Is Your Supply Chain Ready for a Nafta Overhaul?

Manage for uncertainty by focusing on the risks that matter most.

By Rodrigo Rubio, Thomas Huber, Joe Terino and Gabriela Lozada

BAIN & COMPANY

Rodrigo Rubio is the head of Bain & Company's Mexico City office. Thomas Huber and Joe Terino are partners in Bain's Performance Improvement practice, based, respectively, in Mexico City and Boston. Gabriela Lozada is a manager in the Industrial Goods & Services practice and is based in Mexico City.

Copyright © 2017 Bain & Company, Inc. All rights reserved.

In the 23 years since adoption of the North American Free Trade Agreement (Nafta), companies operating in the US, Mexico and Canada have been designing their supply chains for a trade regime of minimal cross-border barriers. But Nafta now looks set for radical change under the Trump administration, after the presidents of the three countries agreed they will renegotiate the pact. For one thing, some trade experts argue that Nafta is obsolete, as it excluded important sectors such as services, finance and largely digital companies. Only about half of Mexican exports to the US, for instance, are traded under Nafta terms.

Renegotiation of Nafta—or at the extreme, withdrawal—has important implications for the supply chain and profitability of US-based companies. However, there is a high level of uncertainty about the ultimate outcome and consequences for companies, in part because the effect could be offset or aggravated by currency-rate adjustments.

In recent months, a few major manufacturers, including Ford and Carrier, canceled plans to build new factories or expand existing operations in Mexico, and affirmed plans to expand in the US, after President-elect Donald Trump singled them out for public criticism. Other firms, including Rexnord and CTS Corp., decided to move ahead with plans to shift some production from the US to Mexico. For most other companies, the uncertain nature of trade policy has left leadership teams reluctant to act.

But waiting for a clear sense of the future is the riskiest option. Successful companies thrive in uncertainty by incorporating change into their strategy process. Leadership teams can limit the negative consequences of Nafta withdrawal and currency moves by adopting an approach that anticipates a range of future scenarios. This approach also applies to companies based in Mexico and Canada, as well as other countries, such as China, with trade agreements that may be vulnerable to US political upheavals.

Senior leaders who have learned to manage in uncertainty focus on the few risks that matter most. They assess each potential scenario and identify the critical trigger points—we call these signposts—that signal a swing from one outcome to another. That approach helps determine a clear portfolio of strategic actions that balance commitment and flexibility. Instead of basing a strategy on conditions at a discrete point in time, leaders engage in a continuous cycle of execute, monitor and adapt, redirecting the company toward the best opportunities over time.

Waiting for a clear sense of the future for Nafta is the riskiest option. Leaders at exposed companies can limit the negative consequences of Nafta withdrawal by adopting an approach that anticipates a range of future scenarios.

How different industries might fare

Nafta renegotiation will entail a lengthy process, starting with consultations among lawmakers and followed by rounds of multilateral negotiation for each industry. Potential outcomes range from increasing local-content requirements to full withdrawal, which would restore World Trade Organization (WTO) "most favored nation" import tariffs between the US and its trading partners. The eventual consequences of Nafta changes are equally uncertain.

Still, given the likelihood of some changes occurring, companies with exposure would benefit from preparing for a range of possible outcomes. Bain & Company has analyzed the Nafta scenarios. We estimate that Nafta withdrawal could reduce the net income margin of companies in the automotive, agricultural and textile industries by as much as 1 percentage point (assuming no pass-through of higher costs to consumers). Companies in these industries tend to rely heavily on imported parts, components and raw material from

Mexico or Canada traded at Nafta terms. For example, California-based berry producer Driscoll's has invested extensively in Mexican berry operations because of the year-round availability of high-quality fruit, lower labor costs and local know-how.

Industries likely to feel the least harm, with no more than a 0.1-point reduction in the net income margin, are aerospace, metals and mining, pharmaceuticals, and oil and gas, which have very few Nafta-related imports from those countries (see Figure 1).

Tax reform, meanwhile, also is brewing in the US Congress. An early version of tax reform included installing a "border adjustment" to promote exports and eliminate deductions for the cost of imports. Although adoption of a border adjustment currently looks unlikely, with all the uncertainty around tax policy decisions, it's still worth considering a scenario that includes the border adjustment.

Border adjustment, as an isolated policy, would have the greatest negative effect on net income for companies that depend heavily on imports, namely the oil and gas, aerospace, metals and mining, and automotive sectors. At the other end of the spectrum, it would help companies with large exports or domestic production, such as pharmaceutical and technology firms.

Should Nafta withdrawal and the border adjustment both occur, the combined effect would weigh most heavily on oil and gas, automotive and aerospace, while giving the largest boost in profitability to pharmaceutical and technology firms.

Currency adjustments might offset much of the impact of both of these changes, due to a higher demand for the US dollar. When Americans demand fewer imports, they also provide foreigners with fewer US dollars. This reduces their supply, makes them more difficult to get and pushes up the relative value of the dollar. Any export subsidy would allow US producers

Figure 1: Withdrawal from Nafta could reduce the profits of many US companies

$ billions

			Impact on net income	
Industry	**2016 revenues**	**2016 net income**	**Nafta withdrawal**	**After currency adjustment**
Automotive	433	21	–4.4	–3.0
Food retail	1,321	32	–2.4	–2.2
Technology	1,626	239	–1.5	–1.2
Agriculture	150	4	–1.1	–1.0
Durable consumer goods	185	15	–0.7	–0.6
Beverages and packaged food	377	28	–0.7	–0.6
Chemicals and plastics	312	20	–0.5	–0.4
Textiles and apparel	57	4	–0.3	–0.3
Electrical and machinery	341	25	–0.3	–0.1
Metals and mining	138	0	0.0	0.0
Aerospace	360	28	0.0	0.0
Pharmaceutical	248	35	0.0	0.0
Oil and gas	1,129	14	–0.7	0.3
Total	6,677	465	–13	–9

Notes: Revenues and net income from all public companies listed in the US; impact on net income margin does not consider potential pass-through of effects to consumers and does not consider non-added-value tariffs; numbers are rounded
Sources: S&P Capital IQ; World Trade Organization; company annual reports; Bain analysis

to lower their prices in foreign markets, raising demand for US exports, which further spurs demand for dollars in order to purchase those exports.

Currency effects could take years to materialize in certain industries, however. That's because many suppliers sign five-year contracts in dollars, not pesos. No matter when a new trade agreement is signed and currency effects start to kick in, those suppliers could adjust their prices only after the contracts expire.

Potential options for the supply chain include expanding procurement sources, increasing the volume sourced from competitive local suppliers or automating operations to some degree.

Three types of action to consider

Companies that develop a strategy for these uncertainties will be able to pivot faster than the competition when Nafta details become clear, minimizing supply chain risk. Timing is key, no matter which scenario unfolds. When planning actions for each possible outcome, companies should pair each action with a signpost that triggers it. Companies can choose among three types of action:

- **No-regret moves**. Some actions will increase a company's competitive edge no matter what scenario plays out. They include improving cost management or operational effectiveness in procurement, supply chain and inventory management. Nafta renegotiations heighten the urgency to look for new operational efficiencies, as they give companies greater flexibility to face new treaty restrictions. For example, a retailer that becomes more efficient will have the option of not passing on cost increases to consumers, without hurting its profit margins.

- **Options and hedges.** Leadership teams that develop strategic options and hedges for a variety of future scenarios navigate better when new developments unfold. These could include expanding procurement options or increasing the volume sourced from competitive local suppliers. For example, back when Nafta was being negotiated, several Mexican companies, such as auto-parts supplier Rassini, seized the opportunity to invest in modernizing their operations so they could expand beyond their local customer base to compete globally.

  One option today is automating operations to some degree. If Nafta is repealed, it would be easier to move a partially automated production line back to the US, compared with a highly manual line. The option value lies in the cost of moving, relative to paying higher WTO rates.

- **Big bets.** The most challenging balancing act involves large-scale investments that have different payoffs depending on how the future plays out. Any company that keeps its supply chain and manufacturing footprint plans for North America may be making a big bet, and management teams should assess their investments from this perspective. Companies could go even further by expanding US production capacity or switching suppliers from foreign- to US-based companies. Or they could make a contrarian bold bet, like the one contemplated by Ammex, a disposable-glove distributor based in the US that sells to labs, hospitals and other companies around the world. Ammex is looking to invest in e-commerce and double down on Mexico, a key developing market for the firm, while nervous competitors draw back from the country.

  If a big bet looks too risky to take immediately, companies can wait for greater clarity and move quickly once signposts point to likely changes ahead.

Companies can monitor a wide range of signposts and map them to possible strategic moves with their supply

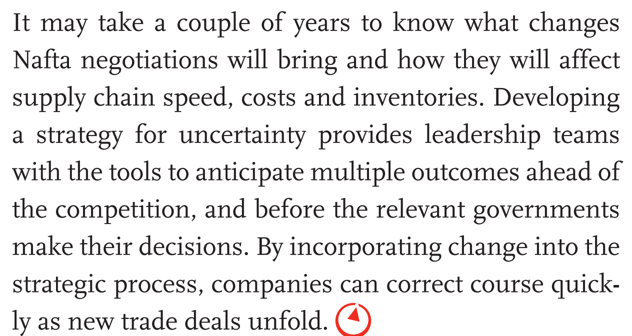
Figure 2: Companies can monitor signposts to trigger specific moves under different scenarios

			Key signposts						
			Nafta renegotiation					Foreign exchange	
Potential moves			Meetings	Negotiation position outlined	Consultation	News/interim announce-ments	Other free-trade agreements withdrawn/signed	Spot rate change	Forward rate change
No-regret moves			Can be launched regardless of signposts						
Options and hedges	Commercial decisions	Expand presence in existing foreign markets		✓	✓	✔	✔	✔	✔
		Expand in existing domestic markets		✓	✓	✔	✔	✔	✔
	Supply chain decisions	Expand procurement options	✓	✓	✓	✔	✔	✓	✓
		Increase volume sourced from local suppliers		✓	✓	✓	✔	✓	✓
Big bets	Commercial decisions	Increase production capacity				✓	✔	✓	✓
		Enter new foreign and domestic markets				✓	✔	✓	✓
	Supply chain decisions	Move operations from abroad to the US				✓	✔	✓	✓
		Switch suppliers from foreign to local				✓	✔	✓	✓

✔ Highly relevant ✓ Potentially relevant, depending on the industry and the nature of the change

Source: Bain & Company

chains (see Figure 2). No-regret moves can be launched regardless of signposts, but a regular check of relevant signposts will precede the implementation of options and hedges or big bets. For instance, if other free-trade agreements are withdrawn or signed, that could prompt some companies to increase the volume of parts or material sourced from competitive local suppliers that have previously been vetted and placed in reserve. Once Nafta negotiations begin, an important signpost would be an announced term sheet that establishes the boundaries of the negotiations—say, an agreement to review regional content rules and include new sectors, but not consider quotas or withdrawal of any sector. Under those boundaries, expanding local supply would shift from being a hedge to a no-regret move for some industries.



It may take a couple of years to know what changes Nafta negotiations will bring and how they will affect supply chain speed, costs and inventories. Developing a strategy for uncertainty provides leadership teams with the tools to anticipate multiple outcomes ahead of the competition, and before the relevant governments make their decisions. By incorporating change into the strategic process, companies can correct course quickly as new trade deals unfold.

Shared Ambition, True Results

Bain & Company is the management consulting firm that the world's business leaders come to when they want results.

Bain advises clients on strategy, operations, technology, organization, private equity and mergers and acquisitions. We develop practical, customized insights that clients act on and transfer skills that make change stick. Founded in 1973, Bain has 55 offices in 36 countries, and our deep expertise and client roster cross every industry and economic sector. Our clients have outperformed the stock market 4 to 1.

What sets us apart

We believe a consulting firm should be more than an adviser. So we put ourselves in our clients' shoes, selling outcomes, not projects. We align our incentives with our clients' by linking our fees to their results and collaborate to unlock the full potential of their business. Our Results Delivery® process builds our clients' capabilities, and our True North values mean we do the right thing for our clients, people and communities—always.

Bain's key contacts on Nafta and the supply chain

Rodrigo Rubio in Mexico City *(rodrigo.rubio@bain.com)*
Thomas Huber in Mexico City *(thomas.huber@bain.com)*
Joe Terino in Boston *(joe.terino@bain.com)*
Gabriela Lozada in Mexico City *(gabriela.lozada@bain.com)*
Peter Guarraia in Chicago *(peter.guarraia@bain.com)*

For more information, visit **www.bain.com**

Amsterdam • Atlanta • Bangkok • Beijing • Bengaluru • Boston • Brussels • Buenos Aires • Chicago • Copenhagen • Dallas • Doha • Dubai
Düsseldorf • Frankfurt • Helsinki • Hong Kong • Houston • Istanbul • Jakarta • Johannesburg • Kuala Lumpur • Kyiv • Lagos • London
Los Angeles • Madrid • Melbourne • Mexico City • Milan • Moscow • Mumbai • Munich • New Delhi • New York • Oslo • Palo Alto • Paris • Perth
Rio de Janeiro • Riyadh • Rome • San Francisco • Santiago • São Paulo • Seoul • Shanghai • Singapore • Stockholm • Sydney • Tokyo • Toronto
Warsaw • Washington, D.C. • Zurich