NEARSHORING AND RESHORING:

On the Rise as Businesses see Greater Opportunities in Keeping Manufacturing Closer to Home

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Introduction

When General Electric (GE) announced plans to move production of a line of energy-efficient hot water heaters from China to Kentucky, Chief Executive Officer Jeffrey Immelt had his eye firmly affixed to one key goal: cutting costs and improving efficiency. Exactly the reasons the company opted to set up production in China in the first place. “Outsourcing,” Immelt said at the time, “is quickly becoming outdated as a business model for GE Appliances.”

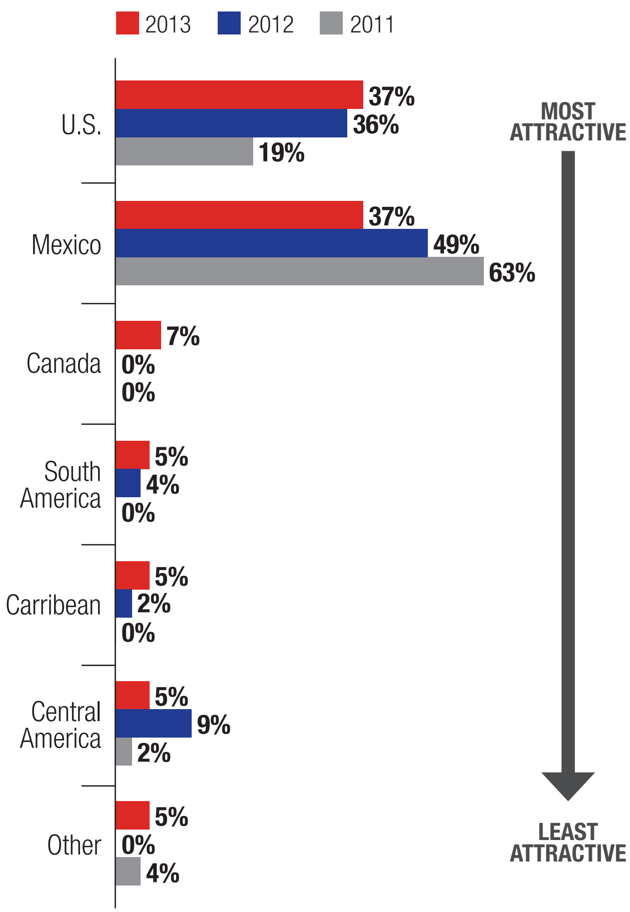
As global economic conditions have changed, and U.S. supply chain operations have become more efficient, a growing number of U.S. and Canadian businesses are realizing that Asia is no longer the low-cost option it once was and that keeping manufacturing closer to home makes good business sense. General Electric is in good company as other leading companies including, Apple, Walmart, General Motors, Ford, Microsoft, and Caterpillar, are among the growing number of businesses returning at least some of their manufacturing to North America. The concept of relocating manufacturing to a nearby country is known as “nearshoring,” while moving operations back to its country of origin is referred to as “reshoring.”

The movement away from Asia has become so prevalent that a 2013 survey by the Boston Consulting Group found that 54 percent of executives at U.S. companies with sales in excess of $1 billion are planning to return production to the U.S. That figure is a sharp increase from the 37 percent of executives who said they were considering reshoring in a 2012 survey.

Mexico has actually been the biggest winner so far in the surge back to North American manufacturing, with international business consultants AlixPartners reporting that 63 percent of U.S. executives chose Mexico as their preferred manufacturing locale. Foreign investment in Mexico has surged in recent years, with an annual growth rate of four percent projected for the 2013-2019 period. The bulk of these investments has gone to build new manufacturing facilities located in free enterprise zones – known as maquiladoras – where manufacturing costs can be as much as 25 percent lower than in the United States.

PERCENT NAMING REGION AS MOST ATTRACTIVE NEARSHORING LOCATION

If nearshoring is a consideration, rank each region in attractiveness. (1 = most attractive; 6 = least attractive)



Source: AlixPartners 2013 Manufacturing-Sourcing Outlook

Canada has also seen its share of nearshoring, especially in the high-tech and information technology sectors as businesses tap into Canada's highly educated workforce and close proximity to the U.S. market.

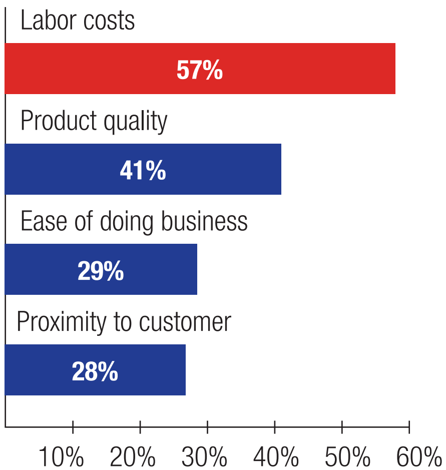
Why the sudden "rediscovery" of North America as a viable source of manufacturing options? In fact, a confluence of factors have made China and other previously desirable locations less attractive:

- Chinese labor costs have skyrocketed at a double-digit pace
- Volatility in world oil markets have driven up production costs
- The U.S.'s own natural gas boom has dramatically reduced energy costs for U.S. businesses
- Political instability and environmental catastrophes – ranging from the Arab Spring to the 2011 Japanese earthquake and tsunami – have demonstrated how vulnerable an Asian-based supply chain can be to external factors
- Severe time zone discrepancies stymied communication between U.S.-based managers and their Asian production facilities
- Difficulty in monitoring quality control and protecting company intellectual property and assets
- Poor working conditions in some Asian factories have caused a backlash against low-cost goods manufactured in "sweatshop conditions"
- U.S. labor has become more productive, causing labor costs to become a smaller portion of production costs

A 2012 study by the Boston Consulting Group asked executives from 106 U.S. businesses the reasons behind their decisions to return production to North America. Following are the top factors cited:

- Labor costs – 57 percent
- Product quality – 41 percent
- Ease of doing business – 29 percent
- Proximity to customers – 28 percent

WHAT DRIVES PRODUCTION LOCATION DECISIONS?



Source: Boston Consulting Group

At the same time China was seeing its star fade, North America's fortunes were rising. Analysis by J.P. Morgan found that "companies are now looking at the bigger picture and factoring in the associated cost of offshore manufacturing, inclusive of all the embedded costs around logistics control, intellectual property, compliance, and quality. They are also finding that bringing production closer to the point of sale means their employees can engage more directly with consumers and adapt quickly to changes in the market," the report said.

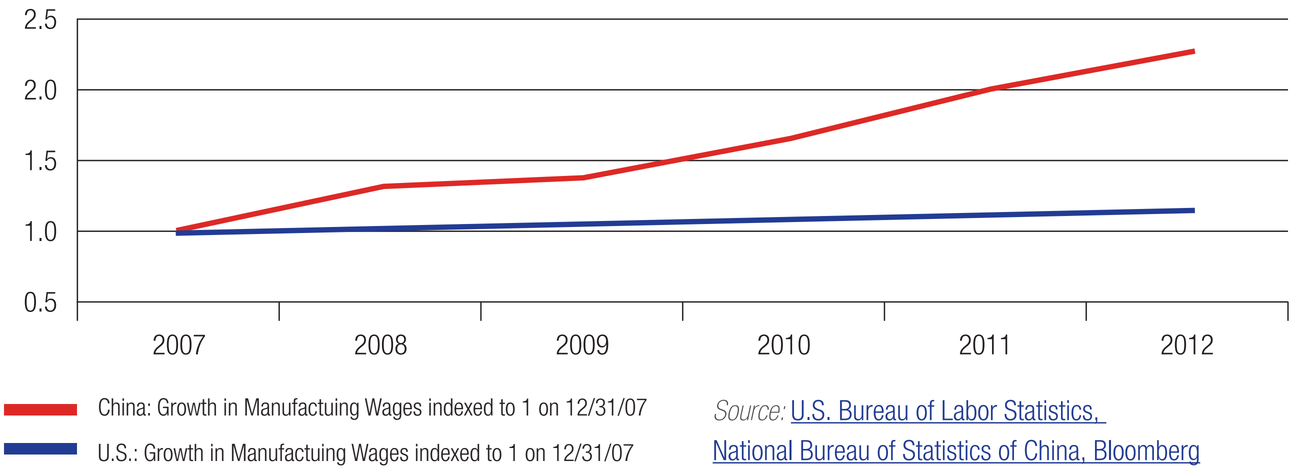
While the number of businesses opting to relocate operations from Asia is undeniably on the upswing, no one is predicting a mass exodus from China anytime soon. For one thing, not all industries lend themselves to such a move. Price Waterhouse Coopers LLC, for example, found that some industries, such as light manufacturing, which depend heavily on low labor costs and not as much on transportation costs, "may find reshoring a less persuasive business strategy."

The following discussion will provide a detailed overview of current nearshoring/reshoring practices, including an overview of conditions that are causing businesses to move manufacturing back to North America, and changes in supply chain preferences. The discussion will also focus on key questions a business needs to consider in deciding whether or not nearshoring might be a viable option.

China No Longer The Bargain It Was

When U.S. manufacturers began outsourcing production to China, management could depend on production costs that were generally 25 to 30 percent lower than in the United States. Lower labor costs, favorable tax structures, and government support for building its outsourcing capabilities caused China to grow its outsourcing revenues by 30 percent annually through 2013. This surge paralleled the growth of outsourcing among multinational corporations worldwide. According to research by Oppenheimer Equity Research, with regard to IT-related production, only 10 percent of the world's multinationals outsourced during 2002, but by 2008 that figure was 70 percent.

CHINA VS. U.S. GROWTH IN MANUFACTURING WAGES: DECEMBER 2007 - DECEMBER 2012



Source: U.S. Bureau of Labor Statistics, National Bureau of Statistics of China, Bloomberg

This all began to change however as economic transitions took hold in China. In The Definitive Guide to Manufacturing and Operations, author Nada Sanders wrote: "The Boston Consulting Group and Accenture recently reported that net per-unit manufacturing costs in China are rapidly approaching those seen in the United States. One reason why is that Chinese wages are rising 15 to 20 percent per year, but productivity remains below that in U.S. factories. The lower productivity was compensated with a substantially lower wage rate. However, as that wage rate grows it may not be enough to compensate for the low productivity and in some cases may become a liability. In addition, the Chinese Yuan is gradually appreciating (approximately 6 percent per year). It is expected to rise faster as China fights an inflation rate that is two to three times that of the U.S. rate and promotes a stronger currency to reduce the cost of imports."

Sanders further notes that because of higher wages and growing inflation, combined with other direct and indirect costs (raw materials, infrastructure, risks), "in many cases it does not make sense for [U.S. companies] to source from China."

But higher labor costs isn't the only reason why many U.S. businesses are opting to return production to North America. As mentioned previously, other reasons include:

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Changing Supply Chain Demands Favor North American Production

Another critical factor U.S. businesses must take into account is the fundamental change in thinking that has taken place with regard to global supply chain management. Outsourcing decisions that were based primarily on lower labor costs were able to accept complicated supply chains that involved long transit times and very little room for flexibility. At that time, it was "normal" for an Asian supply chain to involve a 35- to 45-day transit time.

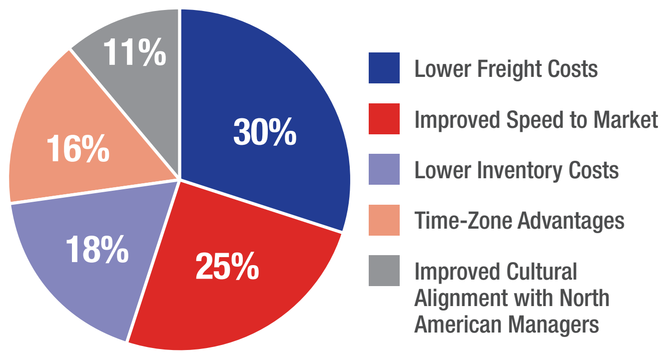
"Many businesses neglected to factor flexibility and agility into their outsourcing decisions," John Ferreira of supply chain consulting firm Accenture told Inbound Logistics. "They didn't consider what flexibility and agility are worth or how to quantify their value. You have to ask whether being able to respond to market demand faster allows you to increase sales or improve margins. If you have ready access to product, can you sell more?"

Today's supply chains have become more regionalized and sensitive to customer demand. Customers expect immediate delivery of products, and empty shelves are seen as a sign of poor supply chain management. Products sitting in a warehouse in China are of little use to a U.S. merchant with demand for those products.

By bringing production back to North America, businesses are taking control of their supply chains. Logistics providers are able to customize solutions that meet the specific needs of businesses. Businesses no longer have to settle for a "one size fits all" approach to moving goods but can choose the solution that works best for them. For example, a business may prefer a supply chain that allows for distribution center bypass, thereby allowing for faster and more direct delivery to customers; or a supply chain that offers accommodations for the peaks and valleys of its business cycle; or a supply chain that is able to consolidate smaller shipments.

North American nearshoring also allows businesses to completely transform their supply chains and reduce freight costs. A separate survey by AlixPartners found that reducing freight costs was the primary advantage businesses expected to achieve from reshoring. Thirty percent of respondents cited lower freight costs, while 25 percent cited improved speed to market, and 18 percent said they expected to achieve lower inventory costs.

WHAT IS THE PRIMARY ADVANTAGE YOU EXPECT TO ACHIEVE FROM RESHORING?



Source: AlixPartners

Also of significance is the ease with which goods can travel within North America. The North American Free Trade Agreement eliminated tariffs on virtually all domestic products, and each country has programs in place to facilitate the border clearance process. This is not to say that crossing any international border is easy – the U.S., Canada, and Mexico each maintain highly complex and exacting compliance, revenue, and security requirements. But an experienced logistics provider can facilitate the border crossing process so that shipments arrive at the border already precleared for entry.

Infrastructure must also be considered. Although far from perfect – Canada is estimated to need $400 billion to fix its crumbling infrastructure, $2 trillion is needed to fix U.S. bridges and roadways, and Mexico faces the double task of improving infrastructure and cracking down on criminal activity – the continent offers a continuous network of road, rail, air, and water options that can form the basis of a well-oiled supply chain.

Which Industries are Nearshoring/Reshoring?

Deciding to move production back to North America requires a great deal of thought and calculation. Just as a business did not make the decision to offshore production lightly, so too will it require careful analysis in deciding to reshore to the U.S. or nearshore to Mexico, Canada, or Latin America. PriceWaterhouse Coopers (PWC) reported recently: "Working with manufacturers on the front line every day, we've observed that when considering the U.S. for its operations, manufacturers evaluate seven critical areas: rising transportation and energy costs; market demand; rising labor costs in China and other developing nations; access to talent, tax and regulatory policies; availability of capital; and currency trends. They look at how such a change will affect all areas of the business."

With regard to energy costs, PWC points out that the price of a barrel of oil was roughly $22 in September 1992, and in August 2014 was hovering at $100 per barrel. This means dramatically higher transportation costs for heavier manufactured goods having to travel from Asia back to the United States – steel, for example. According to PWC, the average cost for U.S. manufacturers to ship China-made steel back to the U.S. during 2010 was equal to 8.1 percent of revenues compared to 3.2 percent during 2006. At the same time, PWC found a 2.1 percent overall cost advantage for steel manufactured in the United States.

Other industries have made similar calculations and are realizing the benefits of returning production back to the U.S.

A Far Costlier Supply Chain:
In the case of U.S. steel products manufactures reshoring from China, shortening the supply chain presents the biggest benefit. In 2010, average transportation costs for U.S. manufactures to ship from China to sell product in the U.S. was equal to **8.1% of revenues** compared to 3.2% in 2006.

Net Cost Advantage U.S.:
Considering labor, transportation, and inventory costs for steel products for sale to the U.S. market, reshoring to the U.S. could contribute to a **2.1% net cost advantage** compared to manufacturing in China.

Source: Pricewaterhouse Coopers LLC, 2013-14

Automotive

Automobile manufacturers were among the first U.S. businesses to return manufacturing operations to North America. While lower labor costs, increased productivity, and enhanced supply chains are generally the key drivers behind reshoring decisions, other factors come into play as well. Reliability and safety issues were cited by Jason Piatt of Praestar Technology Corporation along with a rise in "unmeasured costs and overhead," including travel to and from foreign plants, as reasons in support of reshoring. "Automakers can gain value by having production nearby versus thousands of miles away overseas," Piatt said.

Mexico has been the biggest beneficiary of the surge in automotive production returning to North America. In the past year alone, BMW, Daimler AG, Nissan, Volkswagen, Audi, and Hyundai each announced major investment plans for Mexican-based manufacturing facilities.

As far as sourcing for the U.S. market, Mexico is the largest automotive parts supplier and the second largest exporter of automobiles to the Unites States. Some analysts predict Mexico will surpass Canada as soon as 2015 for the top slot.

Aerospace

The Mexican government undertook an aggressive pursuit of U.S. aerospace manufacturing, and in recent years its efforts have paid off. According to an IndustryWeek report, aerospace-related sales to Mexico increased by 25 percent from 2010 to 2011, which was significantly higher than the industry's overall year-to-year increase of 15 percent.

Mexico's low-cost production process and qualified workforce have been key drivers for many of the more than 250 aerospace companies and suppliers now operating in Mexico. The aerospace "cluster" employs almost 30,000 people and includes Cessna, Hawker Beechcraft, Eurocopter, and Aernnova, among other leading manufacturers.

Aerospace manufacturing depends on a highly technical, qualified workforce, which Mexico is able to provide. IndustryWeek spoke with Tim Meador, chief executive officer of Fridley, Minnesota-based INCERTEC, an aerospace supplier that decided to move some operations to Mexico. "In the industries we serve, precision is critical," Meador said. By moving to Mexico, Meador is able to tap into the pool of 90,000 engineers who graduate annually from Mexican universities – a rate three times the number in the U.S.

Another factor has been Mexico's "maquiladora" factory system, located in free trade zones, which allows foreign companies to maintain control of their production lines and to export finished products tax-free. The Mexican government has also made a concerted effort to facilitate the paperwork and "red tape" that usually result in bottlenecks and delays for any building project. One Mexican manager commented to Aviation Week about the speed with which his aerospace manufacturing was built: "It would be impossible in Europe."

Fashion

According to a white paper by Sourcing Journal Online, Levi's, Hanes, Carhartt, Gap, Walmart, Lee, and JC Penney are among the U.S. apparel companies that have moved manufacturing to Latin America in recent years. Of specific appeal to these manufacturers:

- Lower labor costs
- Favorable trade agreements including:
  - North American Free Trade Agreement (NAFTA)
  - Central American Free Trade Agreement plus

the Dominican Republic (CAFTA-DR)
  - U.S.-Columbia Trade Promotion Agreement
  - Caribbean Basin Trade Partnership Act
  - Hope II (offers incentives for Haitian textiles)
- Shorter supply chains
- Faster lead times
- Better quality control
- Access to trained labor force
- Greater flexibility

Poor working conditions in some low-cost factories have also been a factor. The issue gained much attention in the aftermath of an April 2013 fire that destroyed a Bangladesh garment factory and killed more than 400 people. The tragedy has caused many U.S. companies to question whether or not to keep operations in Bangladesh and has also awakened concerns about poor working conditions in other low-cost nations, including China.

Shortened lead times and added supply chain flexibility are especially important to fashion retailers in today's age of "fast fashion," where success depends on a manufacturer's ability to move products to stores as quickly as possible so as to capture current market trends. As the Sourcing Journal paper points out, fast fashion leaders' lead times have been reduced from 90 days to 4-6 weeks, with inventory refresh rates up to twice as fast as traditional retailers – "40 days on average, versus 80-90 days," the paper noted.

Information Technology (IT)

When Apple founder and then-CEO Steve Jobs famously told President Barack Obama that "those jobs are never coming back," in discussing the movement of IT manufacturing jobs overseas, it was seen as a depressing sign of how far the fortunes of U.S. manufacturing had fallen. So the 2012 announcement by current-Apple CEO Tim Cook that it would bring some MAC computer production back to the U.S. was especially good news. Whether or not Apple's decision will result in a surge in like-minded thinking from other IT companies remains to be seen. Andre Sharon, a professor at Boston University and the director of the Fraunhofer Center for Manufacturing Innovation, told the New York Times: "So much of the know-how has been lost to Asia, and there's no compelling reason for it to return."

Canada, on the other hand, is seeing its long-term investment in its technology sector pay off. Atlantic Canada, which includes the provinces of Nova Scotia and Prince Edward Island along with the easternmost province of Newfoundland and Labrador, has established itself as one of the world's leading IT corridors, and major corporations are taking note. CGI, Microsoft, IBM, EDS, Keane, and CenterBeam have relocated portions of their IT businesses to Canada in recent years, taking advantage of Canada's low corporate tax climate and skilled workforce.

Is Nearshoring/Reshoring Right for Your Business?

Although incidences of nearshoring/reshoring are clearly on the upswing, almost no one is under the illusion that China and other Asian destinations are in danger of losing their status as the United States' top manufacturing hub. Some have called the current surge in reshoring "a correction" or "short term trend."

Regardless of its staying power, nearshoring/reshoring is taking hold among U.S. businesses, both large and small. But it does not make sense for every industry or business.

According to The Wall Street Journal, products more likely to be reshored include heavy or bulky items for which the shipping costs are high in relation to the price, such as heavy machinery. Other candidates for reshoring include expensive items subject to frequent changes in consumer demand for certain colors or styles, such as high-end clothing, home furnishings, or appliances. Makers of products for which safety is a paramount concern – such as food or baby products – might choose to make them at home so they can closely monitor all of the suppliers of parts or ingredients.

But other industries do not lend themselves to an easy shift in production away from China. As noted previously, IT manufacturing has become largely entrenched in Asian manufacturing processes. "It's been a generation since certain types of manufacturing left the U.S.," JP Morgan noted in a recent report. That said though, Taiwan-based FoxConn, which assembles the iPhone and iPad for Apple, and maintains manufacturing contracts with other global firms, has expressed an interest in establishing a physical presence in the United States.

Other considerations that could affect a business's manufacturing plans:

- **Taxation.** Analysis by JP Morgan refers to U.S. tax policy as a "pain point." The United States imposes the highest corporate tax rate of any country in the world. The current corporate tax in the U.S. is 40 percent compared with 20 percent in China, 22 percent in Vietnam, and 27.5 percent in Bangladesh. As far as North America, Canada imposes a corporate tax of 26.5 percent, and Mexico's rate is 30 percent.
- **Experienced Logistics Provider.** Since most businesses list "reducing freight costs" as a top supply chain goal, it is essential to have a qualified logistics provider who can help steer the planning and eventual shift in supply chain operations. Not every logistics provider can do this. Therefore, a high degree of research will be necessary to ensure that a logistics partner has the capability and experience to oversee this undertaking. This is especially true when border crossings are involved, since a high degree of expertise and experience is needed to ensure shipments can travel between the

U.S. and Canada or Mexico hassle free. A few other considerations with regard to choosing a qualified logistics provider:

– **Distribution Network.** Make sure your provider has a distribution network in place that meets your entire coverage needs. If your supply chain includes suppliers or customers in Canada, for example, make sure your provider offers coverage to the more remote regions of that vast country.

– **Flexibility.** A major reason for returning operations to North America will likely be to recapture a degree of flexibility and scalability in your supply chain. Don't assume a U.S.-based carrier will be able to accommodate your needs. Many providers are still stuck in a "one size fits all" service mentality. You will need to shop around to find a carrier that is able to offer a customized supply chain that meets your precise needs.

– **Customer Service.** Similarly, your logistics provider must take seriously your commitment to your customers. A good logistics provider will have staff dedicated to your business, who understands your objectives, and who can advise how best to meet those goals. Equally important, that customer service representative must be easily accessible should something go awry or a last minute change become necessary.

– **Experience.** Do not assume a logistics provider has the necessary experience. When it comes to delivering shipments through a complicated supply chain, clearing shipments across a border, or meeting on-time delivery guarantees, the proof is in the pudding! Check a provider's references, scan the Internet for any customer feedback, and talk with businesses that may have used that provider. A little due diligence can ensure that you partner with the right logistics provider.

Conclusion

Current trends in reshoring/nearshoring may offer a real opportunity for U.S. businesses to lower production costs and wring more efficiency from their supply chains. Businesses that moved production away from North America in order to tap into lower labor and production costs now find the tables have turned and Asia is no longer the bargain it once was. By some estimates, U.S. production costs are on track to pull even with China by 2015 – a feat once unthinkable.

Instead, businesses ranging from multinational corporations to small, privately owned operations are realizing that many of the forces that drove them out of North America could now work in their favor. Increasingly productive workforces, competitive wages, shorter transit times, greater proximity to production, enhanced supply chain control, and less vulnerability to geopolitical and catastrophic events are just some of the determining factors.

A 2013 survey by the Boston Consulting Group found that 54 percent of executives at U.S. companies with sales in excess of $1 billion are planning to return production to the U.S. That figure is a sharp increase from the 37 percent of executives who said they were considering reshoring in a 2012 survey. A separate Boston Consulting Group study offers reasons why production is moving back to the U.S.:

- Labor costs – 57 percent
- Product quality – 41 percent
- Ease of doing business – 29 percent
- Proximity to customers – 28 percent

But as with most critical business issues, there is no "standard" solution when it comes to nearshoring/reshoring. A solution that works for one industry may not work for another. Instead, a business will need to evaluate its unique processes and needs, and weigh those carefully against current economic climate and supply chain opportunities.

Key to that will be to enlist the services of a qualified logistics provider who can create the best possible supply chain, regardless of where production is located.

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Every day, Purolator delivers more than 1,000,000 packages. With the largest dedicated air fleet and ground network, including hybrid vehicles, and more guaranteed delivery points in Canada than anyone else, we are part of the fifth largest postal organization in the world.

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