

2011 U.S.
Manufacturing-
Outsourcing
Cost Index

COSTS AND COMPLEXITY

Will China Remain the Low-Cost Country of Choice?

According to the *AlixPartners 2011 U.S. Manufacturing-Outsourcing Cost Index*, Mexico had the lowest landed costs for U.S. customers while other key low-cost countries (LCCs), including India, Vietnam, and Russia, had higher costs but remained more competitive than China. Looking ahead, as key general manufacturing cost drivers stabilize at more economically sustainable levels after the recession of 2008/2009, we expect LCCs' competitiveness with

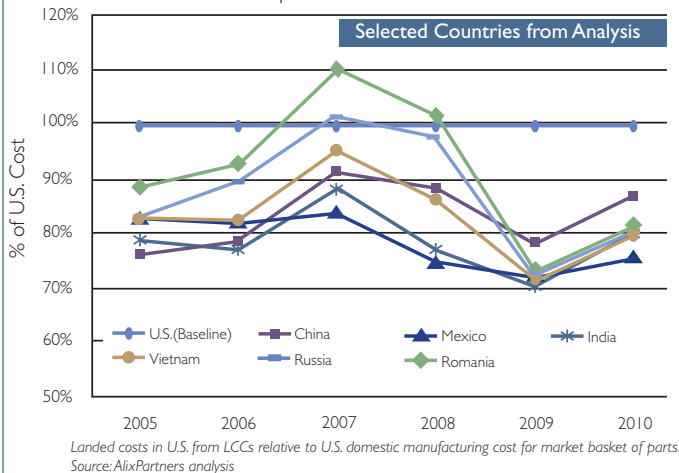
the U.S. to erode. While Asian LCCs will likely be more impacted than Mexico, China may experience particular negative pressure on landed costs due to wage inflation, exchange-rate pressures, and higher freight rates.

Key Trends

While the U.S. regained some cost advantage relative to the major LCCs, due largely to the weak dollar, major LCCs maintained a cost advantage over U.S. domestic suppliers, with savings potential similar to that seen in 2005-2006 (figure 1).

Since 2007, the competitive landscape for outsourcing has shifted significantly to favor Mexico, some locations in Europe, and several locations in Asia other than China. Mexico delivered products at the lowest landed costs in 2010, and emerging LCCs such as India, Vietnam, Russia, and Romania had lower landed costs than China, which faces not only climbing wages but also increasing freight fees and growing pressure to allow the yuan's exchange rate to fluctuate with the currency market.

FIGURE 1: Manufacturing-Outsourcing Cost Index¹
Composite Index - 2010



¹Because the range of goods imported into the U.S. is vast, the AlixPartners study compares LCC cost drivers to a baseline of U.S. manufacturing costs for a basket of parts that can be made anywhere with locally sourced materials: simple fabricated piece parts, auto-welded and complex electromechanical assemblies, and consumer-oriented custom packaging. Several cost drivers are factored into the analysis, including the key variables – wages, exchange rates, and freight fees – but also overhead, raw materials, duties, and in-transit inventory. Each driver is modeled for the part and the country of origin. In addition, the sampling of cost drivers is diverse enough to cast different cost structures in sharp relief and highlight their relative impact.

Nevertheless, China is expected to remain an LCC stalwart for the foreseeable future for many manufactured products consumed in the U.S. due to its mature manufacturing infrastructure and the significant switching costs of moving production.

When Will China Be More Expensive Than The US?

While there are a large number of factors that drive a manufacturing cost, three will be critical in the coming years for China: wage inflation, exchange rates, and freight fees. To understand the relative impacts of these three key drivers on China's landed costs over the next four years, AlixPartners assessed each driver separately (as if the other two were to remain unchanged from 2011 through 2015), and then in combination.

The analysis was based on three assumptions:

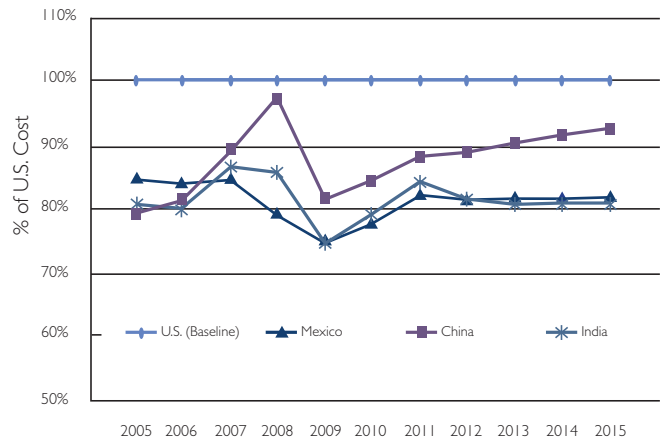
- 30% annual increase in China's wage rates. This is in line with Chinese wage inflation over the last several years.
- 5% annual increase in the strength of the yuan. A widely accepted estimate of the under-valuation of the yuan is 20% - 25% relative to the U.S. dollar:
- 5% annual increase in freight rates. This is a reasonable assumption based on increasing fuel prices and stabilization at pre-boom and bust levels.

Looking at the results of this sensitivity analysis, it's easy to see not only why China's role as an LCC is durable, but also how the three drivers in combination could erode China's dominance.

Four Scenarios

One scenario in the analysis assumes the 30% annual wage rate increase in China, unchanged freight and exchange rates, and a steady, baseline wage-rate increase of 2.5% per year for the U.S. over four years. Under those conditions, China's landed cost for the basket of parts would still be about 10% lower than the U.S. (figure 2).

FIGURE 2: China Wage Rate Increase of 30%



Likewise, if the yuan were to increase in strength 5% annually relative to the U.S. dollar while wages and freight rates remained flat, China's landed cost would still be about 5% lower than U.S. landed costs in four years (figure 3). In this scenario, the yuan's exchange rate would have to strengthen by about 10% annually to push China's landed cost up to that of the U.S. with other factors remaining flat.

FIGURE 3: China Exchange Rate Increase of 5%

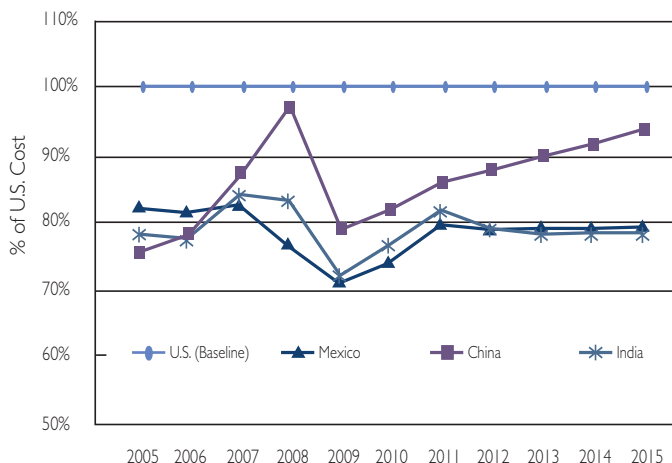
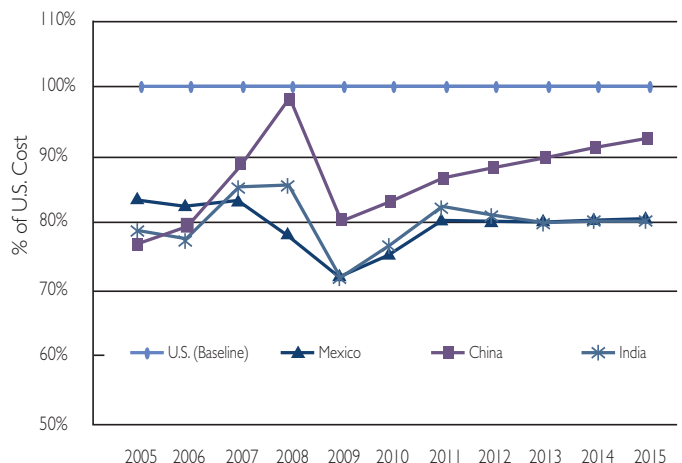


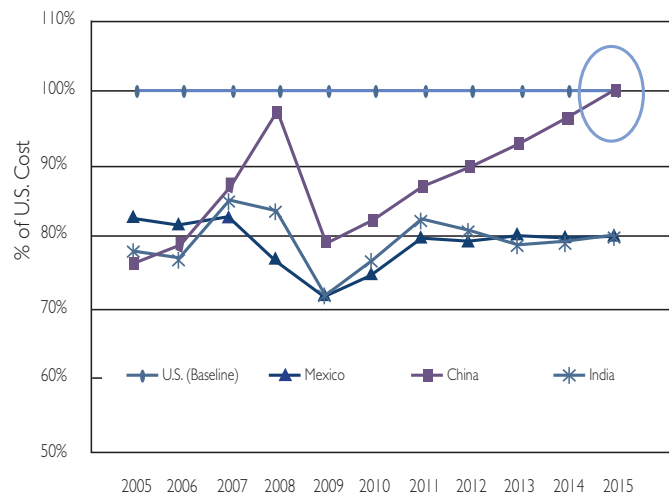
FIGURE 4: Freight Increases of 5% Annually



The study's third scenario has freight rates rising 5% annually and wage and exchange rates flat, which would leave China's landed cost about 10% less than that of the U.S. after four years (figure 4). Freight rates would have to increase 35% annually for China's landed cost to reach that of the U.S.

Based on this analysis, it is very unlikely that any one factor will tip the balance for manufacturing costs in favor of the U.S. over China. However, the three cost drivers' potential combined effect, according to the analysis, would leave landed costs for China and the U.S. about equal four years from now (figure 5).

FIGURE 5: Multiple Variable Scenario



Conclusions

While these hypothetical scenarios certainly don't rule out China as an LCC contender, they do illustrate the challenges that companies can expect if they have concentrated the supply base for their U.S. operations in China. Again, while no one factor is likely to tip the cost advantage in the favor of the U.S. over China, a combination of reasonably

likely factors could well erase some or all of China's cost advantage over the next four to five years. Finally, these scenarios also highlight the need for flexible strategies and constant diligence when implementing an aggressive global supply chain strategy.

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