

Was Mexico Discussed at Your Last Board Meeting?

April 2011

With offices in China's Guangdong Province, Shanghai and Hong Kong, we know that China is and will remain the answer for a lot of companies. But for companies manufacturing in or sourcing out of China who continue to face mounting cost pressures, labor shortages and currency appreciation, it may be time to reconsider the trade-offs of doing business in China and the potential upside of a portfolio approach with diversification in nearshore markets. One of those markets is Mexico.

Beginning in the early 1980s, Mexico began its transformation into a manufacturing-for-export market. According to a study in 2002 by the National Bureau of Economic Research, the share of international trade in Mexico's GDP grew from 11% in 1980 to 32% in 2000.

Of obvious impact to Mexico's growth was its position on trade liberalization and the 1994 North America Free Trade Agreement (NAFTA). According to the Federal Reserve Bank, by 2004, nearly 90 percent of Mexico's exports were shipped to the United States. It appeared, initially, that Mexico's strategy was working. However, by the late 1980s, as the opening of the China markets began to resonate on a global scale, Mexican manufacturers began to lose ground.

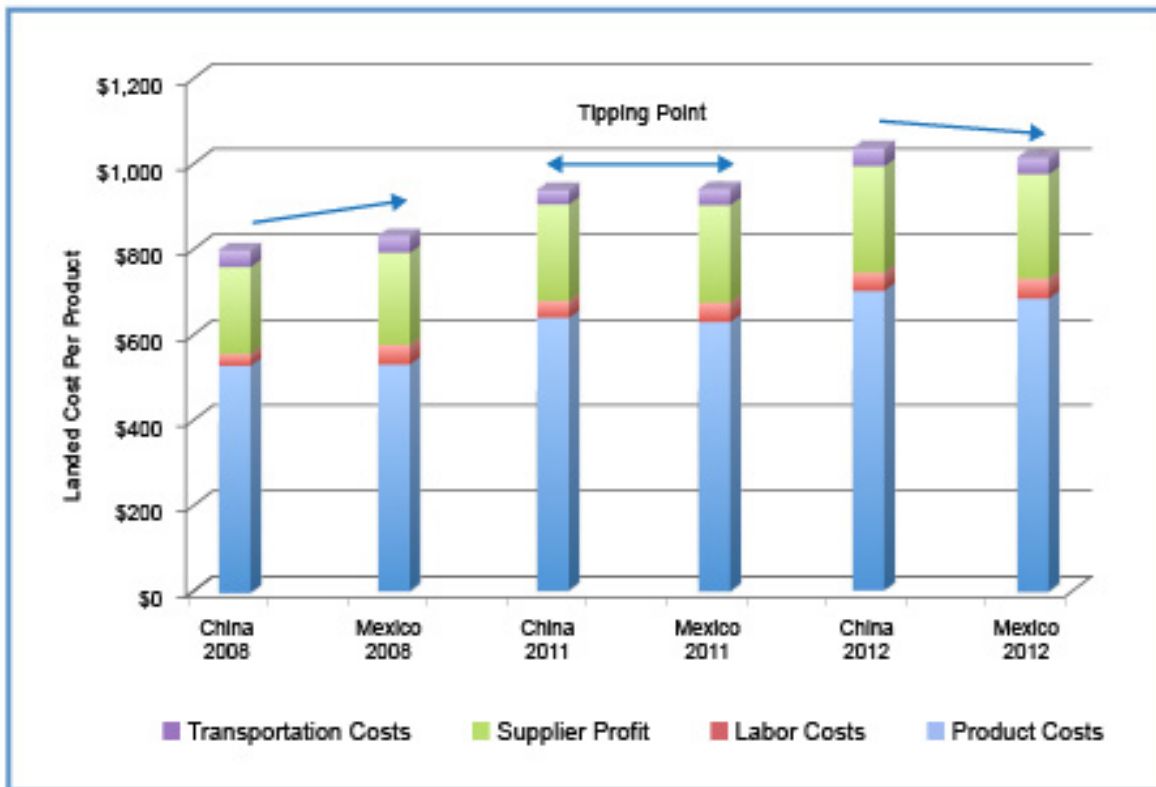
We spoke with Jaimes Anaya, the general manager of a consumer products factory in Tijuana. He experienced the exodus of customers from Mexico and into China first hand. "One day there were thousands of factories here in Tijuana," he explained. "The next day, only a few. Some of us have survived by focusing on specialty businesses. But, companies must understand that they cannot return to Mexico now, in 2011, and expect for things to be the same. Times have changed. Mexico is not the same place it was in 1990."

He is right. Mexico's share of U.S. imports peaked at 11.5 percent in 2001. Only in the last few years has it even come close to those levels. Given China's early-on advantages in labor costs, raw materials costs and currency valuation as well as global costs of fuel and transportation, Mexico could not compete. That is changing.

"We are not in an FOB-only world," explained Kyosay Global President and COO Frank Lazowski. "Today, companies have to think about the total cost of ownership. This means that for each product category, companies must consider design through delivery costs along with the potential cost of risk in doing business in each market. When companies closely analyze the value of their product against the real cost of ownership, including risks, some might be surprised in what they find are the optimal markets for their businesses."

The chart below shows one example of the "tipping point" – the point at which a distributor or manufacturer should consider "tipping" some of its supply spend into another viable market with added value (e.g., lower risk, faster time-to-market). For one of our clients, Mexico was not a viable option in 2008 when we evaluated their opportunities. However, over the past 2½ years, market dynamics have continued to shift. Today, as we look at Mexico again, the playing field has equaled in some respects. In other ways, Mexico offers a nearshore advantage with a skilled workforce, more competitive transportation costs, shorter lead times and NAFTA incentives. For this client, it is time to take a closer look at Mexico.

Tipping Point From China to Mexico



Is Mexico the answer? Perhaps for some. Companies such as New Holland, Cisco Systems, Volkswagen and Ford have found Mexico to be an answer for some of their production operations. Safety is, of course, critical in operating effectively in lower-cost markets, and Mexico has been under daily scrutiny due to the drug-related violence in border towns. However, even border towns like Juarez have seen rejuvenation in growth in the midst of the highly publicized unrest.

According to Lazowski, the key is in evaluating all of the critical market differentials, including safety, in determining the tipping point and the appropriate geographic destinations. What follows below is a quick look at some of the key parameters companies should consider in determining if they are at or near their tipping point.

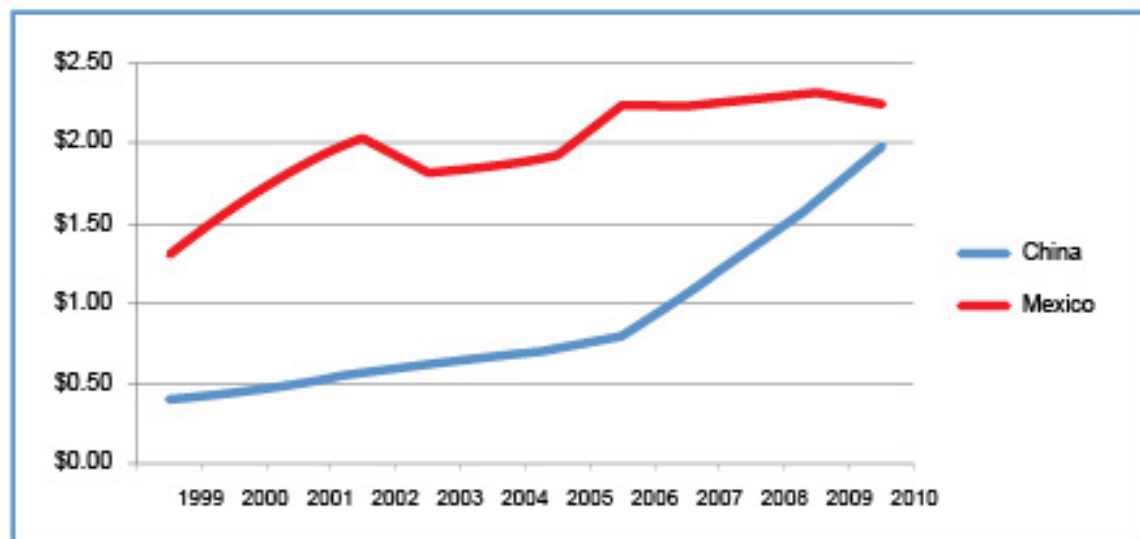
Labor Availability & Cost

The instability and rising cost of China's labor market continues to redefine the advantage of this rapidly developing economy. Our experience in overseeing and working with factories that supply our clients is that over half of their workforces did not return after Chinese New Year 2011. And less than half of those actually returned to the factory at all. As industries and opportunities in the interior of China continue to attract the workforce away from the coastal industrial cities, the shortage grows. Returning workers have more power to force wages increases while provincial and local authorities in China continue to raise wage and living standard requirements.

According to the U.S. Bureau of Labor Statistics, average Chinese hourly wages in the manufacturing sector more than doubled from 2002 to 2008, particularly in the southern provinces. Earlier this month, as reported by the Xinhua News Agency, Shandong and Guangdong provinces both lifted minimum base wage requirements (legal benefits not included in these figures) for factory workers. Shandong's increase of 26% elevated the average monthly wage to approximately US\$167.33 per month. Guangzhou, the capital city of the Guangdong province, decreed an 18.2% increase, pushing wages to an average of approximately US\$197.75 per month. Since 2010, over 30 provinces in China have increased their minimum wage requirements.

Mexico's wages have risen as well, but they are rising at a much lower rate. From 2003 to 2008, Mexico's wages rose only 25% compared to China's 218% increase over the same time period. According to the Mexican Finance Ministry, Mexican average national factory wages are now approximately 14% higher than those in China. In 2002, officials calculated they were 240% higher. The discrepancy in wages is continuing to disappear, giving Mexico a nearshore advantage for some companies and product categories.

China vs. Mexico Labor Rates



Source: International Labour Organization, U.S. Bureau of Labor Statistics (figures in USD)

Currency Appreciation

China's history of valuing its currency at an artificially low rate to attract exporters from around the world has given China the reputation as the manufacturer to the world. However, it has also left importing nations with high unemployment as factories closed as well as a significant dependence on one nation and one economic policy to meet their demand. As importing nations pressure China to appreciate the value of its currency, possibly valuing the RMB somewhere closer to a US\$1:5 RMB ratio (vs. US\$1:6.55 as of this writing), Chinese exports will become less competitive in price unless there are matching productivity gains to offset the increase. This is a reality that U.S. distributors, retailers and manufacturers procuring from China are already realizing as sources continue to push through price increases ranging from 5% to 20%.

The continued appreciation of the RMB is something that all companies doing business in China must consider on a daily basis and plan for in the future. Our projection, based on feedback from our contacts within the Chinese government, is that the RMB will appreciate this year to a range of least 1 USD:6.4 to 6.2, headed toward the upper 5s by 2012. We encourage our clients to carefully monitor this currency dynamic and to build cost of ownership models based on an anticipated devalued currency in China.

Transportation & Logistics Costs

Since January 2009, the average monthly price per barrel of domestic crude has increased from \$34.33 to \$81.01 in December 2010. These statistics have been provided by the Illinois Oil & Gas Association. Today (4/6/11), the Nymex Crude Future is \$108.47 per barrel.

The increase in oil prices is a genuine concern to those who monitor the price daily and its impact on global transportation and logistics costs. For one of our clients, container prices nearly doubled from 2009-2010 to 2010-2011. Based on the median estimate of 34 industry analysts surveyed by Bloomberg, crude futures will average \$87 a barrel on the New York Mercantile Exchange for 2011, the second-highest recorded in a year after the \$99.75 of 2008 and 40-percent more than the \$62.09 of 2009.

While oil prices will most likely fluctuate in the near term, analysts caution businesses to prepare for sustained higher prices in the long term. So, the response is really less about what prices will be and more about shifts in supply chain strategy that quickly address this certainty of high oil prices.

In a March 14, 2011, Bloomberg article, Bill Simon, U.S. chief executive officer of Bentonville, Arkansas-based Wal-Mart, stressed their focus on transportation costs. "Pressure from higher energy and commodity costs are factors that we will watch closely, as they affect our own logistics and transportation costs, as well as the prices the customer pays," he said.

For a supply chain company like Walmart, the wheel is always in motion for evaluation and understanding of the next market. To many, "as goes Walmart, so goes the world." This is not always the case. Product types, manufacturing origination, raw materials and incentives give each company its own unique position within the global market. But transportation and logistics costs – rising costs – must be anticipated if a company is to ensure that China will remain a competitive place to manufacture and source products. If it is not, then it is time to start looking at possible nearshore alternatives.

Capacity & Lead Times

For the past two years, many of our clients – especially those with seasonal businesses – have worked hard to place orders well in advance of Chinese New Year to offset increases in transport cost and factory capacity constraints and to assure continued supply of product. As discussed earlier, as the migrant workforce and manufacturing locations change, many workers never return to the factories. Thus, restarting production and/or catching up on demand after Chinese New Year has become a more difficult task for factory owners. We have seen lead times extended out from 45 to 90 days while sources struggle to rebuild their capacity. This causes delivery delays that had not been forecasted and requires extensive expediting and close management of resources by factories to meet demand. The end result is increased overall total costs of goods for U.S. importers. For these same clients, the opportunity to turn 20 to 30 shipping days into 5 to 7 is worth a closer look at Mexico or other nearshore options.

Additionally, the makeup and long-term goals of the workforce in China are clearly changing. Not only is it shifting from the coastal manufacturing hubs to the interior, but it is changing its mindset. In the last year, multiple key Chinese supplier contacts left their companies to start their own businesses. More telling is that these key employees have not left to start export-focused businesses, but to start businesses that will service the growing Chinese domestic market only. Workers and new opportunities are developing for the Chinese workforce as the Chinese economy grows and changes. Goals are changing. Skill sets are changing. In many ways, China is no longer welcoming its label as the manufacturer to the world. China has become more selective, more ambitious and savvy in its role as a world leader.

These dynamics may create a dilemma and delay for companies considering a shift to an additional manufacturing market. For example, the calculated cost of ownership may be more favorable in Mexico for products with high volume-to-weight ratios. However, companies may find that existing capacity is very small. Thus, there is startup time to develop an existing maquiladora or the investment and time to consider a shelter operation. Companies can face similar capacity challenges in emerging markets such as Vietnam, Indonesia and Eastern Europe. For companies requiring significant annual volumes of production, China is still very competitive. But now is the time to start looking at where the next market might be and what it will take to be ready to produce there in 12, 24 and 36 months.

Lean Manufacturing & Postponement Opportunities

Driving efficiencies through the manufacturing process is difficult when managing suppliers half a world away. Unless volumes are significant enough to warrant that discussion with the factory general manager or owner, it takes nothing less than an in-country representative present at the factory every day to get on the radar of improvement to reduce costs and improve quality and delivery.

Lean manufacturing concepts like engineering for cost and postponing full assembly until orders come through can be done in Asia, but like many offshore initiatives, it takes a serious commitment of time and financial investment by companies to see these programs through to a quantifiable result.

A nearshore option gives companies more flexibility and more opportunity to drive and refine lean manufacturing programs. Travel times are reduced. Time-to-market is reduced. And the ability to make mid-production changes is greatly enhanced.

There is also significant opportunity to alter the inventory model as transportation and conversion times are reduced with nearshore sources, potentially increasing turns and minimizing capital requirements and maximizing cash flow.

Protection of Intellectual Property

Knockoff. Counterfeit. Copy. Pirated product. Whatever the word, many see China as a market that thrives on stealing ideas, designs and brands. For some companies with highly valued intellectual property, experiences in China have driven them to find more trustworthy manufacturing partners. And while not all of China works through the back door, it does take a very focused and diligent effort to protect trade secrets in Asia. An estimate by the Organisation for Co-operation and Economic Development values annual IP theft at \$640 billion.

Is the landscape safer in Mexico? While certainly there exist cases of ongoing product counterfeiting in all emerging markets, Mexico has continued to strengthen its position on enforcement of its Industrial Property Law and Federal Criminal Code as relates to piracy. In the first six months of 2010, the Instituto Mexicano de la Propiedad Industrial carried out 2,512 product inspections upon suspicion of IP rights infringement. As a result of these searches, 872 full search warrants were issued, 50 illegal laboratories were dismantled, 434 people were detained and over \$38 million in goods was seized.

To put things into perspective, a 2007 International Chamber of Commerce survey ranked the top manufacturing economies in terms of IP protection. China, not surprisingly, ranked first as the most unfavorable jurisdiction. Brazil ranked fourth. Mexico ranked 16th. And the U.S. ranked 27th.

Incentives & Economic Policies

As one country's economic policies decrease its competitiveness in the global marketplace, another's look more and more promising. Companies are returning to similar evaluations of Mexico that were taking place in the 1990s following the formalization of NAFTA. In addition to narrowing China's cost advantage, Mexico gives the U.S. its largest free-trade zone. More recently, Mexico's economic policy has focused on specific industries to improve exporting conditions and overall financial incentives.



One of these programs is Programa para la Competitividad de la Industria Electrónica y de Alta Tecnología (PCIEAT). A few objectives of this program include becoming one the top five global exporters of electronic goods, increasing electronic exports up to \$80 billion, increasing direct sector jobs by 60,000 jobs and promoting technology transfer. In other words, Mexico is focused on building its electronics industry to one of the top in the nation.

Infrastructure and logistics congestion are of major concern to prospective exporters. Thus, companies evaluating a move to Mexico should consider the National Infrastructure Program (NIP), a five-year, \$150 billion initiative to improve the quality and coverage of Mexico's infrastructure. Projects include wastewater treatment, increased oil and gas production, road construction, new railways, three new airports and a mega-port.

Central America Free Trade Agreement (CAFTA) and agreements pacts formed in specific Latin American countries all provide their own incentives for businesses that trade from that region. These agreements can make nearshore source quite competitive with Asia.

Migration & Startup Investment vs. Shelter Programs

For companies unable to locate a supplier immediately within Mexico (a common challenge given the exodus of customers when China opened), there exist opportunities to fairly easily and quickly locate manufacturing partners and establish greenfield operations.

Maquiladora and shelter operations give companies outsourced options that eliminate the risk and startup time in doing business in Mexico. In some cases, businesses can export raw materials into Mexico and provide supervisory personnel. The shelter organization manages all other financial, HR, administrative, production, customs, quality and compliance functions, if requested, for a fixed fee.

There are a number of different options and safe geographical markets available to companies who are interested in inquiring into these opportunities.

Security

When people hear of Juarez, Mexico, they think of a city that has become one of the deadliest in North and Latin America. Drug-related atrocities occur weekly. Even one of our own associates, traveling alone near Monterrey as he had done many times before, was confronted at a checkpoint.

Many companies are concerned about the security of management and employees in Mexico. The nightly news has done its job to make us all aware of the threat of terror in Mexico. At the same time, Mexican exports continue to rise, increasing almost 30% in 2010. In the auto industry alone, exports grew 52% to a record in 2010. Some companies have found a way to make it work.

The fact is that there are many emerging markets that can pose a threat. Our teams have been warned to stay out of certain neighborhoods while staying in Shanghai and have encountered demonstrations and riots in Thailand. Members of our teams have been asked to remove jewelry on bus rides in Guangzhou to avoid drawing attention to their valuables. Others have been led to deserted factories, only to be confronted by Chinese authorities.

There are potential dangers in every market. But there are also potential upsides. The challenge is to avoid one while taking advantage of the other. The real key to success in these markets is having people on the ground who know the environment, speak the language and can serve as your advocate. Those of us at Kyosay Global who travel extensively internationally do our best to travel as a team with guides who can make decisions on our behalf.

Being knowledgeable about each environment and prepared for the dynamics of each market is best. But the best advice is to use common sense, and that means creating a team for market exploration and



entry that can help your company steer clear of the dangers while benefitting from the favorable market conditions.

Is Mexico for You?

It is difficult to know the answer to this question without taking a look at all of these parameters and others including the availability and cost of raw materials. And, after that evaluation, Mexico might not be the answer. But there are a lot of answers to be found in terms of developing a strategy that diversifies the supply base across markets that can truly add bottom-line value. The days of producing everything in China are over ... that is one answer we all know is right. Taking on a "total cost of ownership" approach to supply chain management will help all global companies understand that production is not static or always predictable. It is dynamic in every sense. What was a benefit yesterday may be a hurdle today. It is best to know this before your model no longer makes sense for you.

If you would like to take a look at how close your company is to its tipping point, we recommend that you take some time to answer the questions below. Then, contact Kyosay Global at 847.790.7500 to speak with one of our associates about the work we have done for other clients and how we can help move your business forward.

1. Does your business continue to feel significant cost pressures from current suppliers?
2. Has your company experienced a significant upward trend in transportation and logistics costs over the past 2 years?
3. Can you increase supply chain effectiveness by considering other developing markets?
4. Are you thinking about diversifying your supplier base?
5. What do you know of your industry in these other markets?
6. Are your competitors sourcing from countries outside China?
7. Do you need to shorten your lead time?
8. Are you concerned about sourcing all your product from China? the U.S.? other markets?