SVB FX Risk Advisory:

What innovation companies need to know to grow overseas

Ivan Oscar Asensio, Ph.D. | June 2021

The world has changed over the past year, and not just because of Covid. While the pandemic reshuffled supply chains and disrupted economies around the globe, Brexit split the UK from Continental Europe and the US dollar peaked and began what could be a long-term decline. These changes have enormous implications for innovation-economy companies looking to expand outside the borders of the United States.

These changes come as fast-growing companies accelerate their overseas expansion. Four in ten SVB clients now send their first wire outside of the US within a year of opening their first SVB account.[1] *A majority of clients in our tech and life science portfolios* send their first wire outside of the US within a year of opening their first SVB account.[2]

Expanding abroad has always presented challenges to young, rapidly growing companies. Now the changes of the past year have rewritten whole portions of the playbook. Innovation companies must balance the need to act quickly and decisively with the responsibility to plan ahead and make decisions that consider a range of considerations, from operational factors to taxes to currency. Setting up correctly initially — with full consideration of factors such as location, subsidiary structure, hiring practices and FX management — ultimately will prove easier and less costly than unwinding mistakes.

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[1, 2] SVB Client Account data base

Operational considerations when expanding globally

Many of the key considerations you face will be operational. Consider the following questions to inform how you'll set up your overseas operations:

Why are you expanding internationally?

You may be pushing into new markets for a variety of reasons: to collect revenues, to grow your user base, to set up a regional logistics hub, or to tap local labor pools, to name a few. Your objective has important implications for the ways you approach operations.

Where should you set up shop?

Europe and the UK are the top two destinations for innovation companies expanding internationally, based on SVB client FX volumes as of May 2021. For companies expanding into those regions, Brexit has changed the equation. Setting up in the UK still might make sense if you want access to the British market. But the country is no longer a business and financial gateway to Continental Europe now that Brexit has segregated EU and British regulatory authorities and brought increased interchange fees on UK-EU cross-border flows. That's why many companies looking for access to Continental Europe are now establishing operations in Amsterdam, Frankfurt, or other cities on the mainland.

Objective	Implications
Collect revenue or expand user base	• May be as simple as opening a multi-currency cash account. • Make sure to protect intellectual property (IP).
Sell on the ground	• Requires the infrastructure to handle regulations, taxes, and logistics.
Hire talent	• Employment laws make firing more difficult than in the US, so it's essential to be deliberate and tailor your approach to the market.
Handle logistics	• Local third-party providers can assist with logistics while simplifying Value Added Tax (VAT) compliance.

> "If you have to comply with EU directives you need to be in the EU now," notes Sylvan Martha, founder of First European, which helps companies set up shop in Europe. "If you need to comply with VAT or VAT MOSS, or if you registered your subsidiary in the UK for GDPR compliance, that's no longer sufficient for the EU."
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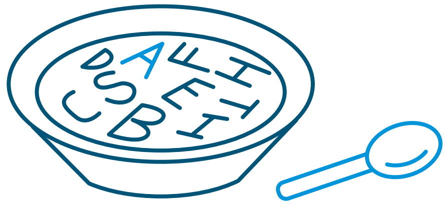
> (For more on these terms see "Acronym Soup".)

The UK is no longer a business and financial gateway to Continental Europe

> Dawn Buehler, Director of Treasury for beauty, lifestyle, and wellness company FabFitFun, notes that the change has complicated the first steps of expansion into Europe. "In the past you'd put your first footstep in London, where you'd know you can get office space and employees and easy flights from San Francisco and New York, and you would run your IP through Ireland," she says. "That's not your setup today. You have to rethink it and talk to experts."

Acronym Soup



Europe in particular has a range of regulations that companies entering the market need to address. Key regulations include:

- **VAT/VAT Mini One-Stop Solution (MOSS).** Companies operating in multiple European countries typically have to account for value-added tax in each of them. Those eligible for MOSS can register, file, and pay VAT in one place.
- **GDPR.** The General Data Protection Regulation is Europe's data privacy and security law.
- **PSD2.** The current version of Europe's Payment Service Providers Directive governs electronic payments; it's intended to protect consumers, enhance security, and encourage innovation.

Should you hire employees?

Setting up shop doesn't have to mean boots on the ground immediately. For example, you may be able to operate a revenue-collecting hub just by opening a multi-currency cash account.

If your goals require bringing on workers—for example, if you're looking to establish an engineering hub—you need to adjust to local hiring regulations and practices. For example, the European Union's mobility laws make it easy to set up in business centers such as Amsterdam and hire employees in, say, Bulgaria. But this approach presents its own challenges. "There are 27 different member states in the EU, with a variety of languages and cultures," notes Martha. "If you set up in multiple jurisdictions, you'll be dealing with multiple supervisory authorities." You'll also need to set up payroll and tax structures in the countries where you're hiring.

> "I had a go team made up of legal, payroll, HR, Treasury, accounting, and others. We had to come together as a group to see where everyone was moving and how we could help bridge the gaps."
>
> — Dawn Buehler, Director of Treasury, FabFitFun

Likewise, strict laws make firing very difficult in Europe, so taking on employees is a long-term proposition with little flexibility. Moreover, potential employees' priorities are likely to differ greatly in international markets. In Europe, nationalized health care systems make health care a non-issue for job seekers, who tend to focus on salary, pension, and time off.

And in today's workplace, you'll need to decide on your remote-work policies. More than half of employees in the UK don't want to go back to working normal hours in an office, according to a study by Theta Global Advisors. McKinsey & Company projects that in major European economies employees will spend between 26% and 46% of time working remotely.

You may decide to work with contractors rather than committing to employees. Contracting tends to be more expensive over time but offers greater flexibility. In a location where you're looking to bring in talent, you might consider hiring employees in leadership positions, such as a head engineer, and using contractors for other roles.

Whatever approach you take, scope out what you'll offer employees, how much it will cost to provide it and the expense of setting up and maintaining the necessary infrastructure. Before you pull the trigger, make sure your business is ready, with the necessary banking relationships in place, and you can afford the expense.

How will you coordinate your team's efforts?

Set up structures within your company, so different groups have a forum to communicate and establish shared agendas. Representation across groups is essential to manage competing priorities. For example, your sales department might want to get boots on the ground as quickly as possible, while legal and Treasury might be more cautious. "I had a go team made up of legal, payroll, HR, Treasury, accounting, and others", says Buehler. "We had to come together as a group to see where everyone was moving and how we could help bridge the gaps."

"Long before companies earn revenues outside the US, costs are incurred: to set up overseas headquarters, satellite sales hubs and billing and collection entities, to hire staff, to set up clinical trials. These costs are generally funded with US dollars. **So, a weak dollar is a pain point. And, crucially, it's a new pain point, as many of our clients have not seen this cycle while they've been in their seat."**

— Ivan Asensio, Head of FX Risk Advisory, Silicon Valley Bank

Plan your approach to currency

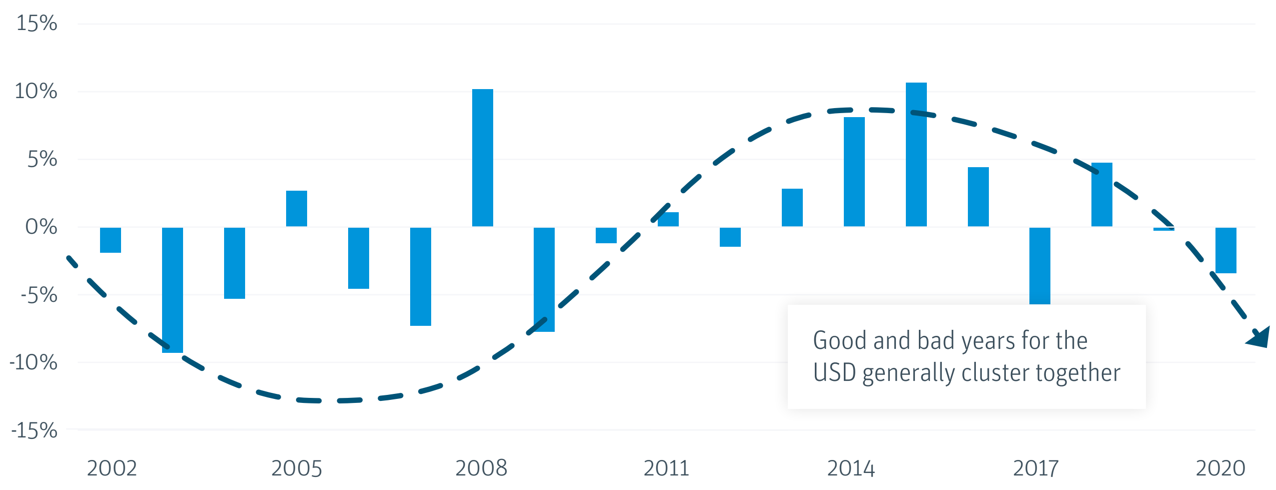
For most of the past decade, an appreciating dollar has put the wind at US business' back as they've moved into foreign markets. In the early stages of expansion, costs typically outstrip revenues, so when the greenback strengthened, it enabled US companies to fund expansion costs with fewer dollars. Likewise, venture and private equity funds raising money in USD for deployment overseas benefited from greater purchasing power. Currently, three-quarters of SVB clients, including two-thirds of later-stage clients, are net sellers of the dollar, meaning they benefited while it appreciated.[3]

Now the tide has turned against the dollar. We expect the USD's recent declines to deepen over the years to come, leading to higher costs for US companies entering foreign markets. The shift makes this an important time for internationally expanding companies to prioritize identifying the impact of foreign currency and whether and how to address it.

A bear cycle beginning

The US dollar tends to move in long cycles of strengthening and weakening versus other currencies. (See chart below.)

Annual % change in US dollar versus trade-weighted currency basket



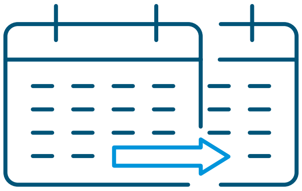
Source: Federal Reserve (Bloomberg ticker: USTWBROA), SVB FX Risk Advisory

3 SVB Client Account data base

The decline is likely to continue. “It won’t happen in a straight line,” says Asensio. “But we expect it to happen to some extent for years to come.” Reasons include:

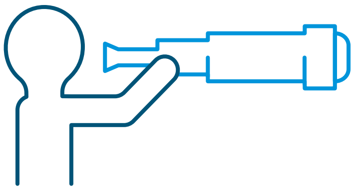
Short term (within one year)

- A strong appetite for risk assets as the global economy recovers and investors seek higher potential returns overseas. Near-zero US yields accentuate this trend.
- Momentum. The USD has posted double-digit losses against most major currencies since the market sell-off in March, 2020.[4]



Medium term (six months to two years)

- Low interest rates dampen foreign demand for the USD. The Federal Reserve has said it intends to keep policy rates near zero in the US at least until 2023. At the same time, quantitative easing is likely to anchor low interest rates on longer-term bonds.
- The current account deficit increased 75% from pre-Covid levels in 2020, to 3.4% of GDP in Q3 2020.[5] A larger current account deficit reflects an increase in the difference between greater US spending overseas and lower foreign spending in the US. That dynamic has increased net demand for foreign currencies relative to the USD, pushing down the dollar’s value.



Long-term (beyond two years)

- Purchasing power parity (PPP) and inflation. Based on PPP, the US dollar is overvalued against all but a few global currencies (read more on PPP). The Fed’s commitment to let inflation run higher than the previous 2% target could put additional pressure on the dollar.
- Fiscal deficits and national debt. The US budget deficit ended 2020 at about $3.3 trillion, the most as a percent of GDP since 1945.[6] Borrowing to finance the deficit pushed the national debt above 100% of GDP in 2020.[7] Some investors believe the growing national debt presents a risk to the USD’s status as a global reserve currency and even question the sustainability of the fiat currency system.

Consider how another double-digit move higher by foreign currencies might affect:

- For companies: Global FP&A and other metrics
- For investment funds: Purchasing power from holding USD earmarked for non-USD investment, and the resulting impact on investment performance

How much does FX matter to you?

Consider two questions as you evaluate your company’s exposure to foreign currencies: Is there an impact? And is that impact material?

The first step is to determine whether a weak USD would adversely affect your business — what we call *risk discovery*. You can start by adopting a framework for embedding FX rates into your financial planning and analysis (FP&A) process. Your framework will help you size up the impact FX moves have on your business results.

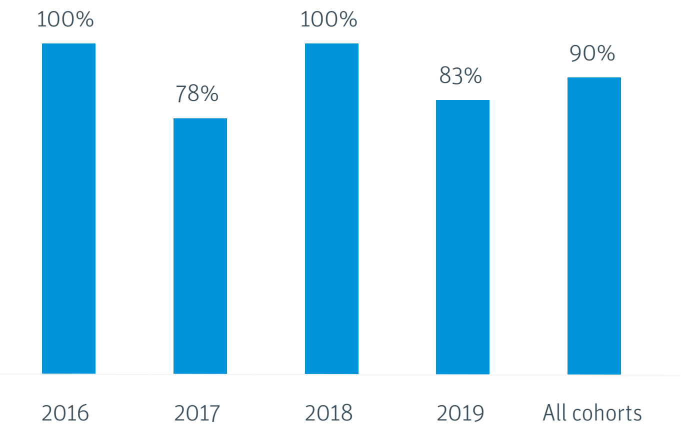
The second step is *materiality*: quantifying the extent to which a weak dollar would undermine your company’s ability to achieve its key performance indicators.

You may find that that the dollar’s decline would have such a minor impact that it’s not worth addressing. In our experience, currency effects generally start becoming material when a company has more than about 20% of revenues in foreign currencies.

4 Bloomberg
5 www.bea.gov/news/2020/us-international-transactions-third-quarter-2020
6, 7 www.cbo.gov/topics/budget

Percentage of firms disclosing FX as a risk factor in their F-1 documents

FX cited in item 1A risk factors



Source: Securities and Exchange Commission (SEC)

If you determine that your company's FX risk is material, finding appropriate ways to mitigate it can help ensure that your success hinges on business performance, not currency swings.

Some businesses don't take action to reduce currency exposure, due to the belief that currency impacts will wash out over time. It's true that currencies tend to oscillate around a long-term mean. The trouble is that they might not revert to the mean on your timetable. Neglecting to address material currency exposure could substantially undermine your business' ability to meet key performance metrics. "I have to be smarter about currency practices now, and start building in some kinds of hedge strategy," says Buehler.

SVB has a dedicated group of currency experts who can help you think through a variety of ways to address your currency risk, from simple, natural hedging strategies to more complex and sophisticated derivates-based approaches.

A changed world hasn't slowed down life science and technology companies, which are innovating and expanding into new markets more rapidly than ever. A weakening US dollar adds another dimension to the issue and one that many younger companies have not faced in recent years. As your firm looks to navigate the new global normal on the path to growth, consider reaching out to experienced partners who can help you make the most of what the world offers your business.

For more information, contact your SVB FX Product Advisor or the FX team at fxadvisors@svb.com.