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Doing business in Latin America: pitfalls, pathways, and promise

Forecasts suggest Latin America could see continued economic contraction, with Brazil reeling from a crippling corruption scandal, with oil-rich, governance-poor Venezuela teetering on the edge of financial default, and with a worldwide commodities price slump that has hit many Latin American economies especially hard.[1] Although the threat of corporate distress in the region centers on Brazil, according to restructuring industry experts, the rest of the region is also expected to face challenges.

For most multinational companies, operating in Latin America even during an economic uptick can be a source of both promise and frustration. In times of economic stress, all bets are off. No matter how strong an overall corporate culture is, effective, local, and loyal leadership is vital to success and consistent performance.

The region's challenging issues include:

Corruption. Even though government controls seem to be improving in the region, corruption in many countries continues to challenge, requiring that companies implement rigorous outside-in controls.

Measurement. The profit-and-loss (P&L) statement for local operation can conceal a lot of problems, and the safest measure is strong cash control.

[1] Ricardo Aceves, "Economic Snapshot for Latin America," Focus Economics, March 16, 2016, http://www.focus-economics.com/regions/latin-america.

Taxation and repatriation of cash. These two factors can lower overall returns, and currency fluctuations can make the capture of accounting gains even more challenging.

Employee costs. On paper, employee costs may look low, but the total cost of employment can itself be high after accounting for payroll taxes, benefits, and severance costs. As with other regional potential pitfalls, strong cost management is a must to protect the bottom line.

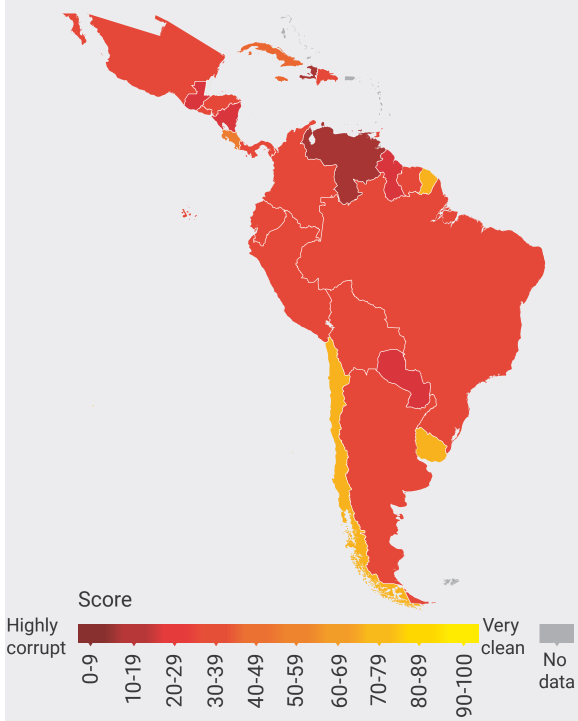
SUCCESS DEPENDS ON LOCAL LEADERSHIP

Multinational companies struggle in Latin America for many reasons. Lack of leadership may be the one topping the list. Many performance issues stem from flawed individual leadership and the absence of clearly defined leadership roles. A successful Latin American operation generally features a single point of responsibility and avoids being a dotted-line organization. As a control mechanism, some companies use an organizational matrix wherein local functional leaders report upward to their counterparts at the corporate parent. As a result, there is no true in-country leader with both P&L responsibility and the ability and authority to fully and effectively lead the local business. As with any multinational operation, leaders have to know their market thoroughly, speak multiple languages, and understand how business is conducted. Finding a quality leader and empowering that leader with authority may not be easy or cheap, but they are strong factors in multinationals' success in Latin America.

CORRUPTION AND CONTROLS

Corruption remains a widely acknowledged regional concern. Studies on perceptions of corruption rank Venezuela (158) among the world's most corrupt countries (of 167 countries), with Brazil (76) and Guatemala (123) in sharp decline. Nicaragua (130), Paraguay (130), Ecuador (107), Mexico (95), Peru (88), and Colombia (83) all registered significant levels of public corruption.[2] Chile (23) and Uruguay (21) enjoyed ratings on par with mature economies such as Japan (18) and France (23) (figure 1). The roiling effects of Operation Car Wash—a $20-billion series of corruption scandals centered on Petrobras, Brazil's state-owned oil company—have entangled multinationals, have seen senior Brazilian executives jailed, and have sullied the reputations of major political figures.[3] The November 2015 election of president Mauricio Macri in Argentina may signal a new, more transparent approach to the country's economic problems.[4]

FIGURE 1: PERCEPTIONS OF CORRUPTION IN LATIN AMERICA, 2015



Source: Transparency International

Because trust is often in short supply in Latin America, many successful Latin American businesses revolve around a family-based ownership structure. For multinationals, the relative absence of trust provides strong incentives to implement rigorous internal controls, well-vetted leadership, and an experienced audit function. Addressing corruption is vital to compliance with the US Foreign Corrupt Practices Act, an established piece of anticorruption legislation. Because the act has a global reach, multinational companies have benefited from intensive investigatory practices, from examinations of internal controls and processes, from detailed transaction-level reviews that complement higher-level business process and procedural analyses, and from prompt and thorough investigations of alleged corruption across each Latin American subsidiary.

[2] "Table of Results: Corruption Perceptions Index 2015," Transparency International, accessed March 24, 2016, http://www.transparency.org/cpi2015#results-table.

[3] Richard House, "Petrobras scandal runs Rolls-Royce through 'Car Wash,'" Financial Times, October 29, 2015, http://www.ft.com/cms/s/0/9d7dec5e-7740-11e5-a95a-27d368e1ddf7.html#axzz419AegRKu.

[4] Argentina's Transformative Election," The New York Times, November 27, 2015, http://www.nytimes.com/2015/11/27/opinion/argentinas-transformative-election.html.

FIGURE 2: SAMPLE NET CASH FLOW

Week number	3	4	5	6	7	8
Week beginning	13 January	20 January	27 January	3 February	10 February	17 February
Entity A	403,108	154,479	(237,155)	(173,646)	(1,635,429)	(900,473)
Entity B	981,274	785,239	1,005,521	850,368	961,227	1,182,529
Entity C	663,580	716,246,	654,055	634,126	828,912	998,902
Entity D	300,912	(91,663)	(293,625)	(492,715)	(596,814)	(545,045)
Total	3,217,635	1,862,264	1,343,805	973,969	(465,373)	774,646

Source: AlixPartners

CONSOLIDATED REPORTING VERSUS GRANULAR DETAIL AND A CASH FOCUS

A profit-and-loss statement can tell a success story—or it can mask serious operational and financial shortcomings. Managing at the regional level may save time in the production of higher-level consolidated P&L statements, but it may also result in a loss of control. Disconnection from local business trends can result in painful lessons and leave local management to solve problems on its own. Management that oversees Latin American operations can benefit by not rolling up multiple subsidiaries in a region but by paying detailed, close attention to each operation. And though it's simpler and easier to include a consolidated P&L summary as a bullet in a management deck, it obscures vital details that convey what's really happening at the local level.

The elasticity of the P&L statement can pose problems in those situations, because it does not represent actual cash and because it can be made to show a modest profit or break-even performance when in actuality, it poses a cash risk. For example, one multinational depended heavily on a consolidated P&L statement to assess its Latin American subsidiaries' performance at the top of the organization. But a drilled-down, closer look into detailed facts and circumstances at the local level showed that the existing P&L was flexible enough to show the "region" as profitable and growing when rolled up. Pulling back the P&L cover revealed that only one of eight countries was performing well, two were breaking even, and the others were performing poorly. In one case, a nominally break-even country was actually running a significant cash deficit that it was funding by not paying down intercompany payables.

In addition to implementing a more detailed, local P&L statement, the company found that a daily cash management system would be central to understanding what was really happening in the business. By initiating a rigorous process incorporating weekly reviews of actual cash positions and expected sources and uses for a 13-week forecast period, management became able to identify cash needs, anticipate them, and prefund them, thereby stabilizing those fluctuations and creating a runway for subsidiaries with the most cash fluctuations (figure 2).

Takeaway: Cash is ultimately the lifeblood of the business and among the truest measures of organizational health. Once a rigorous cash focus is established, maintaining the cash culture becomes easier and easier.

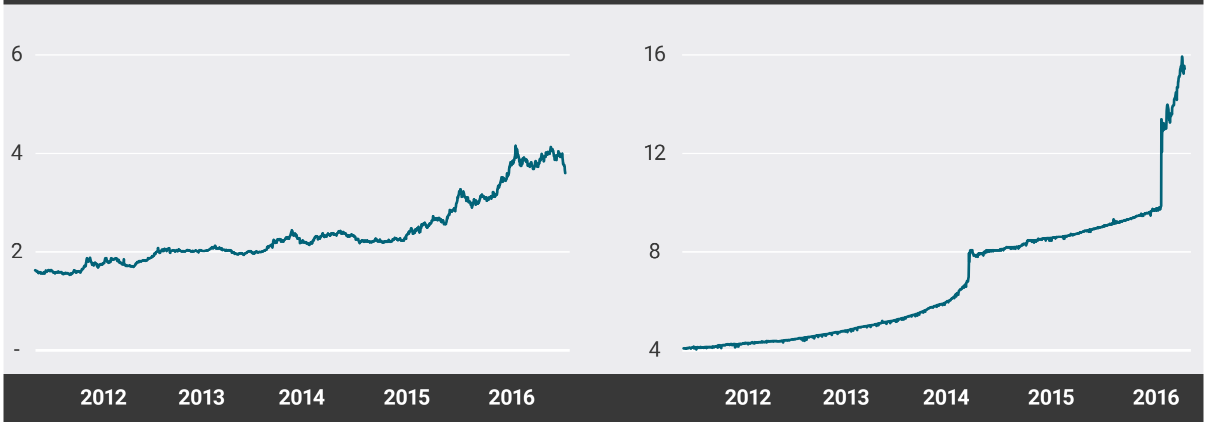
THOUGHTFUL TAX MANAGEMENT: A CORNERSTONE OF REGIONAL SUCCESS

Tax issues can be staggeringly complicated in Latin American countries, with variations based on shipping points, billing and customer locations, and the origination of products. And even though value-added taxes (VAT) appear to simplify issues, they can also serve to add complications and obscure the true financial picture.

Thorough tax planning with trusted local advisors who can optimize tax payment timing can play a pivotal role in cash management efforts. Latin American operations can be improved by making tax payments, tax liabilities, and tax receivables parts of the regular reporting process.

One multinational operating in Brazil was able to save 12% in unreimbursed taxes by moving a distribution center from high-tax São Paulo state to Santa Catarina state, which carried lower taxes.

FIGURE 3: CURRENCY FLUCTUATIONS IN BRAZIL AND ARGENTINA, 2011 TO 2015



Source: Trading Economics

CURRENCY QUESTIONS

Until local cash balances have been transferred to a corporate parent account, they are subject to the major risks of local restrictions on cash repatriation as well as currency fluctuations. Throughout 2014 and 2015, many multinationals struggled with heavy restrictions on repatriation of cash from Argentina[5] and Venezuela,[6] both of them countries where those concerns remain important. Restrictions on cash repatriation spurred companies to explore a wide variety of tactics, from repatriating cash through exports of local products (such as Argentine wine) to using cash on hand in their local subsidiaries to fund lower-priority investments by accelerating projects that otherwise might have been delayed. And though local liabilities are good hedges against currency fluctuations, creating those liabilities can lead to poor results.

It's easier to understand actual business performance by using constant currency, but it can be painfully difficult to forecast actual results. The reality is that in some of the larger Latin American countries, currencies fluctuate broadly and will affect reported results (figure 3).

A multinational can cope with currency risk by:

- Implementing a clear risk management program that anticipates the risk of trapped cash and balances against—among other implications—the US and foreign taxes on repatriation of cash.
- Hedging positions in areas with potentially significant currency fluctuations.
- Securing local counsel experienced at navigating the specific circumstances of each country.

LOWER-COST LABOR MAY NOT BE CHEAP

Understanding the total cost of labor in Latin American economies can be challenging. The hourly or monthly costs of employees can seem relatively low, which means product costs may be calculated using hourly rates without considering the various elements that increase those costs, including local compensation customs, local labor laws, and termination costs. The regulations and restrictions can be complex and limit flexibility.

Among many examples, Brazil's laws stipulate a full one-month salary paid as a holiday bonus. It is paid partially in July and partially in December.[7] In Argentina, that so-called 13th month is also accrued and paid to employees.[8] Again, in Brazil, a company

[5] Graciela Ibáñez, "Foreign Companies in Argentina: Hostages in a Consumer Boom," Forbes, March 17, 2014, http://www.forbes.com/sites/gracielaibanez/2014/03/17/foreign-companies-in-argentina-hostages-in-a-consumer-boom/#369a8661de0e.
[6] "American Writes Off $592 Million Cash Trapped in Venezuela," Airways News, January 13, 2016, http://airwaysnews.com/blog/2016/01/13/aa-592m-venezuela-cash/.
[7] Andréa Novais, "Brazilian Employment Law in a Nutshell," Brazil Business, May 15, 2012, http://thebrazilbusiness.com/article/brazilian-employment-law-in-a-nutshell.
[8] Kirk Laughlin, "The 13th Month Syndrome and Other 'Rigid' Worker Protections," Nearshore Americas, March 9, 2010, http://www.nearshoreamericas.com/buyer-beware-the-13th-month-syndrome-and-wage-protections-nearshore-outsourcing/.

may be subject to a fine if salaried employees are not permitted to take significant portions of their 30-day guaranteed vacation at one time. Terminations in Argentina are also complex, and litigation is common; involuntary terminations carry a 50% premium above the statutory severance that is owed to any employee. In Venezuela, involuntary terminations are prohibited, and employees must "resign." Many Venezuelan employees resign only with significant incentives.[9]

Local economics, too, can play a role, as the management at one manufacturing operation discovered. The plant was shuttered for three weeks in January when the local hourly staff ceased coming to work and went fishing. It seems that they would earn more during those three weeks of fishing than they could by working at the factory. The company therefore found it cheaper to plan for the fishing season and shut down rather than try to train other local hourly labor to do the work.

Labor litigation is common in certain Latin American countries. Litigation costs and outcomes should be considered in anticipation of the true full cost of labor in Latin American countries.

A successful business model demands an understanding of true labor costs, and that requires a detailed buildup of each component as well as resident knowledge of where to get the actual costs. Companies in Latin America must update that information often—not just during planning cycles—and they must keep a strong local focus. Relationships with knowledgeable advisors—from excellent legal counsel to strong local human resources professionals—will prove valuable. Companies should also consider building a severance reserve into their financial results and business planning exercises.

COST CONTROLS CONTRIBUTE TO SUCCESS

Multinationals in Latin America often find that incremental costs may appear modest but can accumulate quickly. Also, standard costing in a weakening-exchange-rate or a high-inflation-rate environment is a particular hazard in the region. Indicators of rising costs and sales forecast shortfalls should be watched carefully. One company was able to consolidate parts of three operations in one country, where it had previously had separate administrative functions. Another multinational defined sales regions and staffed them based on revenue objectives. When revenue didn't materialize, staffing reduction decisions got unreasonably delayed, resulting in increased cost imbalances and, ultimately, higher severance costs.

Continuous reporting and strong accountability can be invaluable, as long as decisive actions result. One multinational found that weekly internal country staff meetings, which US-based management joined by phone, and then regular follow-ups and action planning helped instill a culture of continuous reporting and strong accountability. The regular weekly calls with US operational leadership also confirmed actions, cash balances, regional alignment, and communication.

CONCLUSION: PITFALLS, PATHWAYS, AND PROMISE

Latin America offers multinationals many advantages and access to sizable markets. Brazil, for example, was the world's eighth-largest economy in 2015.[10] Unfortunately, the rewards are not easy to realize. Beyond recent headline events that affect politics, currencies, and economic forecasts, Latin America's levels of business corruption, local legal considerations, labor dynamics, tax issues, and organizational challenges all create pitfalls that can harm companies. However, there are many positive pathways forward. By implementing strong local leadership, getting a detailed view of each local business; establishing rigorous cash management and thoughtful controls; and ensuring smart tax, currency and labor planning, and excellence in cost management, multinationals are in better positions to avoid the challenges of operating in the region and thereby make the most of the promise that Latin America holds. **A**

[9] Fernando Peláez, Carlos Henriquez, María Elena Subero, and John D. Tucker, "Venezuela: Highlights of the New Venezuelan Labor Law," Mondaq Business Briefing, July 26, 2012, http://www.mondaq.com/x/177808/Employee+Rights/Highlights+Of+The+New+Venezuelan+Labor+Law.

[10] "World's Largest Economies," CNNMoney, accessed March 23, 2016, http://money.cnn.com/news/economy/world_economies_gdp/.

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