WHITE PAPER

Canadian Affiliates Abroad: Impacts and Opportunities

Canada

EDC
Realize a World of Opportunity

TABLE OF CONTENTS

INTRODUCTION

This paper is based on an EDC survey that examined the activities of export-oriented Canadian companies and their affiliates outside Canada. The research covered areas such as the motivations for using affiliates, the impact of affiliates on the parent firms and the challenges associated with affiliate use.

There were 546 respondents to the survey, which was carried out in July 2015. Of these, 44 companies were members of the EDC Research Panel and 502 came from the Angus Reid Forum.

Except as otherwise noted, the statistics used in this paper were drawn from the following EDC documents:

- *Foreign Affiliates Research: Research Panel Report* (November 2015)
- *Foreign Affiliates Research: Full Report* (November 2015)

1 THE GROWING ROLE OF CANADIAN AFFILIATES

An affiliate is a company that a Canadian firm establishes in a foreign market to serve its interests there. Although it is owned (or partly owned) by the Canadian parent, the affiliate operates as a local business with respect to regulations, laws and taxes.

Until the early part of this century, our exporters tended to sell their goods and services directly from Canada to their customers abroad. Foreign affiliates existed, but these accounted for a relatively small proportion of overseas sales compared to the more traditional, direct approach. Since 2002, however, this situation has been changing. According to a recent Statistics Canada **report**, the overseas affiliates of Canadian companies generated sales of almost 510 billion[1] during 2013 alone. This compares very favourably with our traditional goods and services exports for the same year, which totalled about 588 billion.[2]

The affiliate strategy, consequently, is becoming an important alternative or complement to direct-sales exporting for Canadian companies. That said, most businesses that engage in international trade do not see traditional exporting and the use of affiliates as mutually exclusive. Many companies, recognizing that one can often be an excellent supplement for the other, do both.

[1] All currency figures in this paper are in Canadian dollars.

[2] This figure was obtained from the **International Commerce By Country** database maintained by Global Affairs Canada.

1.1 Motivations for using affiliates

The 546 businesses examined in the survey use overseas affiliates for several clearly defined reasons. The following motivations were the most cited:

1.1.1 Increase sales via new customers and/or markets

Well over half (59 per cent) of the respondents reported that they establish foreign affiliates to increase their business in a target market where they are already operating. Almost half (47 per cent) do so to support their expansion into new international markets.[3]

1.1.2 Become closer to customers

This was a key motivation for 41 per cent of the companies surveyed. Geographical proximity of an affiliate to its customers can have several advantages, such as simpler logistics, easier provision of after-sales support and elimination of time zone/communications problems.

1.1.3 Lower costs

One-third (33 per cent) of the respondents saw lower costs as a major incentive for using affiliates. This would include expenditures for goods and services such as production inputs, transportation, material capital, labour and freight. For labour in particular, it is standard practice that Canadian firms often establish affiliates to benefit from the wage differentials between Canada and their target market.[4] Using affiliates can also be preferable to outsourcing as a way of reducing labour costs, since outsourcing can deprive the company of full control over its products.

1.1.4 Better access to supply chains and regional trade networks

More than a quarter (28 per cent) of the companies see this as an important motivation for using affiliates. The presence of an affiliate in one market, for example, may provide access to markets in neighbouring countries. This in turn can open a door to new global/regional supply chains and networks.

1.1.5 Increased productivity

This motivation was cited by 24 per cent of the respondents.
This probably reflects what a number of studies have shown, which is that investing abroad allows companies to specialize, to allocate their global activities more efficiently and to expose themselves more directly to global competition—all of which tends to boost productivity.[5]

[3] Many of the survey questions allowed for multiple responses. As a result, percentages in some categories add up to more than 100 per cent.

[4] Phoenix Strategic Perspectives, *Working Paper on Canadian Direct Investment Abroad* (Export Development Canada, April 2013), p. 12.

[5] Ibid., p. vii.

Several other motivations for using affiliates were cited, but by fewer than 20 per cent of the respondents. These included increased access to physical resources, reduced trade barriers and regulatory issues, and better access to human capital and new technologies. Only a handful (14 per cent) said that a low-tax environment is an incentive for establishing an affiliate.

2 A PORTRAIT OF CANADIAN AFFILIATES

The survey indicates that overseas affiliates occupy a robust position in the operations of Canadian goods and services exporters.

2.1 Number and longevity

Fully 65 per cent of the respondents have at least one affiliate that produces and/or sells goods, while 64 per cent have at least one affiliate that provides services. Moreover, 15 per cent of the surveyed companies plan to establish some kind of affiliate outside Canada within the next five years.

Most of these companies by no means restrict themselves to one affiliate each. A sizeable proportion (28 per cent) have 11 or more of these operations abroad, while another 24 per cent maintain four to 10 affiliates. Roughly a quarter (27 per cent) have two or three affiliates, and 22 per cent make do with one.

For the majority of the companies, their affiliate operations are familiar terrain; 61 per cent of the firms have used them for 10 or more years, and another 19 per cent for five to 10 years.

2.2 Sector identification, parent company location and size

Most of the companies with affiliates are in three market sectors: infrastructure and environment (37 per cent), light manufacturing (34 per cent) and information and communications technologies (21 per cent). The extractive, transport and resources sectors account for most of the rest. Almost half of the parent firms (46 per cent) are in Ontario, while the West is home to 33 per cent. Another 15 per cent are in Quebec, with the Atlantic provinces at 5 per cent.

Looking at the data from a purely services perspective shows that overseas affiliates perform a variety of functions in this sector. Sales, after-sales and call centre services rank first, with 46 per cent of the respondents operating these types of affiliates. Another 41 per cent have affiliates doing business development, marketing and market intelligence. Engineering and technical services are a strong third at 40 per cent. This last result likely reflects the substantial number of affiliates operated by the infrastructure and environment sectors.

As for the size of these companies, 63 per cent are large firms with annual sales exceeding 50 million, while 22 per cent are medium-sized businesses with annual sales of 10 to 50 million. Small companies, with annual sales of under 5 million, make up the remaining 15 per cent.

2.3 Preferred affiliate structures

On the structural side, these companies prefer to establish wholly owned affiliates: 57 per cent take this approach. Another 20 per cent have a majority stake in an overseas business, while 16 per cent are satisfied with a minority stake.

Some firms (15 per cent) merely maintain a representative office; while this type of local presence cannot normally do everything an affiliate can (such as selling to customers or producing goods), it is clearly adequate for some companies' purposes. A final 10 per cent of the respondents did not specify the structures of their affiliates.

2.4 Overseas locations of affiliates

Most of the companies (73 per cent) have affiliates in the United States. Runners-up are the United Kingdom, where 39 per cent of the respondents operate affiliates, China (34 per cent) and Australia (27 per cent). It may be worth noting that the bulk of the affiliates (90 per cent) were located in only 21 countries. Some of these, of course, are among the world's largest markets.

Examining the data from a market perspective reveals that 90 per cent of the companies maintain affiliates in developed economies. For emerging markets, the corresponding figure is 65 per cent.

2.5 Challenges of operating affiliates

Regulatory issues, according to 17 per cent of the respondents, are the single biggest challenge of operating affiliates abroad. This reflects the problem of complying with local laws and regulations, which can be less transparent than their Canadian equivalents. Human resources, cultural differences, exchange rates and distance-related communications difficulties were each reported as challenges by 11 per cent of the companies.

Interestingly, however, a full 38 per cent of the respondents said that their foreign affiliates do not encounter any challenges to their local operations. This, together with the relatively low severity of the difficulties that were cited, suggests that operating overseas affiliates can be reasonably trouble free for many companies.

3 IMPACT ON COMPANIES

A majority of the respondents said that their foreign affiliates have a positive impact on the company in areas ranging from sales to competitiveness.

3.1 Major benefits

For the most part, these companies believe that they benefit from their use of overseas affiliates, with 44 per cent reporting a highly positive impact on total sales. Another 43 per cent saw slightly positive effects, and 9 per cent reported no impact. Only a handful (4 per cent) said that their affiliates had a negative effect on sales. For the impact on the firms' customer base, overall profits and growth, the percentages were similar: 40–42 per cent reported a highly positive impact, 40–44 per cent reported a slightly positive effect, and 11–14 per cent said there was no impact either way. A mere 5–7 per cent saw negative results.

The overall positive effects were most marked for larger companies, for companies that sold goods *and* services (rather than goods alone), and for companies that have been operating affiliates for more than a decade.

A strong majority (92 per cent) also reported that their company is more competitive because of their affiliates. This is likely an incentive (although not the only one) for these businesses to expand their affiliate networks, and many are planning to do so. This also bears out what other studies have found: that exposure to a global market can allow companies to improve their performance, thereby becoming more competitive.[6]

Last but far from least, most respondents were highly positive about both the past and future performance of their affiliates. A full two-thirds of them (67 per cent) reported increased affiliate sales during the past five years, while 76 per cent expect these sales to grow further during the next five.

3.2 Sales by country and market

Not surprisingly, 75 per cent of the respondents said their foreign affiliates sell products or services in the United States, while 44 per cent reported that their affiliates sell in the United Kingdom. For China, the corresponding figure is 37 per cent, for Germany, 32 per cent and for Australia, 32 per cent. Mexico, interestingly enough, trails behind Australia despite its NAFTA membership, with only 29 per cent of the respondents reporting that their affiliates sell in the Mexican market.

The distribution of sales by market, as might be expected, favours the developed countries—93 per cent of the respondents have affiliates that sell in these markets, versus 68 per cent that sell in emerging economies. Looking in more detail at the latter markets, 59 per cent of the affiliates sell in Asia, 47 per cent in South and Central America and 32 per cent in the Middle East and Africa.

[6] Ibid., p. ix.

4 GROWTH OPPORTUNITIES

The survey data shows that many Canadian exporters see their affiliate networks as offering important opportunities for sales growth and company expansion.

4.1 Growth potential of existing affiliates

When asked which of their existing affiliates has the best growth potential, 42 per cent of the respondents put the United States into the top rank. China is in second place, with 19 per cent of the companies that have Chinese affiliates seeing it as their major growth market. The United Kingdom, Mexico, India, Australia and Brazil place considerably behind China—only three to four per cent of the respondents with affiliates in those markets see them as having top growth potential.

4.2 Growth potential of new affiliates

During the next five years, half of the respondents intend to set up new affiliates in order to expand their affiliate networks. The most important goal for these affiliates, as reported by 67 per cent of the firms, is to increase their sales and business in their target market(s). Increasing their product offerings is the objective of 56 per cent, while the expansion of physical resources is the goal for 55 per cent.

Companies with expansion plans also tend to be firms that already have a large number of affiliates. This suggests that a broad experience with affiliates may encourage businesses to establish more of them.

4.3 Locations of new affiliates and commercial partnerships

A significant number of the respondents (29 per cent) said that their companies intend to establish new affiliates in key markets. Of these firms, 21 per cent plan to start affiliates in China, followed by India (20 per cent), the United States (20 per cent) and Brazil (16 per cent).

In a related category, 17 per cent of these companies reported that they intend to establish commercial partnerships (rather than affiliates) in new countries.[7] China again is the preferred choice of these respondents, with a quarter of them targeting the Chinese market. The United States is tied with China at 25 per cent. Runners-up are Brazil (22 per cent), Germany (18 per cent) and France (16 per cent).

In a broader perspective, emerging markets are the most common targets for companies that wish either to create new affiliates or to establish new commercial partnerships. Of the businesses that fall into these two categories, 74 per cent intend to set up new affiliates in emerging markets, versus 59 per cent who expect to do so in developed markets. For the establishment of new commercial partnerships, the figures are closer: 76 per cent of these companies are targeting emerging markets, while 72 per cent intend to go to developed markets.

[7] These partnerships include arrangements such as licensing, distribution, franchising and subcontracting.

A regional breakdown of the target locations for new affiliates also shows a general preference for emerging markets. When choosing regions for these affiliates, 64 per cent selected Asia, followed by South and Central America at 42 per cent, Europe at 37 per cent, and the Middle East and Africa at 25 per cent. The United States, a prime example of the developed market category, is last at 20 per cent. This likely reflects the fact that most of the surveyed companies already have U.S. affiliates and, consequently, are not inclined to set up new ones there.

5 FOREIGN AFFILIATES AND THE DOMESTIC SPHERE

The use of foreign affiliates affects both the Canadian parent companies and Canada as a whole. The respondents were surveyed in both these areas.

5.1 Benefits for parent companies

Most respondents (69 per cent) reported that their domestic operations are important in supporting their foreign affiliates. Two in five, in fact, said that their domestic activities are *very* important in this role.

The most important area of domestic support, as reported by 54 per cent of the companies, is made up of business development, marketing and market intelligence. In second place, cited by 43 per cent, is research and development. Ranked third, fourth and fifth respectively are engineering and technical services (43 per cent), sales and after-sales services (42 per cent) and ICT services (42 per cent).

It can be argued that these levels of domestic activity would be lower if the companies had no affiliates. Conversely, this suggests that because they *do* have affiliates, they need to significantly increase their business activities within Canada in order to support these operations. In other words, affiliate growth can lead to domestic growth for a company and thus encourage the development of larger Canadian enterprises.

5.2 Consequences for Canada

More than half of the respondents (58 per cent) agree that using foreign affiliates has positive economic and social results for Canada. Sustaining domestic businesses and creating employment opportunities were the benefits most frequently mentioned by the companies.

Only a minority of the respondents (14 per cent) saw the use of overseas affiliates as having negative consequences for the country. Of these, about half cited loss of jobs as the main drawback, and about a fifth said that using affiliates could divert attention and resources from domestic operations.

6 HOW EDC CAN HELP

It is interesting that only a quarter of the respondents said that the Government of Canada can or should help their affiliates grow and succeed. In contrast, 46 per cent did not believe that the government was capable of assisting them at all (in this area, at least), and a further 28 per cent did not feel that the government *should* help companies develop their affiliate networks.

For the minority that did see government help as potentially useful, the most-reported need was for financial assistance. This, of course, is EDC's basic role. As Canada's export credit agency, it is well positioned to offer support for companies that want to create and/or expand their affiliate networks, especially by means of its **Direct Lending** facilities. EDC's **Working Capital Financing** can also help exporters make international investments, including investments in overseas affiliates.

7 SUMMARY AND CONCLUSIONS

The research shows that most Canadian companies see their overseas affiliates as providing a net benefit to the company as a whole, and that many of these firms intend to expand their affiliate operations as a result. In more detail:

- Canadian companies generate almost as many sales via their affiliates every year as they do via their traditional goods and services exports. The affiliate strategy, consequently, is becoming an alternative or complement to traditional exporting for many Canadian firms.
- The surveyed businesses use overseas affiliates for several clearly defined reasons, ranging from increasing sales to increasing productivity.
- Affiliates occupy a robust position in the operations of these companies. The majority have more than one affiliate, and some maintain well over 10. Most of these affiliates have been operating for more than five years.
- A clear majority of the respondents said that their foreign affiliates have a positive impact on the company in numerous areas. Specific benefits include higher sales, a larger customer base and increased competitiveness.
- Many Canadian exporters see their affiliate networks as offering important opportunities for sales growth and company expansion. When asked which of their *existing* affiliates had the top growth potential, these companies cited their operations in United States, China and the United Kingdom, in that order. The most-reported targets for the establishment of *new* affiliates were China, India, the United States and Brazil.

- Most respondents reported that their domestic operations are important or very important for supporting their foreign affiliates. This implies that the use of affiliates may significantly increase a company's business activities within Canada and thus encourage the development of larger Canadian companies.

- Well over half of the respondents agreed that using foreign affiliates has positive economic and social effects for Canada. Sustaining domestic business and creating employment opportunities were the benefits most frequently cited by the companies.

Financing. Asset protection. Risk management.

EDC can help you with all these and more:

- Need financing to grow your international business? We can help you **find it**.
- Want to protect your foreign receivables? We can help you **secure them**.
- Need to manage risks abroad? We can help you **control them**.

To find out more, 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**

Ce document est également disponible en français.

Canada

EDC

Realize a World of Opportunity