KPMG

Navigating the road to Mexico

Strategies and actions for establishing your supply chain

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There is a saying in the real estate community that there are three key issues in any real estate transaction, “location, location, and location.” Well there currently is a similar mantra from the OEM and Tier 1 automotive companies, “Mexico, Mexico, and Mexico.”

In 2014, Mexico was the seventh largest vehicle producer worldwide and served as an export platform for many of the world's major original equipment manufacturers (OEMs). Mexico has been gaining momentum in recent years.

World auto production 2006–2014

	Thousands of units	2006	2007	2008	2009	2010	2011	2012	2013	2014	CAGR 2006–2014
1	China	8,882	7,278	9,299	13,791	18,265	18,418	19,271	22,117	23,723	13.1%
2	United States	10,781	11,292	8,672	5,699	7,761	8,661	10,328	11,046	11,661	1.0%
3	Japan	11,596	11,484	11,575	7,934	9,626	8,398	9,942	9,630	9,775	-2.1%
4	Germany	6,213	5,820	6,046	5,210	5,906	6,311	5,649	5,718	5,908	-0.6%
5	South Korea	4,086	3,840	3,827	3,513	4,272	4,657	4,561	4,521	4,525	1.3%
6	India	2,307	2,016	2,332	2,641	3,537	3,927	4,145	3,881	3,840	6.6%
7	**Mexico**	**1,979**	**2,022**	**2,103**	**1,508**	**2,261**	**2,557**	**2,884**	**2,933**	**3,220**	**6.3%**
8	Brazil	2,971	2,611	3,216	3,183	3,648	3,407	3,342	3,740	3,146	0.7%
9	Canada	2,578	2,571	2,041	1,477	2,071	2,135	2,463	2,380	2,394	-0.9%
10	Russia	1,660	1,503	1,790	724	1,403	1,990	2,231	2,175	1,887	1.6%
11	Spain	2,890	2,777	2,542	2,170	2,388	2,373	1,979	2,163	2,403	-2.3%
12	France	3,019	3,169	2,569	2,048	2,229	2,242	1,967	1,740	1,817	-6.1%
13	England	1,750	1,650	1,649	1,090	1,393	1,463	1,576	1,597	1,599	-1.1%
14	Italy	1,284	1,211	1,024	843	838	790	671	658	698	-7.3%
15	Belgium	844	918	724	523	555	595	541	480	517	-5.9%
	Subtotal	62,840	60,162	59,409	52,354	66,153	67,924	71,550	74,779	77,113	2.6%
	Others	6,494	13,028	13,111	9,438	11,705	12,121	12,550	12,519	12,637	8.7%
World Total		**69,334**	**73,190**	**72,520**	**61,792**	**77,858**	**80,045**	**84,100**	**87,298**	**89,750**	**3.3%**

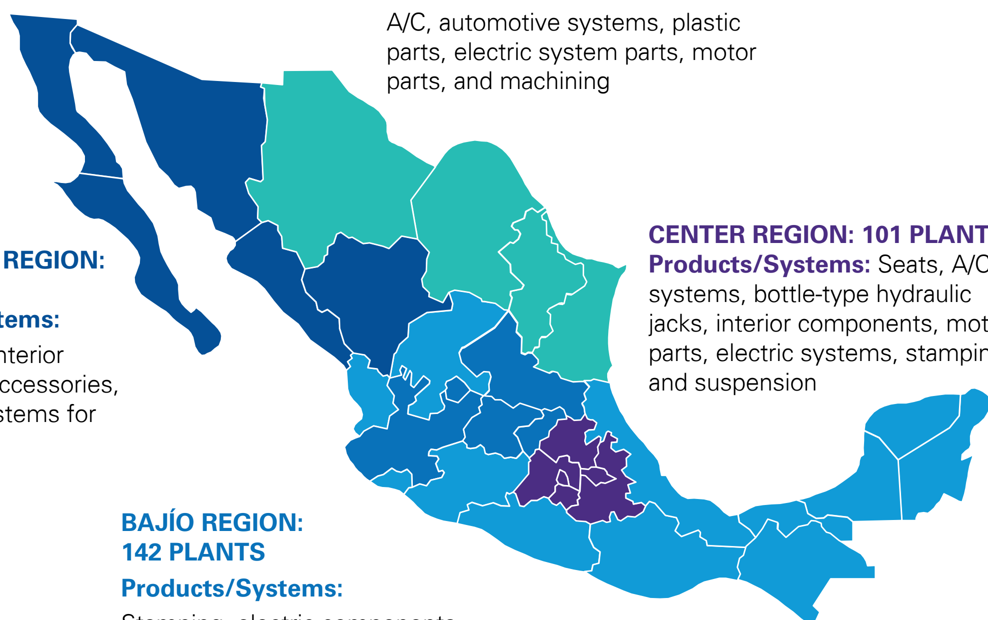
Source: Asociación Mexicana de la Industria Automotríz (AMIA) and International Organization for Motor Vehicle Manufacturers (OICA), 2015

- The Mexican automotive OEM sector is quite concentrated with Ford, General Motors, Fiat Chrysler, Volkswagen, and Nissan accounting for 85.9 percent of production and 73.9 percent of internal sales.
- The majority of manufacturing presence is found throughout the **center and northern regions** of the country, which facilitates access to both the domestic and U.S. markets.
- Of the major leading automotive companies, Nissan is the market leader with 24.2 percent of sales as of September 2015 and General Motors and Volkswagen follow with 20.4 percent and 13.7 percent, respectively. Additionally, Ford, Toyota, Audi, and BMW have recently announced significant new investments in Mexico that will boost vehicle production even further.
- Twenty-three of the top 25 global OEM parts suppliers (based on sales) currently have a presence in Mexico. Most of them are located near the OEMs they supply, which creates a cluster advantage. The disadvantage is the travel between areas is time-consuming, which then requires multiple plants that need to be coordinated.

NORTHEAST REGION: 198 PLANTS

Products/Systems:

A/C, automotive systems, plastic parts, electric system parts, motor parts, and machining



NORTHWEST REGION: 70 PLANTS
Products/Systems:

A/C systems, interior components, accessories, and electric systems for automobiles

CENTER REGION: 101 PLANTS
Products/Systems: Seats, A/C systems, bottle-type hydraulic jacks, interior components, motor parts, electric systems, stampings, and suspension

BAJÍO REGION: 142 PLANTS

Products/Systems:

Stamping, electric components, brakes and its parts, rubber products, and engine and transmission parts for vehicles

Source: Promexico, April 2015

Why Mexico?

In the early 1990s, there was a significant movement away from Mexico and to China and the surrounding countries. This trend has been slowly reversing itself as OEMs and Tier 1s are finding cost savings in bringing production closer to the customer base. OEMs are seeking lower costs for their less profitable vehicles. Three new plants have been built in Mexico in recent years and five more plants have been announced and are in various stages of completion. Several Tier 1 suppliers are also expanding their Mexican footprint to accommodate the OEM demands. The primary reasons for this "reshoring" to Mexico include:

– Lower logistical costs and more secure geographic presence

– Lower operating labor wages are available in Mexico and with the newly negotiated and approved union contracts, the Detroit 3 manufacturers have more flexibility to move production to lower wage countries to better match vehicle sale prices to vehicle cost structures. Source: Chicago Tribune, Detroit-to-Mexico shift predicted after union's big victory, December 9, 2015.

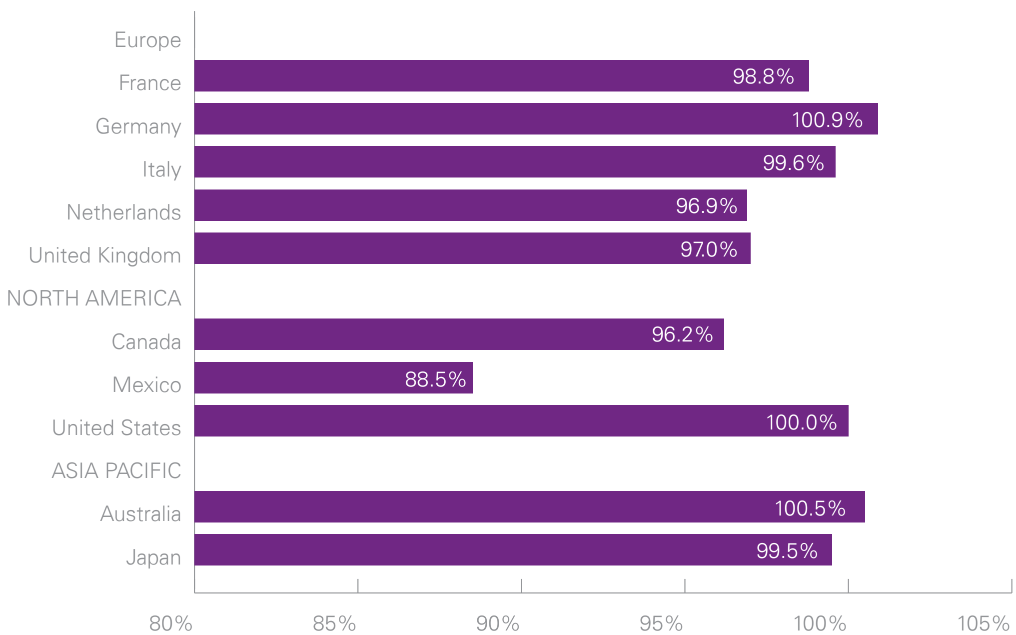
– Favorable trade agreements between Mexico and other nations allow OEMs to use Mexico as an export sales platform in addition to sales to the internal Mexican market.

– The Mexican supply chain is less likely to experience natural hazards that have occurred in places like Japan and Thailand.

– The political landscape in Mexico is primarily business friendly and currently no inflation is being experienced within the country.

– China's economy continues to lose steam and production has begun to move to other locations such as Mexico and the United States. More importantly, shipping costs from Mexico are lower than shipping costs from Asia Pacific.

International manufacturing cost index US=100



Source: KPMG LLP, Competitive Alternatives, KPMG's Guide to International Business Location Costs, 2014, Canada.

With all of this increased automotive activity, more Tier 2 and Tier 3 companies are being encouraged to set up locations in Mexico to better serve customers through lower logistical costs, time to production, and potentially lower piece price costs. At the current time, approximately 80 percent of the Tier 2 and 3 parts are being imported to support Mexican production. Additionally, the Mexican government is creating incentives (as well as requirements) for suppliers operating in Mexico to have greater local content, which has also placed more emphasis on bringing U.S. suppliers to Mexico.

Though the movement to Mexico by automotive OEM and Tier 1 appears straightforward, there are many potential obstacles when moving operations to Mexico that need to be addressed by Tier 2 and 3 suppliers who may not have as much experience with international expansion as the larger global companies. Firms considering a move to Mexico should approach the transition methodically and establish a market entry strategy that includes:

1. **Assessment of local market landscape**
2. **Analysis of market entry options**
3. **Financing strategy and establishing capital resources**
4. **Review of necessary legal and tax structures**
5. **Operational implementation plan**

Assessment of local market landscape

Prior to any action, it is imperative that suppliers considering operations in Mexico assemble the correct team to analyze the potential opportunities and develop a thoughtful and complete business case, specifically, creating a maquiladora, assessing the impact of value-added tax (VAT), conducting a review of the state growth rates, and initiating a location analysis to facilitate site selection.

Maquiladora

A maquiladora is a Mexican corporation that operates under a maquila program approved for it by the Mexican Secretariat of Commerce and Industrial Development. A maquila program entitles the company to special customs treatment, allowing duty-free temporary import of machinery, equipment, parts, and materials, and administrative equipment such as computers, and communications devices, subject only to posting a bond guaranteeing that such goods will not remain in Mexico permanently. This structure may or may not be useful to companies that service both the internal and external markets as the reporting requirements can become quite burdensome.

Value-added tax

The VAT is a consumption tax that taxes the value added by businesses at each point in the production chain. It can apply to both manufactured goods and services. This contrasts with the more familiar income tax, which taxes salaries, wages, and the returns to savings, but does not tax purchases. Because the VAT is a consumption tax, it has some similarities to the sales taxes that most Americans pay at the state and local levels. However, businesses need to be vigilant in the process of paying the taxes to their suppliers and charging such taxes to their customers as there have been numerous examples of companies (large and small) incorrectly applying the credits for taxes paid against taxes owed.

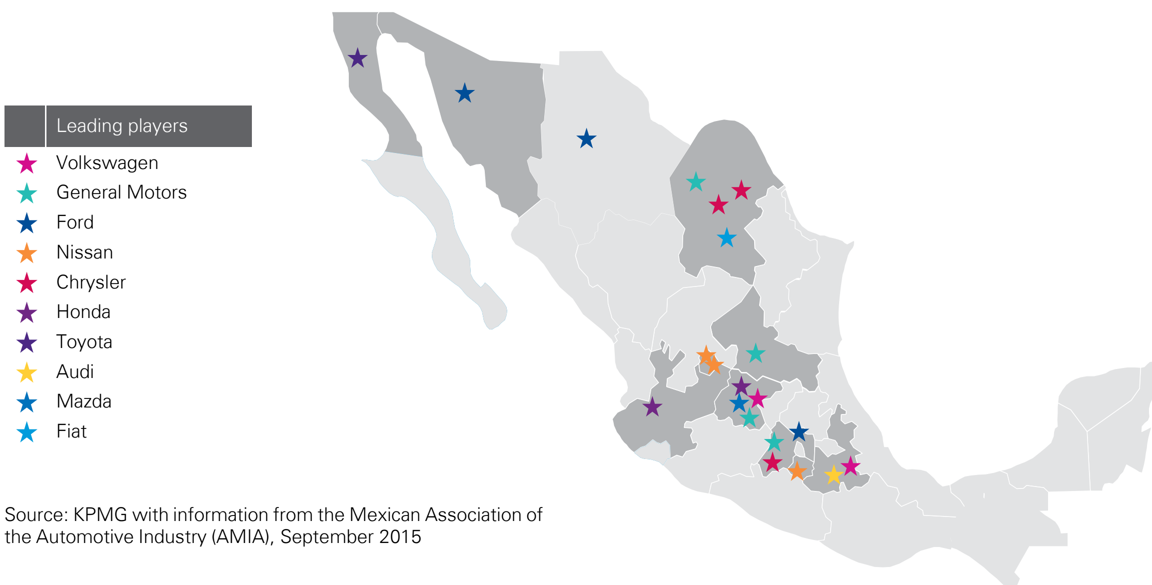
State growth opportunities

The current country economic growth is predicted to continue, but not all areas will grow at the same rate. The availability of employees and the educational strength of regions may differ significantly. It is important to understand the investments that are being made or projected for the individual states that may be under consideration to locate the supplier's operations.

An analysis of the historic and projected growth of the automotive industry must be considered, which includes the main trends that shape the business culture of the area and technical expertise that will be available. Discussions with selected in-country industry experts should be included in assessing the opportunities.

Site selection

Additional analysis of the existing clients active within the sector and their geographic layout may be an important indicator as to site location, commercial relationships, and availability of the necessary infrastructure to allow employees and materials to move efficiently through the region.



Source: KPMG with information from the Mexican Association of the Automotive Industry (AMIA), September 2015

Suppliers should consult pertinent industry reports and conduct interviews with selected customers, prospective customers where possible, and industry experts in order to complement the data obtained from their own knowledge base. Obtaining an understanding of the competitive environment will be a key factor in a supplier's decision-making process. Profiling key competitors in terms of their value proposition to clients, assessing any relevant strategic initiatives that give competitors an advantage in the marketplace, and documenting any emerging competitive trends that could impact the industry can be game-changing factors.

Analysis of market entry options

After the analysis of the local market landscape has been completed, suppliers will need to determine which market entry option is the right one for their business. Suppliers will need to decide whether to (1) purchase an existing facility and retrofit to the needs of the business, (2) create a greenfield operation, (3) purchase an existing business and facility, (4) create a joint venture with a Mexican supplier, or (5) use some other form of combination and collaboration. In most cases the ultimate decision as to which market entry option is selected will be influenced heavily by an objective analysis of the costs, timing, difficulty of completion, and flexibility for future growth. Included in this analysis will be the consideration of the following factors:

- Geographic location against main clients and other suppliers including ease of entry and exit
- State profiles as to key facts and figures that may offer financial support or impede growth
- Installation costs including land availability, potential employee base, and utilities
- State incentive packages available to potential entrants (cash, tax breaks, etc.).

Site profiles require the creation of a long list of appropriate sites for a potential location and then apply key filters in order to shorten the list of proposed sites to be evaluated further. It is extremely important to gain an understanding of these sites from local experts as these are long-term decisions that are not easily reversed without significant costs and production delays.

Financing strategy and establishing capital resources

It is imperative that a supplier entering the Mexican market have a clear understanding of the limitations on financing such operations. U.S. lenders are extremely hesitant to use Mexican collateral to support the operations, and therefore, alternatives need to be identified and evaluated. Such challenges also bring opportunities and require local expertise to evaluate the available financing sources and other access to capital. The key issues to evaluate are as follows:

- Need to address guaranty and collateral issues and gain an ability to assess the intangible/non-cash-flow leverage issues.
- Engage experts to help in structural creativity, timely execution, market pricing, structure, and covenant flexibility.
- Have a dedicated team and streamlined processes that mitigate management burden and enhance the likelihood of a timely closing of the project.
- Identify/highlight credit and investment strengths and bank underwriting issues to proactively mitigate when bringing a transaction to market.
- Employ proven know-how in assisting in the review of transaction documentation and an understanding of market terms and conditions.
- Must have the ability to coordinate involvement of all third parties (lawyers, collateral auditors, consultants, etc.).
- Must execute a multitrack process with multiple financing sources to create a competitive process amongst parties to deliver enhanced price and terms.
- Create or obtain close relationships with a diverse set of capital providers (senior lender, asset-based, uni-tranche, second lien, mezzanine, structured equity, and growth equity).
- Gain or obtain in-depth knowledge of core business issues, capital structure, and focused market knowledge, which helps management teams make informed decisions regarding capital investments, capital structure, and merger and acquisition alternatives.
- Employ objective and trusted advisers to corporate CEOs, CFOs, private equity firms, and governments alike.

Review of necessary legal and tax structures

One of the key challenges facing a potential market entry by a company will also be the lack of understanding and local expertise in terms of legal matters. Experts are needed to advise the supplier on the constitution of its legal entity in Mexico, taking in to consideration the company's specific legal requirements.

The supplier needs a legal adviser that has conducted numerous similar projects for companies all around the world, such projects related to leading companies in the automotive industry, manufacturing industry, and other industrial products and services. The legal issues related to the market entry strategies should focus on (as applicable) the purchase of assets, purchase of a capital participation, purchase of companies, new company setup, industrial property, and data protection, among others.

The supplier will need to also understand the costs and compliance issues that it will face under the tax system, both federal and state. This would include an analysis of the intended initial structures and activities as well as a view of any projected changes that may occur as the business matures.

– Review of rates and statutory tax report and annual tax returns (corporate income tax and additional local taxes if applicable [regional or municipal tax], and net wealth taxes
– Review of tax compliance status
– Review of the withholding taxes levied during the period
– Identification of any withholding tax exposure
– Understanding any tax risks associated with tax planning or optimization strategies, which have been undertaken including tax incentives and exemptions
– Understanding the potential risks of material intragroup or other non-arm's-length arrangements and the basis of transfer pricing issues.

Engage an adviser to help ensure a complete understanding about the employer taxes obligations, including social security contributions and housing fund contributions, local payroll tax, employee profit sharing, and withholding income tax on salaries in order to maintain correct compliance of these obligations.

Operational implementation plan

As with any new operation, it is critical that the supplier create an operational implementation plan to enable the establishment of the operations in an efficient and effective manner. This of course is easier said than done, but proper analysis and right-sizing of the operations from the outset will help ensure the proper structure for the organization as you enter the market and as future growth plans are realized.

Certainly many of the key issues will include the level of staffing, technology, and security that the supplier initially identifies for its operations. There are financial and operational advantages and disadvantages that can occur if the right planning is not done.

Employee wage rates average around $5 per hour, but there are key employees that need to be identified, either locally or transferred from outside locations, to properly supervise and control the operations. Wages are lower, but other employee costs such as transportation, meals, and apparel should be considered. The supplier must also consider the postemployment costs for employees that need to be released once the operations become more efficient after the initial setup and fewer employees may be needed. Additionally, as a Tier 2 or 3 supplier, the highly trained and high-performing employees may be subject to employment offers from the Tier 1 and OEM companies. So properly staffing with a view to the future, not only the present, should be a key consideration in implementing the operational plan.

This also brings to bear the need for setting up the correct technology plan to support the operations. This is dependent upon the resources available to both technical employees and third-party providers as well as the reliability of the physical infrastructure. These factors certainly would be considered in the site selection phase, but in the implementation phase, decisions need to be made to ensure that the proper resources are available when you need them and that replacement sources are available as well if such resources are no longer around.

Security of the premises and the related information flow are key factors. The appropriate level of security around access to the plant is needed. Additionally, in most cases, transportation to the plant may be required and therefore may need to be arranged internally or through a third-party provider. As the internal systems, the implementation of systems that support the local operation and connect to other locations and customers will be necessary and the appropriate selection and implementation of secure and accurate information will be a key expectation of the supplier's customer base.

Conclusion

Navigating the road to Mexico can be a rewarding venture, but proper planning is paramount in order for the enterprise to be positioned for success. Having a clear market entry strategy, understanding how to enter the Mexican market, and what the best entry options are is the first key step. Once entry is determined, organizations need to develop a financing strategy and align themselves with partners who are adept at securing financing in the Mexican market and, in parallel, legal and tax structures should be reviewed with experts familiar with the local market laws and systems. Finally, before commencing operations in Mexico, firms need to create an operational implementation plan that establishes the new policies, processes, talent, and technology required to begin operations.

Printed in the U.S.A. NDPPS 528701

About KPMG

KPMG is well-equipped to support clients interested in setting up operations in Mexico. We have the dedicated specialist teams who have extensive experience in working together to develop and implement effective market entries strategies in the Mexican market.

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