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Brake Lights at the Border: Going International Twenty-Two Miles Away

(An International Marketing/Management Case)

Working Paper Series 02-13— June 2002

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Scott D. Roberts and Joe S. Anderson

1. INTRODUCTION

Russ Clark emerged from the meeting angered and disappointed. He had been listening to a lawyer in San Luis Río Colorado, Mexico who was speaking through an interpreter. It had become clear the man intended to take unfair advantage of Clark as he sought legal advice on how to enter the Mexican auto parts market. In the past, the only way to open a business in Mexico was with a local partner holding a majority interest. Those rules no longer applied, yet this man acted as though he, personally could set up the perfect partnership for Clark's new business.

Was it possible that Clark could get the necessary information some other way? The meeting had soured him on the possibility of getting straight advice from this lawyer. Russ recalled telling his employees repeatedly:

> If the contract or situation is so complicated that you need a lawyer, make it simpler so you can understand it yourself. You don't need a lawyer, you need common sense.

But was this going to be possible? Would he be able to take his own advice when it came to opening a new store in Mexico? Now, he needed to look for other, more reliable and trustworthy information sources.

Forty-one year old Clark pondered his next move. After four years in southwest Arizona, his success as a NAPA[1] franchisee was undeniable. In a growing city of 75,000[2], and with at least 14 local stores dedicated to after-market automobile parts, Clark has nevertheless become the model for corporate success. A keen competitor with 18 years in the auto parts business, 14 of them with corporate NAPA and 4 as a NAPA franchisee, Clark had nearly tripled local NAPA sales and caused three competing stores in Yuma, Arizona to close, while growing his organization from 23 to 60 employees. Due to the proximity to Mexico, many of his employees were bilingual and bicultural.

In Fall of 1998, Clark perceived the auto parts market to be underserved in nearby San Luis Río Colorado, Sonora, Mexico. San Luis, just 22 miles south of Yuma, had an estimated population of nearly 250,000, with a growing number of older U.S. cars being nationalized by Mexican consumers as the local economy grew. At the time, no American car parts chain had a presence in the Mexican city, and the local competition seemed vulnerable to a well-financed, savvy competitor.

2. RUSS CLARK, ENTREPRENEUR

Clark spent 14 years working for NAPA before buying his own stores in Yuma County. His company years took him to Tampa, Denver, and San Diego.

When Clark bought three of the four Yuma County Arizona NAPA franchises in 1994, they had total revenues of $1.8 million and 23 employees. In 1996, he bought out a competitor in Somerton, 18 miles south of Yuma and four miles north of the border. By 1998, revenues for his four stores exceeded $5 million. To acknowledge his success, representatives from Corporate NAPA had recently visited and taken all 60 local employees to dinner.

Clark spoke no Spanish, and claimed a general ignorance of Mexican business culture. However, while working for NAPA corporate in San Diego, he watched as stores were set up in nearby Tijuana. At the time, such ventures in Mexico were restricted to 49% foreign ownership. Clark reported seeing friends in the industry "screwed by the 51% rule," and having to fold up their operations because they couldn't control them properly.

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[1] NAPA is the brand used by Genuine Auto Parts (Atlanta) for its automobile after-market parts division. NAPA stands for National Automobile Parts Association. There were 5,600 NAPA Auto Parts stores, most of them independently-owned, as of the time of this case.

[2] The greater Yuma County area population is 125,000, and from October through March another 90,000 "Winter visitors" live in the area

Newer laws relaxed foreign ownership restrictions. Clark claimed NAPA had no interest in taking corporate stores into Mexico, yet it allowed franchisees with personal initiative to do so.

In addition to this vicarious experience with the Tijuana market, Clark sat on the board of Automotive Parts Exchange for two years. This company manufactured rebuilt alternators, starters, and other electrical components for after-market automotive parts resellers in Mexico and the U.S. Over the last several years, some competing auto parts chains had begun to retest the waters in the Mexican market in larger cities along the border. Now, having been in the Yuma area for four years, San Luis, Mexico began to look attractive to Clark.

3. Business Environments in Mexico

Political and Legal Environments

There are three areas of law that need to be understood by businesspeople considering entry into the Mexican market: employee law, import-export law; corporate law. While employee regulations are relatively straightforward, the signing of the NAFTA agreement has put corporate and import-export regulations into a more fluid state. This uncertainty makes personal experience or hired expertise absolutely necessary for success.

Employee Law

As is true in the U.S., there are minimum wages, social security payments, and laws related to treatment of employees. Social Security taxes for the employer amount to 23% of wages and include health care, retirement, and a housing allowance.

A passport is required for Americans conducting business in Mexico. For those working in Mexico, the "FM3" work visa is necessary. The process of obtaining the FM3 takes between a week and a month, depending upon one's experience with the process. The cost is about US$100. A facilitator might charge additional fees up to US$200 to expedite this process.

The Mexican constitution of 1917 requires businesses to share profits with their employees. Also according to constitutional law, all payments to workers must be made in cash. Maquiladoras have only recently begun to implement direct deposit programs to avoid the risk of robberies of large cash wage shipments.

Import-Export Law

Permission to move goods through Mexican customs requires import and export documentation from SECOFI, the Mexican counterpart to the U.S. Customs Service. This paperwork takes 3-4 weeks, since it must go through official channels in Mexico City.

Clearing items through customs for resale in Mexico is challenging. A "*pedimento*" form lists every item and must be 100% accurate. This is the case even when there are hundreds of items being shipped. If one item is missing or there are too many of an item, the customs officer may want a *mordida* (or bribe) to allow the shipment to go through. If the documentation is off by 10%, the entire shipment, with its accompanying vehicle may be seized and the owner charged with fraud. By contrast, in the U.S. auto parts industry, managers routinely accept shipments with 95% accuracy or less. Orders frequently are shipped flawed or incomplete, with the knowledge that the overages, shortages, and damaged items will be "made good" within a day or two in a follow-up order. Strict conformance to the *pedimento* disallows this commonly accepted U.S. practice.

Moving cash across the border is also potentially problematic. Large amounts are unsafe. Small and large amounts require paperwork. Even checks drawn in dollars on Mexican accounts require high fees ($30-$40 per transaction). This can make repatriation of funds problematic.

Some products are illegal in Mexico, or illegal to cross borders, or illegal in the U.S. For example, moving auto paints into Mexico is quite tricky, due to their toxic nature. Freon, used for charging air conditioning systems, is available over-the-counter in Mexico, but is restricted to licensed installers in the U.S.

Many Mexican consumers can cross the border into the U.S. with crossing cards. They are limited in the total dollar amount of merchandise they can return home with. In 1998 this number was US$50, though four consumers can together carry US$200 worth of merchandise back into Mexico.

Corporate Law

The cost to the business of obtaining city/municipal permits is quite reasonable at US$30-40 per year.

Many U.S. firms choose to make their Mexican operations customers of the U.S. subsidiary, rather than have the Mexican entity make a profit. A form of transfer pricing, this practice avoids the requirement for profit sharing with employees dictated by Mexican law. This type of creative accounting is common practice in the *maquiladora* industry.

Because of the complexity of the Mexican legal system, it might cost Clark US$20,000 and take 3-6 months to maneuver through the bureaucracy with the help of a local lawyer or consultant. There is an ongoing, though diminishing expectation of paying informal "fees" to make things happen with more facility. An intelligent individual with cultural knowledge and local ties might complete the necessary work in 6-10 weeks, and could cut the costs by 2/3rds. As a dweller along the border, Russ perceives that bureaucrats filling out forms still do so on typewriters, so they "can go as slow as they wanna go."

Economic and Financial Environment

Most residents of San Luis, as in other parts of Mexico, are unaccustomed to having credit. The middle class is just beginning to enjoy credit card usage. Mexican banks tend to apply high and variable interest rates to their credit cards to cover fluctuation of the Mexican peso. Hence, nearly all transactions are cash on delivery. Commercial and institutional customers also tend to pay cash, or negotiate credit terms that require weekly payments.

The minimum wage (*salario mínimo*) at the time of this case was less than $3 for a ten-hour day. The prevailing wage in San Luis for unskilled workers was about double that, due to a shortage of workers in the Mexican *maquiladora*[3] industries in the local community. Because of these lower incomes, consumers often choose repairs over replacement. This may extend to purchase of kits for rebuilding components rather than buying new or remanufactured ones.

Many businesses along the border prefer to deal in U.S. currency, and all of them accept it. At the time of the case, translation was not difficult, as the U.S. Dollar was valued at about 10 Mexican Pesos. Since many Mexican workers cross the border to work at U.S. jobs, they receive their pay in dollars.

Technological and Infrastructure Environments

Telephone customers in Mexico bear the cost of extending the infrastructure to their homes and businesses. Currently, that amount is about US$400 per line, installed.

Communications between Mexico and the U.S. can be quite expensive. Long distance faxes and phone calls can easily run 60 cents to $1.00 per minute. Motorola 2-way radios provide a common solution used by many cross-border businesses.

Radio stations along the border are easily heard on both sides. Many Spanish-language stations emanate from the U.S. side, and many consumers on the U.S. side are comfortable with Spanish. Yuma County is approximately 60% Hispanic.

Mexican border cities have experienced rapid population growth over the last two decades. The ability of cities to supply utilities such as water and power frequently lags behind housing growth at the fringes. Thus, car batteries are often used for more than starting cars. For example, they might be used to power lighting systems in the home. Additionally, paved roads in these housing areas tend to be very rare.

Social and Cultural Environments

Due to traditional expectations and lack of powerful consumer protection legislation and enforcement, Mexican consumers do not expect warranties on car parts. Warranties are known to exist north of the border, and extending this concept into Mexico may provide a competitive advantage to a business that introduces it.

Mexican consumers have a high degree of respect for U.S.-made products. Many consider U.S. chemicals, for example, to be superior to an identical product produced in Mexico.

Simpler forms of promotion in Mexico include fliers handed out at the border as citizens wait to cross. Other popular sites for distribution of fliers include shopping center parking lots and busy intersections. Another form of promotion is the mobile "billboard," where many vehicles drive together parade-style, sometimes using loudspeakers, but always with visual representations of the product.

According to MOTORSAT's International Automobile Statistics[4] for 1998, 952,909 autos and 499,983 trucks were built in Mexican plants. In the same year, 426,038 new cars and 217,322 new trucks were imported. These numbers represent 3-5% growth over 1997 figures. MOTORSAT estimates there are about 15,000,000

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3 Maquiladoras are manufacturing plants in Mexico which enjoy tax-exempt status on the import of raw materials, so long as the resulting finished products and resultant byproducts are then re-exported. They are taxed on the "value added" in the production process.

4 MOTORSAT at: wysiwyg://12/http://person.club-internet.fr/motorsat/DonneesStat/mexique.html

registered cars and trucks on Mexican roads. In addition to the 2.1 million new vehicles added to the road in 1998, many thousands more are officially "nationalized" annually, having started their lives as American cars. The process takes paperwork, inspections, and the cars must be at least seven years old. These cars are only allowed to circulate along the northern border, and carry yellow license plates to distinguish them from other Mexican cars. This is a cheaper option for Mexican drivers than driving Mexican vehicles.

Another set of cars on northern Mexican roads is American cars with U.S. plates. Since many workers travel across the border, residence is a fairly fluid issue here. Thus, many Mexican drivers sport Arizona, California and Texas plates on their cars. This is the cheapest way to register a car.

Many of the cars along the border are older Fords and Chevrolets. The age of the cars, along with the harsh local weather and poor road conditions, contribute to a nearly constant need for maintenance.

Mexico is a "high-context" culture, in which the unwritten and nonverbal elements of communication are highly important, and trust is required before one can transact business. Although there are plenty of laws about how to conduct business, nevertheless, many contracts are still done by a handshake commitment. Doing business with someone in this culture might require extensive trust-building, which might include long hours socializing with your host, negotiations that seem to go nowhere for too long, and other seemingly irrelevant relationship-building exercises that tend to frustrate American businesspeople (who prefer a more direct, more context-free environment).

Mexican mayors (*Presidente Municipal*) enjoy more real power than their U.S. counterparts. They are able to make appointments and decide on contracts for city services and employees. City services typically include fleets for police and fire vehicles. Getting an audience with the mayor might result in profitable contract sales, but would require *una persona bien conectada* (someone with good connections) to make the initial introductions.

Competitive Environment

At the time of the case, San Luis had 6 auto parts stores. All were small, *mama-y-papa*, family-run operations, and none was affiliated with a national chain. Due to the shortage of investment capital in Mexico, most small business owners do not have lines of credit to extend their inventories. Thus, US$30,000 equivalent in merchandise on the shelf represents US$30,000 in equity for the owner.

As is common in Latin American retailing, stores with similar lines of merchandise in San Luis tend to congregate together. Most of San Luis's auto parts retailers are located within 150 meters of the intersection of 26th Street and Libertad Avenue and within a block of one another.

Checker Auto Parts, a large U.S. chain, has a store about three blocks from the border on the U.S. side. Many Mexican customers come across the border to shop in this store and in Clark's Somerton location, four miles further inside the U.S.

4. TARGET MARKET

Comparative Customer Mix

The potential market in Mexico could be quite large, depending on where Clark puts his efforts. The following list shows profitable market segments for his U.S. operations. He might seek the same or some modified customer mix on the Mexican side, depending on his perceptions of profitability among the groups.

Agriculture Fleets – Yuma county agriculture is a $1 billion annual business. Virtually all of the U.S.'s winter lettuce and lemons come from there. The local climate allows for three and sometimes four crops annually. Farm equipment is subject to frequent breakdowns, due to this constant usage. The farming entities in the area choose Clark or others as suppliers for these needs. On the Mexican side of the border, a similar, though somewhat smaller agriculture industry exists. Fleet agriculture buyers sometimes ask for non-vehicle-related items, such as cleaning and warehouse supplies. They tend to buy in large quantities, for example by the pallet for some items like engine fluids. As organizational customers, their primary orientation is toward reliability and convenience rather than to low price.

Walk-in – Retail Customers – This is the "visible face" of the enterprise. Buyers are either self-service for certain (usually non-mechanical) items, or they go to a counter and describe the part they desire. Specialists then find the part in a back storage area. Clark has four stores, and millions of dollars worth of on-hand inventory. The stores are not located in high retail-traffic areas of their respective cities. Because auto parts are a shopping good rather than a convenience good, buyers are willing to drive a few miles to take care of their needs. Most of the "big name" competition such as Autozone, Checker and Pep Boys are likely to derive the majority of their profits from walk-in business. For Clark's operations, however, the retail customer accounts for less than half of the profits.

Service Shops – Wholesale with Delivery – In the U.S., Clark has agreements with 10 repair shops. He supplies them with parts as they need them, they hang a NAPA banner and agree to buy some amount of product from him. Mechanics pass along the costs of parts (often with their own mark-up), and so are less price sensitive than walk-in customers. They tend to buy only mechanical and electrical parts, plus occasional specialty tools.

Institutional Customers – At the time of the case, there was potential to sell to non-agricultural fleets, such as school districts, city and county governments. However, Clark claimed that these organizations tended to buy from Phoenix suppliers, almost two hundred miles away, rather than from local Yuma suppliers.

Each of these market segments demands a different kind of promotion from Clark's NAPA organization. With the walk-in customers, all that has to be done promotionally is to inform the customer base and create the traffic. With service shops, there is daily or more frequent interaction including visits from delivery drivers and a dedicated sales force that responds to immediate and long-term needs. For the agricultural fleet customers, Clark must often provide personal service on large-volume and specialty orders. Institutional customers, if pursued, would require sales force attention similar to that provided to repair shops or to agricultural fleet customers.

5. MARKETING MIX: FOUR P'S

Merchandise Mix

Normal stock for Clark's Arizona stores includes: oils, filters, lubricants, and other fluids; electrical system parts (starters, modules, wiring, batteries, alternators, bulbs); gaskets and adhesives; tools (high-priced, mechanic-quality); antifreeze/coolant; shocks and suspension parts; cleaners, wipers, and accessories (such as steering wheel and seat covers, air fresheners, etc.). Also included in the mix are rebuilt engines, carburetors, and fuel injection components. Additional, in-house services include common machine shop services, such as brake turning, radiator repairs, and crankshaft polishing.

The older stock of cars in San Luis needs more maintenance than do newer vehicles north of the border. Off the main thoroughfares, roads can be less-than-smooth (some are dirt, some are paved, but with potholes, and the city has many, many speed bumps, which are used for speed control). Summer temperatures often reach 115 degrees Fahrenheit. Electrical systems need replacing every few years. Lower incomes and lower cost of labor may influence whether certain parts are bought new, remanufactured, or as rebuild kits. As an example of savings that might be realized, an AC Delco rebuilt starter for a popular Chevrolet retails for US$80. A non-branded rebuilt starter for the same application sells for US$37. The main difference between the branded and non-branded components is the length of the warranty, two years versus 90 days, respectively. The repair kit to rebuild the customer's starter, including bearings, bushings, electrical contacts, springs, engaging mechanism, and other small parts prone to wearing out, would retail for about US$19.50. An experienced mechanic could do the rebuilding job in an hour or less.

Distribution

Pivotal to Clark's decision to enter the Mexican market are decisions about which market segment or segments he will pursue at first, and from which location he will pursue them. In addition, decisions must be made about how a store in San Luis would be supplied, including the ins and outs of importing merchandise and repatriating profits across an international border.

<u>Location Decision Options</u>

Follow the Mexican custom of retailing clusters – locate near them or buy one out. The 6 local competitors are located near intersection of *Calle 26* and *Avenida Libertad*, about 4 miles from the border crossing. Latin American customers (this is common in some other parts of the world also) tend to know what part of town certain types of businesses locate in. This expectation is not exhibited in the U.S. to such an extreme degree. Clark could locate a new store in this area, or alternatively, an existing store of about 1,800 square feet on *Calle 26* is for sale for US$90,000, though Clark suspects that is a highly inflated value. He also wonders about safety and environmental issues of the shop. The interior of the building was attractive and exhibited beautiful craftwork, but the back alley appeared to be littered with "twenty-five years worth of used motor oil poured into the dirt."

Locate on the main road going south out of town – This location would be closer to *maquiladora* industrial parks and agriculture customers. Retail space here requires higher rent around $1.50 per square foot per month, but may generate higher traffic. There are several locations potentially available - sized between 500-1200 sq. ft. All traffic heading toward the Gulf of Cortez beaches from the U.S. travel this thoroughfare. Franchise-style repair services, such as Goodyear, tend to locate along this type of main artery in Mexico, as they do in the U.S. Unaffiliated auto repair shops tend to be off the main roads in Mexico, and are sometimes seen in small neighborhoods and even in the yards of residential homes.

Find a cheaper, low-risk location – Clark has identified available retail space (about 500 sq. ft.) near the border crossing at 5th and *Madero* for US$160/month. The owner would like a three year lease. This kind of low overhead location will make the expected break-even point fall considerably. This location is just seven blocks from the border crossing, making delivery potentially easier. The city police garage is less than a block away. If things don't work out, this option may allow Clark to pull out easily, should the venture not succeed.

Supplying a store in San Luis could be done either by Clark's existing employees and vehicles, or he could outsource all or a portion of the logistics function. Decades of trade along the border have created an entire full-service industry to facilitate the movement of goods across the international border.

Promotion

Saturation radio is Russ Clark's promotional tool of choice in the U.S. with AM radio talk shows and FM radio country stations. He writes his ads, and is the voice of his own commercials. He uses attention-getting humor to keep his stores in the mind of his customer. Radio ownership and listenership levels in San Luis are similar to that on the Yuma county side of the border. If this approach is to work in Mexico, he will need assistance with all aspects of creating his ads.

On a scouting trip to San Luis, Clark noticed that during his wait to cross the border, several things happened, People came up to his car and tried to sell him food and trinkets, or to give him fliers and print ads for businesses on both sides of the border. For Clark, this is an untested method of promotion, though its ubiquity seems to argue for its effectiveness.

Clark had a choice when it came to warranties. Offering U.S. style warranties could offer him a competitive advantage, but at a cost in convenience, and to the bottom line. Any warranted product would have to be shipped back across the border to Yuma, not an easy process. Further, customers would have to be educated about American style warranties, since they don't expect them in Mexico.

Pricing

Clark believed he could ship merchandise to San Luis from his Yuma stores and still beat the prices at competing parts stores. A popular tube of sealant was selling in San Luis for US$4.50. Clark was selling the same product in the U.S. for about US$3.50. For Mexican consumers, even a small price difference is significant given local wages. Clark planned to price his products on a cost-plus basis, including all incidental costs accrued between Yuma and San Luis.

IVA, the Mexican value added tax of 10% would have to be paid at the border on all products to be sold in Mexico. In addition there was an average 5% tariff on auto parts and associated product. Further there was a small, "per load" border processing fee of approximately US$15. Additionally, logistic and documentation would add a small amount to each delivery. Fully outsourcing these transportation and processing functions would add 15% to the cost of getting products from Yuma to San Luis, by Clark's estimate.

Clark believes he can treat the San Luis store as he would any other retail customer. This level of transfer pricing would allow the store to function without making a profit. For example, the delivered cost of products to this store would be exactly the price charged the final consumer. In this way, Mexican profit sharing and income taxes become insignificant issues in the business decision.

6. Who to go to for Help

Clark has many competent bilingual employees. One is Rosa, who actually grew up in San Luis, but who now lives and works on the U.S. side. Rosa is a trusted clerical employee and occasionally helps with childcare for the Clark family. She is well connected in the San Luis community. Another is Rigoberto, the manager in the Somerton, Arizona store. Rigo grew up along the border as well. He knows the business well, but is a little less connected in San Luis. Rigo's Somerton store is quite well run, and if he is put onto the new task, it could compromise that store's performance.

There are likely other existing employees that could carry out the task of researching and putting the new store together. This option might include sending an employee for further training. For example, the local university offers a class called "Doing Business in Mexico." Also, with 60% of Yuma County being Hispanic, many with ties south of the border, he could look outside the organization to hire expertise. Another possible avenue is to tap the local network of expert consultants, both legal and otherwise, that can facilitate Clark's desired venture.

Clark's philosophy on trust in the business environment is that "unless you're running a hot dog stand, you have to trust somebody."