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Translating Success:

Essential Elements for Manufacturing Internationally

With the advancement of globalization in nearly every customer segment, American manufacturing companies often find themselves pulled into setting up shop in foreign markets. This can be a result of (1) tapping out the US market and seeking new customers; (2) interest from potential customers in foreign countries (and a desire to eliminate resulting shipping costs or reduce delivery times); or (3) an interest in building on the success of existing non-domestic manufacturing facilities (and potential labor cost savings).

Market Opportunity

The potential benefits of expanding internationally are considerable and include revenue growth, diversification, and economies of scale, among others. With rapidly growing populations and increasing disposable income, many foreign markets offer U.S. manufacturers significant opportunities for new sales. By broadening the customer base, businesses can also reduce vulnerability to cyclical market fluctuations and take advantage of economic expansion in other places. Often manufacturers find that going global can provide significant cost advantages as well. If the product can be sold to a sizeable new international market with minimal customization, the cost per unit typically decreases as the fixed costs are more widely distributed.

For these reasons and many others, expansion abroad can be the next logical step to growth for many companies.

However, with such a capital-intensive investment, there is certainly the potential for costly mistakes. To avoid them, manufacturers should carefully consider a wide range of logistical and financial factors, and move into new markets strategically.

Logistical Issues

A wide range of practical issues—some as basic as availability of electricity in an area and what local language is spoken—arise when manufacturing abroad. Yet many companies don't think to exhaustively explore all matters. Proximity to raw materials is another key consideration as importation can be expensive, or in some cases even prohibitive. Close access to potential customers is just as important, if not more so, as it is their demand for goods that yields critical revenue. When customers aren't physically nearby, distribution costs and security can become additional concerns. Of course, all these factors are interrelated and different for each company.

Adding to this complexity is the question of labor, which can become problematic if a company fails to do the proper research in advance. For example, a manufacturer might set up operations to build high-tech medical devices in a particular country only to find the labor market there doesn't have the high-level training or education needed to perform such work. Then there are the complex labor laws that may differ significantly from U.S. regulations.

Another issue that's been well-publicized recently is intellectual property (IP) (otherwise known as “intangible property” or “intangible assets”) protection. In particular, China—the early go-to destination for many foreign manufacturing operations of U.S. companies—has a mixed record for deterring IP theft, causing many businesses to return production domestically or identify alternate destinations, such as Vietnam.

Companies can begin searching for the best country to host their operations at doingbusiness.org, which provides detailed information about a variety of considerations.

Financial Issues

In addition to logistical issues, businesses must grapple with many financial considerations and opportunities. The following matters can have a big impact on how much a company spends during startup and beyond:

Tax Incentives and Rates

For the best outcome in a particular country, businesses should find out what tax incentives are available. For example, a country might have a program (such as a 0% tax rate for the first five years) to promote job growth in a particular “zone.” Some countries, however, might have comparatively high tax rates or charge significant additional taxes on labor, materials, and production activities in addition to revenue.

Transfer Pricing

One of the most powerful tax strategies for international manufacturers is transfer pricing. The Organization for Economic Cooperation and Development (OECD) and many individual countries have developed sets of rules to govern pricing transactions among related business entities. For example, if a company has headquarters in the U.S. and Switzerland and manufacturing plants and sales offices in five different European countries, it could potentially shift pricing (known as “profit shifting”) to avoid taxes. The OECD rules state that related business entities must pay one another the same amount they would pay a non-related third party.

Appropriate Legal Structure

Some types of legal entities can help companies save on taxes as well. For example, for a company that’s already operating in Europe, a holding company can allow it to defer income from U.S. taxation for several years. Sub-contracting the manufacture of some goods, purchasing a local manufacturing business, or forming subsidiaries might also create tax minimizing opportunities. Joint venture arrangements can be another way to gain tax and other types of benefits.

Type of Manufacturing Arrangement

When outsourcing manufacturing in both a related and unrelated party context, manufacturers can choose to set up a toll or contract manufacturing operation. The difference is that a contract manufacturer will own the raw materials to develop the goods and take responsibility for the risk involved while a toll manufacturer will develop the goods using raw materials purchased and owned in inventory by the hiring company. Either option can work well. The best strategy always depends on analyzing the value chain of each company and understanding a manufacturer’s unique situation and objectives.

Regulatory Concerns and Risk Management

Health, Safety, and Other Country-specific Compliance Requirements

Each country has its own regulations that manufacturers must follow; non-compliance can be costly and interfere with operations. Typical areas that must be covered include hygiene, safety, environmental conditions, manufacturing processes, training, documentation, records, distribution, data protection, anti-corruption, fair competition, employment, and methods for handling complaints.

Risk Management

Finally, to mitigate large issues (and the costs that often accompany them), manufacturers need to have a backup plan in place. For example, a supplier of a key raw material might go out of business, forcing manufacturers that depend on it to come up with a plan B. Other situations can have the same impact, such as significant changes to shipping access or compliance regulations. Operational and supply chain redundancy are important strategic considerations for a new or growing foreign manufacturing facility.

Conclusion

As American manufacturers discover the benefits of setting up operations abroad, they should also consider the potential risks. Proactive planning, and the advice of an experienced team of advisors, can help avoid a wide variety of logistical and financial problems associated with international manufacturing, including taxes, compliance, labor, materials, shipping, IP protection, and risk management.

EKS&H offers international business consulting services based on deep experience and international partnerships. This expertise can help you understand the complex considerations of international manufacturing so that you can be more effective, successful, and profitable in your venture. To find out more about how EKS&H can help you with the complexities of international manufacturing, please contact Kari Ritz Thiessen at KRitzThiessen@eksh.com or 303-740-9400 or Kreg Brown at kbrown@eksh.com or 303-740-9400.