PROFIT

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for investment and trade

Risks in internationalisation

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1. Introduction

This note has been prepared to assist you to think about the risks that you might face when engaging in international trade or investment. Whilst some of the risks may apply more broadly, this fact sheet does not attempt to cover all aspects of business risk.

Many entrepreneurs and managers either assume that risks are small or possibly do not think about them at all. Certainly, few businesses ever undertake any sort of risk assessment or put in place mitigation plans, unless they are pressed by a customer or funder. But the recent health crisis has reminded businesses of the importance of looking at risk. Moreover, businesses cannot begin to mitigate the risks until they have identified them – and there are many risks to consider once you start to trade internationally.

The risks from trading are likely to be somewhat different from the risks in investment. Investment risks will be very similar to the risks that you face in your domestic business; trade risks will generally, but not always, limited to the value of the cargo.

2. Thinking about risk

Whilst it does not reduce the number of risks, many businesses find it helpful to categorise risk, partly because that offers a more systematic way to consider risk (including the likelihood of the risk coming to pass and the potential impact if it does) and partly because risks in the different categories can be addressed in different ways. Risks can be divided into three categories: 'firm risk', 'market risk' and 'environment risk'.

Kaplan & Mikes (2012) classify them as preventable risk (which they define as risks arising within the business), strategy risk (risks taken to improve returns) and external (uncontrollable) risk, though firm risks are not always preventable and market risk may be about more than strategy risk.

3. Possible risks

3.1. Firm risk

Firm specific or internal risks tend to be specific, are usually controllable and thus can be minimised or avoided. Examples include unauthorised or inappropriate or unethical actions by staff; employees performing poorly because they have been inappropriately or inadequately managed; failure of operational procedures or processes; faulty or insufficient corporate infrastructure. It is generally too costly for businesses to eliminate all risks, so you will want to allow some tolerance but, as far as possible, you will want to consider and minimise these risks. Firm risks can be mitigated through active prevention: putting in place procedures designed to minimise the risk from occurring (for example, screening incoming email and blocking email from unknown sources) and then encouraging appropriate decisions and behaviour by staff (for example, still questioning the veracity of any e-mail that looks suspicious).

Quality risk

The customer may reject your goods on the basis that they do not meet the specified quality. Usually it is too expensive to bring the goods back home and they may have been specially made for the particular export market. Before you start selling, you need to ensure that your goods will meet the specified quality standards. It is good practice to allow the customer to have a sample, though for large machinery may not be practicable.

One consideration, though you will also have this with domestic merchandise, is that some problems may not be immediately apparent – so the goods will not be rejected – but will still cause harm. Food products, for example, may lead to food poisoning; a metal product may suffer metal fatigue and break unexpectedly causing damage to life and limb. Occurrences such as these can lead to you being sued and can be existential.

Prohibited goods

You may find that the export of some goods to some countries is prohibited or restricted, either by the importing country or the exporting country. The US, for example, prohibits the export of certain technologies. This is generally easy to check. Check whether you need an export certificate and how to have the goods verified when they arrive at their destination.

Ethics

We believe that it is important to act ethically and without engaging in corrupt practices. Businesses engaging in international trade or international investment are bound, at some point, to find themselves facing questions regarding their values so be clear in advance about your values and behaviour. If you do not already have a code of ethics or a code of conduct, you may want to prepare and adopt one. Ensure that your partners and suppliers are aware of your position and stick to it.

Cultural risk

It will help you to understand the culture of the country with which you plan to trade or in which you plan to invest, so that you are not caught out by behaving in a way that offends the country's cultural norms. Finding a local partner can help you with this.

Legal risk

Commercial law differs across countries. Whilst it may be easy to check out the law, if you are entering into a contract – whether with a supplier, customer or partner – and no matter how cordial the relationship at the outset, you will want to specify where disputes will be settled. In many countries, resorting to legal remedies to resolve disputes is expensive and time-consuming so many contracts now allow for the appointment of an arbitrator.

3.2. Market risk

Businesses work in markets and there is inevitably a degree of risk that comes from so doing. Examples include the threat of new competitors or the threat of a completely new technology or the risk that fickle customers will take their custom elsewhere. Businesses accept some risk, however, because otherwise they would not be able to compete. A bank takes a risk every time it makes a loan; an investor takes a risk that the investment may not generate a given return or indeed that the whole investment may be lost. All money spent on research and development is at risk.

Risks such as these are inherent in being in business and, whilst businesses would prefer not to face them, recognise that they have to live with them. Indeed, a strategy intended to generate a high return may mean living with a higher risk. International trade and international investment can both lead to those higher returns but they inevitably lead to higher risk. And usually it is the exporter who carries the risk.

Market characteristics

The market requirement may change. Apparel and garments, for example, need to be designed and manufactured months before they go on sale in foreign markets. Customers may suddenly decide that your designs are 'out' and someone else's are 'in', if you have not presold the consignment.

Transport costs

The cost of transport is usually a high proportion of the total cost. When oil prices are rising rapidly, the cost of transport can rise rapidly as well. So you will want to ensure that your transport costs are fixed at the point that your goods arrive on board the carrier. But you will also want to ensure that you do not quote a price to your customer too far in advance to minimise the risk of transport costs rising in the interim.

Exchange rates

It seems that exchange rates are constantly on the move. That is why many firms quote prices in dollars or euros – and why they then attempt to hedge the risk by requiring that their own suppliers also quote in dollars or euros.

Import tariffs

It is less likely that duties and tariffs will change without notice, but it is not unknown. Customs may decide when your goods arrive that they are in a different HS code and thus attract a high rate of tax, which is why many exporters and importers seek 'advance customs rulings'.

Credit risk

Even in countries where domestic trade tends to be carried out for cash, rather than on credit, selling internationally tends to be done on credit – not least because the customer refuses to pay until they have taken possession of the goods. This increases considerably the risk of not being paid, or not being paid the expected amount. You should conduct due diligence checks on your customers to assess their ability to pay. You should take up references from other suppliers. If possible, you should seek at least an advance payment. And you should, wherever possible, insure against the risk of not being paid. In India, for example, the Export Credit Guarantee Corporation of India Limited will provide insurance to cover export credit risks.

In some cases, though it is not always easy for new exporters, it is possible to secure a 'letter of credit' from a financial institution. This commits them to pay an agreed amount to the exporter provided the goods have been delivered within an agreed timescale. This provides protection for both seller and buyer.

Intellectual property

There is always a risk that others will steal your intellectual property – which is why businesses aim to protect themselves with patents, registered trademarks and copyright. However, the risk increases when you trade internationally because it is more difficult, and usually more expensive, to defend your rights. You can take the precaution of registering trademarks and patents in the target country, but you will still have to be prepared to pay to defend your rights if necessary. A better strategy may simply be to keep innovating and improving your offer so that you stay ahead of the competition.

3.3. Business environment risk

Businesses do not work in isolation: they operate in a world in which they have no control over a wide range of factors that include economic trends, legislation and regulation, infrastructure, corruption, security, revolutions, natural disasters such as earthquakes or typhoons or pandemics, trade wars, the sudden imposition of tariffs, power cuts etc. Since, like market risk, firms cannot prevent any of these from occurring, they need to focus on identifying the possible risks and then taking actions to mitigate the likely impact. In some cases, the business may consider the risk so low that they ignore it: this was the view taken by most businesses in relation to pandemics, though Wimbledon Law Tennis Club perceived the risk differently and had pandemic insurance which covered all its losses resulting from the cancellation of the tennis in 2020. Some risks creep up on. Like changes in weather arising from global warning, yet businesses could be taking steps now to mitigate the potential impacts. In some countries, power cuts are seen as so unusual that most businesses do not have generators; in other countries, the risk is perceived as so high that most businesses have a generator.

Political risks

There are any number of political risks with which you may need to contend. A change in governing party may lead to a sudden change in regulations or in tariffs or in quotas or even lead to a trade war. Coups, rebellions and wars will undoubtedly present challenges. You

can, to some extent, avoid these by choosing countries where you perceive the risk to be low. And some political risks can be covered by insurance.

Cargo risk

There are many risks that could impact on your cargo whilst in transit, including storms, theft, vandalism, explosions, fire, piracy etc. This can generally be covered by insurance. It is worth noting that the International Chamber of Commerce has set out rules for each of the parties and their responsibilities in relation to shipping risk.

Exchange control regulations

It is not unknown for some countries suddenly to prevent importers from being able to access the dollars or other hard currency that they need to pay. Many developing countries still have some exchange control regulations so check these out. Explore, too, whether this is an insurable risk for your target countries.

Repatriation of investment or profit

Companies are often tempted to invest in foreign markets lured with incentives, tax reliefs and light touch regulation – and then find the legislation changes and they can no longer repatriate their original investment or even repatriate their profit. There may be little that can be done about this, but it is a risk that should be considered before the investment is made.

4. Managing risk

Once you have a list of all the possible risks, you are in a position to identify mitigating actions. This may depend on the category of risk.

A compliance-based approach may be appropriate to manage preventable risks, but will be inappropriate to manage market or environment risk. Firm risks can be managed through taking actions designed to minimise the risk – such as being clear about the process required to determine whether to export a particular product to a particular country. Market risks may be insurable, as may at least some of the environmental risks, though some such as variation of exchange rates may just have to be managed.

Once you have a list of risks, it is worth summarising them all on a spreadsheet together with an assessment of impact (typically scored 1-5, covering insignificant, mi nor, moderate, major, severe) and an assessment of likelihood (typically scored 1-5, covering rare, unlikely,

possible, likely, almost certain). These can be combined into an overall risk factor (typically describing the risk as minor, moderate, major or severe). In the next column, for each risk, set out the action that has been undertaken to mitigate the risk or the contingency plan that has been put in place. For each risk, you should also consider appointing a 'risk manager', a member of staff who has responsibility for worrying about the particular risk and ensuring, for example, that contingency plans are kept up to date.

5. Further information

Kaplan, R.S. & Mikes, A (2012) Managing risks: a new framework, Harvard Business Review 90(6) available at https://iga.fyi/risk.

There is no shortage of websites offering advice on international trade risks and generally offering to provide insurance as well.

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