INSIGHT

Manufacturing

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Strategic Manufacturing Sourcing Outlook: Promise and Challenges in Global Nearshoring

Political and Security Risks are Hampering Development in Proven and Promising Regions

The practice of nearshoring—which involves moving production, business processes, or information technology from a far-off overseas location to a closer site, often right next door to a company's destination market—continues its global progress.

However, concerns are rising that the stability and security of certain popular or potentially promising locations are in decline. It's not a crisis, but corporate leaders are feeling worried about the implications, even as nearshoring progresses on a global basis. A recent AlixPartners survey of manufacturing and distribution companies serving North America and western Europe shows that 32% have already nearshored or are in the process of doing so to meet end-market demand. Of the company leaders surveyed, 48% said nearshoring activities are likely within the next one to three years.[1]

The benefits of nearshoring have been clear and consistent since the trend gained renown: companies move manufacturing closer to consumption markets in order to lower freight costs, improve time to market, and raise customer service levels. But even with clearly sustained North American and western European interest in nearshoring, levels of enthusiasm are tempered by concerns about stability and security in both established nearshoring locations—such as Mexico—and emergent regions, such as North Africa and the Middle East. Those worries dampen efforts by North American companies that want to make use of Mexico's developing infrastructure, and they could squelch western European companies' growing interest in North Africa and the Middle East as potential sources of attractive labor rates and capable workers. Eastern Europe clearly benefits as the preferred nearshoring destination for Europe-bound goods.

Eastern Europe rises, China ebbs

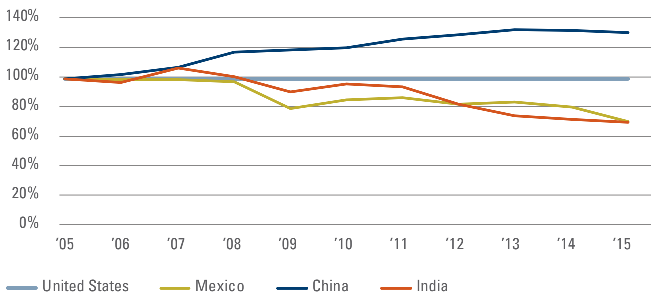
The situation may in turn hasten eastern Europe's power to command higher labor rates, thereby diminishing eastern Europe's popularity—similar to the downward trajectory of China's popularity as an inexpensive manufacturing destination. If eastern Europe begins to lose out on nearshoring work—essentially a victim of its own success—companies in developed markets will have to search out other destinations, or they may simply have to accept a higher degree of risk when they locate in Mexico, North Africa, or the Middle East.

The value of the renminbi has climbed sharply against the US dollar since 2005 (figure 1), diminishing the savings once gained by locating manufacturing in China. That contrasts sharply with the decline of the Mexican peso among other notable currencies during the same period, which makes the question of security and stability in Mexico an even more important consideration. Those trends in foreign currency

1 More than half of the companies surveyed were concentrated in the aerospace/aviation/defense, heavy-equipment/automotive, high-tech/electronics, and energy/oil and gas sectors. Apparel, consumer goods, chemicals, and durable goods makers were among the prominent nearshoring practitioners surveyed across 20 industries.

exchange rates have favored the nearshoring of manufacturing for consumption in the United States but at the same time reduced the relative levels of attractiveness of US exports.

FIGURE 1: Exchange rates used in the Mfg Cost Index



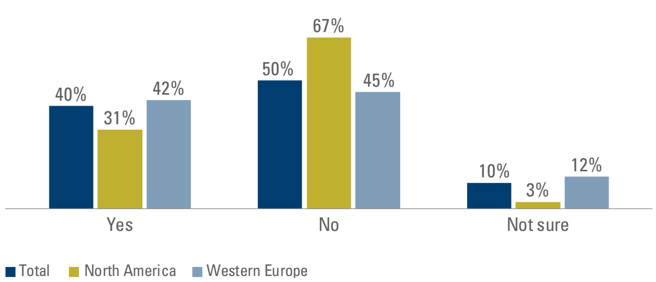
Source: www.gocurrency.com/FX as of May 1, 2015

Fundamentally, the nearshoring concept retains its appeal. Manufacturers continue to be generally upbeat, and 75% of global survey respondents said they expect they'll need greater capacity to meet both foreign and domestic demand. Nearshoring will play a role in controlling costs as that demand ratchets up: 41% of respondents said they would boost foreign capacity to meet domestic demand in their end markets and would dedicate other resources to meet increases in foreign demand.

Western Europe gets on board

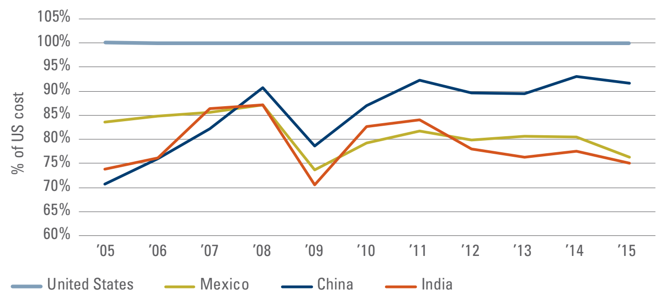
There's a gap, though, between North American and European respondents in their consideration of nearshoring to meet domestic customer demand: 42% of European respondents said they see moving manufacturing closer to their domestic markets, whereas only 31% of North American respondents said that was a likely option (figure 2). That's a significant drop among North American manufacturers—down from a 49% positive response in 2013. It may be because American manufacturers have already carried out their nearshoring operations, though the decline could also point to heightened security concerns about Mexico, which remains the most popular nearshoring destination for US companies.

FIGURE 2: Is nearshoring a possible opportunity for your company to serve domestic demand requirements?



The benefits are expected to increase for all respondents. The average estimated savings in total landed cost (the total price of a product once it's in a buyer's hands) now averages 8.5% globally, up from 6.3% in 2014. The majority of respondents forecast savings of 0 to 5%, with half of North American respondents and 31% of western European respondents projecting that rate range. North American manufacturers were more likely to project greater savings—of 16% to more than 20%. Among European respondents, 51% estimated total landed-cost savings of 6 to 15% (figure 3).

FIGURE 3: Manufacturing Sourcing Index™



Source: AlixPartners

Security clouds prospects in Mexico, North Africa, Middle East

For North American companies, the United States and Mexico remain the most attractive nearshoring destinations, though pessimistic views of Mexico's security and stability outlook continue to proliferate. Only 42% of respondents in the 2015 survey expected improvement, down from 55% in 2014 who expected higher levels of Mexican stability and security. This is a trend to watch closely. A deteriorating security situation in Mexico will have major implications for US companies with Mexican operations, as well as for companies that are considering the practice.

Among non-US companies, eastern Europe was seen as the most attractive nearshoring destination, followed by Turkey and western Europe. Interest in North Africa and the Middle East was significant, though security and stability concerns were higher for those regions. Only 31% of respondents said the region would remain stable, and 46% predicted it would worsen during the next five years.

Reshoring or nearshoring—although an easily understood concept—can prove difficult to execute to a company's fullest advantage. To garner maximum cost and efficiency benefits, companies must overcome myriad challenges. The top three challenges remain the same as they've been since the practice became more widespread: the availability of skilled labor, product quality and consistency, and local government regulations.

Whereas those challenges might make a stronger case for reshoring, or moving production or services back to the home country, the factors that prompted a cross-border search for savings remain obstacles. Reform of tax rates was cited by all respondents as a way governments could encourage reshoring, though experience shows that such reform is rarely accomplished easily. Taxes were the top concern among American respondents; western European companies cited the need for lower labor costs and reform of labor laws as their top two concerns, followed by home country tax rates.

Strategic manufacturing sourcing remains a top priority among manufacturers grappling with the challenges of global production and the mix of domestic and foreign demand. Since 2013, about three-quarters of all companies surveyed are seeing sourcing as a significant issue, though there was less urgency about it in 2015: only 21% of respondents said sourcing was a more important concern than it was a year ago. But the lure of lower-cost production locations is tempered by concerns over security in certain otherwise proven and promising regions—in part because of documented political and criminal instability and in part from lack of detailed knowledge about emerging locales such as North Africa. Other concerns also prevail, even about locations where security risks are low. Companies must consider and carefully plan for tooling and transition costs, regulatory approvals, labor agreements, shifting materials costs, and other macroeconomic uncertainties such as issues with foreign currency exchange rates, interest rates, and industrial policies. Nearshoring destinations may well be in flux, and global manufacturers' actions and attitudes will remain in focus.

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