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Global considerations for mid-market companies

Form and function
Defining the investment

This article is part of a series devoted to global expansion considerations for US businesses, particularly those in the middle market segment

Standing up an overseas expansion happens in stages. First an organization articulates *why* it wants to make the move. Then it determines *where* the new operation should be located. After that, the next question is *what* form it should take. The structure of an investment has many implications that cascade into other decisions and define what options will or won't be available for years to come.

Defining the investment considers questions like growth strategies; the choice of legal entity type; the capital structure; its use of investment funds; the way it manages transfer pricing, fixed assets, and inventory; and the tax environment. In order to get to these answers, an organization must have a strategic plan in place to achieve the business goals set for an expansion.

Should the expansion be inorganic or organic — a buy or a build? It depends, among other factors, on what the parent organization aims to achieve, and what its sense of acceptable risk and return is. If pressing customer demand or some other force makes the move a "must-have," it may be more advisable to take the leap of an acquisition. If instead the plan is for steady growth, and the parent company intends to moderate risk by making adjustments over time, building the new investment in stages, perhaps even with a joint venture partner, may be the appropriate course.

That decision will set up the opportunities that come next. Growing an organic operation has its advantages and difficulties, while integrating a post-M&A structure that's expected to perform right away presents a different set of opportunities and challenges. Deciding whether to buy or build depends on market need and risk appetite.

Mergers and acquisitions

M&A is both a high-level question from a growth strategy perspective and a detailed one on the execution and integration front. It may be the method through which the new investment comes into being in the first place. Whether M&A is the method to launch an overseas investment or a strategy for solidifying a presence in the new market, the process should include some familiar considerations and some new ones that are specific to cross-border deals.

Upon entering the market, it is important to know which competitors are operating there – and review the potential opportunity to acquire them. Consider strategic merger or alliance opportunities in the new environment. As with any potential inorganic growth move, it's vital to be particular about target identification, pricing, and due diligence.

Doing M&A across national boundaries adds steps and complexity. For one thing, the desired end-state entity should align with the home company's global needs as well as local-market strategy, and the calculation of merger synergies should also work on a global basis. And because an acquisition is an investment, it is critical to know the local rules that govern it. Once the transaction is complete, significant integration challenges can be expected — for example, treasury integration tasks may include a re-examination of the capital structure, credit quality and ratings, and funding operations that support the business; the establishment of new banking relationships and credit lines; and the task of integrating or standing up new treasury technology strategy. That can include new bank interfaces and payment files, which require long lead time to set up.

Legal entity

Depending upon the laws in each jurisdiction, a new or acquired overseas expansion can take one of many forms: joint venture, licensee, franchisee, branch, subsidiary, or partnership. Each has a different potential to carry out the business objectives that led to the decision to make the investment in the first place, and each one requires different steps to establish.

With a strategic vision not only for the inception but also the long-term operation, companies should consider the governance structure that each potential entity type would require to function effectively and assess whether the choice will affect employment feasibility, not only in the new location but also in the ways that location interacts with other parts of the global enterprise. Companies should be comfortable with who will be responsible for the new entity by establishing the requirements for directors, shareholders, and key executives.

Some requirements might not be apparent at first glance. For example, in some South American and European countries, certain entity types must publish their financial results.

While assessing local laws in the target location, it is important to perform a similar check of US tax regulations. The choice of certain overseas legal entities can affect a company's US tax flexibility. Certain legal entities are per se corporations for US tax purposes, while others are eligible to elect their US tax entity classification status.

Once a legal entity is chosen, consequences of that decision may be locked in and additional costs to change may be incurred. Retention of 100 percent ownership of the new operation may not always be practical, or in some cases even legally possible.

When deciding on legal entity structure, the impact on treasury strategies and operations should be evaluated. Will a joint venture structure limit the co-mingling of cash in pooling structures? How will the functional currency choice of the entity affect treasury foreign exchange exposure management strategies? How will the new legal entity structure fit within the existing treasury in-house bank design and operating model? Will it be tax efficient? What updates to existing bank accounts and structures are needed — and will executing those changes create an additional administrative burden? Are there any potential impacts to existing credit arrangements with banking partners or to the scope of credit availability?

Capital structure

Just as the structure of the business must align with business objectives, so must the structure of the capital associated with it. Factors such as equity, cash, debt, and interest rates all combine to determine what resources will be available to carry out operational objectives.

In some places, the initial investment must reach a certain threshold to qualify for certain incentives, while the business' own needs may be an even more central determinant of how much to invest at the start. What are the minimum capital requirements, and do external considerations call for more than that? The implication of that decision varies from place to place.

Each jurisdiction has different rules with respect to tax deductions for interest, which means certain types of instruments may give rise to interest deductions subject to local country tax limitations. As such a company's decision on balancing between debt and equity may have significant consequences and provide the opportunity to lower the group's worldwide tax rate. Determining the currency in which the debt is denominated can carry significant accounting, legal and tax implications.

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Future cash planning should be considered. If there arises a need to move cash out of the new overseas structure, what will the vehicle be and what are the potential tax costs to doing so? Through debt, as equity, or via a hybrid instrument? Is the legal entity structure set up to allow the efficient repatriation of cash? Should the new investment be placed under an efficient holding company structure? This is another area in which day-one decisions may lock certain options in or out down the road.

Use of investment funds

When funds are put into a foreign location, how, when, and whether they can be repatriated are key considerations. It may make a great deal of difference whether necessary financing originates locally or crosses the border from the parent company's home jurisdiction.

Factors that influence the use of investment funds include repatriation, further capitalization, the potential need to borrow or lend, exchange rates, and the larger treasury needs of the global organization.

To find the stance that accommodates those forces, companies can start by identifying the new entity's expected working capital needs and assessing the new entity's role in the organization's global treasury and tax strategy, including implications for liquidity management, FX exposure management, and intercompany financing. As capital investments that may be required in the future, questions to consider include: how much money will have to move, and when; what is the functional currency of the entity; and are there local-country currency restrictions that may change the financing choice of currency and sources of investment funds? A plan should be established for the deployment of excess cash in an efficient tax manner to mitigate the potential for dilution of performance by local rules or the movement of cash to be subject to high taxes.

Transfer pricing, fixed assets and inventory

A manufacturing location may have obligations around duties and customs for raw materials coming in and finished products going out. So may an overseas location that operates under a distribution arrangement. But that's only one of many possible ways in which the location and movement of assets contributes to a business strategy.

The way a new entity will fit into the parent company's global structure helps determine when and where assets will need to move. From that point, an organization can assess the new entities and anticipated transactional flows in light of local rules. What will compliance look like? What systems will be necessary to support compliance? And what documentation requirements apply? Are the prices arm's length under transfer pricing principles, including related and third-party transactions in addition to ones that begin or end directly with the new entity?

Direct and indirect tax environment

Almost every decision associated with an overseas investment's establishment, structure, and operation has some tax implication. But there are specific ones that require attention when setting up a new location overseas. Remember that in some cases, the measure of an entity's income tax strategy is the resulting cash taxes paid and/or the effective tax rate. For companies considering EBITDA and cash flow as a measure of performance, some taxes, such as indirect taxes, can also increase the costs and lower operating margins and EBITDA if these costs cannot be passed on to the customers.

What local tax laws apply to the entity's transactions? What are the opportunities for deferral, and does the new jurisdiction offer any temporary or permanent advantages in exchange for bringing the investment within its borders? Does the form of the business shape its tax profile?

Because tax permeates so many other questions, it is important to know the environment as well as possible. Competitors in the same market will likely face the same questions, and decisions around implementation could cause a competitive advantage or disadvantage.

Conclusion

The overall purpose of a global expansion is to achieve the business objectives and goals of the global organization. The decisions that define the tax, legal, capital, and material structure of that expansion investment will have an impact on the organization's ability to meet its goals relating to the expansion. The challenge is to balance that big-picture view with the fine-print attention it takes to satisfy local rules and make the most effective use of local circumstances. Once the intended function of a new overseas investment is established, that determination can serve as a guide for all the detailed decisions that follow.

Perspectives

This report is the third in a series on global expansion and just one example of Deloitte research on topics of interest to mid-market private companies. Presented by Deloitte Growth Enterprise Services, Perspectives is a multifaceted program that utilizes live events, signature reports, research publications, webcasts, and other vehicles to deliver tailored and relevant insights in an integrated fashion.

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