April 9th, 2012

Dear clients and colleagues,

Many US and European companies we have interviewed in the last few months have mentioned their interest in moving some of their manufacturing operations closer to home. From textile to wind turbine component manufacturers, relocalization is taking place in a broad range of industries.

What drives companies to reassess their sourcing strategy?

Wages and cost inflation:

With labour costs soaring 15% to 20% annually in the past few years and forecast to continue, the Chinese labour cost advantage should decline considerably by 2015. Some supply chain experts argue that even with increased productivity, the cost savings of Chinese versus US manufacturing could be a mere 10% to 15%. And this is before transportation, duties and inventory costs.

Rising crude oil prices also have a direct impact on profitability. Every dollar increase in the oil price increases transportation costs by approximately 1%. With oil prices forecasted to stay high, manufacturers are looking for ways to be more cost effective by moving closer to their end markets.

In some specific industries where energy is an important cost, relocalization can result in an enormous advantage. With cheap natural gas prices, US-based industrial companies, particularly chemical producers, enjoy a very competitive cost structure.

The gradual appreciation of the Renminbi also makes Chinese goods more expensive, which should speed up nearshoring and onshoring.

Efficiency, quality control and other factors:

Following the 2008 recession, time-to-market has been a major consideration in supply chain management. Keeping low inventory levels while being able to react quickly to changing consumer behaviour is extremely important in today's operations.

Etam, the European lingerie company, has recently decided to reallocate some of its Chinese production to Morocco, Portugal, Turkey and Tunisia due to a decline in the quality-to-cost ratio in China. The management team mentioned the importance of protecting the brand image and pushing the product to market faster.

Other reasons that motivate companies to change their sourcing strategy include time zone, cultural similarities and generous fiscal incentives such as tax breaks and cheap loans.

China remains a major manufacturing hub, especially for basic goods that require higher labour content. However, with rising costs and the other factors mentioned above, nearshoring and onshoring will become more attractive for companies serving America and Europe. The shift in international competitiveness has already started. Morocco and Mexico are not the only countries likely to benefit from this sourcing trend. The US is also seeing the rebirth of its longtime declining manufacturing sector.

A new report by Boston Consulting Group entitled *"U.S. Manufacturing Nears The Tipping Point: Which Industries, Why, and How Much?"* was recently published and states that the United States should add 2 to 3 million jobs and an estimated $100 billion in annual output to the U.S. economy by around 2015. This report follows last year's report entitled *"Made In America Again: Why Manufacturing Will Return to the U.S."*

Have a good week.

The Global Alpha team