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10 Misconceptions that Cause Distress for U.S. Companies Going Global *page 14*

By Sandra A. Reese, Jason D. Ramey
and Abhi Hazarika

On the Inside

Delaware Decision Revisits "An
Interest of the Debtor in Property"
page 26

By Patricia A. Redmond and Jessica D. Gabel

Should SIPA Trustee Have Greater
Power than Chapter 7 Trustee to
Pursue Third-Party Claims? *page 30*
By Patrick M. Birney and Travis R. Searles

Into the Brambles:
Section 507(a)(4) and Executoriness
page 36

By Pamela M. Egan



Restructuring
& Turnaround
Issue

Turnaround Topics

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Misconceptions that Cause Distress for U.S. Companies Going Global



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U.S. multinational companies continue to expand internationally, seeking new growth markets for their products and services. In fact, the value added by majority-owned foreign affiliates of U.S. companies has grown at an annualized rate of 7 percent, more than *four times* that of their U.S. parent companies (1.7 percent),¹ according to a recent study by the U.S. Bureau of Economic Analysis (BEA). The faster growth abroad was concentrated in emerging markets such as India, China, Eastern Europe and Brazil. The increases in Africa and the Middle East were concentrated primarily in oil and gas extraction and reflected the rise in petroleum prices over the period.

There has been a lot of press recently about U.S. companies considering moving manufacturing back from China to the U.S. primarily due to increasing offshore labor costs. However, the same BEA study also showed that the motivation for expansion in the past decade has been shifting from reducing labor costs for goods and services destined for sale in high-income countries to selling in local markets. This would suggest that future growth and competitiveness for many U.S. companies is likely to be shaped by global businesses—both new and existing—serving international markets. Favorable changes in demographic profiles and infrastructure led more U.S. companies to explore ways to enter new markets or restructure operations in existing ones. The risk of being marginalized by competitors should they choose not to enter new markets is also a critical consideration. However, the authors' experience has shown that many such expansion and/or restructuring efforts fail, leading to financial distress in the medium- to long-term due to any one of several common misconceptions about why and how to achieve and sustain profitable long-term growth in foreign markets.

There are 10 common misconceptions in current thinking on international growth and restructuring. Not all are created equal, but individually and collectively, they highlight the need to embark on a comprehensive process that evaluates the various choices and trade-offs related to strategic, financial and operational issues. Additionally, political, regulatory, legal, intellectual property and accountability issues also will shape the outcome.

10 Common Misconceptions

"We have a checklist to guide us through the entire process."

When it comes to international market expansion, checklists are pervasive. In fact, a simple web search will return thousands of results. These checklists are usually an exhaustive list of items around legal entity structure, tax and accounting, financing, intellectual property, documentation, location, and regulatory and legal issues that a company should consider. The problem is that a checklist is just a list; it is generic and therefore not tailored to a specific company's situation. It is akin to learning a language from a dictionary. There is an inherent lack of prioritization and focus, and more importantly, there are little or no linkages to key strategic, operational and financial factors to consider in developing and testing the business case. Last but not least, checklists do not provide for much of the intangible component of decision-making that comes into play when analyzing a particular company's current business model, its direct and indirect competitors, and the impact of potential new entrants or suppliers.

"By following global customers abroad, we will achieve profitable growth."

There is nothing inherently wrong with the above strategy, except that global customers are likely to have a business model that is very different in local markets: *different customer segments, supply chain and cost considerations*. Additionally, margins are not the same along the value chain, so while growth may be easier, profitable growth may not be. Customer concentration and the resulting volatility in demand could be another problem. Consider one company planning to set up manufacturing operations in China to serve its largest global customer following competitive threats from its sole-source Chinese manufacturer. The company could have averted this situation if it had multiple suppliers in different locations supplying to a final assembly and test facility. Instead, the company now has to change its business model to compete with that same manufacturer who has local capabilities, product know-how and economies of scale. Even if successful in moving from a distribution to a manufacturing business model, there are no assurances that the growth will be profitable.

¹ See 2009 Benchmark Survey of U.S. Direct Investment Abroad, the Bureau of Economic Analysis (BEA), November 2011 (value added is measure of net dollar value of goods and services produced).

continued on page 76

Suggested Reading: Broke: How Debt Bankrupts the Middle Class

from page 47

that bankruptcy is not the easy-out some claim it is, but these chapters delve deeper, relying on the data to reveal more fundamental—and more disturbing—inequities seemingly built into the system itself. In Chapter 9, Angela Littwin explores the bankruptcy experiences of those filers electing to proceed without an attorney to represent them in the process. These *pro se* filers are 10 times more likely to fail to receive a discharge in chapter 7 and in chapter 13; in most of these cases, the lack of a lawyer ensures dismissal.²⁰ With the number of *pro bono* attorneys and legal clinics handling bankruptcy work decreasing, these debtors electing to forego the costs of representation end up wandering through a perilous system bearing all the stigma of a filing without achieving the desired relief.

In Chapter 10, Dov Cohen and Lawless provide a fascinating look at the impact of race on bankruptcy relief.²¹ The data indicates that “African American households file [for] Chapter 13...at more than double the rate of debtors of other races.”²² “Because Chapter 13 debtors, as compared with Chapter 7 debtors, are less likely to receive a discharge of their debts, more likely to pay higher attorneys’ fee[s], must stay in the bankruptcy system longer and typically must repay some of their debts, the differential in chapter choice translates to differential debt relief among racial groups.”²³

20 *Id.* at 14.

21 This work was featured on the front page of the *New York Times* on Jan. 21, 2012. For the article, visit www.nytimes.com/2012/01/21/business/blacks-face-bias-in-bankruptcy-study-suggests.html.

22 *Id.*

The final part of *Broke*, “The Once and Future American Dream,” addresses the broader concerns for the overall economy that stem from a struggling middle class. In Chapter 11, Kevin Leicht argues that since the 1970s, stagnating wages and easy credit have trapped families into depending on debt to finance a middle-class lifestyle rather than wages.²⁴ Through the use of a simulation returning the 2007 CBP families to pre-1970 lending standards, Leicht illustrates how the deregulation of credit markets has led to unprecedented levels of debt among middle-class American families—with devastating financial results.²⁵

In Chapter 12, Jacob Hacker discusses the need for a social safety net in light of the heightened financial risks associated with achieving middle-class status and the financial vulnerability that persists once it is achieved.²⁶ He also discusses the importance of economic stability for American families to the overall economy.²⁷

All in all, *Broke* is a fascinating read. It provides a straightforward discussion of the data and takes the next all-important step of addressing the policy implications of that data. As an attorney, I consider *Broke* a must-read for anyone practicing in the field of consumer finance. As an American, I consider *Broke* a must-read for anyone who votes. **abi**

23 *Id.*

24 *Id.* at 15.

25 *Id.* at 195-204.

26 *Id.* at 15.

27 *Id.*

Turnaround Topics: Misconceptions in Pursuing International Growth

from page 14

“Find the best location and a reliable partner first.”

The authors’ experience suggests that many middle-market companies initiate their market-expansion plans by first searching for and identifying a location and, in some cases, a reliable partner. The authors often hear of company executives making trips to emerging markets scouring for locations and partners. Unfortunately, location and potential partner decision is a subset of the various elements comprising a business case, many of which are interdependent. More importantly, commitment and flexibility are inversely proportional to each other: the greater the commitment made, the less flexibility remains, thereby creating artificial constraints. All too often, companies approach the authors looking to “retrofit” existing global business into a different model, or worse yet, they are in severe distress due to a hasty location selection and/or partner decision made at the onset.

“Our current business model will work for local market requirements.”

Conventional wisdom suggests that companies need to modify existing business models to reflect local country opportunities, needs and unique market factors. Yet many companies only “tweak” their models as opposed

to the “outside-in” thinking of mapping opportunities from evolving customer profiles to the company’s ability to serve those target segments. The approach is prone to overestimation of points of differentiation and customer-perceived value of the product or service. In many cases, localization of a product or service is key, as Yum Brands and McDonald’s have successfully demonstrated in many countries around the world. However, localization is not easy, and even domestic players have faltered. A case in point is the Tata Nano, billed as the world’s least-expensive car at around \$2,100, which did not meet initial sales expectations.

“Work on organizational structure after other elements are in place.”

Most companies underestimate the importance of thinking about a comprehensive organizational structure and human resources function, including recruitment of key management and other resources needed to support the expansion. Additionally, international growth puts stress on existing domestic management, especially when going overseas has not been a core competency of the organization. Language barriers and the need to recruit, train and retain both foreign workers and expatriates further compound

this effort. Finally, change management and integration are important components to success as local employees and leaders may have an interest in preserving the *status quo* and resisting change.

“If we cannot predict with certainty or precision, why bother?”

A major challenge in developing forecasts is that choices are made today, but the results, which cannot be fully controlled or predicted, occur in the future. While nobody has a crystal ball to predict the future, critical steps to take when embracing uncertainty are to develop economic modeling and apply tools such as scenarios and sensitivities to identify the most critical assumptions—and correlating business strategies—inherent in the financial forecasts. Modeling helps identify the drivers of uncertainty as a means to identify the levers available to mitigate such risks. It is also a way to “de-bias” decision-making. The importance of modeling “what-ifs” cannot be overemphasized. In the recent case of a large U.S. manufacturer, the authors applied economic modeling to simulate various scenarios related to commodity and energy costs that helped shape the company’s purchasing and energy strategies.

“Capital is not an issue for us.”

While this may be true today, it may not be so in the future. Most companies take into consideration the initial capital required for the expansion or restructuring, but fail to adequately factor in the demands on

working capital during the ramp-up phase, or worse, the impact of unexpected operating losses. Companies need to assess working-capital requirements of not only their own operations but also across the supply chain to see if financing constraints up or down the chain may thwart the company’s own growth plans. In an alternative scenario, companies find their cash to be trapped because of either regulatory reasons or tax considerations relating to repatriation.

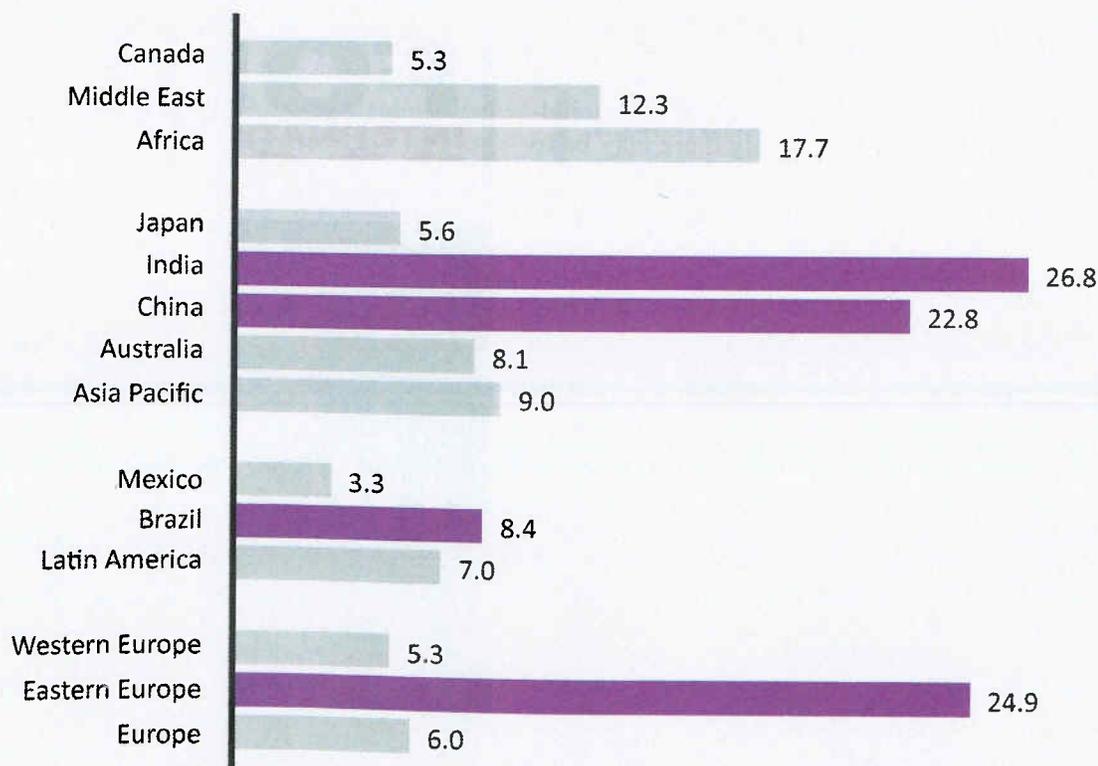
The genesis of this is usually an inefficient country-by-country affiliate set-up based primarily on tax and legal considerations, which results in suboptimal liquidity and cash-flow situations over time. The company may be able to minimize taxes, but that may have the unintended consequences of increasing operating and financing costs. It could create a bureaucratic legal entity structure by geography with few opportunities to streamline corporate-level activities such as treasury management, multiple international credit facilities, accounting, billing and collection, and even logistics. Restricted capital flows among entities may adversely affect overall liquidity. Additionally, assets typically available for financing may be left out because financing solutions may not be cost-effective, freely available or even possible in countries where these assets are located.

Global organizations must balance a range of competing factors when structuring operations to be effective.

continued on page 78

Average Percent Annual Rate of Change in Value-Added (1999-2009)

Majority-Owned Foreign Affiliates of U.S. Companies



Notes: “Eastern Europe” comprises Albania, Armenia, Azerbaijan, Belarus, Bulgaria, Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, Latvia, Lithuania, Moldova, Poland, Romania, Russia, Slovakia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan. “Western Europe” comprises all other European countries.
Source: 2009 Benchmark Survey of U.S. Direct Investment Abroad by the Bureau of Economic Analysis (BEA).

Turnaround Topics: Misconceptions in Pursuing International Growth

from page 77

tive and profitable, including the ability to finance international operations. Decisions that do not integrate all of these influencing factors frequently result in compromised solutions. Progressive organizations develop their global-operating strategies using a holistic approach where all factors are considered, trade-offs are evaluated and decisions are made for the overall long-term health of the business and its owners. Use of a holistic approach that generates multiple operating scenarios—taking into consideration a range of influencing factors, criteria, business priorities and constraints—is optimal. Companies can use these scenarios to evaluate options and trade-offs, and set a direction for decision-making.

“Do the deal now or miss the opportunity.”

As pressures to grow increase, managers often feel they do not have the luxury of time to develop, test and refine the market opportunity and business case. The authors’ experience shows that, more often than not, such deadlines are exaggerated. More importantly, this notion misses the mark on how markets operate and how a company can “beat the market” or seize new opportunities over time. Additionally, many issues uncovered after a deal was done could have been avoided had sufficient due diligence been performed.

“There is no need to consider exit options up front.”

Managers often suffer from over-confidence when considering expansion or other options. They fail to take into consideration the restructuring options that would be available should the business performance not go as planned. It is critical to keep in mind that the more capital-intensive the business, the less flexibility there may be to restructure or exit in the future. In many cases, such planning for future eventualities has to be done up front. In a joint-venture scenario, for example, majority-vs.-minority position, composition of the board, deadlock resolution and exit options are all critical elements to consider before signing an agreement.

“Of course it’s different. It’s just the local culture.”

Far too many companies use culture as a catch-all category to describe all things either unknown or seemingly incomprehensible. Let’s face it: Companies should remember that irrespective of the country of operations, business fundamentals such as *return in excess of cost of capital*, *profitable growth (not just growth)* and *minimization of risk* are applicable. At the same time, it is equally important to identify the underlying elements of “culture” that will influence the business, which includes business and personal relationships with various stakeholders (customers, suppliers, government officials), governmental policies and actions, differences in decision-making and problem-solving, talent priorities (soft vs. technical skills), business-integration challenges and negotiation styles, among others. A detailed

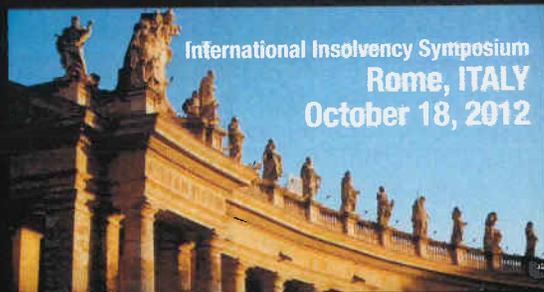
and well-thought-out business plan, which stimulates discussion around these attributes, can help ensure a more realistic assessment of the required financial and human capital investments and be a roadmap to profitability.

Conclusion

Even though the global recession continues to have a significant impact on corporate strategic planning, international expansion will continue to tempt U.S. multinational companies for the foreseeable future—and with good reason. The global economy is evincing signs of recovery, albeit high debt levels in developed markets and rising oil prices remain key risks. For a U.S. company considering international growth or restructuring, these could have wide-ranging implications, from a “liquidity crunch” in its European operations to a slump in demand in “growth” markets around the world. Companies must follow a systematic, rigorous process to execute on these opportunities in ways that do not allow these misconceptions to creep into the picture.

A structured fact-based approach helps ensure a thorough assessment of both strategic alternatives and potential risk factors. By leveraging tools ranging from scenario planning to modeling of alternative future states, uncertainty will be reduced. This preparedness ultimately positions companies for growth because they can act on opportunities that may arise—or minimize risks that may emerge. **abi**

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