WHITE PAPER

Beyond Exporting: Building or Buying International Operations

Many Canadian companies are now growing their overseas operations by establishing or acquiring businesses outside Canada. These investments range from relatively simple ones, such as setting up a sales office, to much larger projects—building a manufacturing plant, for example, or buying a foreign company. This white paper will help you understand the basics of international investment and its potential advantages for your business.

TABLE OF CONTENTS

WHO INVESTS AND WHY?

While it's true that bigger firms are more likely than their smaller cousins to put money into foreign investments, many of Canada's smaller companies have learned how to make this strategy work for them as well. And it's paid off handsomely: According to EDC research, companies that invest internationally tend to be more innovative, productive and better able to compete than businesses that stay at home. The research also shows that most of these firms consider their investments a success.

Companies invest for different reasons, but most are looking for one or more of these benefits:

- Increasing sales and profits (the most common motivator)
- Getting closer to their customers
- Improving their competitiveness
- Gaining access to new supply chains, markets, technologies and resources

An evolving strategy

Investing represents an important shift in how Canadian firms do business internationally. Until recently, traditional exporting—shipping products directly to a customer, for example—was the usual approach to international business, and investment was more of an afterthought (or disregarded entirely). This is no longer the case—according to a 2013 Statistics Canada **report**, growth in the sales of Canadian overseas affiliates[1] has exceeded the growth of purely export sales over the past decade. This has increased the importance of affiliates as a way for Canadian companies to operate outside the country.

Canadian companies now generate at least as many yearly sales via their affiliates as they do via their traditional goods and services exports.

Barriers to investment

Not all Canadian firms see international investment as something they need to do. This is often because they're satisfied with their domestic market. In other cases, however, companies that might consider investing abroad don't try it because they don't know where to start. The most common reasons cited are lack of financing, problems finding local business partners and a dearth of high-quality information about overseas market environments and their potential local and cultural barriers.

Moreover, once a company begins to invest, it faces further challenges: dealing with local bureaucracies, getting financing to support the investment and putting the right people in place (in both Canada and the overseas market) to oversee operations. Other problem areas can be managing the local workforce, maintaining partner relationships and complying with local laws and regulations.

[1] An affiliate is a company you set up in an overseas market in order to do business there. Sometimes called a subsidiary, it operates as a local firm but is owned by the Canadian parent company.

Before you invest

Before you decide to invest in an overseas market, you should consider issues such as the following:

- What competitive advantage might this give me? What advantages does my product or service have over other companies in that market?
- Do the advantages outweigh the risks?
- What about the political risks in the market? Does the government want to attract international investment? Does it make it easy for foreign companies to do business?
- What are my alternatives to this investment? Would it make more sense just to ship my merchandise there, or license a local representative to sell my product or service?
- Is the investment a good match for my company's business model and growth plans?
- Do I have the right people and financial backing to make the investment—such as building a plant in the market—and keep it going?

ESTABLISHING OPERATIONS ABROAD

If your company does decide to invest abroad, the next question is how to do it. The approach you take, and the specific investment[2] you make, depends on the industry you're in and on your company's size, business model, goals, needs and opportunities.

The bottom line here is that international investment is complicated, so throughout the process you should rely on the guidance of reputable experts, both in Canada and in the target market. Consulting local professionals is especially important, since they are familiar with the investment, legal and tax requirements of their country, and can help you avoid expensive mistakes. Meticulous due diligence is also a must; it can range from financial checks (as part of an acquisition or merger, for example) to looking at local foreign-investment rules (for setting up an affiliate). Again, professional help is indispensable.

There are several approaches to making an international investment. The major ones are as follows:

Set up an affiliate

An affiliate, sometimes called a subsidiary, is simply a company you establish in a market to serve your interests there. It operates as a local business with respect to regulations, laws and taxes, and is the most common vehicle that Canadian companies use to invest abroad.

[2] Franchising, licensing and production outsourcing don't count as investments, since they don't involve an actual investment on your part.

In general, an affiliate's size is unimportant; you may simply want to establish a legal presence in the market, or you may intend to build a full-scale manufacturing firm with many employees and millions of dollars in annual revenues. Even a small affiliate, however, has advantages; not only will it give your customers a place where they can deal with you directly, but it will also reassure them of your commitment to the market.

Most Canadian companies use their affiliates to sell their goods and services locally; others use them to warehouse Canadian-made products for local distribution, or to produce goods for the target market. Affiliates can be especially important if you're a service business—depending on the local rules for foreign investors, you may have to establish a company in the market before you can deliver your services there.

Governments vary widely in their attitudes to foreign-owned affiliates. Some are welcoming and offer incentives such as tax and duty relief, simplified customs clearance, development financing, real-estate price reductions, long-term land leases and warehousing and logistics facilities. Others may treat foreign-owned businesses unfavourably compared to local ones—by imposing heavier taxes, for example, or by putting some sectors of the economy out of reach. Some governments don't allow wholly owned foreign affiliates at all, and you'll have to set up some kind of partnership with a local firm if you want to operate within the country. The most common ways of establishing an overseas affiliate are to acquire or merge with a local company, or to build a brand new facility from the ground up.

Acquire or merge with a local company

In this approach, your company invests by buying some or all of a local company's shares and/or assets. To qualify, the level of ownership has to be large enough to give you influence over that company's activities. A general rule of thumb is a minimum of 10 per cent.

Typical reasons for acquiring a company are to tap into its revenues or to obtain its technologies. Acquisitions are complex, though, and require careful due diligence as well as expert legal, accounting and tax advice.

Mergers are a little different. In a merger, you combine your existing business in that market with a local one. The new business then functions as a wholly owned affiliate of your Canadian parent company. Like acquisitions, mergers are complex and must be handled carefully.

Acquisitions and mergers can be the fastest ways to enter an international market. The advantages are:

- You secure immediate access to an established market.
- You acquire the company's knowledge base, technology, customers, suppliers and workforce.
- Licensing and compliance requirements are already met.
- You don't need to establish a brand.

Their disadvantages can be:

- You pay too much for the other company's shares or assets because you're not familiar with the market.
- Cultural differences may make it difficult to manage the new business.
- You may need to upgrade the company's technology, workforce or operational processes, and train both local and Canadian management to run the new firm.
- The merger/acquisition process may turn out to be longer and more expensive than you planned.
- Integrating the business processes or technologies of the Canadian and local companies can be challenging.

Build from the ground up

This can be the most complex and expensive way to set up an affiliate. It involves acquiring real estate, building your facility, hiring personnel and (if it is a manufacturing plant) installing machinery and ramping up production. It could provide you with major advantages such as these:

- You get exactly the facility you need in terms of equipment, marketing, finance, R&D, logistics and purchasing.
- You have complete control of the business, its branding, staffing and long-term strategy.
- The local government may provide investment incentives such as tax breaks, reductions in real-estate costs, lower import fees and various forms of administrative relief.

The ground-up approach does have drawbacks, however, including these:

- It can take a long time to build the facility and make it profitable.
- It is expensive and may require hard-to-find financing.
- If the government isn't particularly investor-friendly, you may find yourself at a disadvantage compared to local competitors.

Set up a strategic alliance

A strategic alliance is a cooperative arrangement between two or more businesses and is designed to achieve a shared goal. It can take many forms, such as technology transfer agreements, purchasing and distribution agreements, marketing and promotional collaboration or joint product development.

Strategic alliances are also intended to share risk, which requires a considerable level of cooperation and trust between the two companies. Investing in such a relationship can help you expand your business in the market and gain access to resources that would be very difficult to get on your own.

In general, strategic alliances offer the following advantages:

- You get immediate access to your partner's customer base, distribution networks, market knowledge and expertise. As a result, you can increase your market share much more quickly than you could by going it alone.
- Because your partner's strengths complement yours, you can focus on your core business.
- You reduce exposure to market risks by sharing them with your partner.

There are some drawbacks, including the following:

- You'll have to split the profits, reducing your return on your investment.
- The relationship may go downhill, leading to business disputes and/or damage to your position locally.
- You may lose control over the direction of the partnership if your partner is the larger company and decides to override your decisions.

Set up a sales or marketing office

If all you need is a basic presence in the market, opening your own sales or marketing office (sometimes called a branch office) may be the answer. In most countries, these offices are restricted to basic tasks such as market research and identifying customers. Other business activities, such as placing orders, signing contracts, collecting payments or issuing invoices, may be off limits.

If your office does more than the regulations allow, even accidentally, it may be reclassified as an affiliate of your Canadian company. It is then subject to local taxes and corporate regulations, possibly to your disadvantage.

Setting up a sales or marketing office has several advantages:

- You have greater control of your business activities in the local market.
- The office provides a point of communication and marketing for customers.
- It's easier to attract customers who want to deal exclusively with a local representative.
- Expansion is easier if you already have a foothold in the market.

On the downside, there are several legal and financial issues associated with setting up a local sales office. For example:

- Local sales offices can be expensive to establish and operate.
- If you use local employees, you have to comply with foreign labour codes and standards.
- If you send Canadians to work in the office instead, you'll come up against immigration issues such as restrictions on using non-local labour.

In some jurisdictions, setting up a sales office has no real advantages over establishing an affiliate. Make sure you get professional advice before assuming that a sales or marketing office is the local presence you need.

UNDERSTANDING THE RISKS

Investing in international markets, especially emerging markets, always involves some risk. Here are some that you could face:

Changes in local laws and regulations

One example is a government imposing tougher performance requirements for your locally manufactured product. If there are large-scale regulatory changes, your local operations might become less profitable or even unviable. To help protect your company, you should:

- abide by all local laws and regulations;
- closely monitor corporate and social responsibilities;
- consider operating or investing in countries where Canada has good relations or has signed a bilateral trade agreement; and
- ensure that your affiliate's relations with local governments are open and transparent.

Import restrictions

New import restrictions (on the materials your affiliate uses to produce goods, for example) could seriously disrupt your operations or even cause your affiliate to collapse. This risk can be handled in the same way as the risk of changes to laws and regulations.

COUNTRY RISK AND INTERNATIONAL INVESTMENT

Doing business in international markets, especially emerging markets, always involves some risks. These can range from changes in local investment rules to new import restrictions, and even to political violence. Trade analysts often refer to these hazards collectively as *country risk*—the overall risk, in a particular country, of not getting paid, or of being unable to complete a contract.

Successful businesses use a two-pronged approach to managing their country risk and its possible effects on their investments. First, they learn as much as they can about the market so they can accurately identify its top risks and estimate their potential severity. Second, they find ways to *reduce the probability* of the risks occurring, and then take measures to *reduce their effects* if they do occur. To find out more, refer to EDC's new white paper on ***Dealing with Country Risk***.

Restrictions on moving money to Canada

These restrictions (often referred to as currency transfer and conversion risks) may prevent your affiliate from making payments in hard currency back to your Canadian company, or to its suppliers and lenders. This means, essentially, that you don't get paid, you get paid late, or your affiliate's suppliers and lenders turn you down for future support because they're not getting paid either.

Since this risk is usually driven by events beyond your control, managing it can be problematic. Your best protection is to avoid holding cash abroad unnecessarily, and to avoid isolated transfers of large amounts of money to Canada—instead, move smaller amounts more often.

Breach of contract by a government

A contract with a local government may expose you to hazards such as non-payment, unilateral price and/or quantity changes, or outright contract cancellation. To manage this risk, you should:

- make sure the contract was awarded in a transparent manner;
- make sure the contract does not unduly favour your company (or your affiliate, in the case of a local investment); and
- diligently observe all contract obligations and all laws regulating contracts. Ensure that your contracts include clear terms on pricing, steps to resolve a dispute, termination conditions and payments.

Expropriation

Outright expropriation rarely occurs today, but you might encounter a related problem. Sometimes called "creeping expropriation," this happens when the local government gradually interferes with your property rights—for example, by steadily increasing taxes or by making it increasingly difficult to transfer your profits back to Canada. This risk can be handled in the same way as the risk of changes to laws and regulations.

Political violence

In this situation, your affiliate may be destroyed or ongoing violence may force you to abandon it. Even if the affiliate's business is only interrupted, the affiliate or its customers may default on their payments or contractual obligations.

To reduce this risk, you should:

- select local partners and customers whose familiarity with their business and the local political situation can help you avoid trouble;
- have contingency plans in place to move equipment and inventory out of harm's way; and
- ensure that the terms of your contracts reflect the risk of political violence.

Resources for assessing risk

There's a lot of publicly available information to help you assess the risk of investing in a particular market. Some of these resources include the following:

- Export Development Canada (**EDC**) provides a wealth of **economic analysis and research** that you can use to examine more than 170 overseas markets. The ***Country Risk Quarterly***, for example, provides risk information on more than 100 countries.
- The World Bank Group's **Doing Business** website examines business regulations for local firms in 189 economies and in selected cities worldwide. The **rankings** section looks at the ease of doing business in these places, ranging from starting a company to enforcing contracts.
- Also supported by the World Bank, the **Worldwide Governance Indicators** site provides information on 215 economies in the areas of accountability, political stability, government effectiveness, regulatory quality, the rule of law and corruption.
- The Country Commercial Guides available from the **U.S. Commercial Service** offer up-to-date, detailed information about a huge range of world markets. They're available through the service's **market research portal**.
- The **Global Competitiveness Report** ranks the competitiveness of 144 countries using 12 criteria that include institutional strength, infrastructure, education, training, technological readiness and innovation. Many of these indicators, such as the infrastructure and financial market development rankings, can be very useful for investors.

HOW EDC CAN HELP

EDC offers **customized solutions** to support Canadian businesses at every stage of their international investment program, from making the initial investment to protecting and growing it.

Growing your operations

No matter how big or small your company, EDC can make it easier to get the cash and market knowledge you need to **grow your business** internationally. We offer a full range of **international financing**, **lending** and **market intelligence** solutions that can help you:

- **Get established in a high-potential market.** We can provide your bank with a guarantee of up to 100 per cent so you can secure a loan to make or grow an investment outside Canada, such as setting up an overseas manufacturing facility.
- **Access more cash.** When the sales in your international operations are insured against non-payment, your Canadian bank can lend against all of your invoices for up to 90 per cent of their value. This can help you increase your working capital under your Canadian operating line.
- **Post standby letters of credit without tying up your working capital.** We can provide your bank with a 100 per cent guarantee for standby letters of credit posted on your behalf. There is no impact on your working capital because the bank doesn't need collateral from your cash reserve or credit line. This support can be provided to your bank in order to support the operations of your Canadian company or your foreign affiliate.
- **Secure a line of credit from an international bank.** We can guarantee up to 100 per cent of a standby letter of credit from your bank, helping you to obtain a line of credit from a bank outside Canada.
- **Borrow against the value of your international inventory.** We can provide your bank with a guarantee of up to 100 per cent so it can lend against the value of your international inventory.
- **Use your international assets as security for a loan.** We can offer a direct loan against your international assets so you can make an investment outside Canada.
- **Get the market knowledge you need to grow.** Through our representatives in 12 high-potential markets around the globe, we can provide you with market intelligence and the opportunity to form overseas partnerships.

Protecting your operations

EDC offers a full suite of solutions to **protect your operations** against risks such as not getting paid, foreign exchange restrictions and legal and regulatory changes. With our help, you can:

- **Prepare for risks before you invest.** EDC understands the complexities of high-potential markets and can help you protect your credit and cash flow. This can reduce the impact of commercial and political risks over the lifetime of your investment.
- **Protect against not getting paid.** EDC can cover losses caused by a wide range of risks such as payment delays, customer bankruptcy or contract cancellation. Insuring your international operations against bad debt can mean a more secure profit margin and more borrowing power.

- **Protect your assets or cash accounts.** EDC solutions can help you deal with political risks such as government expropriation, political violence and the inability to move your money out of the country.
- **Maximize potential and minimize risk.** We can protect your investment against political risks, which can make your international operation more attractive to lenders or partners. This may give your bank the comfort it needs to provide a loan or extend your credit to support your investment goals.

Financing. Asset protection. Market expertise. Risk management.

To find out how EDC can help, call our Solutions toll-free number at 1-800-229-0575, or go online and **submit a question.** We'll answer your inquiries within one business day, weekdays between 9 am and 5 pm EST.

For more information, please visit **edc.ca**

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