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Global considerations for mid-market companies

International expansion
A passport to growth?

Expanding into global markets can offer companies of every size opportunities to diversify their operations, reach new customers, and tap into new sources for materials and talent. This article is the first in a series that will focus on issues that mid-market companies should address as they consider global expansion, including: strategy and business model, finding the right location, financing and enhancing the investment, regulatory requirements, and securing and managing talent.

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

Global expansion can be an attractive prospect, often on an emotional level. But making it work means asking tough questions, accepting only realistic answers, and making choices in the right order. What does the company hope to gain? What would happen if the company didn't grow, or grew in another direction? There is a lot of "what," "how," "where," and "who" involved when considering a business expansion across international boundaries. But the first question has to be "why."

Why expand internationally?

A company may expand into an overseas market to build revenue through increased sales, to cut costs by moving closer to sources of material and labor, or to build the reach and eminence of a valuable brand. It may be a combination of factors. To become a global player may be a dream, but to do so sustainably is an exercise in reality that requires clear goals and a well-defined strategy to meet them.

What is realistic?

To company leaders ambitious for growth, global expansion may shine in the imagination as a promised land of boundless opportunity. Frontiers — and the global economy in which many of today's leaders grew up — can inspire such thinking. But are those new markets as big as you think they are? Do they truly offer the business opportunities you imagine? Have you added up what the expansion effort will cost, and do responsible projections show the return will be worth it?

What is the method?

Just as with domestic expansion, there is more than one pathway into a foreign market. A company may expand through organic growth, building on relationships that began on a long-distance basis and establishing offices (or plants, warehouses, or whatever applies) that bring those relationships closer. It may expand at a single stroke via an M&A transaction. It may license franchise rights. Or it may embark on a joint venture. The way a company chooses to cross a border determines the way it will do business once it's on the other side.

What haven't you thought of?

It's structurally impossible to be certain of the answer to this question, but trying to answer it is an invaluable exercise. In practice it means research, reaching out to people on the ground, and thinking as many steps ahead as possible. The time and cost associated with setting up new infrastructure may vary greatly depending upon variables like the local regulatory regime or the local talent pool. Moving money and other resources where they're needed may be slower, or more difficult, or more costly, than at home. Visions of material speeding through a new supply or delivery chain may shatter against the reality of long delays in bonded warehouses. Whenever you think you've cornered all the "what-ifs," you haven't.

No matter what a company's rationale for expansion or its starting point, it must approach the process with deliberation. This isn't an impossible challenge — the many effective expansions that other companies have made testify to that. But history also contains less encouraging examples that show it's a case for careful attention to detail. The right strategy can help shape the many specific judgment calls a company will have to make.

The macro forces that affect an overseas expansion aren't all overseas. Considerations within the United States also shape the calculus.

To take just two examples: Life sciences companies facing margin pressures in developed countries are beginning to accelerate efforts to enter emerging markets. Or consider the case of a joint venture with a non-US company whose long-established business practices need to be brought into compliance with the US Foreign Corrupt Practices Act, national security protocols, or other regulations. An expanding US company may find a third of its projected sales revenue stripped out from under it before operations even begin.

If a company's expansion target is in an emerging market, it is vital to have an up-to-date picture of where those markets really stand. The subordination of local leadership and talent to US and European headquarters is becoming an anachronism, and competition from locally based entities can be at least as vigorous as the competition from other foreign entrants. It's not uncommon today for global organizations to mine developing markets as sources of new leadership, capital, and ideas.

Critical considerations for new market entry

Strategy
- Growth drivers
- Stability
- Brand awareness
- Type of activity

Business model
- Adapt domestic model?
- Identify unmet opportunity
- Outline of business model
- Start-up mentality

Local market analysis
- Competition
- Risk
- Economy
- Historic presence and start date
- Sustainable labor availability

Tax & legal environment
- Tax & legal framework
- Global trade considerations
- Multinational tax and legal compliance and risk management
- Tax-aligned business and treasury model

Financial analysis
For M&A, joint ventures:
- Complete financial due diligence
- Confirm current valuation of business

A tax decision that reverberates

For many private companies, one important decision that influences an overseas expansion is the way a new entity is classified for US federal tax purposes. An entity that is otherwise legally separate and distinct from its owner or parent organization may, depending on the way it is organized, elect to be treated as a "disregarded entity" — that is to have its autonomy "disregarded" and to be taxed as an owned branch or division of the parent or "partnership" if it has two or more owners.

The result of that determination is either a "deferral" or a "flow-through" approach to taxing the new entity.

If the overseas expansion takes the form of a disregarded entity, its income "flows through" to its US tax owners, even if it doesn't distribute earnings. Those owners will pay tax on their share of that income at their applicable tax rates less any direct foreign taxes that are applicable.

But if the overseas expansion takes the form of a corporation — likely a "controlled foreign corporation" because a US company and/or US shareholders own it — the income it generates may not create an immediate tax liability for its US owners, depending on the income streams of the corporation and how its business model and cash management policies are structured. Instead, it may be possible to defer the earnings at a lower tax rate than the applicable US tax rate until the company makes a formal distribution and repatriates such earnings.

Setting the stage

An overseas expansion raises a long list of issues, including rationale, location, investment type, compliance, talent, business model, treasury policy, and others. It can be tempting to dive straight into those details. But a company that's setting out to put its stamp on the globe needs to begin with a broad view and good understanding of its operating model and capital structure. Only then can a company embark with confidence on a journey to effectively manage its global tax rate and cash flow positions while complying with regulations and managing risks.

Many decision points. Many options. Perhaps the only choice that's never correct is to follow a spontaneous approach without fully vetting the important considerations. If you have clear answers to the "why" and "how" of planting your flag in a new market, the other issues won't simply solve themselves — but solving them will be much less difficult. The other entries in this series of articles can help you take it from there. •

This article is part of a series devoted to global expansion considerations for US businesses, particularly those in the middle market segment. Future articles will explore related issues in more detail. To learn more, contact one of the Deloitte professionals listed on the next page, or visit www.deloitte.com/us/dges.

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