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Build or Buy?

A discussion of alternative strategies for the establishment of international market presence.

International Subsidiary or Representation?

The pros & cons of building your own international subsidiary or contracting someone to do it for you.

Executive Overview

The intention of this paper is to discuss the pros & cons of alternative strategies for the establishment of international market presence, which for purposes of this paper, is simplified to the "build vs. buy" analogy. Building, or establishing a wholly owned subsidiary is the option often perceived as having higher risk and cost, but which affords greater control over many more aspects of the business. Buying, or contracting a representative firm, has the attraction of lower cost and faster start-up, but is often perceived to suffer from a lack of control.

This paper does not seek to recommend one solution for every company's international market development needs, because we believe there simply is no single answer. From our experience, each situation requires a careful examination of a company's needs, and the creation of a custom-made international market development plan that is often a synthesis of various parts of each strategy. Whatever the solution, it must fit the company, its products, and most importantly the management culture, and the people that will ultimately implement it (and determine its success or failure).

Each strategy is discussed in some detail, and a broad overview of planning steps provided to assist management to make the decision most appropriate for their company. This paper is not meant to be substitute for a careful examination of a company's needs by a qualified consultant (or its internal management) required to create a full fledged international market entry plan. What is outlined in this paper are some of the steps for planning and preparing an international operation and for evaluating a consulting firm to represent your company internationally. Ultimately corporate management is responsible for choosing the strategy and setting up an implementation plan. Their commitment to that strategy and implementation plan will, most often, determine success or failure. But perhaps the most important element is the people they choose to carry out its objectives.

This last point deserves reiteration – people make the difference. A fool-proof plan with the wrong people carrying it out, fails. A modest plan will succeed if the people behind it are flexible, resourceful, committed, and willing to work together as a team to achieve success.

The Pros of Building

Why do companies build rather than buy, particularly as a first step? The reasons are as varied as the companies. There are many advantages to having your "own people" in markets outside the domestic base. This is by no means an exhaustive list, but covers some of the answers found repeatedly in client meetings.

Control – This is the key to the remaining arguments. Building an operation means you have the right to choose location, corporate structure, pricing, sales channel, marketing strategy, and of course, personnel. By choosing the people who sell, support, and market your products, a certain consistency in approach and execution can be achieved.

Quality – This comes back to control … the way to make certain quality remains consistent, is to do it yourself. By controlling your process from end to end, you can ensure that it is carried out in the way you want – whether that process be sales, support, marketing or any other part of your overall business.

Profit – Prices internationally are often higher than in the domestic (USA) market, particularly for localised product. The ability to set end user and transfer pricing allows for greater control over profitability and repatriation of those profits.

Flexibility – Having your own employees provides a measure of control over the use of time and resources, as well as sales model. Resources can be marshalled to whatever event or activity is important to your business at that moment (within reason). It all comes back again to control – if you own the resources, you can control what they do and when.

People – By recruiting the people in your organisation, you have the freedom to assemble a team that works best within your corporate culture. A well assembled team will be an extension of your company in a distant market, bringing your customers consistent service and support.

The Cons of Building

Now a look at the cons to building a subsidiary. To illustrate a point, let's discuss the same topics above, but from the other side.

Control – Short of going to manage the business yourself, control over a subsidiary is usually a matter of degree and compromise. Notwithstanding the often misguided belief that "they all speak English", cultural differences account for some of the most difficult, frustrating, and time-consuming management challenges in managing a successful international operation.

Subsidiaries take on a personality of their own, similar to the head office, but influenced strongly by the culture, laws and attitudes of the local market. Over time, control changes in character, particularly with the second generation of employees - people who also have history with the company, but a very different one to those working in the home office - regardless of frequent head office visits.

Thus, we believe control is perceived, and often fleeting. For example, the location chosen initially for the convenience of visiting home office executives, goods import and shipment, or tax holidays, may have to be abandoned if potential employees do not want to travel there to work.

Sales strategies that work successfully in the home market may not work at all in other places (telemarketing or direct mail, for example), and require the adaptation of methods more suitable for the markets in which your subsidiaries operate. Marketing campaigns may cause strongly negative reactions in foreign markets (e.g. Chevrolet's "Nova" model which failed in Spanish speaking markets where its name translated to "no-go"). Every such change relinquishes another element of control to some extent.

Quality – Perceptions of quality are culturally biased. A product or service that is perceived as positive at home may have quite the opposite characteristic and/or connotation in other markets. Some products enjoy a very positive reputation in some markets based their country of origin (German cars, Swiss watches, Belgian chocolate, American software, etc.) while others carry strongly negative connotations in others, often based on cultural, economic, and social influences completely unrelated to the products themselves.

An American software company that releases three new versions per year may be viewed as leading edge, or innovative in the USA, while potential customers in Germany or Switzerland may view the company as unstable – in an environment where evaluation cycles are often longer than release cycles! Thus, quality is not innate, inanimate, or obvious – a product perceived as high quality in one market does not guarantee it will enjoy the same perception in others.

Profits – Let's examine the opposite side of profit – cost, since higher costs directly impact profits. Consider that while price for your product is often higher in international markets, it is by no means unique - every other item and business service in these markets is also more expensive – taxes, housing, office space, transportation, utilities, communications, food, insurance, financing, computers, etc. The domino effect drives overall business costs higher, pushing salary demands higher, and the cost of doing business significantly higher. Get the picture - prices are higher for a reason.

Employment costs are another significant area often overlooked. In Europe, for example, American companies accustomed to the labour flexibility of their home market are often shocked by contract based employment laws. These reduce labour flexibility, and complicate hiring practices – or cost a lot of money to fix if you get them wrong.

Social insurance costs paid by the employer over and above gross salary in most European countries are 100%-300% higher than in the USA. Vacation allowances hover around 4 weeks, but routinely go to 6+ weeks, meaning that every 8th employee just covers vacation time for the first 7. Benefits packages, particularly in Europe, routinely include company cars or commuting costs, a 13th, and sometimes 14th month's salary, phone lines at home complete with fax machines, club memberships, and much more that is unusual in the USA, but normal in Europe.

Flexibility – Employment contracts, particularly in European countries, reduce flexibility in many important ways. Contract based employment means that any significant policy change affecting labour may require government approval (and they can just say no), and then cost thousands to implement in the approved fashion, or to pay out the often-generous severance allowances for employees who do not want to move, change positions or possess skills the government believes to be in surplus (for whom you may be responsible for re-training). The presence of unions is another factor reducing labour flexibility – they are much more widespread in the white collar work force than in the USA, and take an active part in worker welfare as well as industrial actions.

People – the very base of your business. After investing considerable time, effort, and money recruiting, creating equitable labour contracts, leasing company cars, buying cellular phones, and all the rest… why is it not working?

Management directives are met with "why" instead of "when", and challenged at every turn. Seemingly innocent corporate policies meet with vehement disapproval or worse, legal challenge. People who seemed to wave the company flag during interviews now challenge headquarters on seemingly basic issues. What changed? Why? Welcome to one of the greatest management challenges in running international operations – cultural conflicts. Just because people look alike, speak the same language does not, repeat not, mean they are the same. Perceptions of work ethic, management, responsibility, mobility, and every other aspect of life will surprise and amaze.

Managers in many European companies cannot conceive of the idea of making sales calls – “our job is to manage”. Hiring employees does not guarantee a smooth implementation of company policy or culture – usually because there is more than one culture to be considered. At least in Europe, the caution for hiring managers is to review employees carefully, because they may be with you forever.

Summary - Building

Arguments on building can either support or oppose the strategy very easily, depending on the tack taken on viewing each one as we have shown above. There is no clear method by which a company can determine empirically whether to build their own operation or not. It is a complex combination of internal needs, market forces, and sometimes, just the fortitude to take on the challenges involved in setting up the first (and every) subsidiary, and move ahead.

One piece of advice based on the author’s experience in setting up many subsidiaries: Add 25% to implementation plan time frame, and 50% to expense estimates – then multiply the time scales by 2, and expenses by 4 to have a greater chance of being correct.

The Pros of Buying – using a representation firm

An alternative to building is buying - hiring a representative consulting firm to set up and develop international market presence. There are significant advantages to using such a strategy, which include:

Cost – Consulting fees and expenses can all be agreed in advance, making it easier to budget the costs of representation. No need to establish a company, no worries about legal structure, employees, etc., just a contract.

Speed to Market – Using a good representative firm brings to the table people from the industry with contacts, market and competitive product knowledge, insider experience, and more – to bring products to market more quickly using their established channel contacts.

Market Presence – Building your own market presence takes time and effort, and is littered with obstacles. Some consulting firms offer a very quick solution to presence in a target international markets using their office and infrastructure, providing your company near-instant "identity", including a phone number, postal address and other required services, to answer customers and reseller calls, provide pricing information and often much more. This address and phone number can be included with print advertising, as well as other media, including web site, product literature, and much more – providing the benefits of a subsidiary for the price of a fixed monthly fee.

Flexibility – While subsidiaries and employees cost money immediately, compensation structure can be varied with consulting firms combining service fees with commissions generated through direct sales or by the resellers they recruit. Some even offer fully commission-based compensation. The commission is then at a higher rate, and generally continues for the life of the relationship with the resellers they recruit. Others might accept stock or stock options as a part of their compensation if the client company is, or plans to go public – sharing risk (and reward).

Experience – Most consulting firms (Globalis is no exception) employ or contract a wide variety of people from a number of countries, with years of industry and international market development experience. This kind of experience may be difficult to recruit yourself, particularly at a reasonable price. With consulting firms, the client need not pay for all of a consultant's time, but only the piece relating to their business – effectively buying more experience than may otherwise be possible, particularly on a part time basis.

Focus – Hiring a representative firm to handle international market development provides the management the freedom to focus – on growing domestic sales, developing new products, recruitment, improving support, product positioning, technology acquisition, initial public offering, whatever. International market development continues day-to-day without de-focusing management from other tasks that require their direct presence and participation.

Contractual Relationship – Contracts have a beginning, and usually an end, and the ability to define the terms under which they are carried out. This is not always the case with employees, so the advantage of a representative firm here is having a clear, defined objectives, performance criteria and again, defined costs.

Definable Scope – It is hard to buy 25% of an office or 35% of an employee, but this is feasible when buying services from a consulting company. Contract for as much or as little as you need - a specific project, an entire marketing campaign, a product launch, ongoing reseller channel management, or anything in between, since you have the ability to define the scope of the project and relationship.

Transition – Hiring a representative firm is usually the means to an end. They can play a transitional role in the process of going international – building a market presence and creating sales channels, which can all be handed over to you when the time is right to set up your own subsidiary. If you have hired the right firm, the transition will be professional and smooth – particularly if they have an ongoing financial interest (commissions) in the operation.

The Cons of Buying

In the interest of consistency, we will examine the same points from the opposing viewpoint, as we did with the other approach.

Costs – While costs are definable, they are usually higher than the often less effective practice of hiring a mid-level employee in the home office, but generally much lower than building a subsidiary. Consultants charge a premium for their services, based on risk, experience, or the premium available due to their name and reputation.

Speed to Market – Does the firm you have chosen have contacts to whom they can bring your products or can they build them quickly? Does your product require specialised representation or can high volume distribution companies handle sales internationally?

Market Presence – Where are the offices, how are they staffed and what do they do? Is the company registered in or near your target markets? Do they have the staff to provide the service you have contracted?

Flexibility – Once the channel is established, how will the relationship be managed day to day – how much contact will you have with resellers and customers? Are ongoing commission payments an obligation you are willing to support for rapid market entry?

Experience – Experience in one industry or market area does not always transfer readily to another (database to networking, for example), so careful evaluation of the consultant's background is required to make certain you are getting the kind of experience you need to meet the needs of your business.

Focus – Internal resources will be required in any case to work with, co-ordinate, and manage consultants. Management involvement is necessary for a successful consulting relationship, so measure carefully.

Contractual Relationship – Contract infringement by either party can lead to long legal or arbitration processes that can drain resources.

Definable Scope – If needs grow during the contract, expanding the scope of an agreement can be difficult, if the resources required are not available within the representative firm, or can take time to recruit (although the risk of recruitment and employment is borne by the consulting company).

Transition – Transition is always difficult, and the eventual transition of contacts, and other business related goodwill can be complicated, difficult or adversarial. Relationships are based on people and chemistry, and require careful management.

Summary - Buying

As with building a subsidiary, the argument can be made both ways. Choices regarding strategy, investment, personnel, etc. can make the difference between a successful international launch or lead to costly delays that could stifle a product's growth in today's ever shrinking product life cycles. Getting products to market quickly and finding appropriate partners to establish a positive and productive market presence is critical to international, indeed overall, success. Using a representative firm is a faster and lower cost way to introduce your products to new markets, capitalising on their experience and the synergy that can often be created by their representation of complementary products.

So, which is better and when?

One, the other, neither or both? Usually, it is both, in some combination. Beginning with a representation firm provides a lower cost method of market entry to build a revenue base on which to base the eventual development of a subsidiary – if one is ever required.

In our experience, the establishment of a fully staffed (5 people), operational subsidiary in Europe costs approximately $500.000. Using that base for calculation, the point at which a subsidiary becomes economically feasible depends on objectives and sales model – which determines expense ratio. In a direct sales, outside account-manager based approach, the expense ratio might be as high as 50% in Europe. With a reseller based sales model, expense ratio could be as low as 5 - 15%. When the cost of opening the operation corresponds to or exceeds the expense ratio for the model used, then it could be time to contemplate a direct operation.

Using the numbers above, when a reseller based operation at 10% expense ratio reaches sales of $5 million, it may be time to consider setting up a support operation with key account sales. It could well be done before that, but that would be a strategic choice.

Buying – steps to setting up the plan

Having taken the decision to use representation, there are certain steps you should take to evaluate the firm carefully, the first of which is internal, and perhaps the most important:

(1) Evaluate your company’s situation

  (a) Is management committed to the move into international markets?

  (b) Is your product ready?

(c) Is your company financially prepared?

(d) Is product management and development up to the task of making modifications in the product if required?

(e) Is marketing up to the task of working with international partners to create the required materials in new languages and with different designs to meet local needs?

(f) Do you have the internal mechanisms to support working with a third party – providing sales and technical training, ongoing field evaluation and after sales support and much more?

(2) Evaluate your needs

(a) Full service – with the representation firm handling everything?

(b) Partial service to complement existing resources? If so, how will they work together and to whom will they report?

(c) Which markets are key, secondary, and tertiary?

(d) Which sales model fits your product and company culture?

(e) Establish a budget

(3) Finding the right representation company

(a) Ask for recommendations

(b) Search the web

(c) Work through the software associations (the WSA)

(d) Interview companies – personally – finding a partner you can <u>trust</u> to represent you to potential customers is critical to success in using representation

(4) Logistics

(a) Set up a working relationship that is comfortable for both parties – without this, the effectiveness of the relationship will suffer

(b) Arrange for meetings between the consulting company and the entire management team, sales, marketing, product management, technical support, training, and the people who will be the primary interface for international partners and the consulting firm on a day to day basis, particularly the reporting manager.

(c) Provide thorough, complete product training – on your product, plus a good overview of the competitors

(5) Implementation – the tricky part

(a) Establish a realistic reporting schedule

(b) Invest the time to make your partner a success

(c) Insist on regular, personal meetings

(d) Set up a reseller meeting

(e) Commit to the relationship

Building – steps to setting up the plan

If the strategy chosen is that of building a subsidiary, the process begins, the same, but is perhaps more complicated by the fact that getting it wrong can cost real money, and is not easy to undo:

(1) Evaluate your company's situation

- (a) Is management committed to the move into international markets?
- (b) Is your product ready?
- (c) Is your company financially prepared? (remember the rough figure of $500,000 to set up a fully operational subsidiary)
- (d) Is product management and development up to the task of making modifications in the product if required?
- (e) Is marketing up to the task of working with international offices, customers, and partners to create the required materials in new languages and with different designs to meet local needs?
- (f) Do you have the internal mechanisms to support a remote office many time zones away?

(2) Determine the scope of your subsidiary's operations – which will in turn dictate the staff level.

- (a) Complete activity
- (b) Master distributor operation
- (c) Support activity
- (d) Which markets will you address primarily?

(e) Determine the legal structure

(f) Establish a budget

(g) Get good help

(3) Find the right location for the new company – location plays a key role in success.

(a) Is the subsidiary domestic market important for you?

(b) Where is the competition? Why?

(c) Do government business development agencies offer any advantages?

(d) Visit the locations in person

(e) Interview companies in the same location

(4) Be methodical.

(5) Management – home or local?

(a) Will a home office manager take the reigns of the new operation?

(b) Will other employees also go?

(c) Who will recruiting the replacement manager?

(6) Logistics

(a) Set up a reporting and information exchange schedule

(b) Make your remote office employees feel like a part of the company

(7) Implementation – the tricky part

(a) Do not hide behind e-mail for communications. Talk regularly.

(b) Be sensitive to the needs of the local market (employees)

(c) Visit the office regularly, and spend time with the people there –

(d) Every single employee should visit the home office

The process of opening a subsidiary is complicated and often fraught with pitfalls. Just because people work for your company, they may not understand the culture or feel a part of the company if you do not make a constant effort to include and educate them.

The danger of developing an "us-them" attitude amongst both home and remote office staff is great, and managers on both sides must work to facilitate communications and open dialogue between offices. Exchanges help, but are only effective when properly prepared, and carefully monitored for participant feedback.

Which way for you?

Reading this report, the task of international market development might seem daunting. It is, but the rewards are significant. With proper planning and implementation, your company and its people will grow, you will gain more customers, make more money for your stockholders, and achieve your business objectives all that much sooner.

Which way should you do it? It is impossible to recommend a single strategy for every company. Take the steps to reflect, talk with consultants, colleagues, competitors and anyone else whose opinion you value, and choose the strategy that is best for your business. Better yet, hire a good outside consultant to evaluate your business from a neutral point of view and give you one additional point to consider.

Internet marketing has changed many perceptions of national and cultural boundaries, but do not be fooled into believing that this medium will reach all your potential customers. This is naïve – there is a significant group of potential customers for many products that do not have access to the internet (particularly decision makers), and to exclude them from your scope of interest is to deny your company market share and growth potential without even investigating it first.

Action Plan – for your business

The action plan will be different for every reader of this paper, but the first step is the most important. If you are at the point of readiness to move into the international market, then take the first step, whatever it is.

Clichés aside, planning and execution are the keys to success. There is no magic, just experience and the willingness to learn from mistakes. Hiring the right people who have done it before can help shorten the process and keep you from making the mistakes they made (so you can make some fresh ones that you can call your own). So, take the first step.

About the author…

Gopal RajGuru set up international operations in The Netherlands, Germany, France, the UK, Norway, and Switzerland for a variety of American and European companies (including WRQ, a Seattle based software company). In 1998, he joined The York Group, an international market development consulting company with offices in 20 countries. Globalis advises its clients on market development, channel establishment, management and restructuring, joint ventures, acquisitions, subsidiary establishment, key personnel recruitment, and other aspects of international business development. In addition, The York Group offices provide “virtual office” representation for companies that want international presence without the cost of a subsidiary. He can be reached at: Gopal@TheYorkGroup.com or +41 22 990 22 60.