Nearshoring in Mexico
Local Views
June 29, 2023

INTRODUCTION

For over three decades, globalization transformed the way nations and businesses interacted. As the world became increasingly interconnected, so did production, consumption, and investment flows. Companies expanded their markets and explored new manufacturing options in efforts to improve supply chain efficiencies.

Views on globalization, however, have evolved over time as geopolitics has increasingly come into focus. Importantly, tensions between the US and China have become a constant in the global backdrop causing political leaders on both sides to increasingly look inward and retreat from the push towards dismantled global barriers. Today, the dominant trend is "nearshoring" or "friendshoring."

The term refers to relocating supply chains to nearby countries where the risk of disruption from geopolitical tensions is deemed to be lower. As this trend evolved, it has created meaningful opportunities for some countries. Mexico, with its proximity to the United States, is among the countries that most stands to benefit. Indeed, nearshoring opportunities have changed Mexico's fortunes and brightened the outlook of this once forgotten market. We asked our local partner, Alejandro Rojas Domene from Armada Capital LLC, based in Mexico City, to share their perspectives and insights on this subject.

– Natascha B E Willans, ABS Global Investments

LOCAL VIEWS: AN INTERVIEW WITH ALEJANDRO ROJAS DOMENE

Why nearshoring now?

Over the past several years, the prolonged trade war between the US and China has driven several US businesses to re-think their manufacturing processes and their locations. As tariffs increased and geopolitical tensions escalated, many have taken steps to relocate their production and sourcing activities from China to locations closer to home.

This shift in manufacturing location towards Mexico has not been limited to US companies. Many Chinese and Asian manufacturers have also relocated parts of their operation to Mexico to satisfy growing demand from the North American market. The move has allowed these companies to retain their spot as top suppliers to the US despite their ties to Asia.

While this shift has slowly been occurring over the years, it has accelerated materially in the last 2 years. Both the extended Covid lockdowns in China and the war in Ukraine further burdened global supply chains, forcing companies to accelerate their relocation plans. The combination of these trends and events have resulted in Mexico becoming the largest trading partner to the US, surpassing China's market share of US imports for the first time since 2003.[1]

What makes Mexico attractive and why are companies looking to Mexico now?

Today, Mexico stands out as Latin America's leading exporter of manufactured goods with roughly US$400 billion in exports per year.[2] *Its most notable trait as a manufacturing destination is its favorable geographical proximity to the United States, allowing it*

[1] Alanis, A., De Abiega, P. and Miranda, D. (April 2023) 'Mexico Equity Strategy,' in *Mexico Takes Pole Position in Share of U.S. Imports…Can This Be Held Through 2023?,* Santander Corporate & Investment Banking
[2] Alanis, A., De Abiega, P. and Miranda, D. (January 2023) 'Mexico Equity Strategy,' in *Nearshoring: Each 1% of Gained Share in U.S. Imports Expected to Add ~1.3% to Mexican GDP,* Santander Corporate & Investment Banking

to serve one of the biggest markets in the world at a lower transport cost. But its attractiveness as a manufacturing hub goes far beyond its preferred location.

First, the country offers a high-quality labor force at a relatively low cost. More specifically, Mexico produces approximately 120,000 engineering graduates per year, while US annual engineering graduates are approximately half that size. Meanwhile, labor costs in Mexico average at $22 per hour, compared to $2 per hour in Mexico.[3]

Mexico's economic and political stability adds to its allure. Mexico has a healthy fiscal discipline that has not seen an increase in the effective tax rate in 5 years, as well as healthy debt levels and Central Bank independence. Finally, Mexico has 12 free trade agreements with over 46 countries, which eliminates trade barriers and makes it easier for companies to do business in our country.

While other countries, particularly those in Southeast Asia, have benefited from these same trends, Mexico has been more focused on becoming the "assembler." This gives it an edge for the American and European manufacturers who strive to become "asset-light."

What is the potential impact of nearshoring for the Mexican economy and stock market?

According to Morgan Stanley's estimates, nearshoring could represent a US$156 billion opportunity in incremental exports for Mexico over the next half decade.[4] This would represent an increase in exports of approximately 30% by 2028. The resulting impact on GDP would also be material. While Santander estimates a boost in GDP figures of an additional 1.3% for the year; the increase could be larger if Mexico continues to gain market share of US exports.[5]

While the economic impact of nearshoring is just starting to appear in economic data, equity markets have been quick to price in the expected boom to industries and companies. Mexico is among the best performing emerging markets in 2023, up over +20% through May 31st. Since October 2022, the market is up +35%. As more companies invest in Mexico and new jobs are created, corporate earnings have upside risk which generates increased investor confidence and investment interest. The market has been quick to attract interest from investors. Indeed, Mexico has been the recipient of approximately $1 billion, roughly 60% of equity flows into Latin America. In 2022, it was the only country to receive positive inflows into equity markets in the region.[6]

What are the greatest challenges to the nearshoring opportunity in Mexico?

The key challenges facing Mexico's nearshoring theme relate to infrastructure and security. According to Morgan Stanley, Mexico needs US$40 billion of spending over the next 4-6 years to build enough generation capacity to power its nearshoring potential.[7] Mexico could face a power deficit by 2025 if these capacity issues are not resolved. We think there's a good chance they will be.

Furthermore, safety and security have emerged as the most acute risks at the national level with no clear resolution in sight. This is driven primarily by government inaction and its inability, or perhaps unwillingness, to thoroughly address this issue. Indeed, Mexico's high crime rate makes it a less attractive destination for various types of companies, particularly due to risks of cargo theft and business extortion. We anticipate that this will be an ongoing problem, but not an insurmountable one.

As an investor, it is important to constantly monitor political and economic developments in each country, and to maintain a diversified investment portfolio to hedge principal risks. As we evaluate these risks and weigh them against the potential benefits of nearshoring to Mexico, we think the benefits significantly outweigh the risks.

[3] 'Tesla Inc: Mexico's Newest Resident: A Case Study in EV Nearshoring' (April 2023). Adam Jonas, CFA. Morgan Stanley Equity Analyst

[4] Lippman, N., Obregon, A., Byrd, S., Masia, A., Waever, S., *et al.* (March 2023) 'Mexico Equity Strategy', in *Made in Mexico 2.0: How to Exit Mexico's Electricity Limbo and Power Nearshoring Potential,* Morgan Stanley.

[5] Alanis, A., De Abiega, P. and Miranda, D. (January 2023) 'Mexico Equity Strategy,' in *Nearshoring: Each 1% of Gained Share in U.S. Imports Expected to Add ~1.3% to Mexican GDP,* Santander Corporate & Investment Banking

[6] Alanis, A., De Abiega, P. and Miranda, D. (January 2023) 'LatAm Funds & Flows', in *2022: A Year of Lower Inflows with Outflows across Mutual Funds in EM and LatAm,* Santander Corporate & Investment Banking

[7] Lippman, N., Obregon, A., Byrd, S., Masia, A., Waever, S., *et al.* (March 2023) 'Mexico Equity Strategy,' in *Made in Mexico 2.0: How to Exit Mexico's Electricity Limbo and Power Nearshoring Potential,* Morgan Stanley.

How do you position portfolios for this long-term trend?

New nearshoring announcements have already surpassed $11 billion in 2023.[8] These will not be deployed all in one year as they include multi-year investments focused mostly in the automotive, manufacturing, and consumer goods industries. More than half of these investments come from the US and have been allocated to the northern states of Mexico: Nuevo León and Coahuila.

We expect the benefits of nearshoring to eventually spill over to most sectors and companies within the economy, making us remain positive on Mexican equities over the longer term. Nearshoring should continue to increase the formal employment sector, which in turn provides employees with more access to credit.

Some industries that we believe are well positioned to take advantage of this trend include:

Real Estate: *We see industrial real estate continuing to benefit from increased lease demand. The industry has been enjoying an environment of higher prices and sold-out spaces to the point where investments in additional space has become necessary.*

Materials: *With the increase in demand for new manufacturing facilities in Northern Mexico, the cement industry has experienced a new boom.*

Financials: *The banking sector has also reaped benefits, with commercial credit in the northern states increasing at an accelerated pace.*

Transportation: *Nearshoring should result in more cargo activity to the US and Canada. Well positioned transportation and railway companies could be market winners in this environment. In addition, the airport sector has experienced meaningful growth as traffic to and from industrial hubs and business centers in the northern cities has increased.*

Automotive Parts*: The auto parts sector is expected to flourish as leading foreign automotive companies set up manufacturing hubs in Mexico.*

CONCLUSION

In 2012, then-incoming Mexican president Enrique Pena Nieto penned an article titled "Mexico's Moment," promising reforms, which included opening national industries to foreign investment and competition. The stock market rallied almost 30% that year. This "Moment," however, failed to live up to the hype for various reasons, and from 2013 to 2020, the stock market produced a cumulative return of -12%, compared to MSCI Emerging Markets up 20% and the S&P up over 260%.

The Mexican equity market had long been a forgotten one, until now. With nearshoring trends gaining pace, Mexico is finally having its moment and is set to be a winner of the next global trend in manufacturing. So far, the evidence suggests this will not be another fleeting "Moment" for Mexico. As the shift in global trade evolves, so will the potential opportunity evolve for the Mexican economy and its equity market. We continue to believe investors with deep local knowledge, like Armada Capital LLC, will be best positioned to capture this opportunity.

BIOGRAPHY: ALEJANDRO ROJAS DOMENE

Alejandro Rojas Domene co-founded Armada Capital S.A. de C.V. in 2008 in a joint venture with ING Alternative Asset Management LLC ("ING"). In 2012, Mr. Rojas purchased ING's shares in Armada. He is the portfolio manager for the Armada Latin America Opportunity Master Fund Ltd. Armada Capital LLC is a Delaware Limited Liability company formed in January 2020. Armada succeeded to the business of Armada Investment Management, Ltd., a Cayman Islands exempted company, which was formed in January 2015. Mr. Rojas started his career at Grupo Bursatil Mexicano, S.A. de C.V. ("GBM") in 1995 and began working in asset management in 1997. During his tenure at GBM, his responsibilities included sell side research; institutional, HNW equity and fixed income management; development of derivative structures for GBM and its clients; and trading securities on behalf of GBM and its clients. He also served as a director of the board of certain listed GBM mutual funds. In addition, Mr. Rojas has often been retained to advise clients with respect to M&A and private equity transactions within Mexico. In October 2006, he founded Maya Capital S.A. de C.V. hedge fund. In 2004, Mr. Rojas designed, structured, launched and managed the GBM Global LP, a hedge fund with a focus on Mexican securities. Through his various activities, Mr. Rojas has gained valuable

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[8] Alanis, A., De Abiega, P. and Miranda, D. (April 2023) 'Mexico Equity Strategy,' in *Mexico Takes Pole Position in Share of U.S. Imports…Can This Be Held Through 2023?,* Santander Corporate & Investment Banking

experience with respect to investing and trading G-7 and emerging markets securities, including long/short equity, debt, convertibles, derivatives, foreign exchange instruments, distressed assets and private equity. Mr. Rojas helped to establish and chaired from November 2000 to November 2001 GBM por una Sonrisa, a non-profit organization founded by GBM and its employees that, among its many activities, helps to bring aid to remote locations affected by natural disasters. From January 1992 to August 1994, Mr. Rojas worked with Grupo Rotoplas S.A. de C.V., a Mexican water solution company. Currently, Mr. Rojas serves as President of GosMo Mexico (a non-public energy solutions company), a Board Director and Audit Committee Chairman of Agile Thought (software co) and a Board Member of Juganu (tech co).

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