Near-Shoring/Right-Shoring Strategies: Weighing the risks of global sourcing

As more attention is being paid to volatility in the supply chain, many shippers are reassessing their global sourcing and distribution strategies. Will multinationals retreat to a hemispheric, near-shoring model or opt for a hybrid that maintains an international component?

BY **PATRICK BURNSON,** EXECUTIVE EDITOR

Risk mitigation may now be the top concern among supply chain professionals. Given the state of today's volatile world, is it any wonder?

Natural disasters in Iceland and Japan have been highly disruptive, as has the political upheaval in the Middle East and emerging markets. Piracy, whether it be intellectual or physical, is also an ongoing worry. And, of course, there's the energy card that will potentially put even more stress on already stretched transportation budgets.

As a hedge against rising transport costs, many industry analysts are advising Fortune 500 clients to weigh the benefits of prevention and response when it comes to managing their global pipelines. Dr. Bruce C. Arntzen, senior research director at MIT's Center for Transportation and Logistics, says that there are several key drivers pushing a global reversal in sourcing strategies.

"No discussion of this topic can be started without first looking at China," says Arntzen. "The emerging middle class and mass of new consumers will be a major force for change. The demand for luxury goods manufactured outside of China is going to remake the manufacturing landscape within that country. For example, a Gucci bag made in one of the local provinces is not going to have the cache of an authentic item from northern Italy."

Furthermore, he says, the sheer quantity of these new purchasers of high-end foreign-made goods is impressive. In a few years, the number of Chinese middle-class consumers will equal the entire U.S. population, says Arntzen.

"Multinationals hoping to sell the Chinese their own manufactured products are going to take a fall," he says. "And the escalating wage structure in China will soon take away another cost-saving advantage."

At the same time, a variety of social pressures outside of China may transform that country's manufacturing base as well. Global demand for "green" products, for example, is already having an impact, says Arntzen. He points to Sourcemap.org, a non-profit consumer web site that allows buyers to create open supply chains for a wide range of products and services using a shared carbon catalog and life cycle assessment (LCA) tools.

"With the complexity in outsourcing from China, the network of sub-contractors is not going to disappear quickly," says Arntzen. "For a new generation of global consumers, the carbon footprint is a critical part of the buying process."

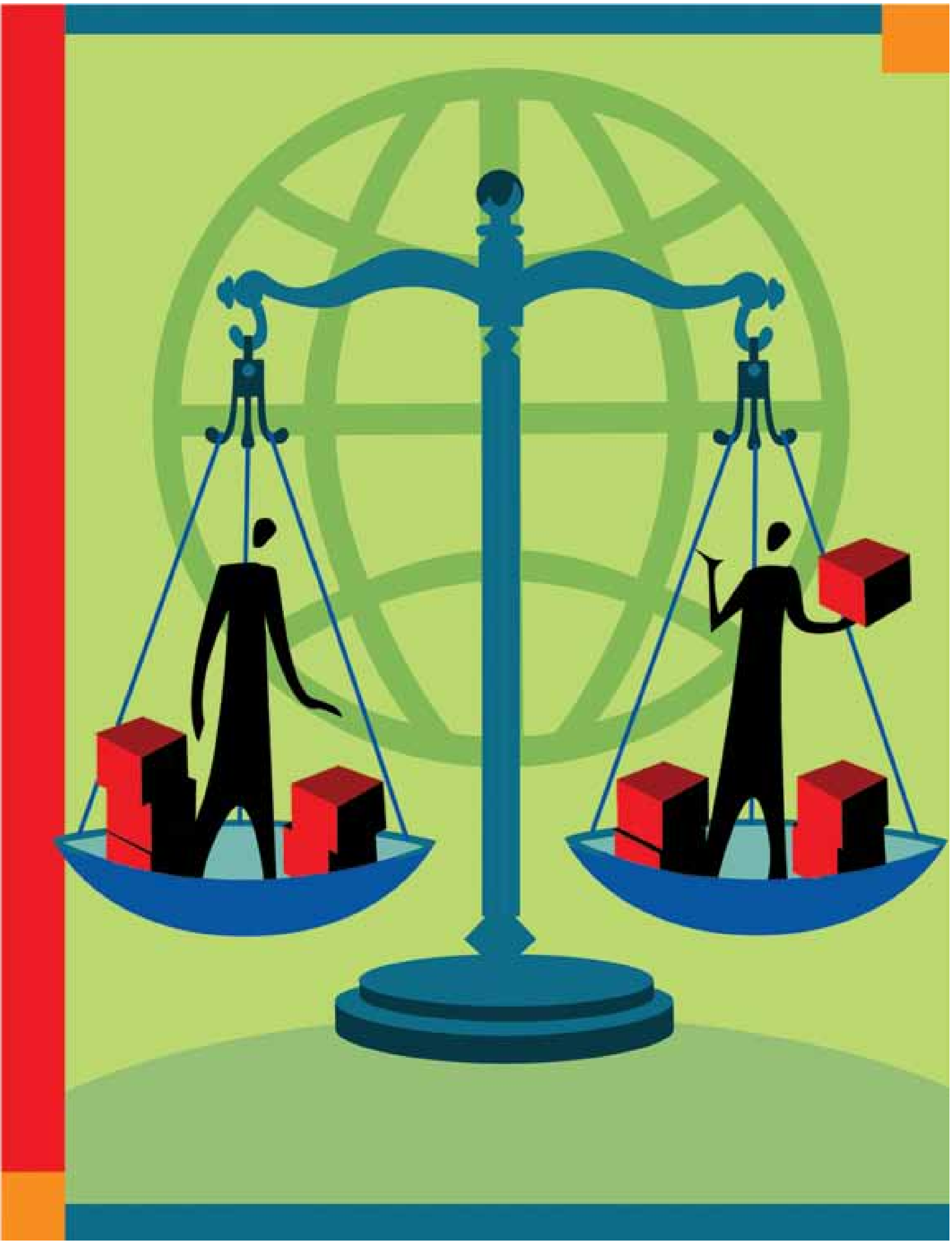
Indeed, even if a multinational is doing everything right when it sources from overseas, the perception that it may be socially irresponsible can be devastating. "It only takes one episode," he says, recalling when a certain Fortune 500 toy-maker had a scandal related to lead paint in one of its products.

"The threat did not come from the primary subcontractor," he says, "or even the secondary or tertiary subcontractor. It came from one of the many obscure providers of services that were vital to keeping manufacturing cost down. And guess what? The company is still paying for that mistake."

Finally, says Arntzen, the risk of losing intellectual property and control over inventory is changing the way companies plan for outsourcing.

LABOR-INTENSIVE FIRST TO SHIFT

Data from Panjiva, an online search engine with detailed information on global suppliers and manufacturers, however, suggests that it's too soon to see a major shift in outsourcing.



China actually increased its share of the U.S. import market from 32.3 percent to 33.4 percent."

In contrast, adds Green, Mexico dropped from 22.9 percent to 19.9 percent. "The one notable bright spot in the Western Hemisphere is Costa Rica, which has grown—but still has a tiny share of the market."

However, in lower-tech, labor-intensive products, like apparel, Panjiva is seeing more movement to the Western Hemisphere. In the most recent three-month period for which this data is available, China lost 1.7 points of market share—though it still retains a massive one-third of the U.S. import market. Of the 10 countries that gained share in the labor-intensive sector, five are in the Western Hemisphere (Haiti, Honduras, El Salvador, Nicaragua, and Peru).

NEAR-SHORING: ADVANTAGE MEXICO

According to a recent poll of 80 C-level executives across more than 15 industries by AlixPartners LLP, a global business and supply chain advisory firm, 63 percent of senior executives chose Mexico as the most attractive locale for re-sourcing manufacturing operations closer to the U.S. market, compared with just 19 percent who would re-source to the U.S.

According to the findings, respondents highlighted geographical proximity and improvements in transportation services between the borders as the key driver in this decision. The survey also found that 9 percent of executives surveyed have already taken efforts to near-shore manufacturing operations, and another 33 percent plan to do so within the next three years.

Additionally, just 19 percent of those surveyed have experienced supply-chain disruptions in Mexico due to

"The trade deficit with China has grown of late, suggesting that the U.S. is more dependent on China, not less," says Panjiva CEO Josh Green. "This is despite the fact that sourcing executives are talking incessantly about moving beyond China."

This is, in part, due to the fact that sourcing executives are finding it difficult to move beyond China quickly, Green adds. Also, China is growing more dominant, not less, in high-tech industries.

"For instance, we pulled data on harmonized trade, which captures the electronics and electrical machinery," he says. "In the most recent three-month period for which data is available, security issues.

"While safety and security in Mexico are certainly issues to be taken very seriously, our survey suggests that many companies believe these issues can be effectively dealt with," says Foster Finley, managing director at AlixPartners and head of its logistics and distribution practice. "As companies think about near-shoring production that was previously off-shored to respond to rising labor costs overseas and exchange-rate changes, Mexico is obviously high on their lists."

According to the survey, Mexico's average ranking for attractiveness among those U.S. executives likely to near-shore was more than seven times that of Brazil's and countries in Central America combined.

The survey also polled executives on plans to off-shore current U.S. operations, and found that 37 percent of respondents have already completed or are in the process of off-shoring, while 27 percent expect to off-shore U.S. operations within the next three years. Of those who have off-shored or plan to off-shore, Mexico also topped the list as the most attractive locale, beating out the much-touted BRIC countries (Brazil, Russia, India and China).

"Despite security concerns in Mexico, the country has a lot of appeal right now because of its proximity to North American demand and the continuing need of many companies to improve their working-capital positions," says Chas Spence, a director in the Latin American manufacturing practice at AlixPartners. "That appeal could grow if fuel prices continue to rise globally."

In terms of the expected advantages to be gained from near-shoring, lower freight costs, improved speed-to-market times, and lower inventory costs were the top three reasons cited on average. Other reasons included "time-zone advantages" (easier management coordination) and improved "cultural alignment" with North American managers.

"In-transit inventory, in particular, was a high priority among those interviewed," says Russ Dillion, a vice president in the Latin American manufacturing practice at AlixPartners. "Obviously, shipping products in from long distances eats up a lot of inventory expense, and that's something companies would like to improve if possible."

RIGHT-SHORING = BALANCE

Other analysts insist that hybrid strategies will be in place for the foreseeable future. Eric Peltz, associate director of the RAND Corp.'s national security division and director of its supply chain policy center, says that capital-intensive industries, like automotive and farm machinery, may prefer to remain in the North American hemisphere, while more agile industries in high-tech and pharmaceuticals can remain in distant lands.

"And then there's the tactic of remaining in China, for example, but moving from the coast to further inland to save on labor costs," says Peltz. "It depends on what makes the most sense for the given organization. We don't see this as a static trend, either. Multinationals are weighing the balance of sourcing so that it can be defined and defended as right-shoring."

RAND, which conducts research that addresses issues critical to the supply chains that drive the U.S. and international economies, places a special emphasis on freight transportation policy and infrastructure. To get closer to the day-to-day issues, Peltz serves on the Board of Directors of the Council of Supply Chain Management Professionals (CSCMP) and co-chairs the CSCMP Research Strategies Committee.

Peltz and other RAND supply chain policy center analysts say that for several decades, firms have optimized their networks of suppliers to minimize inventory and increase responsiveness to customers. These actions have been an economic boon and were predicated on inexpensive and efficient freight transportation. However, several factors are conspiring to erode these gains:

1) The growth in international trade is overwhelming intermodal freight capacity in the U.S. and other countries.

2) Congestion at critical ports, border crossings, transfer points, and urban areas is slowing the flow of freight throughout North America and major gateway locations worldwide.

3) Safety and environmental concerns including noise and air pollution make expansion of the freight transport system difficult.

4) Labor shortages and security concerns compound capacity constraints.

While it certainly presents these and other evolving problems, the globalization of the world economy—leading to the rapid growth of international goods movement—is essential to world economic health. RAND and others interviewed for this article maintain that there's no easy solution to maintaining a free flow of goods and services worldwide.

"Put quite simply," adds Peltz, "it's a work in progress." □

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Near-shoring's unforeseen consequences

For much of this young century, the ports of Los Angeles and Long Beach have continued to benefit from a steady crush of inbound cargo emanating from off-shore factories in China and elsewhere in Asia. However, recent statistics suggest those days may be numbered.

Zepol Corporation, a leading trade intelligence company, reports that U.S. import shipment volume for June, measured in twenty-foot equivalent units (TEUs), decreased 4.57 percent from May and 7.38 percent from June of 2010. The total number of shipments also decreased 4.79 percent from May and more than 6 percent from June of 2010. Year to date, total TEUs are up 4.80 percent this year over last year.

Tellingly, the overall June shortfall was largely caused by the nearly 6 percent decrease in incoming shipments from Asia. China played a large part in this, with a 5.82 percent decrease in shipments.

"As the nation's primary gateway to the Pacific Rim, California derives ample economic benefits from the import trade," says Jock O'Connell, Beacon Economics' International Trade Adviser.

"As much as we might like to reduce our dependence on imported goods, it's worth emphasizing that moving imported goods to markets throughout the nation represents a vital source of jobs—many of them well-paying—in a state where unemployment rates remain perilously high," says O'Connell.

—Patrick Burnson, Executive Editor