An Agility White Paper

Nearshoring is a valuable part of a company's logistics strategy

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Many companies have already had experiences with nearshoring or have come into contact with it. However, nearshoring is often addressed in very different ways. This article will ground the discussion of nearshoring with a couple of definitions and give some examples and thought frameworks as well as highlight its importance within the context of today's volatile markets.

Beat Simon

About the author
Beat Simon, CEO Agility Europe is responsible for the overall performance of Agility Europe and for over 3'000 employees in more than 20 countries.

In a world dominated by fads, we often turn left and right with whatever the idea of the day is. For many years there has been a mad rush to outsource and offshore to save costs. In 2008 there was a lot of discussion around “nearshoring”, and today, we are all focused on the economic downturn and its consequences. In these fast moving times, it is important to stop and think critically not just about the ideas of the moment, but also about important long term trends. Offshoring and nearshoring are important trends to understand, and those trends need to stay in focus as managers work through a difficult and changing 2009.

Definitions and opportunities

There are three related terms we need to distinguish: outsourcing, offshoring and nearshoring. Outsourcing is the subcontracting of a business activity to a third party. Offshoring means relocating a business process to a foreign nation, for example India or China. And nearshoring is relocating a business process to a foreign location that is geographically close. When processes are outsourced to a third party, they might still be performed in the same country (see also figure 1).

During the initial stage of offshoring, one of the main decision factors was the substantial percentage of labor cost in the manufacturing process of some goods. By moving a production process to China, manufacturers could be more profitable as well as more competitive by greatly reducing that part of the production cost.

A counterbalancing factor from the logistics perspective is the increased cost in the supply chain in terms of complexity, lead time and transportation. Still, for many products labor cost savings were much higher than an increase in logistics costs, and many companies chose to offshore.

In addition to low labor costs, there were many other enticements to offshore, namely: less complex building regulations, less strict environmental regulations, huge potential economies of scale, or more straightforward labor contracts and labor regulations.

Huge opportunities, certain risks

A great number of companies moved their production or their services offshore, and gained substantial cost savings from doing so. It is difficult, however, to turn those into sustainable advantages, as competitors were and are able to do the same. How long does the story last?

For example, China's wage inflation was approximately 16% in the year 2008. If those workers are nearly twice as expensive after five years, does it still make sense to offshore to China? At the moment, it does not appear that Chinese labor cost has grown very quickly in comparison to East European labor. However, this is partially driven by an artificial peg to the US dollar that has kept real labor costs low for the time being.

Under the current circumstances, with Western currencies under huge pressure, how long will the Chinese be able to keep their currency within such a narrow band, as they have done in the last few years? Once they completely drop the peg, how much more expensive will labor become?

If not, and companies follow the cheaper labor into Central China or to Vietnam, will the infrastructure and business environment be good enough to allow operation? And if everyone else that offshores to China first tries to hire your employees and first movers have to retrain new employees from scratch, is that labor really still so low-cost? Also, one should not forget the cost of poor quality, and the risk to quality created by operating in a new environment.

Another important topic is intellectual property. How much does it cost when a Chinese subcontractor suddenly becomes a competitor, using all the processes and know-how he has been taught over the previous five years for its own operations? Energy is a hot topic, too, as we have seen in 2008. Oil costs reached 140 US-Dollars per barrel this summer and are now down to less than half that amount. It is not easy to plan a sustainable supply chain with that kind of volatility.

These are only a couple of factors, but one could also look into investment costs, working capital financing, and other areas to find additional pitfalls. The question is: When do all these risk factors start to outweigh the labor cost advantage?

Tricky decision

Offshoring seems to be a tricky decision. Is nearshoring the answer?

Nearshoring, from a European perspective, tends to be viewed as the relocation of production facilities to either East Europe or North Africa. Currently the main focus is the Eastern Block countries, as there are lower wages, they are connected by land and many are already part of the EU. However, there are huge differences in wages, local industry clusters and business environments.

A typical development is the example of a move of a company's production site from Iberia to Romania. Unfortunately, some of the developments happening in Asia are now taking place in Romania as well. As an increased number of manufactures are zooming into the region, companies have many problems retaining staff and keeping salary cost under control as the available labor is getting scarce. This constant changing of staff is leading to large investments in retraining, slow down of production, and ultimately, some quality problems. With a comprehensive analysis before the move, some companies might not have moved East in the first place.

In 2009, with the market downturn, some of these HR problems may start to recede. This will especially be the case if heads of state, like Sarkozy, threaten industry not to move their activities out of Western Europe. In fact, beyond just labor availability and cost the current downturn changes a number of other variables, for example the financial stability of the supplier base, the availability of funding and of course the overall demand for goods. Any company planning a production move will need to closely study these variables and understand future volatility.

Shift in offshoring

In a 2008 article in the McKinsey Quarterly, the authors came up with a useful framework to understand how some of these trade offs might work (see figure 2).

The graph shows the cost per unit to manufacture a product versus the weight of the product. With 2005 data on manufacturing and transportation costs, one can draw the trade off lines where it becomes better to produce in China, Mexico, or the US. Basically, if a good has a high manufacturing cost and is not heavy, it is better to produce it where labor is cheap. If it has a low manufacturing cost and the goods are heavy, it is better to produce closer to consumer markets. In 2005, for example, it made sense to produce mid-range copiers and assembled TVs in Mexico.

Based on the 2008 labor costs, and oil price, the trade-off curve shows a different picture. It is interesting that the answer presented goes against the popular wisdom. We often think of offshoring the cheapest goods. However, if a good is simple enough to produce, like a mid range copier for example, then it may not need much human content at all to produce it and it is better to produce in the US than in Asia.

However, the framework – as presented – is a simplified version. To take a sound offshoring or nearshoring decision one has of course to take a more robust view including a wider range of elements.

Future Perspectives

It's also worth thinking about the future. What are we offshoring? Often, it is a simple and repeatable processes. However, how long does this last before we replace that labor with automation and mechanization?

If the plants are automated, then where should they be? Should they move closer to the raw materials, or closer to the consumer markets, or be purely driven by scale? The answer is different for different products.

Also, we have seen a lot about the volatility of oil prices, and we have seen the issues of quality problems throughout 2008. Robust supply chains then might not be about offshoring or nearshoring, but rather about offshoring and nearshoring. There is value in having the option and the flexibility.

Volatility didn't stop in 2008, and the market downturn we are observing in 2009 has far reaching consequences. "Optimization" sounds good, but if the assumptions that optimization rest on change completely, what are the costs and dangers of being locked in to a model that is out of date every 6 months? Again, the value of flexibility of production and of the supply chain becomes important.

The more experience we gain in this area, the more we are aware how complex it is, and how fast a good decision can become a bad one and even endanger the future of entire companies. The far reaching consequences of supply chain changes imply that the issues are more than tactical but actually strategic. More and more companies will find themselves moving towards dealing with supply chain issues at a board level supported by serious investigation and analysis.

Figure 1: Differentiation of topics discussed.

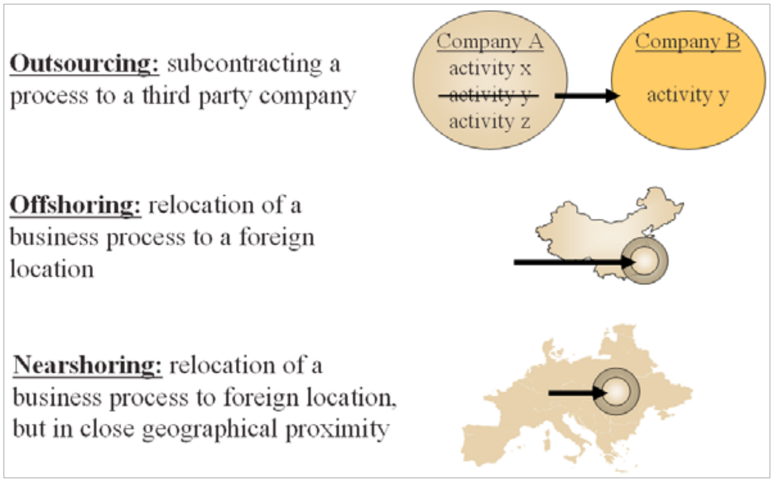
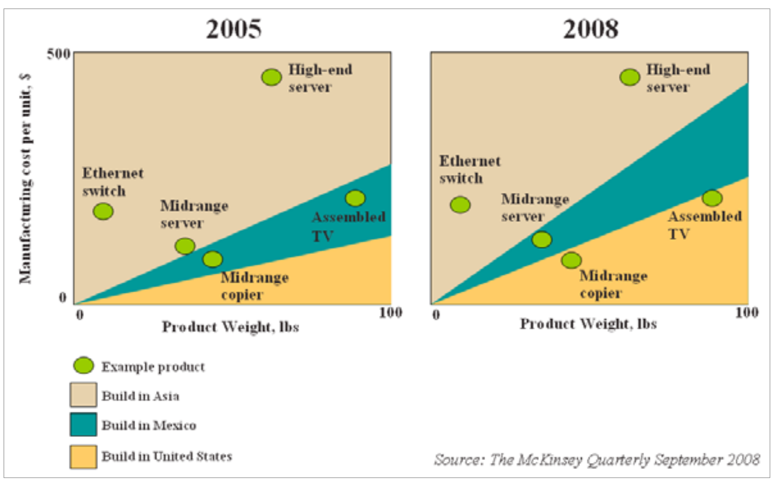


Figure 2: Contexts for deciding on locations



Service process offshoring

More than just production process offshoring, there is also the possibility of service process offshoring, for instance a call center in India that supports a client in the UK.

The hurdle of communications and data transfer infrastructure cost was almost completely removed during the «dot com» boom when immense investments were made in this sector. Even if many investors went bankrupt, they left a high quality communication infrastructure grid behind. The combination of cheap communications and innovations in process design for services have created large opportunities for cost savings.

The reduction of transaction cost is one of the key drivers to stay competitive in freight management in the long run. But most of the players in the logistics industry have not yet begun or have taken only the first steps to actively develop internal or external solutions for customer service desks or back office offshoring. The sector will certainly move more and more in this direction.

No green benefit for slow moving goods

Another look at the topic is through the environmental lens. Supposedly, if a company produces in Europe, it will be better for the environment, as it can avoid the transport from China to Europe. Unfortunately, today, that supposition is not correct.

In fact, in a current analysis from a study Agility is participating in with the World Economic Forum, the researchers have found that the entire container voyage from China to Europe is equaled in CO2 emissions by about 200 kilometers of long-haul trucking in Europe. So, for most freight, which is slow moving, there is not really a green benefit to moving production to Europe – except if the goods would be moved by train.

Will the future be different? – Certainly, we hope. There are a number of rail development plans and work is being done to make trucks cleaner. However, at the same time emissions from container ships will also reduce further – so it is hard to know what the final trade off will be.

There is one caveat, however. The trade off mentioned above is for slow moving ocean vessels. For goods that need to move fast by air there is potentially a substantial carbon benefit to nearshoring which will replace that airfreight with roadfreight.

About Agility

Agility is one of the world's leading providers of integrated logistics to businesses and governments. It is a publicly traded company with $6.8 billion in annual revenue and more than 37,000 employees in over 550 offices and 120 countries. Agility brings efficiency to supply chains in some of the globe's most challenging environments, offering unmatched personal service, a global footprint, and customized capabilities in developed and emerging economies alike.

Agility's commercial division, Agility Global Integrated Logistics (GIL), is headquartered in Switzerland and provides supply chain solutions to customers in technology, retail, chemicals, and other industries. Agility Defense & Government Services (DGS) offers logistics services to governments, relief agencies and international institutions worldwide. Agility Infrastructure group companies primarily focus on opportunities in the Middle East, Africa and South Asia, providing infrastructure support in the areas of industrial real estate, customs optimization, and airline services.