you're holding goods which cost you probably triple the deposit and they mightn't be of use to anyone else.

It's time to consider a documentary credit, more commonly called a letter of credit or L/C. This means that your customer's bank promises to pay you if you submit complying documents to your bank after the goods have been shipped, and normally requires as one of those documents a "draft" drawn "at sight". Your customer will be paying for the goods even before they arrive over there.

Your competitors might be offering your customer payment terms of 30 or 60 days so how can you get in on this game without going broke?

If your financial position is fairly solid you could consider giving your customer terms of say 60 days after despatch, by way of their L/C requiring presentation of your draft, not at sight, but at "60 days after bill of lading date". This means that you won't see the payment until that due date. Your customer will quite likely be very happy with this arrangement as it can free up their cash flow until after the goods have been received by them. If they put up cash security then it will sit in their bank probably earning interest. They will however have a currency risk for those 60 days. And of course there are a number of issues for you too. Very importantly, if you sold in a currency other than Australian dollars then your exchange risk continues until that due date. There will also be a negative impact on your cash flow and you are reliant on the overseas bank honouring their promise.



So on the assumption that your customer is delighted with the arrangement and is happy to hand over their order to you instead of to one of your competitors, how do you resolve those issues? Firstly, have your bank or another local bank “confirm” the L/C for country, bank, and most importantly document risk. This means in effect that your bank guarantees payment so long as they consider that your documents are in perfect compliance with the L/C. This will cost you a fee, depending on how the confirming bank judges their risks, of anywhere from less than one percent to 5 or 6 percent per annum, often only a few hundred dollars. With a term drawing under a confirmed L/C, when you present your complying documents you instruct the confirming bank to “discount” the draft meaning that they pay you immediately. Two major benefits are that they will pay you “without recourse” meaning that even if the issuing bank for some reason fails to pay on the due date your bank cannot take the money back from you, and your foreign currency exchange risk also ceases when you are paid out. Naturally the confirming bank will charge you interest from when they pay you until they are reimbursed by the overseas bank, but the rate will be based on that applying for the particular currency plus an agreed margin and is sometimes less than your overdraft rate. This “loan” is secured by the confirmed L/C so it is not counted against your other facilities with your bank.

At this point you’re possibly thinking “oh no, more bank fees!” But let’s say for example that the confirmation fee is 2% pa, the L/C expires in about four months and drafts are at 60 days. The confirming bank’s exposure therefore will be a maximum of about 180 days so the confirmation fee will equate to 1% flat. Let’s also say that the discount interest for the 60 days is 7.5% pa, equating to 1.25% flat. If your gross profit margin was say 20% of your total costs then you will be reducing this to 17.75%.

But isn’t it better to make 17.75% than not make the sale at all?

*Disclaimer: The information in this article is intended to be of a general nature only and is not advice. You should consult with your bank and your financial adviser to determine if this is the best course of action for you.*

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© Bob Ronai (JP, AIEA, AIMM) heads Import-Export Services Pty Ltd, an independent provider of document preparation and consultancy services to exporters. Bob was the only person from Australia who attended the ICC’s Incoterms® 2010 Release Conference and Masterclass workshops in Paris late September 2010. As well as being a member of the both the Banking Technique and Practices Committee and the Incoterms Committee of the International Chamber of Commerce Australia he is a member of the Australian Institute of Export since 1975 and the Australian Institute of Management (NSW). He can be contacted at 02 99863000 or bob@exports.com.au.