CORPORATE PERFORMANCE IMPROVEMENT

Revamping the Supply Chain by Nearshoring to Mexico

Content

Introduction

Starting in the 1980s, companies began offshoring elements of their supply chains to low-cost countries in the Asia-Pacific (APAC) region. For decades, this trend was a reliable and certain low-cost option. However, while cheaper labor/materials are often a cost-benefit of the offshoring model to APAC, companies also incur additional logistics and inventory management costs and limit their ability to respond to market changes due to long travel times.

Today's hyper-globalized supply chain paradigm is shifting, given increasing labor, transportation and logistic costs as well as trade barriers, global instability, and supply chain disruptions in inputs and conditions has shifted the paradigm of offshoring.

This article will:

a. Highlight the benefits of nearshoring to Latin America (LATAM), specifically to Mexico, for those companies producing physical goods in Asia with a customer footprint in the U.S.

b. Propose a model that organizations can follow to implement this transformation to maximize and realize the value of an improved supply chain.

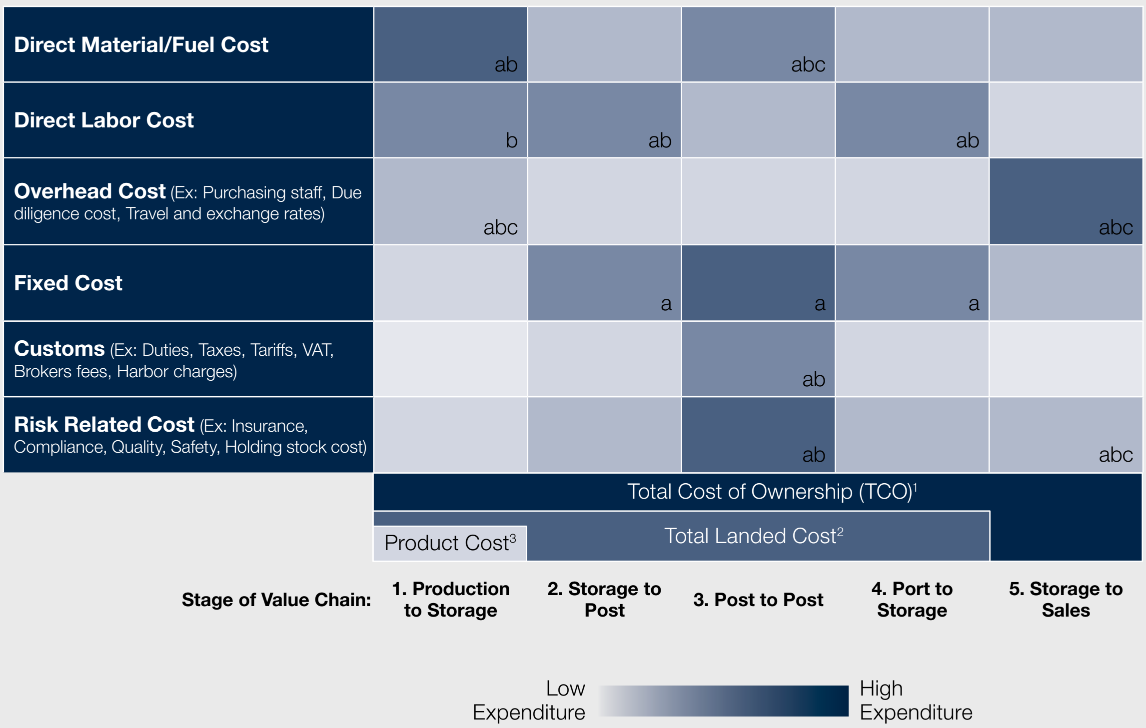
Traditional Offshore Value Chain Challenges

The traditional offshore value chain model in Asia has been a predominant strategy for many global companies seeking cost advantages through outsourcing and offshoring. However, in recent years, the world has seen a change, with more significant disruptions happening more often. Global events like trade disputes, intellectual property and data security concerns, natural disasters, wars, pandemics and changes in countries' economies have destabilized global supply chains. Disruptions have led to shortages and increased costs in inputs, from labor to raw materials across semiconductors, fertilizer, food and beyond (See Fig. 1). Challenges to the value chain are expected to grow in frequency and without warning — signaling exigency to develop resilience in the supply chain. As companies look to modernize their supply chain practices and become more agile and responsive — particularly between North America (NORAM) and Asia — to an ever-changing consumer demand, the costs associated with managing these processes will continue to increase.

Challenges to the value chain are expected to grow in frequency and without warning — signaling exigency to develop resilience in the supply chain.

To minimize the challenges and risks, businesses are exploring ways to bolster the resilience of their supply chains. This may entail relocating or sourcing a portion of production closer to their key customers. For those organizations that serve the U.S. market, this means looking at North and Central America.

Fig. 1 - Traditional Offshore Value Chain Framework



1. **Total Cost of Ownership** (Procurement staff, Supplier management, Currency effects and Total landed cost)
2. **Total Landed Cost** (Shipping, Duties, Tariffs, Taxes, Insurance, Compliance, Shrinkage and Product cost)
3. **Product Cost** (Direct material, Direct labor, Indirect and overhead, Fees, Margin)

Potential Cost Increase Drivers

a. **Geopolitical:** Ukraine conflict, Taiwan, U.S. isolationism, Energy transition

b. **Physical Foundation:** Climate change, Globally transmissible pandemics, Demographics and rapidly aging populations

c. **Demand Variability:** Rapid technology changes, Changing working styles, Consumer ethical/ sustainable preferences

III. Nearshoring to Mexico

In evaluating the current risk environment for companies with a global supply chain footprint, especially between Asia and NORAM, nearshoring production elements to North or Central America, especially Mexico, can be a cost- and value-focused hedge to mitigate risk for companies with a global supply chain footprint, especially between Asia and NORAM.

The value of nearshoring manufacturing, sourcing and operations to Mexico stems not only from its proximity to the U.S. market but also from a host of environmental factors in Mexico's business and economic environment — and aligns to the four groups of Cost and Liquidity Advantages, Process and Organizational Advantages, Growth and Strategic Advantages, and Sustainability and Resiliency Advantages.

Nearshoring production elements to North or Central America, especially Mexico, can be a cost- and value-focused hedge to mitigate risk for companies with a global supply chain footprint, especially between Asia and NORAM.

Additionally, critical specific advantages around labor and logistics costs, supply chain agility, taxation/trade agreements with the U.S. and improved greenhouse gas emissions stand out as primary focal points for the benefits of nearshoring to Mexico.

Nearshoring is not new for Mexico but, more recently, it has been the transformation of the talent and the technology ecosystem that has been the most important and disruptive competitive advantage compared to Asia. Mexico has become a driver of innovation and not only a supplier of basic, second-tier or labor-intensive products.

Below are some of the key benefits of nearshoring to Mexico.

Key Benefits of Nearshoring to Mexico	
Cost and Liquidity Advantages	• Reduced shipping costs via simpler and less variable logistics.[1] • Reduced inventory carrying costs from shorter lead times and higher frequency of shipments.[2,3] • Potential incentives via trade agreements and U.S. industrial policy (IRA, CHIPS).[5] • Reduced corporate tax burden via Mexico's federal policy (e.g., Maquiladora, shelter).[6] • Improved cash-to-cash cycle time from reduced quote-to-cash cycle.[2,3,4] • Reduced and less variable labor rates when compared with the lowest costs in APAC.[6]
Process and Organizational Advantages	• Overland shipping drives less complexity/activities. • Simplified planning, logistics and inventory processes. • Highly skilled (and young) workforce with many engineers and skilled technical workers across different regions.[8] • Management oversight and time-zone advantage.
Growth and Strategic Advantages	• Significantly improved lead times and adaptability to changing market conditions.[4] • Optimized customer service — reduced stockouts, faster response to changes in demand and increased speed to repair/replace products. • Industrial policy and infrastructure spillover from the U.S. • Stable political relationships with the U.S.
Sustainability and Resiliency Advantages	• Considerably reduced risks of shipping and transportation disruptions. • Reduced intellectual property risks (when compared to some APAC countries). • Reduced CO2 Emissions due to optimized transportation.[9]

1. Shipping a container from Asia to the U.S. can be at least two times more expensive than shipping from Mexico to the U.S., according to an internal analysis/research from Optilogic.
2. Delivery lead times between China and the U.S. vary from 20 to 40 days, whereas transportation from Mexico typically takes one to nine days.
3. The following thesis from the MIT Center for Transportation and Logistics evaluates the benefits of shorter lead times and higher frequency of shipments – thesis.
4. By reducing both lead time duration and variability, companies can optimize inventory levels, mitigate the risk of stockouts and adapt faster to changing demand patterns.
5. Mexico has 13 free trade agreements with 50 countries, including the USMCA. Additional incentive programs with the U.S., such as the Inflation Reduction Act (IRA) and the CHIPS Act, reduce duties and provide tax incentives for companies producing goods exported from Mexico and for consumers buying products made in Mexico.
6. Mexico's corporate income tax is 30 percent. Still, incentives for manufacturers, such as the Maquiladora program, lower the tax burden by removing duty taxes on imported raw materials/machinery under the condition that all finished goods will be exported out of Mexico.
7. According to Statista, the hourly wage for manufacturing workers in China increased from $5.78 in 2019 to $6.50 in 2020, a growth rate of over 12 percent. Meanwhile, Mexico experienced a much smaller increase from $4.66 to $4.82, or 3 percent, over the same period.
8. Mexico has a young labor force, with 42 percent of the population between 20 and 49 years old. In addition, Mexico graduates more engineers each year than almost any other country – Statista.
9. Based on an internal assessment, relocating supply chains from Asia to Mexico can reduce emissions from freight transportation and business travel by more than 80 percent.

IV. Nearshoring Model: Implementation and Risks

While multiple key attributes make Mexico an attractive nearshoring destination, realizing value requires leaders to consider nuances and complexities around execution as well as understand the country's business requirements and cultural differences. Critical to success is having a clear and validated execution framework, injecting local knowledge early and throughout the process, and having a partner with a local footprint to help navigate the key steps to nearshoring. The complex path to nearshoring operations can be framed in six stages with key considerations:

Six Stages to Nearshoring Design and Implementation

1. **Analyze your corporation's current challenges and define the corporate goal:** Evaluate financial, customer and strategic considerations; supply chain requirements; internal and external growth drivers; and new market penetration opportunities.

Risks and Opportunities to Manage in Mexico

- **Multiple Avenues for Value:** The table discussing Mexico's nearshoring value proposition shows that Mexico provides important advantages to the U.S. market, but there is no one-size-fits-all approach.
- **International Trade Friendliness:** While an initial move to Mexico may be driven by only a few key customers, Mexico's abundance of trade deals makes it a good candidate for expansion — especially if future growth is targeted in the Americas.
- **Evaluate Tax Feasibility:** Determine the financial impact of a move from a tax perspective and identify potential considerations as the business proceeds down the path to nearshoring.

Learnings

- **Timeline Alignment:** Depending on the strategy and industry, nearshoring at scale could take months to years. In these cases, a well-planned transition is needed to ensure that customers and operations are not impaired.
- **Location Design Timeframe Lens:** Separate the short-term from long-term for location decisions. Consider the case for the value of relocating production facilities in Southeast/South Asia vs. Mexico; also consider if Mexico is the short- and long-term solution that aligns with your corporate strategy.

√ *A&M's Corporate Transformation Services team specializes in aligning significant transformations with corporate strategy and positive EBITDA results. Our restructuring heritage sharpens our ability to act decisively in complexity.*

2. Define objectives, implementation timeline and requirements:

Determine variables, priority and requirements to develop your Optimal Location Rubric Model.

Risks and Opportunities to Manage in Mexico

- **Assess Supplier Ecosystem Needs:** Industrial base maturity varies relative to Asia; some new processes may require tighter connections to supply partners early on. Too little emphasis on customer and supplier strategy can hamper results.
- **Consider Nuances in Labor Availability and Incentives:** For example, certain locations have seasonal workforce demand, and incentives can make a difference in attracting workers.

Learnings

- **Define Key Requirements:** These must be more detailed than working in the U.S. or parts of APAC. It is paramount to assess the availability and reliability of resources (e.g., energy grid, water, roads, etc.) to overcome potential risks with under-investment, climate changes and national-focused policies.
- **Holistic Approach:** Factors that businesses may not perceive as directly impacting cost are important in location decisions, such as the availability of easy/direct flights from HQ to the facility.
- **Design Operating Model:** Design the legal entity structure, business activities and transaction flows around the new Mexican operations, taking into consideration tax, transfer pricing and duties.

√ *Analyzing network efficiency and helping clients leverage supplier ecosystems are core areas of our A&M Supply Chain Services practice.*

√ *A&M's Talent, Organization and People (TOP) practice focuses on understanding the nuances in labor availability and workforce development across industries and geographies to build effective organizations.*

√ *Our International Tax and Global Customs teams grasp the fine points of tax and the broader strategic implications, helping mitigate risk, manage tax burden and drive business performance.*

3. Determine optimal city/region and company structure:

Align requirements with ideal city/region and company structure. Use qualitative and quantitative elements to model options.

Risks and Opportunities to Manage in Mexico

- **Significant Regional Variation:** Energy availability, infrastructure, security and labor force: Southern Mexico vs. Central and Northern Mexico provide very different pictures.
- **Security Challenges:** Relevant risks exist in areas such as cargo theft; mitigation requires regional familiarity to reduce exposure. The use of adequate technology and security solutions should be prioritized. Consider political risk insurance and implementing travel risk protocols.
- **Consider Multiple Routes to Invest in Mexico:** Multiple options exist for the optimal investment approach and company structure (e.g., Maquiladora, shelter, joint venture, acquisition, etc.). While there are significant benefits to each approach depending on your situation, administration and initiation can be complex.
- **Evaluate Local Incentives:** Tax and other economic development incentives can often depend on specific locations being considered and should be evaluated.

Learnings

- **Company Structure and Urgency:** Consider moving toward shelter options vs. greenfield to begin quicker execution.
- **Analyze Multiple Levels of Geography:** Analysis is needed at both the regional and city level to home in on ideal candidate locations.

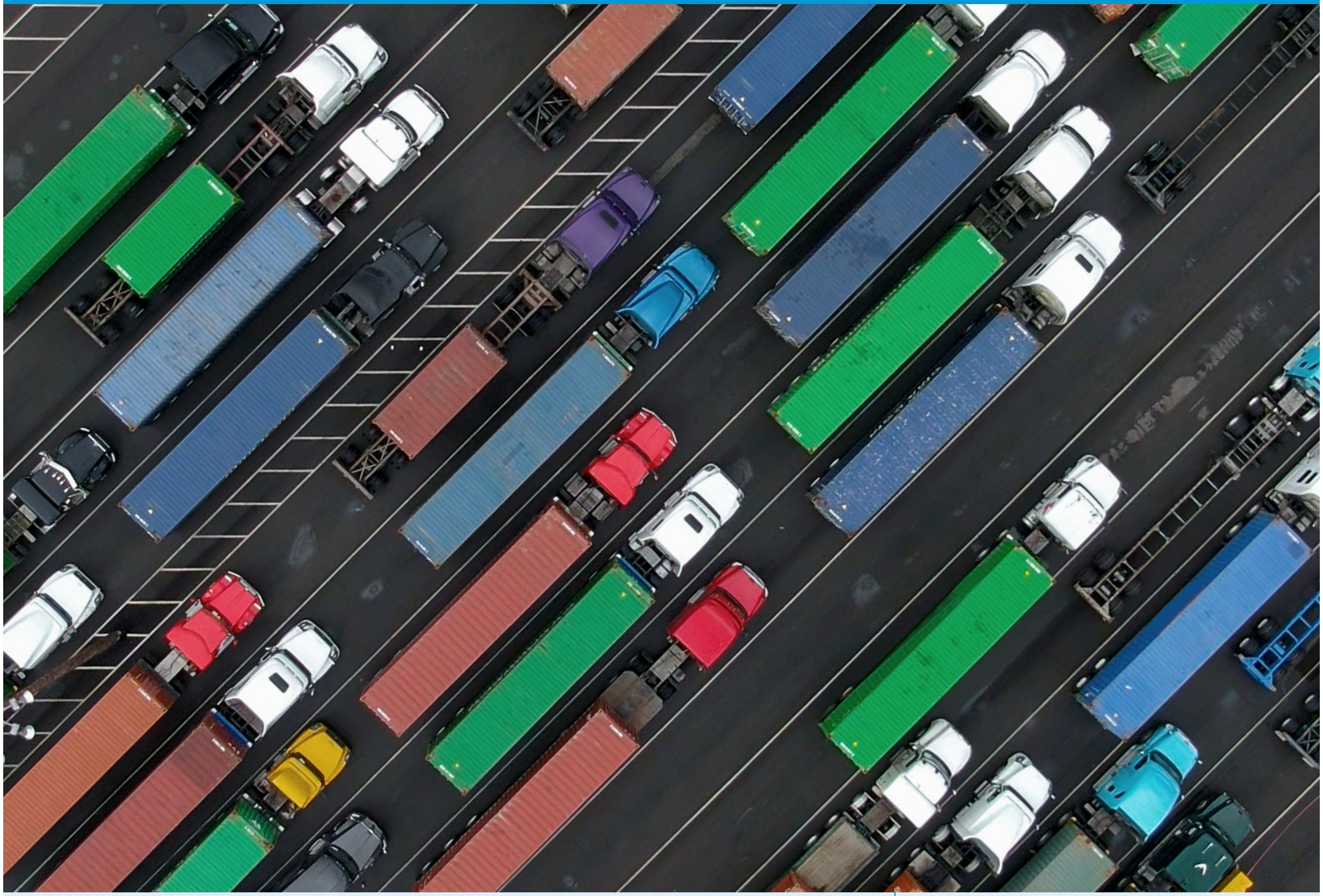
√ *A&M's Supply Chain Services team utilizes a proprietary Network Optimization Tool to reduce transportation spend while considering variables such as manufacturing and labor costs.*

√ *Supply Chain Services al so leverages AIMMS, a software that models scenarios to test hypotheses, understand trade-offs and optimize networks.*

√ *With 600+ professionals specializing in supplier management and third-party risk, our firm can help serve your company's specific needs.*

4. Engage local/federal government:

Initiate discussions with government officials and negotiate incentives.



Risks and Opportunities to Manage in Mexico

- **Engage the Right Parties:** Understand which parties to engage for location incentive discussions; rules may be harder to discern than in the U.S.
- **Incentives at Multiple Levels of Government:** Requires discussion and negotiation with stakeholders at various levels.
- **Corruption:** Mexico still faces corruption challenges; local knowledge can help navigate and avoid difficult situations by region.

Learnings

- **Local Experience:** People familiar with Mexico's investment landscape, as well as tax professionals, are critical to helping navigate complex and unfamiliar situations.

√ *In addition to having a globally-connected team across Asia and Europe, A&M has a fully integrated, multicultural team between Mexico, LATAM and the United States. A&M's strong staff of specialists and senior advisors have extensive and demonstrated experience in the tax, transaction advisory and performance improvement required to make an organization's nearshoring journey successful in the short, medium and long term.*

5. Identify and select local partners:

Determine key local partners — spanning industrial park developers, real estate, shelter services and beyond.

Risks and Opportunities to Manage in Mexico

- **Limited Reach of Local Partners:** Local firms tend to be specialized/limited in terms of company requirements and location.

Learnings

- **On-Ground Presence:** Need a team with a strategic perspective and a presence on the ground to engage/vet potential local partners.
- **Company-Structure Decision Dictates Partners:** Partner requirements highly depend on the company-structure approach.

√ *A&M's Supply Chain team has innovative methodologies to analyze and compare supplier partners. We have also worked with 500+ suppliers from past strategic sourcing projects and leverage relationships and learnings in future engagements.*

√ *Our global reach with 9,000+ professionals enables us to collaborate and engage seamlessly with partners across all regions.*

6. **Develop and execute a detailed plan to relocate and begin operations:**
Mobilize the organization to execute on — and maximize — the nearshoring opportunity.

Risks and Opportunities to Manage in Mexico

- **Project Execution:** To be successful, close collaboration with key suppliers, vendors and partners should start as soon as possible and continue throughout the execution phase.

Learnings

- **Advisors With Local Knowledge and Global Reach:** Global perspective and understanding of the details enables smoother identification and connection with ecosystem partners — ideally being able to cover the spectrum from customer to supplier strategy to detailed execution management.
- **Process Improvement Focus:** Key to having detailed and thorough process design/improvement built into the transition plan, especially around collaborative cross-functional processes (such as S&OP) that may span new geographies.
- **Project Management and Execution:** Holistic project management for relocation of operations is key. Designing and managing a detailed cross-function execution plan and supporting the various impacted business areas is essential.

√ *Clients select A&M for our deep expertise and ability to create and deliver pragmatic and holistic solutions to unique problems.*

Conclusion

As the world's geopolitical challenges worsen and drive complex globalization uncertainties, supply chains will continue to be challenging to manage. Consider engaging a partner with broad strategy and nearshoring experience and capabilities, a global presence and deep operational experience to help your organization navigate major production footprint decisions — and the subsequent difficult, execution-focused work — to realize their full value.

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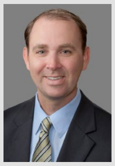

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