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Tariff Talk: Slicing Through Uncertainties and Revealing Risk

Introduction

One in four of the earnings calls we analyzed in the first six months of 2019 contained questions and responses related to global tariffs and trade wars. We saw these questions across all types of industries and topics, including: suppliers, operating expenses, pricing, inventories, demand, and earnings/guidance. Generally speaking, our analysis showed that management teams were forthcoming with information about the effects that tariffs have had or could have on their businesses. Where we did see concerning behaviors around the tariff issue most frequently was when management teams had significant supply chain or manufacturing footprints in the affected countries. Sometimes, management teams demonstrated genuine uncertainty about the implications of tariffs to avoid answering more general questions. This inherent uncertainty about what will happen means that management legitimately cannot provide full answers in many cases. BIA's approach enables our clients to determine where management possesses more information, even in areas of uncertainty, than they want to reveal. As we move into the Q3 earnings season, we provide tips on how to better ask questions to get at management teams' specific concerns and their potential impacts.

A Convenient Source of Uncertainty

Management teams have been able to use legitimate uncertainty about the implications of tariffs in order to avoid answering a broad range of questions. For example, in their Q1 Opening Statements, one large retailer provided their expectations for comps, which they "kind of" laid out and said were "a bit" conservative. They also stated that this guidance did not "specifically" contemplate tariffs. When asked for more specifics about comp expectations, management refused to answer, implying this was due to uncertainty about the impact of tariffs. These vague and somewhat conflicting statements allowed considerable leeway for what actual comp results could have been and clouded the exact impact that tariffs would or would not have on performance. These behaviors went beyond mere uncertainty and reflected an effort to mask actual expectations, raising questions about what other factors could negatively impact comps that management was not discussing. Similarly, on a logistic company's Q1 earnings call, management used tariffs to avoid providing concrete insight into trends in one of their segments. Despite asserting that they saw an impact from the tariff during the quarter, they refused to quantify this effect, claiming that it was "hard" to do so. This is not the equivalent of saying that they were unable to provide any insight, suggesting that they were using the tariff issue to avoid providing complete information into trends in that segment.

When asking about a topic where tariff uncertainty could impact management's answer, one way to mitigate ways management can use the issue to avoid answering fully is to utilize a well-formulated prologue. This allows the questioner to be the first to raise the topic of tariffs, preempting management using it as a justification. For example, the following prologues are likely to be effective:

- With everyone in the sector facing the possibility of tariff headwinds, we understand that there is a lot of uncertainty in trying to project results right now. We have discussed these issues with several of your competitors and they are all facing the same challenges. If there were no further changes to tariff policy…
- It must be frustrating to try to plan for next year given all the uncertainty around tariffs. Clearly there is a large range of potential outcomes that could result depending on how the tariff policy is ultimately crafted. Under a best-case tariff policy scenario… Under a worst-case tariff policy scenario…

- Some of your competitors have indicated that they expect tariffs to have an impact, in some cases quite severe, on the supply chains in your industry. Different companies clearly have different levels of exposure to China, and so the tariff policy is likely to have highly variable impacts. How much less exposure…
- Variations in the political climate and government policy make long-term planning difficult. It is completely understandable that you did not foresee concerns around trade becoming salient so quickly. Knowing what you know now about how the political situation has played out….

Another strategy is to remove tariffs as a factor when formulating a question. For example:

- Excluding any possible impact from tariffs…
  - what is the most that gross margins could increase during the year? What is the least?
  - which factors would be most likely to impact where results come in within your guidance range? Which others?
- If no additional changes to tariff policy were to be made...
  - what is the longest that you expect favorable industry trends to continue? What is the shortest?
  - what is the most you expect to be able to reduce costs over the coming year? What is the least?

Concerning and Combative

Some of the most concerning behaviors surrounding tariffs came from companies with significant supply chain connections or manufacturing footprints abroad. One retailer's management team felt the need to attack competitors who were moving manufacturing out of China, sarcastically wishing them "good luck" and warning of "disruptions" from that strategy. The need to go to such lengths to attack the strategy of shifting operations suggested they anticipated negative impacts from maintaining production in China, even if they felt it was better than the alternative. Another retailer's management team elicited a similar degree of concern: when asked about their exposure to tariffs in both China and Mexico, they exhibited an inappropriate level of concern, joking that the "biggest issue" with Mexican tariffs was that avocados were some of their "favorite fruits." This was meant to downplay the significance of the Company's tariff exposure, but the need to do so in such a way suggested the likelihood the Company's exposure to Mexican tariffs would have a meaningful impact on results. They went on to make a concerted effort to assure investors of their "strong relationships" in China that would allow them to "mitigate it significantly" if there were a large tariff impact. These statements in lieu of providing the details of their level of exposure suggested that management was significantly more exposed to tariffs on the Chinese market than they wanted to admit. In this Company's case, while it was true that the exact impact of future tariffs was unknown, a behavioral assessment of management's statements indicated that the Company was likely exceptionally vulnerable to increases in tariffs.

Facing highly concerning behaviors such as these, BIA recommends using follow-up questions that are tailored to pinpoint the source of management's heightened anxiety, elicit more information, and determine the potential for significant negative implications.

The following follow-ups may be effective:

- What would be the biggest benefits to shifting production outside of China? What would be the biggest drawbacks?
- If the tariff policy situation warranted, what is the fastest you could fully shift production out of China? What is the slowest?
- Once production is shifted outside of China, what is the most that cost of goods sold could increase on an ongoing basis? What is the least?
- When is the soonest you would expect smooth functioning of production subsequent to a move out of China? When is the latest?
- What is the most in pricing concessions you expect to be able to earn in China as a result of your strong relationships? What is the least?
- If we were to speak with your Chinese suppliers, is there any reason they may tell us that pricing concessions will not be forthcoming?
- What is the highest that tariffs would have to go before you would feel the need to shift production?
- What are the next best sources of supply outside China? What else?
- How much more expensive will supplies from outside China be than your current China supply?
- What is the longest it could take to build supplier relationships outside of China? What is the shortest?

About this Report:

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