Setting Up a Subsidiary

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by Rod Turner

There's no survival manual for setting up a subsidiary in another country, no guidebook that will change the odds of whether you'll swim or sink when you take the plunge. There are so many questions to ask and situations to deal with that the process can be overwhelming. However, there are several key approaches that, if well considered, will reduce the potential pain and setbacks when making the transition from a distributor to a subsidiary.

If you are setting up a subsidiary, up to this point you've most likely been using a distributor. (Usually when starting a venture of some sort, either independently or as part of a large company, you initially aren't big enough to be forming international subsidiaries right away.) However, in very competitive markets, I suggest not hiring a distributor who may be only half committed because of the competitiveness of the market. Instead, hire an employee and have one person on-site who cares 100 percent about protecting and furthering your interests. That person can manage the local distribution channels. If you hire a mediocre distributor and have the attitude of "I'll change it later," it may be a big mistake. Changing horses in midstream is difficult and isn't conducive to success. So in these cases, it's often best to start a subsidiary early on, even if it's a very small one.

Chances are, though, you'll be working with a distributor. One of your biggest challenges will be to smoothly transfer the business away from him. Making the transition can be a sensitive and sometimes painful experience for all parties, if it's not handled with thorough forethought, planning, and diplomacy. You should handle the transaction delicately and carefully, because otherwise the distributor can become antagonistic and "turn off the tap."

HOW TO SMOOTH THE TRANSITION

There are several things you can do to minimize potential problems. When you negotiate a distribution agreement, set the expectation from the start that your partner won't be your partner for life. Let him know that if you're successful together, you may replace him with a subsidiary at some point. (You might not; the distributor may be so successful that you'll continue business as is.) If possible, define a plan for a possible transition in the contract, including terms that spell out exactly what will happen if you terminate your partner to set up a subsidiary rather than because he's failed you. You need your partner on your side while making this transition. And when the time comes, give the distributor appropriate advance notice. Even if your contract doesn't require it, it's good business to do so.

Give the distributor an incentive to continue supporting your product during and after the transition. One option is to define a royalty you'll pay your distributor for a specified period after the transition (for example, five percent for a year and a half) on all sales in that market, because a subsidiary will take exclusive rights away from this partner. The main goal is to arrange something that will make it in that company's interest to cooperate, something along the lines of "In return for providing my company with the specified level of performance, technical support, marketing effort, sales resources, and cooperation, we will give you a specific percentage royalty on all our sales during the following period." Or "We'll give you an advantageous discount of the following amount for the next year—if you deliver." Be specific about what the distributor must do; don't leave it as a general understanding that he'll be good to you if you're good to him. Often that will work, but when it doesn't, the cost can be devastating.

Make sure that you own outright all translations/
localized versions of your products and that there are no cumbersome complications. Also, be sure that you have in hand the source code and everything else needed to produce the translated product. Don't be caught at the last minute without all the disks, or discover that you have version 1.0 instead of version 3.0 of your French product, or find that you're missing a disk because a bug was being fixed and the code was never returned to you. Likewise, make sure that you have an electronic copy of the documentation so you can reproduce it if necessary. Be forewarned that although you may contractually have all the rights to software, documentation, and the like, it still can be a nightmare to actually get possession of the items and begin manufacturing the product yourself.

Take It One Step at a Time. During the transition, don't try to start by doing everything at once. Take over the various responsibilities from the distributor one step at a time while also taking an appropriate percentage of the profits. Try to avoid a situation in which you've got all the responsibility for technical support, marketing, and sales while the distributor has only distribution responsibilities—and *gets most of the profit*. Frankly, distribution is a relatively easy function and doesn't warrant a huge profit margin.

One way to do that is to calculate, with the distributor's input and buy-in, what proportion of revenue is profit, cost of goods, technical support, marketing, sales, and translation. Allocate the profit to each of those areas of real costs on a pro-rata or value basis. (You can negotiate the rates with your distributor.) Then take responsibility for one function at a time, along with its calculated "profit loading." For example, say that the cost of maintaining the sales force is 10 percent of revenue. If you've calculated that a quarter of the profit margin should be allocated to this function, then when you take responsibility for the sales force, you'll also take a quarter of the profit.

SOME KEY DECISIONS ABOUT THE SUBSIDIARY

Here are a few of the important questions to ask yourself when opening a subsidiary:

In which country should you set up a subsidiary? There are typically three basic issues to consider: where to base the financial headquarters, where to manufacture, and where to have marketing and product support. One way to decide is to examine these issues from a tax point of view. For example, when doing business in Europe, you may want to manufacture in Ireland, because you get certain tax breaks there; you may wish to establish a financial headquarters in Holland for several reasons, including the tax benefits; and you may opt to place marketing and support headquarters in the target country.

Be aware that geography is an incredible delegator. Being physically separated from your office will give a great deal of autonomy to whoever is in charge there and can easily lead to a loss of control. So put the proper control and feedback procedures in place; make sure you visit the subsidiary often enough to stay in touch with what's really transpiring, and make sure that employees of the subsidiary come to see you often enough. Don't finally make a visit there only to find that your managing director is driving a very expensive car that you didn't think was a part of the employment contract—but it actually was.

How many people should you hire? A frequent misperception is that you need to open a subsidiary with 8 to 12 people or with a fixed percentage of the number of people in your home-country operation. However, one person (the right person) can generate great results; this may be the best approach for you.

Nonetheless, when setting up a European operation, I caution against hiring one person to be in charge of all of Europe right away. It's a very big risk; in some cases, the European market may be larger than the U.S. market for your products. One way to put this decision into perspective is to ask yourself: If you were based in Europe, for example, would you be prepared to hire one person in a country as large as the U.S., put him in complete control of such a huge market, and give him a large degree of autonomy because he is so far away? If you did that, you wouldn't be aware of what was really going on in the subsidiary for a long, long time. The same caution holds true for setting up business in Europe. A good strategy is to divide it into several regions, each with a managing director. After a while, you'll get to know those people very well, and then you can appoint someone to be the European managing director. It's a very important position, and hiring the wrong person can be a big mistake.

In the case of a U.S.-based company, should you hire locally or send over a tried-and-true American employee? There's no simple answer, but there certainly are some big mistakes you can make by relying solely on Americans in international markets. Americans are not popular in some places and often aren't well educated enough about a foreign culture or its practices. However, if you know someone who is particularly savvy and sensitive enough to the local issues—and who has the know-how to tune in to local people for advice rather than overrunning them with his own opinions—then that person may be a good choice.

How do you find job candidates? Hiring an international employee is not easy the first time around, and it takes time. You don't have to spend a month in the target country to hire a managing director; but if you don't have someone in that country you can rely on yet (an employee, a head-hunting firm), it can take time. You don't have to go to the expense of hiring a top-notch recruitment firm, although it's probably a very good idea.

Another option is to find a marketing firm or agency you can trust. Typically these are fairly easy to find. They can run local recruitment advertisements and prescreen the resulting candidates. Then by telephone you can determine if the candidates' caliber is approximately right and decide whether to spend time in that country interviewing those people.

How should you support the subsidiary properly? You must support it the way you would support an excellent sales force in your home country. Subsidiary employees need fantastic competitive information (not only for the home country but also specifically for the local market), good training, and proactive information transfer from you.

How should tax issues influence your decisions? Strongly. Not understanding these issues up front can cost you dearly. Some examples of questions to ask are: If your subsidiary has contract-signing authority, what is your tax liability in that case versus having contracts signed in the home country? If you incorporate, are you taxable in that country? Never make assumptions about tax issues; hire an expert to help you make the appropriate decisions. The same holds true for understanding a country's governmental/bureaucratic/trade requirements.

AFTER YOU SET IT UP

Once the subsidiary is functioning, keep it focused. Because international subsidiaries have a lot of autonomy, they tend to want to do things that aren't part of your goals or plans. A subsidiary should do marketing, sales, and technical support and probably drive the translation process. Typically, you don't need to do anything else in an international subsidiary. However, it may want to start developing or acquiring new products or divert too much effort to developing value-added versions of your product. Although in some cases, these may indeed be the right things to do, you should at the very least know exactly what is happening before the subsidiary embarks on that path.

The best advice I can give you: Once the subsidiary is up and running, if you avoid the "out of sight, out of mind" mentality that is so easy to slip into—if you continue to give this "distant relative" a high level of constant focused attention, scrutiny, and care— you are more likely to swim than sink after you take the plunge. □

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