Entrada Group

whitepaper

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Different Routes to Mexico Manufacturing

How will you get there?

For companies looking to improve productivity, reduce operating costs and access new markets especially in the Americas, expanding to Mexico can be an attractive solution. With preferential access to 14 free trade agreements with 50 countries and proximity to key US and Canadian markets, Mexico attracts diverse companies from numerous industries with its abundant, youthful labor force, solid technical/engineering talent, and deep-rooted manufacturing tradition.

ENTRADA GROUP'S MEXICO MANUFACTURING EXPERT SERIES

Audience:
C-level decision makers from any sector

WHY EXPAND OFFSHORE?

There are many reasons to consider foreign expansion, including:

- Reaching new markets
- Adding topline revenue
- Improving productivity
- Reducing operating costs
- Developing new technologies and product lines
- Accessing labor and skills

When expanding production to Mexico, there are several operational models to choose from, including the four we will cover in this paper; **Standalone, Contract Manufacturing, Joint Venture** and **Shelter Model**. We'll also cover the Entrada Group platform, which is more of a next-generation Shelter Model. Each model has its own pros and cons, and each is best suited to specific company types and business objectives. Each model is detailed below, with the goal of helping your company find the right solution for your Mexico expansion.

The Standalone Model: Full Control, Full Responsibility

The Standalone Model is best suited for companies requiring complete independence and complete control of all aspects of not just production, but all G&A support elements. Under this model, you establish a wholly owned subsidiary in Mexico.

Although operating in Mexico as a standalone company lets you maintain 100% control over all activities, you do so at significant investment – and risk. For example, just getting started requires selecting and either leasing or buying a site, establishing a legal Mexico entity, securing permits and leases, adhering to Mexican tax obligations, etc. You need to be fully compliant with all Mexico regulations from day one, which requires you to hire a full G&A support staff, regardless of production levels. All of this demands a deep amount of local knowledge, attention to detail, time and capital.

You must also secure municipal and federal permits and leases for construction, electrical, and other infrastructure elements. You must also select the right location. Regardless of whether you buy or lease a site, this is a time-consuming task. Once the site is selected, establishing the site's utilities can take significant time. You also have to take into account and budget the long-term costs, at the start.

Thus, before even becoming operational, the standalone company has to manage all human capital responsibilities (recruit, retain and train); stay up-to-date on Mexican employment laws; work with labor unions; manage payroll and taxes; comply with local environmental, health and safety regulations; oversee maintenance, security and accounting; gain all required customs permits; manage logistics and coordinate warehousing – and much, much more. And all of this in an unfamiliar, foreign country with its own language, culture and legal system.

THE STANDALONE MODEL

PRO:

100%

control over all activities in Mexico.

CON:

Company bears all the responsibility, costs, exposure and risks associated with operating in a foreign country; long lead time.

BEST FOR:

…large multi-national OEMs and Tier One manufacturers whose business model demands they keep all functions and expertise (including, for example, intellectual property) in-house.

Compare all four models in the matrix "Different Routes to Mexico – At a Glance," on page 8

For large multinational OEM and Tier One companies like Audi, BMW, GE, Volkswagen, Delphi and Johnson Controls – all of which operate in Mexico under the Standalone Model – such investments and risks aren't an issue. This is because large companies such as these already have the benefits of scale, specialized services, infrastructure, internal talent already possessing operating experience in Mexico, the culture for establishing operations overseas and the financial and legal resources to withstand potential missteps.

One clear disadvantage of the Standalone option is time. It can take years for an OEM or major Tier One to complete a site location, fully staff operations, and build a plant and select suppliers before the first car, light truck, airplane or widget rolls off the production line.

Clearly, for companies of this size, the benefits of having complete control – including of institutional knowledge – can outweigh the associated costs and risks. But for most smaller companies, the Standalone Model in Mexico is cost-prohibitive and, in most cases, overkill.

The Contract Manufacturing Model – A Hands-Off Approach

For small-to-midsize companies lacking the level of capital and risk tolerance of a multinational OEM, foreign expansion via the Standalone Model simply doesn't make sense strategically. For companies not ready, willing or able to set up their own Mexico-based subsidiary, but still wanting to take advantage of the many benefits that expanding to Mexico brings, the Contract Model could be a viable option.

Under the Contract Model, your company would contract with an existing Mexico-based manufacturer that has the capacity and capabilities to make your products. This entails sharing design(s) and/or prototype(s) with the contractor, critical information about your clients and your business relationships, and the contractor quoting a price. Once a contract is signed, the manufacturer serves as your company's Mexico-based plant, producing on your behalf.

This model allows companies to start manufacturing in Mexico relatively quickly and cheaply. The biggest time commitment occurs upfront in seeking and evaluating proposals from Mexican manufacturers, negotiating prices, drafting contracts and non-disclosure agreements, etc. After that, manufacturing can begin almost immediately, without the long lead times associated with the Standalone Model.

That being said, the Contract Model isn't without risks – lack of control of production being the main one. Here you have no input in staffing, the work environment, facility design or operations. This means the contract manufacturer ultimately controls the product's level of quality.

THE CONTRACT MODEL

PRO:
Quickly expand into Mexico with little start-up cost; no exposure to Mexico compliance issues or risk.

CON:
No direct control over production, quality, delivery, risks, efficiencies and improvement; highest exposure to intellectual property theft and loss of institutional knowledge.

BEST FOR:
…companies not ready or able to have their own operation in Mexico, but still wanting to quickly benefit from the potential strengths that Mexico offers.

Compare all four models in the matrix "Different Routes to Mexico – At a Glance," on page 8

In addition, working with a contract manufacturer you have to accept the fact that you sacrifice margin that goes to the contract manufacturer's bottom line. As their client, you are underwriting their business and production.

For Tier Two and Tier Three manufacturers contemplating Mexico, contract manufacturing can be the least desirable method. Not only does a business cede its control of production, quality and intellectual property, Mexico simply does not have a significant history of subcontracting. Because Mexico never substantively entered the international market to establish a large supply base — instead relying on proximity to the US/Canada supply base — it hasn't developed strong international ties or supply chains. Instead, subcontractors in Mexico operated under a "capture" model, wherein they would be hired by one client and would invest what was needed for that specific client, without establishing a sustained or scalable process of operation.

Under the Contract Model, an all-too-common scenario is that a company only learns about quality issues after complaints start flooding in from customers. For technology and R&D-focused companies, the Contract Model also brings the significant risk of losing intellectual property – an even bigger concern considering your contract manufacturer may also be working for your competitors.

Take for example the case of Calibur11, a Duluth, Minnesota-based manufacturer of game console cases. When its finances were tight and it was looking to cut costs, it turned to a contract manufacturer in China. Soon after, one contractor lost $700,000 in tooling equipment, another was demanding a $150,000 bribe to release the product and, on top of this, Calibur11 found out its product was being sold on the black market. Quoted about their experience in the Dallas News, the company's owner said, "We just kind of got kicked right in the teeth… it wasn't any fun by any means."

When you opt for contract manufacturing, you also lose control of institutional knowledge and legacy expertise – if you fire the contractor you need to ramp up their replacement from scratch.

For companies looking for a quicker start up at a lower cost than can be done via the Standalone Model, the Contract Manufacturing Model might be the way to go. However, the inherent risks that go with ceding control to gain speedy entry into Mexico can outweigh the benefits.

The Joint Venture

THE JOINT VENTURE MODEL

PRO:	**CON:**	**BEST FOR:**
Share the risk with a Mexico-based partner company and access new knowledge or information you didn't have before.	Puts a lot of pressure on finding the right partner; creates extraordinary legal liability in Mexico that you don't have full control over.	…companies not large enough to form their own standalone company in Mexico, or those lacking an aspect of business expertise required to succeed in Mexico; those seeking more control and protection than offered by the Contract Model.

Compare all four models in the matrix "Different Routes to Mexico – At a Glance," on page 8

A third potential route to manufacturing in Mexico is the Joint Venture, or JV. A JV entails two companies forming a cooperative business venture where resources, risks, rewards, and responsibilities are shared and assumed by the new, combined corporation.

For a company looking to expand its production to Mexico, they could consider forming a JV with an established Mexican company. For example, one potential JV scenario involves the non-Mexican company bringing the manufacturing to the partnership and the Mexican partner bringing knowledge on government workings, regulations, internal markets and distribution. Another scenario, similar to the Contract Model, has the non-Mexican partner contributing the intellectual property and the Mexican partner the manufacturing capabilities.

Often a company will use the JV as a "first step" into a foreign market before transitioning into a standalone entity. The first step JV often entails partnering with an existing Mexican company to form a completely new company, one in which both the Mexico company and the foreign company are stakeholders.

If all goes as planned, JVs can be an attractive option for small companies that have limited capital and manpower, and prefer to reduce and share risks. Unlike the Contract Model, in a JV, the Mexican-based manufacturer is an invested partner in the venture, which should help mitigate against risks relating to quality control and loss of intellectual property. The JV also enables a company to target the exact activity they are looking for and avoid tying up capital and resources in establishing a standalone company.

Of course, all of this is in theory. Much hinges on selecting the right, trustworthy partner. Clearly, JVs also come with limitations and risks. First and foremost, with a JV, all profits, risks and tax liabilities are shared. There's ample room for disagreements, over marketing or management, for example – disagreements that can become amplified due to cultural differences. Also, if one JV partner is acquired, the existence of the JV can complicate the acquisition process.

Before creating a JV, it is important that you know the environment, know your partner and know how to terminate the agreement if things don't work out. That part is crucial because you are fully dependent on your Mexico JV partner to navigate all the "Mexico complexities" you are unfamiliar with. If they make mistakes in the process, whether through incompetence or negligence, you are equally liable alongside them, in the eyes of the Mexico government.

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See page 6 for details on how Entrada's Manufacturing Platform outperforms traditional shelter providers.

The Shelter Model

THE SHELTER SERVICES MODEL

PRO:	CON:	BEST FOR:
Maintain full control over operations, processes and corporate culture; increase speed to market; quick start up time; protection against the risks and complexities of the Mexican government.	You cede some control to the shelter provider over G&A services support; most importantly, you are dependent on the performance of the shelter operator.	…companies wanting to minimize risks while increasing manufacturing efficiency. and maximizing potential growth.

Compare all four models in the matrix "Different Routes to Mexico – At a Glance," on page 8

For many Tier Two and Tier Three manufacturers, neither the Standalone, Contract nor JV models meet all the requirements. Small-to-midsize manufacturers may lack the resources to expand their production to Mexico via the Standalone route or may prefer to dedicate resources to other priorities. At the same time, they want more control and protection than the Contract or JV models offer. What most SME manufacturers need is something in between – the Shelter Model. This model is unique to Mexico, where the government has created a special legal status for it, in order to promote economic development.

With the Shelter Model, your company sets up operations within an established Mexico manufacturing community. Here, you maintain full control and responsibility of the actual manufacturing process, but the shelter provider handles the full boat of non-production-related responsibilities. This can vary somewhat among shelter services providers, but typically includes a raft of required G&A support functions – legal, regulatory, import/export, infrastructure, HR, finance, security, administrative and much more (see "Different Flavors of Shelter Providers," on page 6). In essence, the Shelter Model provides the structure, facilities and services while you provide the machinery and production know-how. You can build the operations to your specifications and scale general and administrative support services up or down according to your needs. With some shelter service providers, you can also increase or decrease your square footage or headcount, based on your fluctuating needs.

This allows Tier Two and Tier Three companies to maintain sufficient control over their manufacturing operation and keep in place their proprietary processes and corporate culture, increasing their speed to market while indemnifying them against the risks and complexities of the enormous range of ever-changing "Mexico obligations."

If operating under the legal entity of a shelter, a company is not subject to income tax so long as the finished goods or components are produced for eventual export out of Mexico (see page 6 for more details on tax implications). Furthermore, companies benefit from all-inclusive, time-limited contracts that cover everything from the leasing of manufacturing and office space to overhead and staff. Many shelter services providers also offer building management, IT, human resources, payroll, administration, regulatory and import/export services.

When opting for the shelter route, it's important to select a provider with a proven track record in Mexico. They bear your risk, but if they haven't proven the ability to deliver support services and the flexibility and scalability for future growth, their shortcomings will set you back years.

In summary, with the Shelter Model, you get a strong balance of quick startup, minimal risk and complete control, so long as you select the right, experienced partner.

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DIFFERENT FLAVORS OF SHELTER PROVIDERS

Shelter services, so named because they "shelter" companies from some of the inherent risks and liabilities of offshore production, has a long, established tradition in Mexico. However, not all shelter programs are equal:

- **Soft-landing shelter provider:** companies that primarily focus on getting your operations set up and running, after which you become responsible for all operational and compliance aspects of the business.
- **Traditional Shelter Provider:** companies that offer a range of support services for manufacturers and, sometimes, physical space.
- **Ongoing services a la carte:** more akin to renting a shared office space, these shelter services providers focus mostly on the real estate, with the business services and support often provided as a means to facilitate the real estate transaction, which remains the core business. Typically, the manufacturer is responsible for all administrative operations, with compliance handled on a case by case basis.
- **Entrada's Manufacturing Platform:** a comprehensive, next-generation, ongoing shelter solution, with continuous investment and improvement. Entrada is responsible for all non-production-related support, while also being fully accountable for all aspects of compliance with the Mexican government, at all levels.

Tax Implications of Each Route to Mexico

The tax and compliance implications of Mexico manufacturing are complex and ever-changing. *This table provides an at-a-glance overview of the different requirements for foreign manufacturers. Should you require more in-depth information for the various approaches, please contact Entrada Group.*

IS THE FOREIGN MANUFACTURER RESPONSIBLE FOR...?	STANDALONE	CONTRACT MANUFACTURING	JOINT VENTURE	TRADITIONAL SHELTER	ENTRADA GROUP
Mexico corporate income tax	Yes. A standalone IMMEX pays income tax under "safe harbor" rules	No. Tax obligation is for Seller only, not Buyer	Yes. A standalone IMMEX pays income tax under "safe harbor" rules	No taxes for the first 4 years; then obliged to pay under the "safe harbor" rules	No taxes for the first 4 years; then obliged to pay under the "safe harbor" rules. Entrada actively lobbies Mexico government for preferable income tax treatment for clients.
VAT Payment	Yes, unless company is VAT certified*	VAT Payment: No (VAT obligation is for Seller only, not Buyer)	Yes, unless company is VAT certified*	Yes, unless company is VAT certified*	Yes, with clients qualifying for immediate exemption for VAT, due to Entrada's AAA certification
Duties**	Depends; Company-specific, depending on programs in place**	No. Obligation is for Seller only, not Buyer	Depends; Company-specific, depending on programs in place**	Depends; Based on programs shelter provider has in place**	Depends; Client-specific depending on international trade treaties and sectoral programs; Entrada clients benefit from extras such as "forgiveness" component and consolidated Customs filings (expedited service)

* VAT exemption applies only for IMMEX companies possessing A, AA, or AAA VAT certification.
** Payment of Duties are associated with 1) Country of Origin, 2) International trade agreements, such as NAFTA, and 3) Special Sectoral Programs developed by the Mexican government to encourage certain industrial sectors (e.g. Automotive)

Entrada's Manufacturing Platform – How Is It Different?

There is much diversity in the world of Mexico shelter providers, offering a varying range of services. Entrada Group's Manufacturing Platform takes the concept to its highest level.

While Entrada Group's manufacturing platform falls under the umbrella of the Shelter Model, we go beyond the approach of traditional shelter providers. Traditional shelter providers focus on services, while Entrada's platform centers on the key concept of providing fully integrated support that enables our clients to grow, based on a concept of shared interest and risk mitigation. Our platform provides our clients with consistency, economies of scale and expertise that drive efficiency, enabling them to compete against larger players in the market.

(See "Our Manufacturing Platform: Entrada vs. Client Responsibilities," below, for the categories of services covered with our platform).

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Specifically, here is how Entrada's manufacturing platform is different:

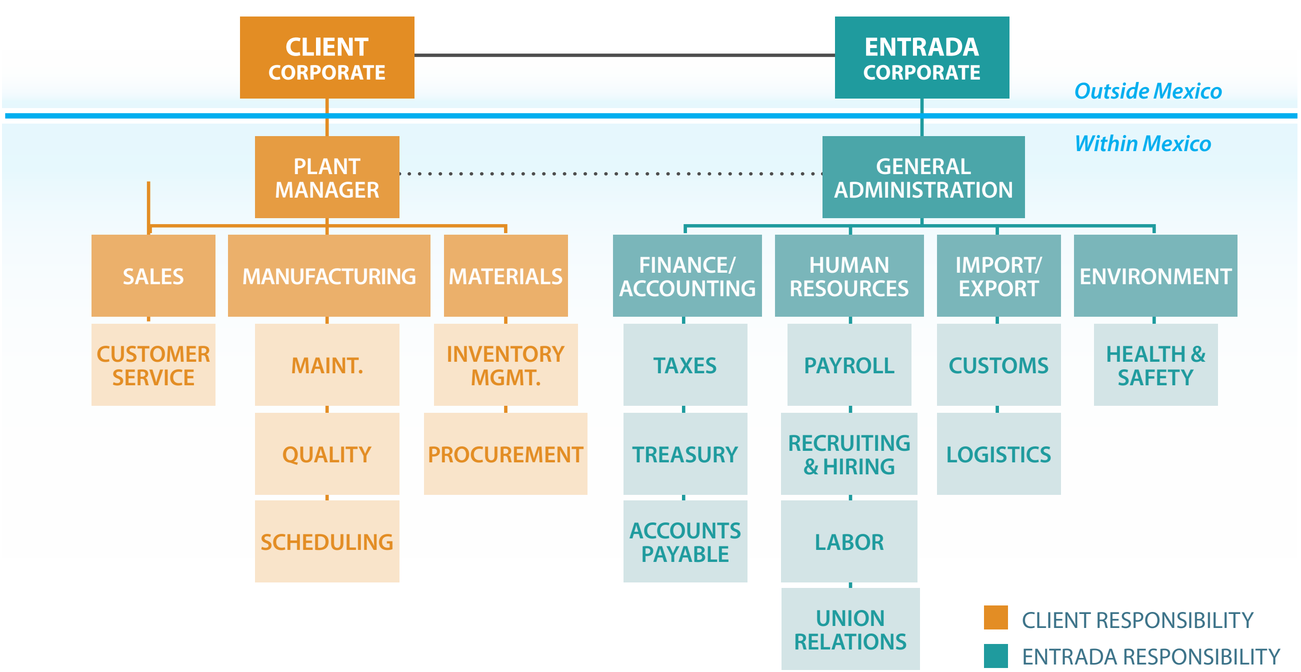
Corporate Infrastructure: We are the legal entity of record in Mexico for our clients, fully responsible for all governance, in-country compliance, import/export laws, and government and community relations. By indemnifying our clients from legal risk in Mexico, they are free to focus on high-quality production and business growth, not a long list of ever-changing Mexico responsibilities. In addition, our clients are able to accelerate and scale their entry into Mexico, by piggybacking on our corporate structure, rather than having to establish a corporation on their own.

Manufacturing Campuses: We employ over 6,000 people working as part of a shared community with aligned interests, giving our clients greater collective strength than they would have on their own. Our ongoing investment gives our clients access to better infrastructure, technology, processes and expertise, as well as economies of scale and enhanced buying power. We are also an important contributor and employer in the communities where we operate, a benefit our clients appreciate from a human capital standpoint. Our strategically positioned central campuses give our clients options for a location tailored to their needs. Further, our model gives our clients full flexibility and scalability to increase their Mexico production head count and footprint – something our clients have consistently shown the need for.

Managed Services: Our platform entails full management of the General & Administrative services required to run a successful manufacturing facility. But beyond just focusing on a comprehensive list of services, Entrada also prioritizes, and continuously invests in, how services are delivered, giving our clients access to more advanced processes, efficiencies, expertise, standardization and specialists than they could afford on their own. These efficiencies drive continuous improvement, with a focus on measuring and implementing successful best practices across the campus to best suit individual clients.

Culture of Accountability and Anticipation: The three attributes above are what distinguish our platform from what other shelter providers deliver. Equally important, our platform rests on a solid foundation of a unique business culture that stresses aligned intention and accountability. In the absence of cross-intention, decision making becomes easy, and progress and growth happen faster. Because accountability is inherent in such an environment, owner-operated Entrada is proactive rather than reactive, able to anticipate the needs of our clients before they are even expressed. This results in a unique corporate culture for our clients, possessing the speed and efficiency of a small company with the scale of a large corporation – the best of both worlds.

OUR MANUFACTURING PLATFORM: ENTRADA VS. CLIENT RESPONSIBILITIES



Taking Shelter from Contract Manufacturing in Mexico – A Case Study

For 50 years, Bowles Fluidics, a recognized leader in designing, developing and manufacturing the fluid management and system components behind many of the world's leading automakers, had operated from its US headquarters. But in the early 2000s, the company started finding it increasingly difficult to recruit and retain talent and keep up with customer demand for more variations and options.

These changes required Bowles Fluidics to invest in more complex designs with multiple components, meaning they had to shift assembly processes to a less-automated system. This in turn required more people – a luxury Bowles Fluidics simply did not have with US production.

China vs Mexico

As a result, Bowles Fluidics started looking toward outsourcing some of their processes. The first question was – Where. "We started by considering China," says Bowles Fluidics Senior Vice President of Operations and Quality Ron Tobb. "We thought we could make our products in China and either put it on a boat for 12 weeks or fly it to the US – which is incredibly expensive."

In addition to these cost concerns, there were also concerns regarding sudden changes in a long supply chain, communication and the protection of their intellectual property. "Consequently, we took China off the plate and started looking at Mexico," says Tobb.

A Shelter Model Success

Not in the position to establish their own Mexican entity, Bowles Fluidics first looked at the Contracting Model. However, they were wary of handing over their designs and IP to a contractor. "The Contracting Model was not at all attractive, particularly when Entrada proposed their alternative Shelter Model that permitted us to fully control and manage the manufacturing process ourselves."

Today, based at Entrada's manufacturing campus in Zacatecas, Mexico, Bowles Fluidics has 1,200 people working in a 70,000 sq. ft. facility – and looking to expand. "Our entry into Mexico has been an enabler," says Tobb. "The Entrada Shelter Model gives us the lowest cost of labor in North America, and instead of putting our resources toward administration, human resources, legal and import/export, we can focus on our core competencies and let Entrada take care of the rest."

DIFFERENT ROUTES TO MEXICO – AT A GLANCE

	STANDALONE	CONTRACT	JOINT VENTURE	TRADITIONAL SHELTER	ENTRADA GROUP
ENSURE OPERATIONAL CONTINUITY	●			●	●
MAINTAIN FULL CONTROL	●			●	●
SCALABLE OPERATIONS	*Maybe*		*Maybe*	*Maybe*	●
AVOID THE NEED FOR A PERMANENT MEXICO ESTABLISHMENT		●		*Maybe*	●
QUICK START UP		●		●	●
PROTECT INTELLECTUAL PROPERTY	●			●	●