How can companies best leverage Mexico in their Global Supply Chain Strategy?

March 17, 2022

east west associates®

DRIVING COMPANY GROWTH IN CHINA, ASIA, MEXICO & CEE

Webinar Agenda

1. **Introduction of East West Associates**
2. Introduction of Corporate Speakers
3. Why Mexico?
4. Webinar Discussion Rationale
5. Challenges for companies
6. Goal for the companies
7. Trade Definitions
8. Case Studies

EWA Personnel & Core Expertise

- A leading provider of Corporate Strategy, Commercial, Operational & Risk Management solutions

- Founded in 2005, EWA executives have held senior management positions with P&L responsibilities for western MNCs, including

✓ Briggs & Stratton (NYSE: BGG)

✓ Bechtel Corporation

✓ Littelfuse, Inc.

✓ Eastman Kodak (NYSE: KODK)

✓ Ashland, Inc. (NYSE: ASH)

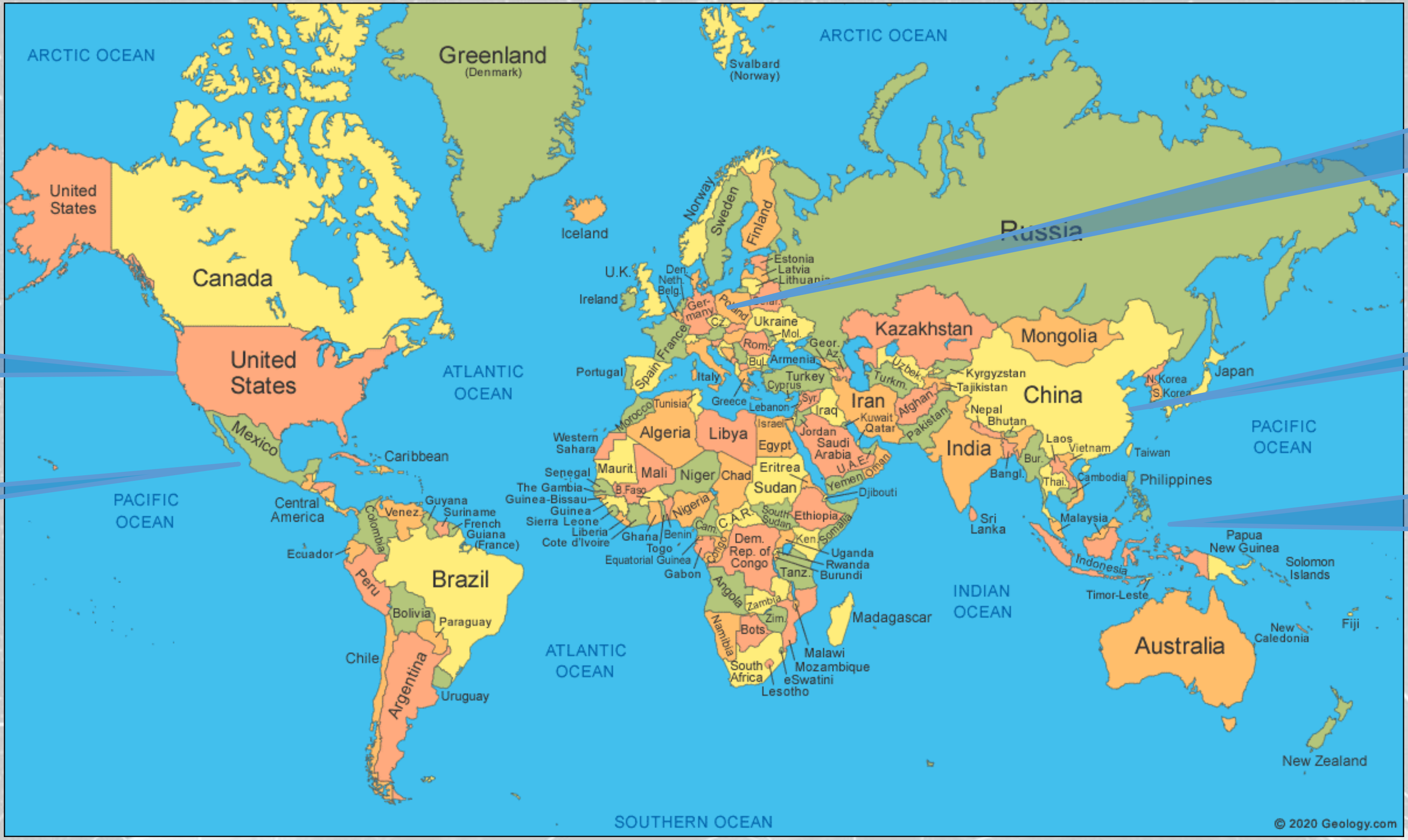
EWA Core Areas of Service

- Strategic Business Planning
- Manufacturing Footprint Optimization
- Supply Chain Optimization
- Performance Improvement
- HR & Executive Recruiting
- Risk Management
- M&A Due Diligence
- Business Assessment
- Research Services

EWA Executives in 5 Regions

United States

Mexico



Central Eastern Europe

China

South East Asia

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Introduction of Corporate Speakers

1. **Stefan Lachner, Senior Automotive Specialist**
2. **Dan McLeod, Director**
3. **Mark Plum, Director**

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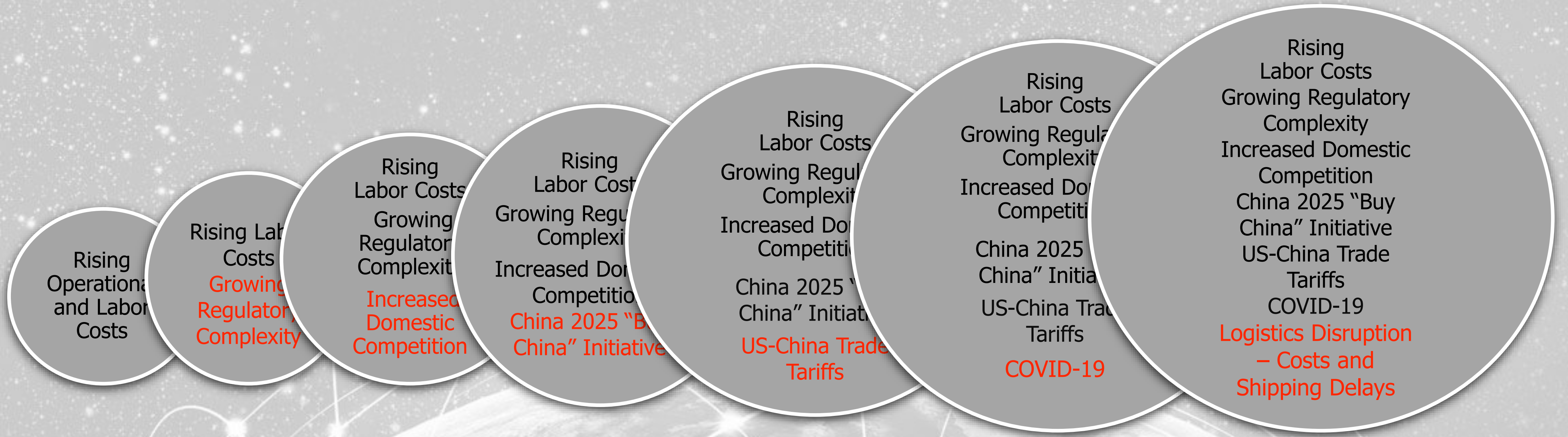
Economic Challenges In China

During the last 13 years, the economic challenges facing western companies operating in China have been continuously evolving and growing for years:



Why Mexico?

- Location to the US and North American market
- Growth of the Mexican industrial base, particularly in automotives, electronics, durable goods, medical, etc.
- Quality supply base in certain industry sectors
- Competitive labor base costs and skills
- Trade governed by USMCA trade agreement
- Not subject to the US/China Tariffs

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Webinar Discussion Rationale

- Companies are evaluating opportunities to improve their Global Supply Chain and Manufacturing Strategies
- Includes: potentially diversifying more supply chain and manufacturing into Mexico if their market is US/North America
- Even keeping their Chinese supply base, manufacturers can still take advantage of the USMCA trade agreement – local content
- The strategies include:

I. <u>Sourcing components / finished goods with local content from Mexico, for consumption in the U.S.</u>

   i. Basic approach

II. <u>Sourcing components / finished goods with local content from Mexico and imported content from China, for consumption in the U.S.</u>

   i. China content likely result of qualified long-term Chinese/Southeast Asian suppliers, lack of qualified Mexican suppliers

   ii. Impact on supply chain cost & impact by USMCA

III. <u>Setting up subcontracting or manufacturing in Mexico, utilizing local content from Mexico and imported components from China and elsewhere</u>.

   i. Establishing a wholly-owned operation in Mexico with all its complexity

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Challenges for Companies

Challenge to companies is to look past the immediate pressure vs. establishing a long term strategic solution

Requires:

I. Experience in identifying and qualifying stable & reliable supply base – real challenge – having an established relationship with suppliers is more important than ever before

II. Understanding the impact of using imported components and raw materials on your cost structure

III. Knowing how to leverage the rules of USMCA and importing countries

IV. Understanding the culture, business environment when establishing an operation or subcontracting relationship

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Goal for the Companies

Develop supply chain and manufacturing strategy compare:

- Create more stable supply chain strategy
- Comparing Mexican & Chinese suppliers equally – landed costs, cost of money tied up in freight
- Reduce dependence on China
- Address the consistently rising labor costs in China
- Diversify supply chain base to ensure a consistent supply of qualified raw materials and components
- Protect against the volatility of international trade – logistics, tariffs, currency fluctuation
- Reduce the risk of geopolitical impact

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Trade Definitions

1. Prosec
2. Rules of Origin
3. Regional Content Value
4. Transaction Value Method & Net Cost Method
5. Summary

Trade Definitions

PROSEC = Promoted Sectors

I. PROSEC allows companies that supply or work within the promoted sectors to import goods & material from outside any free trade agreement for preferential duties, normally 0%.

II. Only applies to imports into Mexico

III. Currently 24 different industry sectors are being promoted, under which steel, automotive, chemicals and electronics are the most prominent ones.

IV. Example:

* Import Chinese auto components into US and possibly face US/China tariff
* Import Chinese auto components into Mexico and possibly no/low duty/tariff due to PROSEC
* Only applies if the importer adds value in Mexico to the imported auto component

Rules of Origin

I. Concept governing USMCA permitting duty free trade for products that "originate" within US, Mexico, Canada

II. USMCA has product-specific rules to determine whether a particular product meets the requirements for "originating"

Trade Definitions

Regional Content Value

I. Term describing whether a product qualifies for the trade benefits under USMCA
II. If a product is determined under USMCA to meet the Regional Content Value, then entitled to the duty/tariff benefits of USMCA
III. Regional Content Value differs significantly depending on the end product usage
IV. For a more protected industry sector like automotive, the USMCA requires a higher Regional Content Value – to protect against significant imports
V. For less protected industry sectors like appliances, USMCA allows for a lower Regional Content Value

Transaction Value Method & Net Cost Method

I. 2 calculation methods to determine whether a particular product meets the Regional Content Value
II. Webinar is not a class on compliance training, but need to know basics to understand so can best determine how it will affect your Supply Chain Strategy and cost structure
III. Net Cost Method evaluates the %s of "originating" material used by producer in the production of the goods
IV. Transaction Value Method is the transaction value of the particular product used by producer in the production of the goods – allows producer to include the cost of equipment deduction, marketing and overhead costs & royalties

Trade Definitions

Summary

1. The USMCA allows for free trade of goods between USA, Mexico and Canada if they were produced in any of the three countries.
2. Various exceptions to these basic rules apply for protected industry sectors like automotives, automotive electronics, steel, oil & gas, chemicals, etc.
3. Prosec allows companies to import goods & materials into Mexico from outside USMCA at preferential duties – often 0%
4. Even if goods are being assembled with imported components, there are possibilities to trade them tax free (no tariffs or duties) between the USMCA countries.
5. Since some industries are more protected than others (automotives, electronics, steel, etc.), an imported product will have varying tariff codes depending on the industry sector using the product

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Stainless steel tubes produced in Mexico and exported to the US

100% regional content of material (either US, CA or Mex)

+ 100% Mexican value add

⇒ Complies with any Rule of Origin

Manufaturing in Mexico
- Labor
- Material
- Consumables-Lubricant
- Expenses
- Utilities

} 100% Regional Content

Stainless steel tubes produced in Mexico and exported to the US

Material imported from China under PROSEC (0% tax) to Mexico + 100% Mexican value add

- Net value method calculated due to steel being the main component = 65% regional content:

- Complies with **50%** requirement for appliances (8509)
- Complies with **50%** requirement for automotive aftermarket (8708)
- Complies with **60%** requirement for heavy truck (8708)
- Complies with **65%** requirement for oil and gas (7306)
- Does not comply with **70%** for passenger cars w/o chassis (8708)
- Does not comply with **75%** for chassis (8708)

Manufaturing in Mexico

– Material (w/o transport etc) } 35%

– Labor
– Services
– Utilities
– Expenses (w/o marketing etc)

} 65% Regional Content

- So exactly same tube will have different tariff codes depending on the industry sector using the product

Case Studies

Electronic equipment (sensors) produced in Mexico and exported to the US

Material imported China under PROSEC (0% tax) to Mex+ 100% Mexican value add

- Net value method calculated for automotive sector = 65% regional content:

- Complies with **0%** industrial use (8504)
- Complies with **40%** consumer electronics (8537)
- Complies with **60%** requirement for bus (8527)
- Does not comply with currently **67.5%** for passenger cars (8527)

- Sector and application focus

Manufacturing in Mexico
- Material (w/o transport etc) } 35%

- Labor
- Services
- Utilities
- Expenses (w/o marketing etc)

} 65% Regional Content

Conclusion

Global Supply Chain Strategy

I. Given the current situation in China (Covid travel restrictions, rising labor costs, logistical costs) and improvements in Mexican supply chain base, companies are diversifying their Global Supply Chain and Manufacturing to Mexico to better service their customers in the US & North America

II. Companies evaluating the impact of diversifying their Global Supply Chain Strategy to Mexico

* Available Mexican Supply Chain base
* No specific Mexican duties on Chinese imported products
* Use of imported components allowed under certain circumstances
* Lower logistical costs
* Impact of USMCA
* Companies are taking a much more "holistic" approach to leveraging Mexico as a Supply Chain base in order to determine the effect on their supply chain cost structure

Conclusion

Global Supply Chain Strategy

III. Companies which are sourcing a product produced in Mexico with Mexican content are comparing their costs to their current Chinese suppliers

* tough sourcing environment in Mexico because potential suppliers overloaded and Mexico is not China

IV. Companies which are sourcing products from Mexico which are made with imported products must go a little deeper in their cost structure analysis in order to compare with their current imports from China