

C & I PROJECTS

COUNTERTRADE EXPLAINED

by

Malcolm J R Taylor

THE CURRENT SITUATION

Many Australian exporters now understand that although their buyers in the Asian markets affected by the recent problems are having difficulty paying for imports, they want to keep trading. This means looking for alternative ways of doing business.

One of the mechanisms the international trading community has developed to cope with such market conditions is countertrade.

- What are the current trading problems - in Australia and in the export markets?

WHAT IS COUNTERTRADE?

It is a collective term which is used to refer to various methods of linking two export transactions between companies in different countries or, in some instances, between countries themselves. In a simple countertrade arrangement the respective exporters and importers accept reciprocal delivery of goods in part or full settlement of the value of their deliveries of goods. Few deals are that simple.

In an ideal market countertrade would not arise and to many analysts it is an undesirable bilateralization of world trade. It developed after the Second World War and has grown in sophistication since.

Countertrade is now a worldwide practice and since the early 1970's has emerged as a significant medium of world trade. Estimates vary but on average suggest that countertrade today accounts for more than 20% of total world trade. Australian exporters have in the past been reluctant to embrace countertrade as a method of doing business - in my opinion all they have been doing is denying themselves (in times like this) the opportunity to participate to the fullest extent in the opportunities that exist in world markets.

- WHAT IT IS NOT - The misconceptions:

It is not the Indonesian Government mandated countertrade program, nor the programs in Thailand, Malaysia or the Philippines.

Also forget the horror stories.

Often, when one mentions the possibility of countertrade playing a role in a particular export opportunity the uninitiated have visions of shiploads of Russian tomatoes or tractors ending up at their warehouse in Australia. This is not what happens.

- WHAT IT IS - The realities:

Countertrade is more appropriately viewed as simply another financing technique designed to put dollars in your bank whilst delivering the following general advantages to the trading parties involved:-

- a. It gives access to markets for Australian companies that may otherwise be closed to them.
- b. It helps conserve foreign currency reserves of the importing country.
- c. It allows access to foreign markets without necessarily setting up marketing companies or programs.
- d. It allows the importing country to export products for which markets might not otherwise exist.

NOTE: Countertrade is not the "be all and end all" - if you can structure a cash/financed deal then this will usually be the better option. Or countertrade can be part of a mix of strategies.

TYPES OF COUNTERTRADE.

Countertrade is an umbrella term which has been adopted to encompass what is largely an ad hoc or deal by deal arrangement. The various forms of reciprocal trade which fall within the countertrade umbrella include:-

- a. Barter. This involves the direct exchange of unrelated goods with in principle, no alternative means of payment.
- b. Counterpurchase. This is the most common form of countertrade and involves two separate flows of goods usually done under two separate contracts. In a short term agreement the seller is committed to buy goods from the importing country but this obligation will normally be assigned to a third party trader and the seller will neither handle nor see the outbound goods - only receive cash into its bank account. The value of the counterpurchase goods is an agreed percentage of the price of the exported goods.
- c. Buyback. An exporter of equipment agrees to take back products produced by that equipment as payment. The buyback agreement specifies precise particulars as to the products to be bought and perhaps the markets in which they can be sold.
- d. Offsets. The seller of defence, aerospace and sometimes other hi-tech products is required to undertake the local purchase of components, technology transfer, investment, training and sometimes straight counterpurchase as a condition of the sale.

Which type is going to suit will vary from case to case.

THE PARTIES TO A COUNTERTRADE TRANSACTION.

It is certainly true that any deal which involves an element of countertrade will be more complex to negotiate and administer than a straight cash sale transaction. In the ideal arrangement you sell your goods to the importer, receive a confirmed letter of credit, pay some bank charges and the money is in your hand. In an example countertrade transaction for an Australian company there will be a number of parties involved.

1. The Australian exporter.
2. The foreign importer.
3. The supplier of the outbound goods in the other country. This need not necessarily be the same party as the importer.
4. An "independent" bank perhaps in Singapore (or Australia).
6. A countertrade company or "compensator" which will most likely take over the Australian company's obligation to take counterpurchase goods and dispose of them on the world market, in return for a commission fee or "disagio". It is not essential that such a party be involved but it is often the most practical means by which an Australian company can handle its obligation to purchase goods that are outside its field of business and with which it is not familiar. In the less complex countertrade transactions it may be that the Australian exporter will be able to purchase goods that it has a direct need or market for and the cost of the countertrade company will be saved.
7. A countertrade consultant & lawyer.

THE COSTS OF COUNTERTRADE.

What is apparent from the above list of parties is that, if nothing else, the negotiations necessary to bed the deal down will be more lengthy and complex than an ordinary cash sale transaction.

As a result the Australian exporter must be prepared to either devote considerable time and resources of its own to the proper negotiation of the contracts or engage a suitably experienced countertrade consultant to handle this process on its behalf. This will necessarily involve payment of a fee which the Australian company will treat as a cost in the transaction. In addition there will be the commission paid to any countertrade company involved, the bank fees payable on the handling of any standard letters of credit that might be used in the transaction and also specific bank fees that might be payable for the establishment and supervision of special accounts (often termed escrow accounts) which are maintained to evidence the flow backwards and forwards of entitlements under the countertrade agreement.

The other party will be aware that these extra costs will accrue as a result of it requiring or preferring countertrade as a means of financing its desired import of goods. As such there will be an expectation (even if unstated) that the price for your Australian goods will be slightly higher than would otherwise be the case if you were to be paid in a straight cash transaction. It is usually preferable, however, not to enunciate this openly but to simply bear it in mind when formulating your negotiation strategy and when ultimately determining the price for your product. It is critical, however, that you withhold putting a price on your product until the end of the negotiations.

Apart from these straight costs which I have referred to, the other unknown at the start of negotiations of any countertrade transaction is the quality and market price of the outbound goods. In essence you do not know what net return you will get from each shipment of outbound goods until you have been able to fully particularise them, run the proposal past your proposed countertrade company, find out from it what contractual terms it will impose to take over those goods and what commission it will charge. Only then can you calculate the return to you less the various costs which I have referred to above and put a price on your inbound goods.

One of the greatest traps that unwary Australian exporters fall into in negotiating deals in difficult markets is to put their price on the table at the start of the negotiations in the expectation that it will be a cash deal and then find that there is a countertrade element but they are unable to increase the price of their goods to cover the costs associated with the countertrade.

DEVELOPING A CORPORATE COUNTERTRADE STRATEGY.

An exporter confronted with a countertrade demand can react in four possible ways.

- The first is to refuse to consider the proposal; although this will certainly lose the sale, it will save the company trouble.
- The second is to push the demand aside and delay any action as long as possible.
- The third is to respond positively to the demand, having prepared beforehand to engage in countertrade.
- The fourth is for the company to have a commitment to a pro-active countertrade marketing strategy and accept countertrade as a way to give the company a competitive edge and to develop a long-term relationship with the customer.

Developing a pro-active corporate countertrade strategy calls for definite and decisive attitudes in the company's management:

- . Prejudice against countertrade must be overcome.
- . The commitment of corporate resources to develop a countertrade strategy must be the decision of the company's top executive.
- . Countertrade is not for its own sake.
- . Undertaking a countertrade commitment does not imply that the exporter carries out the countertrade himself.
- . Developing countertrade know-how.

KEY NEGOTIATION ELEMENTS.

The essential terms that should be negotiated are:

- * ~~Quality of the Goods~~
- * ~~Quantity of the Goods~~
- * ~~Delivery~~
- * ~~Anti-Dumping~~
- * ~~Government Approval~~
- * ~~Banking and Payment Mechanism~~

DOCUMENTATION AND CONTRACTUAL TERMS.

There will usually be at least three or four contractual documents:

- a. The protocol which is the document evidencing the link between the contract for the sale of inbound goods, services or knowhow and the counterpurchase transaction for the sale of the outbound goods;
- b. The document evidencing the primary export transaction;
- c. The document evidencing the counterpurchase transaction;
- d. The banking facility.

Elements that must be covered in these documents include:

1. Definition of the counterpurchase goods.
2. Total value of the counterpurchase commitment.
3. Pricing the goods, services or knowhow.
4. Assignment.
5. Payment.
6. Time schedule for performance.
7. Monitoring the performance.
8. Liability.
9. Force majeure.
10. The effect of termination of one contract on the other.
11. Settlement of disputes and governing law.
12. Usual miscellaneous provisions.

The above is not an exhaustive list of the issues which need to be covered but it is an illustration. Countertrade can be a profitable means by which a company can increase its market share and develop markets that are not otherwise open to it on a cash sales basis. It can, however, increase the risks and costs involved in international trade and for the unskilled it can be a minefield of unforeseen costs and losses.

Therefore, in my opinion, there is no substitute for experience and specific skills in this difficult area. If your company does not have an experienced countertrade negotiator on its staff then it should engage the services of a consultant for each particular deal. That consultant should be engaged as part of the team from the earliest possible time, as too should the lawyer. Many deals that involve countertrade do not ultimately come to fruition. It is much better, however, to identify the insurmountable problems in advance during the negotiation stage than to blindly enter into the agreement and get caught with a significant trading loss or exposure.

We wish you well with your trading endeavours.

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