AlixPartners

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ADDRESSING TARIFFS IN UNCERTAIN TIMES

Higher tariffs and uncertainty over ongoing trade disputes have increasingly become a fact of life for multinational companies, throwing business planning into a state of upheaval and putting significant margin pressures on many corporations. Unfortunately, for a host of reasons, both economic and political, these trade frictions are expected to linger, forcing businesses to determine how best to respond.

Due to a heavy reliance on Chinese manufacturing, multi-year trading relationships, and integrated supply chains, factory relocation is an expensive and lengthy process. Although there were some early movers following the announcement of the first round of tariffs against China last year, many corporations were uncertain if and how to react. Hoping higher tariffs were temporary, they were torn between taking evasive action or simply maintaining the status quo. But now, slowly, it is becoming apparent that higher tariffs are likely to persist, and importers to the US need a Plan B.

Tariff concerns now loom over other countries, as well, as the US Department of Commerce evaluates the trade situation with other low-cost countries (LCCs). Trade tensions beyond China are running high due to protectionist policies, and conflicts are escalating in several important international trade agreements.

Even without these trade issues, businesses are already struggling to respond to margin pressure from competitive threats, new technologies, and changing consumer behaviors. And an unstable geopolitical environment is making it very difficult to manage business risks. Some of the most challenging decisions executives face are:

- **How to manage supply priorities in such a turbulent environment**
- **How to build and maintain a flexible manufacturing and supply chain strategy to mitigate trade risks going forward**

CHINA IS GETTING DISPLACED AS THE SUPPLY-CHAIN CENTER OF THE WORLD

New trends are emerging that could lead to permanent and irreversible dislocation of China's manufacturing dominance. The prolonged trade war has taken a toll on this relationship, and China is rapidly losing its attractiveness as the default destination for global manufacturing. For example, Crocs Inc. expects less than 10% of US-bound products to be made in China by next year, down from 30% in June.[1] Diesel-engine maker Cummins Inc. reportly avoided $50 million in tariff expenses by moving some production to the UK and other countries (not including China).[2]

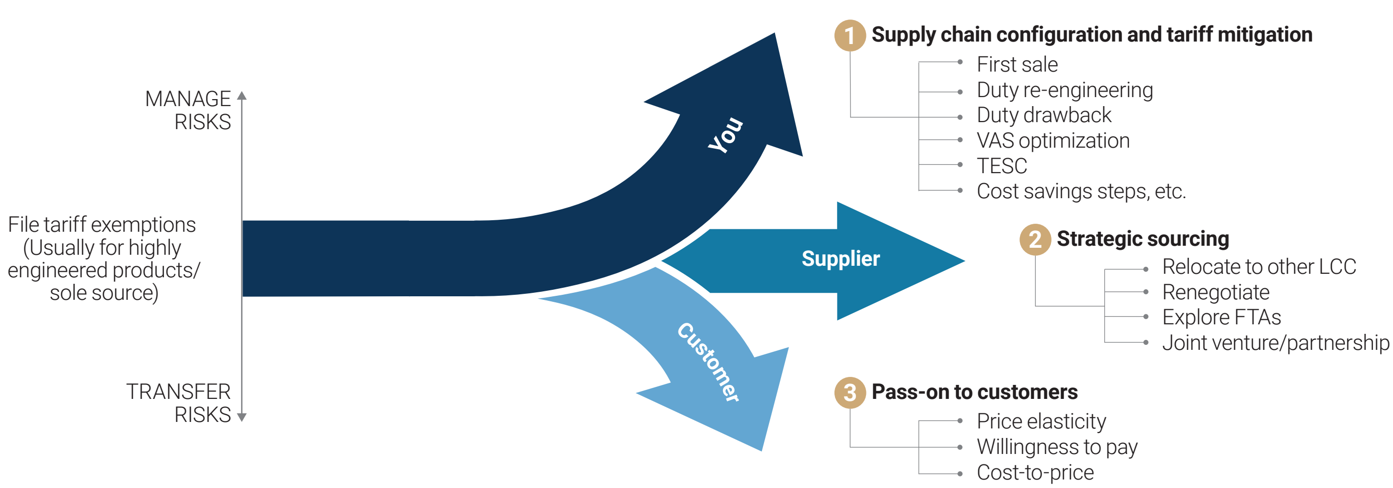
The current trade deficit between the US and China, which climbed to over $400 billion in 2018,[3] now sounds unsustainable. Although tariffs and the trade war advanced the agenda, the rising costs of manufacturing was already driving a shift to manufacturing in other LCCs. AlixPartners' tariff analyzer that captures import trends by commodity shows a major shift in "country mix" over the last five years. China may still be a preferred destination for many products for several reasons. However, for many companies and even entire industries, the effects of the trade war, even if concluded tomorrow, will likely last for some time.

HOW SHOULD YOU ADDRESS THESE CHALLENGES NOW AND GOING FORWARD?

Companies put themselves at risk by waiting to develop short- and long-term plans. Big changes in the supply chain aren't necessary to make a material impact, and building an internal compliance and trade management team will pay off in the long term. Any successful approach must include a plan to mitigate as well as situationally transfer risks.

There are fundamentally three non-mutually-exclusive alternatives that companies can use to manage tariff risks. They focus on changes within your organization, to your relationships with suppliers, and to your relationships with your customers.

FIGURE 1: THREE MAJOR WAYS COMPANIES CAN ADDRESS THESE CHALLENGES



Source: AlixPartners

1. https://markets.businessinsider.com/news/stocks/gopro-crocs-us-manufacturers-flee-china-as-trump-tariffs-bite-2019-7-1028351936
2. https://www.wsj.com/articles/manufacturers-move-supply-chains-out-of-china-11563096601
3. https://www.census.gov/foreign-trade/balance/c5700.html

1. YOU

TRADE OPTIMIZATION, SUPPLY CHAIN RECONFIGURATION, AND TARIFF MITIGATION

Historically, companies haven't worried about building trade capabilities in-house and have mostly relied on brokers, logistics and trading partners, and other third parties. Instead, international trade functions often focused on documentation, compliance, recordkeeping, and audit and logistics support.

Companies are now realizing the necessity of building sustainable capabilities in this area. Along with filings for exemption, which may be the last resort, there are several short-term measures companies can take to weather these challenges (figure 1).

One option includes changes in supply chain focusing on value added services (VAS) optimization to lower tariff costs. Partnering with suppliers, you can lay a foundation that remains intact if tariffs change in the future.

As an example, an international frozen food producer importing into the US incurred high taxes on imported shelf-ready packaging. As a mitigation strategy, they shifted to bulk shipments with final packaging performed in the US. This substantially lowered cross-border taxes based on the location of the value-added service.

Other options include employing FOB ("Free-on-Board") to exclude all shipping charges from the invoice and avoid paying duties on the shipping charges. An industrial manufacturer employed late stage configuration to continue manufacturing in origin source countries but set up final stage configuration in preferred countries in order to qualify for "made in source" or "substantial transformation" in the preferred country.

Benefits from these short-term, actionable steps can also help fund longer-term mitigation.

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2. SUPPLIERS

PHYSICAL RELOCATION, STRATEGIC SOURCING, AND PARTNERSHIPS

Working with suppliers to mitigate trade risks starts with understanding the outlook and the emerging new geographies that can potentially reshape the global manufacturing landscape, including companies with favorable trade agreements in key export markets. Chinese manufacturers are shifting into emerging LCCs to realign the supply chain and fill in gaps in supply, particularly in more commoditized products, like apparel, shoes, and plastic components. This trend has been less evident in more highly engineered products.

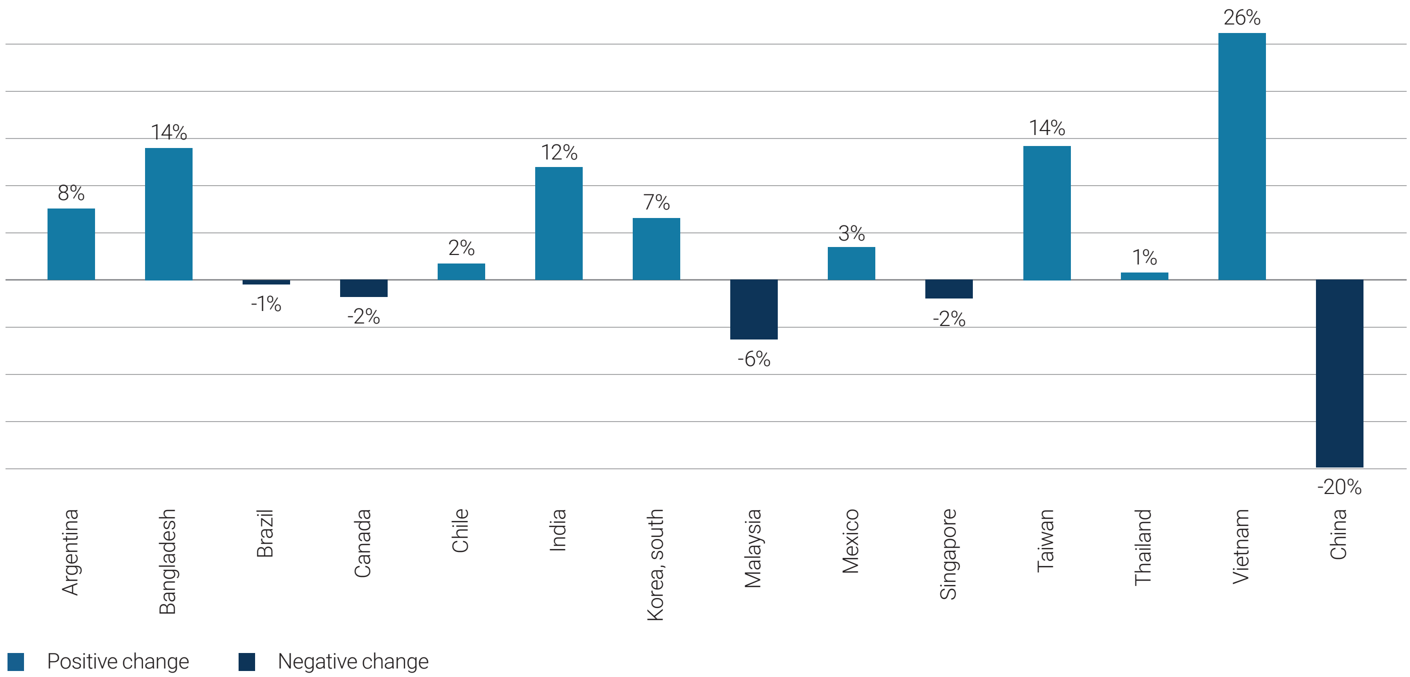
It's not uncommon for a product to be composed of components and materials sourced from multiple countries. Altering those supply chains is like dropping a pebble into a pond: the ripples can spread far and wide. Suppliers in China have started moving their own production from China to other Southeast Asian countries including Vietnam, Malaysia, and Thailand.

Through May 2018, Vietnamese exports to the US grew by 32% year-over-year to $30 billion.[4] Even though this number is relatively small compared to China currently, this trend is expected to grow over the next few years.

But these countries may not be immune to higher tariffs, in fact, it's very likely they may be the next target.

4. https://www.ustradenumbers.com/country/vietnam/

FIGURE 2: IMPACT OF TARIFFS AND SHIFT IN IMPORT TRENDS (OVER LAST 18 MONTHS)
Percent change in average monthly import – 2018 versus first half of 2019



Source: AlixPartners Import Trade Analyzer (using US Census Bureau trade import data)

With an understanding of these developing trends in manufacturing, companies can overlay their existing footprint to better understand the potential risks and opportunities and answer some key questions:

- Is your supply base in the right location?
- How is the competition responding?
- Do you have the right supply-base agility?

Developing and deploying a new approach to strategic sourcing and supply chains built for agility takes both time and effort. Global suppliers with footprints in multiple LCCs have a unique advantage in being able to shift production based on current tariff realities. For example, companies can explore options to dedicate China-based factories for exports destined for non-US markets and non-Chinese sites for the US market. If tariffs change, prequalified factories can quickly readjust their production without undergoing a multi-year relocation.

Smaller suppliers with single-country exposure can supplement these global suppliers. Understanding the competitive options of the various LCCs is key to mitigating risks through dual- or multi-sourcing or rebalancing the capacity by region.

Companies must evaluate their supply base using a three-tier supplier model:

- **Tier-1 suppliers** with global footprints and scale
- **Tier-2 suppliers** that have the ability to partner/build capabilities in other countries (i.e., non-China)
- **Tier-3 suppliers** that are based out of a country with high tariff risk but mitigants (listed in figure 1) can be implemented to limit risks

3. CUSTOMERS

PARTIAL TRANSFER OF RISK AND VOLATILITY

The volatility caused by changing trade regulations may not be fully mitigated by working on supply side and goods procurement, however. At some point, you may ask, "Is it reasonable and prudent to ask for relief from my customers?"

Passing tariff costs to the customer is risky and can easily backfire if not deployed correctly, leading to a drop in sales or dissatisfied customers. Companies need to evaluate this based on several factors: brand position, price sensitivity, brand loyalty, customers segments, buying behavior, and the competitive landscape.

Techniques such as a cost-to-price model and a price elasticity study can further help generate insights into customer flexibility, competitive differentiators, and willingness to pay.

Finally, customer communications are best managed with a transparent and data-driven approach. Explaining necessary changes to customers in a clear way, backed by the relevant facts, will help build trust and may diminish negative reactions.

A WAIT-AND-SEE APPROACH IS NO LONGER TENABLE

A fundamental shift is happening in the global supply networks, and those firms that continue to wait to implement necessary changes might have an unpleasant surprise. The stakes for getting the strategy right are high, as is the pressure on executives to test their supply networks, capital spending, and product pricing.

We will see a significant readjustment in many industries with early adopters receiving a significant advantage. Flexibility to move quickly in response to changing tariffs is important but making the investments to optimize supply chain locations based on the longer-term outlook will drive future margins.

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ABOUT US

For nearly forty years, AlixPartners has helped businesses around the world respond quickly and decisively to their most critical challenges – circumstances as diverse as urgent performance improvement, accelerated transformation, complex restructuring and risk mitigation.

These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.