Entrada Group

Podcast Transcript: Doug Donahue and Darron Gifford, Management Consulting Partner with Plante Moran

"Seizing New Opportunities – 23 Billion Reasons Why Auto Suppliers Are Looking at Mexico," September 2015

Doug Donahue: Welcome ladies and gentlemen, to Entrada Group's ongoing series on manufacturing in Mexico. Today we have Daron Gifford. Daron is management consulting partner with Plante Moran. He has more than three decades experience in automotive and manufacturing, including operations and strategic management consulting with OEMs, suppliers, dealers and service providers. Daron, thank you for joining us today.

Daron Gifford: Oh, thank you. I'm looking forward to it.

Doug Donahue: So let's jump right into it. You recently wrote a guest blog in Automotive News titled, "How Suppliers Can Seize New Opportunities in Mexico". In that post, you discussed the tremendous investment that went into Mexico over the last couple of years. I think you quoted a figure of around $23 billion dollars. Why is Mexico becoming so attractive for the automotive OEMs?

Daron Gifford: Well, Mexico has been a place where many of the OEMs have operated for quite a long time. They've gone there traditionally for lower labor costs and built primarily smaller cars, or maybe some of their older generation cars in some cases. Some real examples in the past have been things like the old Nissan Sentra, the Mercury Milan, and the Pontiac Aztec. Now what's become more attractive for OEMs the last few years and going forward is still the labor and the cost overall, [but] it's not just labor cost, it's also [that] the infrastructure cost in Mexico is really becoming much more equivalent to where China is. Some of that is because China's costs are coming up so much. But it's also about easy access to the North American, the U.S. market. From a North American standpoint, Mexico is a great emerging country to be able to locate production in. And with the NAFTA agreement in place it's also easy to move goods across the border up into the U.S., but also to export some of these vehicles from Mexico into other countries.

Doug Donahue: It's interesting that you mentioned that. We have seen a number of European suppliers, which we're going to talk about a little bit later, that are looking to produce in Mexico. Because not only can they qualify for NAFTA, but allow them to ship to North America, maybe back to Europe or to Asia. Do the other trade agreements have an effect on manufacturers' decisions to [enter] Mexico, [in order to leverage trade agreements with other countries]?

Daron Gifford: Yes. We believe that's [happening] exactly the example you cited [of] European automakers coming into Mexico. But Mexico has favorable trade agreements with 42 different countries [editor note: 44 countries]. So it's more than just the United States. I'd foresee that [Mexico] is going to become a hub for exporting some of these vehicles to other countries around the world, U.S. included, of course, because as I said, we're probably the easiest for them to install land transport up to the U.S. But I think we're going to see that from a number of the OEMs. And you're seeing, as you said, that the Europeans are here. The Germans are clearly investing heavily in Mexico. Volkswagen's doubling the size of its Puebla operation, I believe, and BMW's putting its new plant in San Luis, Potosi for the 3 Series, which is really one of the crown jewels within the BMW lineup.

Doug Donahue: You had another quote in your blog post that was, "Smaller and even midsize suppliers will have to decide if they have the capability, financial and otherwise, to follow their key customers into Mexico. And the clock is ticking, as new plants need to be online within two to three years to meet vehicle launch targets". What are the major challenges that suppliers are going to see in setting up in Mexico? And what is the urgency that's driving this? Is it the OEM pressure?

Daron Gifford: Well, I'll start with the second one, because the urgency is the customer in this case [as] the OEMs have identified their launch program and have their timing and cadence in place now. The 3 Series for example, back to BMW, is supposed to launch in 2018. So we have a three-year window here. If you're a supplier to that vehicle and to that plant, you need to be online and you need to be through all of your certifications, your PPAP, and APQP processes, and make sure your parts are ready to go when that vehicle is supposed to roll off the production line on job one. So that's a lot of that time pressure from the OEM and customer standpoint and it's very expensive to miss those kind of deadlines. They're also pushing all their suppliers to locate with them down there. So they want to minimize the inbound transport cost as well as the real time reactive schedules by being close by. So that's the second part of the question. The first part really I think is around some of the challenges facing them that you asked about. For one especially, if you're a much smaller midsize company and supplier it's going to be just the capital requirement to follow the OEM down there and to setup an operation with the capacity that they need. So there's risk around that, of course, so it takes money to get that going and, you know, it's money that is precious capital because they may need it for also expanding operations in the U.S. or in other countries. So they really need to go through that process and understand what is their return on investment? In many cases, and we've recently conducted a survey of midmarket suppliers in the industry, around some of their pressures. In many cases, because it's their critical customer, they feel like there's no choice. And so they've got to figure out the financial and the operational mechanisms and to get that to happen. The operational side being what kind of expertise and resources are they going to need, beyond just the capital for plant equipment and tooling that have to go in down there. And then how do they keep that program moving along so it's on time to meet that pressure on the deadline, on making sure they get that into production in time for the OEM for their vehicle that's coming off the lines? So there's a lot of moving parts to make this happen.

Doug Donahue: I'd also like to talk to you a little bit about the strategy of some of these suppliers in terms of the market. You mentioned that they're all going down for critical clients. But they can't just possibly be going down for one client. I assume that they've got their critical client, but their plan is then to potentially expand their business and to further utilize that investment.

Daron Gifford: Absolutely, Doug. The companies that we've worked with, our clients, that are only going down because of one customer, sometimes we've had to advise them on how firm and how strong is the contractual relationship with that particular customer? To go down for just one customer is high risk. To go down without a customer is very high risk. We would not advise people to take on the build it and they will come strategy. Getting to one customer is key to getting that initial capacity established and getting the operation moving, and getting revenue frankly, into [their] business. So that's the critical part of this, it's really going to drive the success of the business. But very quickly they need to diversify, expand and look for other customers that they can supply those components or materials to. The sooner they can do that before they launch production, the better off they're going to be. They're going to have more diverse revenue base to work with. Frankly, their original customer that they probably had followed down there will actually be happier as well, because now there's going to be more stability in the operation for them going forward. So they will be able to reduce their risk factors around maintaining that supply base into the plant.

Doug Donahue: We've seen, for lack of a better word, the internationalization of the Mexican automotive market. The Detroit Three, Nissan, and VW were some of the first ones [in Mexico], but we're now seeing additional Japanese companies, [and] now a South Korean company. Audi is setting up, BMW is setting up, so it's really becoming much more international. My experience has been, and I'd like to get your input on this, as the suppliers of particularly the German OEMs set up their Mexican operation, they're looking for a way to penetrate the whole North American market. Yes, Audi is providing an opportunity for [suppliers] to establish, but they intend to sell to the Japanese transplants and they intend to sell to the Detroit. They are creating more competition for the traditional North American suppliers. So my question is two-fold. Are you seeing that trend also, that this competition is coming? And what does that mean for the traditional North American suppliers? And then the second part of my question is what is that going to mean? Do you think it's a true statement that where Japanese used to traditionally sell to Japanese, Germans traditionally to Germans, North Americans to North Americans, do you see in Mexico that market breaking apart? Will we have a German supplier selling to a Japanese OEM?

Daron Gifford: Doug, I think you're absolutely correct in that view. There's a lot of diversification happening among the supply base. So I think that you're going to see a lot more of that movement, where a supplier may have a lead customer [but have a diverse supply base]. For example, if it's a German relationship that's very strong, and we see that all the time, they are looking to sell their parts, their components, their systems, into U.S. companies, Japanese companies, Korean companies, other global players out there. What they're selling is their expertise and capability and so that's what they're competing against. Likewise with the Japanese Karatsu suppliers, they're all on a mission to diversify their customer base as well. So serve the primary [customer] in most cases and make sure that that doesn't fall apart. You can imagine, it's going to create quite a bit of confusion amongst the different suppliers in some cases, because they still are going to have their primaries and what they might call their secondary targets out there. [Suppliers] are going to have to step up their game as far as the requirements, because each of the requirements of OEMs are somewhat different as far as what they are really looking for out of their supply base. For North American suppliers, I think that actually creates a lot of opportunity for them. For the North American supplier, what used to be a closed market to them within the European or Japanese or Korean OEM, now may be an opportunity that opens up a bit. I think [supplier] expectations need to be realistic, as far as the level of business that they make to be able to acquire. Once they get themselves established and can get that footprint inside of one of those OEMs, as that OEM grows they can also grow along with it. I think it's a real opportunity for North American suppliers, more than a threat, in many cases.

Doug Donahue: So before my next question, I need to disclose to the audience that Entrada Group assists medium-size manufacturers and smaller manufacturers set up and manage their operations in Mexico. For the smaller companies who may have limited resources, what are viable options for them to set up and work in Mexico?

Daron Gifford: There are a number of options for setting up your business in Mexico. The challenge when you're a smaller supplier is the level of investment that you can take on. It may not make a lot of sense. You may not have the kind of customer commitment that you can justify setting up and a wholly-owned subsidiary in Mexico. So the options – that we also work with our clients on as well and consult with them on what those alternatives might be, and work with your group as well – what are some other options that reduce the capital requirement and reduce the risk to you as an organization? Some of those would involve contracting with manufacturers there, or outsourcing, if you want to call it that. That does create some risk for the suppliers in some of the intellectual capital they might be sharing, as well as just the control and management over the operation. The opportunity to use the shelter manufacturing – that's something that I know is growing in popularity – is a great opportunity in many cases for the mid-market supplier to control more of the production and quality, as well as then take benefit out of the experience for that organization to be able to access the resources, skills, capabilities of the local market out there. It's a very reasonable entry point for a mid-market supplier to get into Mexico and see how it really goes, rather than trying to greenfield their own operations. And then really learn the marketplace, because a lot of this is going to be new to the smaller and midmarket manufacturer. Mexico is – even though is still pretty accessible, is very close to the U.S. – it's still another country. It's still a different culture; it's a different environment to go conduct your business and your operations in.

Doug Donahue: So when we first started our business 13 years ago, and when the industry really started 25, 30, 40 years ago, a lot of what you saw in the supply base that was coming down had a significant amount of labor in it. We currently over the last three, four years, we have seen far more sophisticated companies taking a look at Mexico. Heavy investment and capital machinery, far more capital machinery intense than labor intense. Is this a trend that you're seeing and can Mexico support this type of industry?

Daron Gifford: Yeah, absolutely we're seeing the operations that are going into Mexico are not last generation operations, their next generation operations. So companies going down there are putting in their technology. It's a leapfrog process in many cases, of putting in the higher-tech type of operations, more automated operations, more precision manufacturing type capabilities. Those don't require as much manual labor. They do require higher-skilled labor in order to be able to set up those machines, to maintain them, to do the programming. That's a different skill set than just someone who's a traditional low-skilled type laborer. Mexico does have some good capabilities that way, but they need to grow those. That's going to be the challenge and the government is very conscious of that as well. They're providing incentives; they're trying to encourage people. It's going to be to be a more educated workforce going forward. There's a lot of opportunities from that standpoint that are really good in Mexico. The other part of Mexico [that] I think is attractive – because it's not just about labor costs, it's the infrastructure as well – the ability within Mexico from not only a cost standpoint, but the ability to build out a manufacturing operation and to transport goods. There are some challenges, but there are also good capabilities in Mexico as well that can be very attractive to an automotive manufacturer.

Doug Donahue: A lot of our clients, second and third tier suppliers or smaller first-tier suppliers, they run into issues of financing. When they bring their equipment or their raw material across the border, the bank no longer will look at it as collateral. Are you seeing this also? Have you seen any creative strategies to overcome this?

Daron Gifford: We see that quite frequently. Actually some of our clients are the banks themselves, so they struggle with that as well. The lending rules and the lending practices really prevent them from being able to use those assets once they cross the border and be able to put a really good lien against them. I think we've seen the creative side on financing those kinds of things is working with one of the larger banks. The global banks that have established their own relationships in a country like Mexico – could be Mexico or other countries – and try to set up the lending operation through that local entity so they have access to the assets on that side. With [a] loan, they want to have assurance of the ability to repay the loan terms. But in the case of a default or a problem with that, that's when they want to have access to the assets themselves. It's kind of a simple financing equation, but it creates some very difficult situations or intricacies as you've just described in that case. The other part that we have seen, although they don't like to do it a lot, but if you're truly critical to the process there's going to be some funding from the customer themselves. It could be the OEM or the tier one supplier, because they're just larger entities if they really want to support you. I wouldn't start with that because you can't count on that all the time, and they don't like to be a financing mechanism. But we have seen instances where that does occur, so you don't have to just lean purely on the bank.

Doug Donahue: I want to give you the opportunity, if there's anything else you would like to add please feel free to do it. But I do appreciate your time today.

Daron Gifford: Thanks very much Doug. I would add a couple points for really driving success for any suppliers looking to expand into Mexico. It's back to the original discussion point, the launch of your production is absolutely crucial to be successful. I can't [overemphasize] that putting the resources toward making sure that operation gets up and running on a timely and cost-effective basis, but it needs to meet the production timeline for the OEM. It's not only the labor force, but really couriering that local labor force and working with that labor force to really work on developing innovation and the ability to adapt and move the organization in Mexico. So it's not all coming purely out of headquarters somewhere, but getting the operation to also provide that kind of innovation to the customer is another area that would be key to success and to differentiating yourselves from competitors in the future.

Doug Donahue: I think that's a very interesting comment. We always have clients that initially go down thinking that it's about cheap labor, maybe they'll have 35, 40, 50 people to get going. Three to five years later, they've deepened what they're doing there. They've put in automation; they've put in some engineering. For lack of a better word, it's indigenous. The companies that succeed really well let that grow organically within their operation in Mexico. Obviously with good systems, obviously with good oversight, but they let them figure out how to adapt to Mexico.

Daron Gifford: Absolutely. And the opportunity in Mexico at this point in time is really enormous right now. The growth down there is going to be very significant over the next few years.