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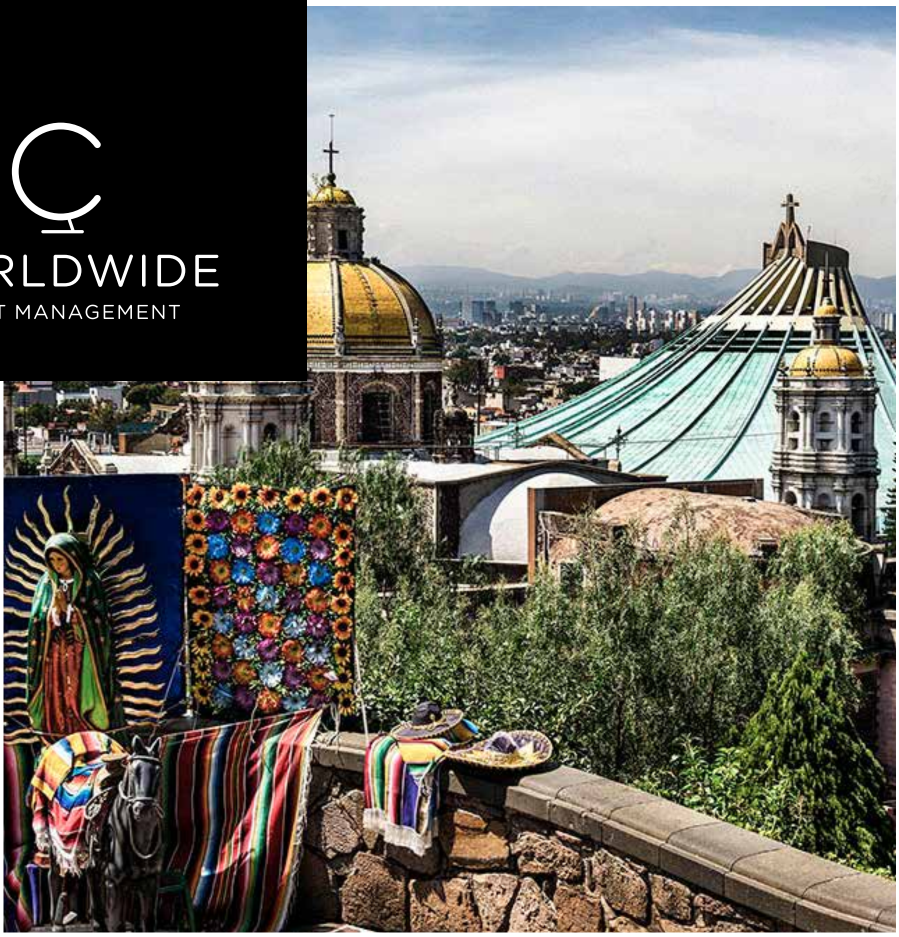

Investigating the nearshoring theme in Mexico

– and its investment implications

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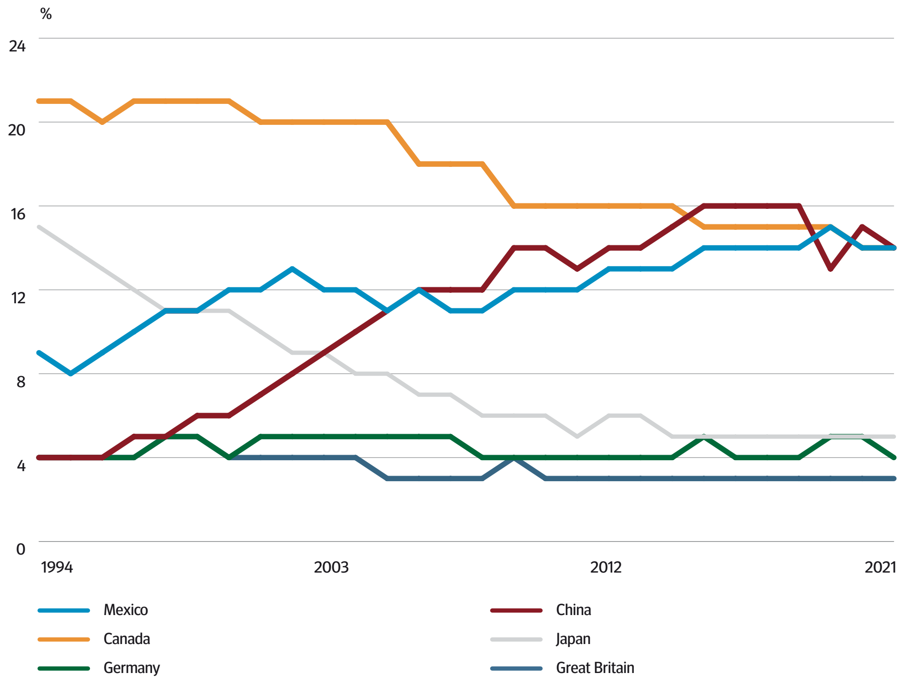
For the past few years, increased geopolitical tensions and disruption of supply chains have driven the global realignment of supply chains closer to the country of consumption. Following a week-long visit to Mexico, we in C WorldWide can conclude that nearshoring is real and is creating select investment opportunities in Mexico.

Why Mexico?

With its geographic proximity and well-developed supply chains, Mexico stands as a clear beneficiary of the USA's nearshoring drive. In terms of manufacturing, Mexico

Figure 1

Import/export – share of total US trade



Source: United States Census Bureau as of July 2022

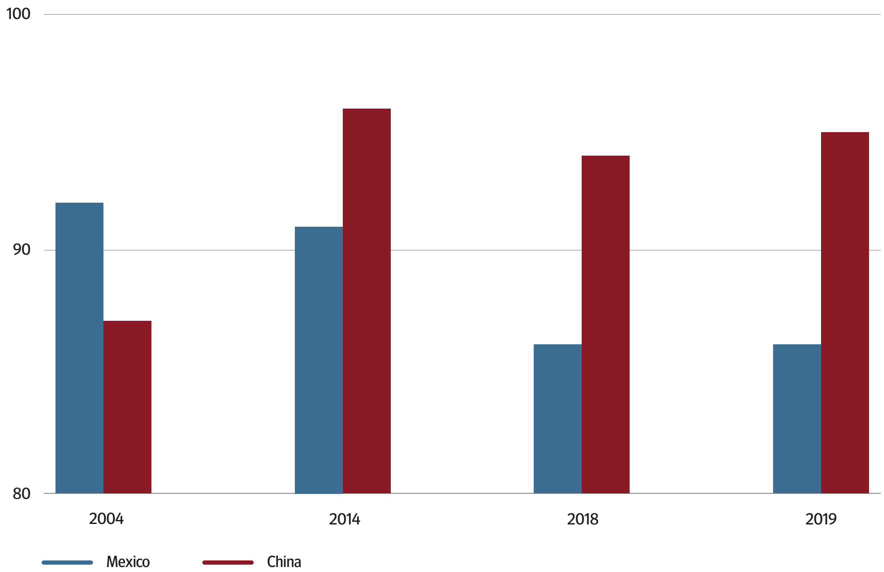
> *"While China was more cost-competitive than Mexico in the early 2000s, this has reversed in the past decade"*

and the USA are joined at the hip, and the supply chains between them are intricately linked – 81% of Mexico's exports go to the USA. Mexico is becoming the largest trading partner of the USA as can be seen on the next page. Auto manufacturing is a large export category for Mexico, and this category clearly highlights the sophisticated nature of the relationship between the two countries – a car that is manufactured in North America crosses larger components in some cases the border between Mexico and USA approx. 25 times before it is put on sale.

In addition, Mexico's young and cheap workforce provide an advantage over China as, see figure 1. In contrast to the rapidly aging population in China, Mexico has a young population with a median age of 29 years compared to that of China at 38 years. In terms of the labour market, Mexico has the additional advantage vs. China as well as the USA in that the minimum wage levels in these two countries are 1.6x and 7x higher respectively than in Mexico. This has helped drive an improved cost-competitiveness vis-a-vis China. While China was more cost-competitive than Mexico in the early 2000s, this has reversed in the past decade, as seen in figure 2 on the following page.

Figure 2

Global Manufacturing Cost-Competitiveness Index (The lower, the better)



Source: the Boston Consulting Group, Shipa Freight and Freight Quote as of February 2022

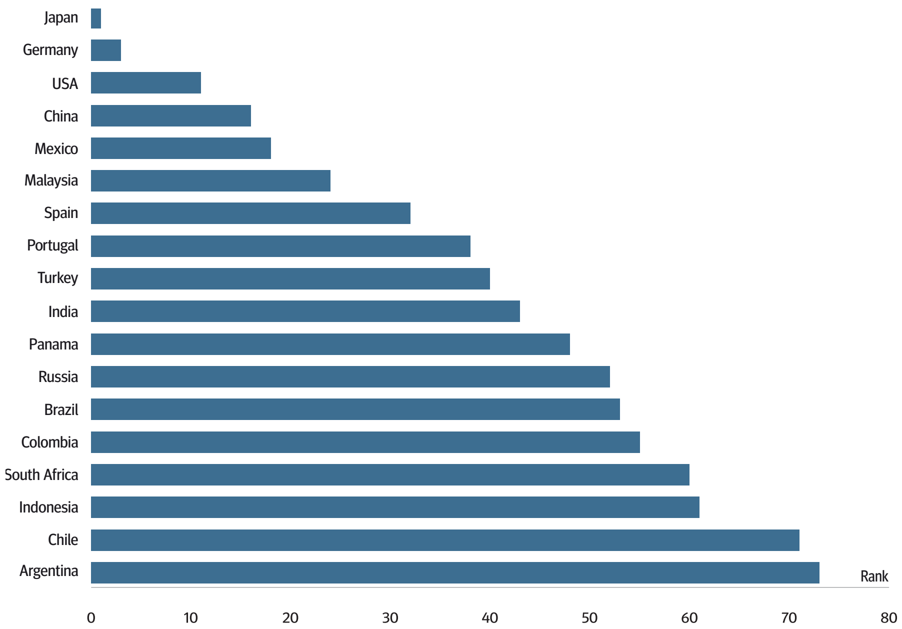
Even more pertinent to the manufacturing opportunity, Mexico graduates approx. 125,000 engineers annually – not far behind the USA at 150,000. So, although Mexico ranks poorly in terms of innovation, this group of engineers has helped and will continue to help to support the manufacturing growth story and Mexico's economic complexity, as itmeasures how complex economic activity is including the manufacture of goods in a country and which Mexico on which the country scores well, as can be seen in figure 3, page 4.

Four Mexico's

In theory, the above factors should have resulted in Mexico benefiting immensely from the decoupling between the USA and China. However, this has only been marginal compared to Vietnam, Taiwan, and India.

However, what must be remembered is the relatively low base of a country like Vietnam, which despite the increase, accounts for 9% of US imports as compared to Mexico at 14%. Also, given the geographic proximity, Vietnam's free trade status, and close economic ties with China, Vietnam has been among the first beneficiaries of the realignment of supply chains away from China. However, nearshoring by Chinese companies in Mexico has picked up in earnest in the past couple of years. According

Figure 3
Mexico ranks high in complexity



Source: The Atlas of Economic Complexity, OECD, The World Bank, Morgan Stanley Research as of 2019

> *"According to Mexico-based Fibra Prologis, Chinese companies now account for 50% of the total nearshoring demand in Mexico."*

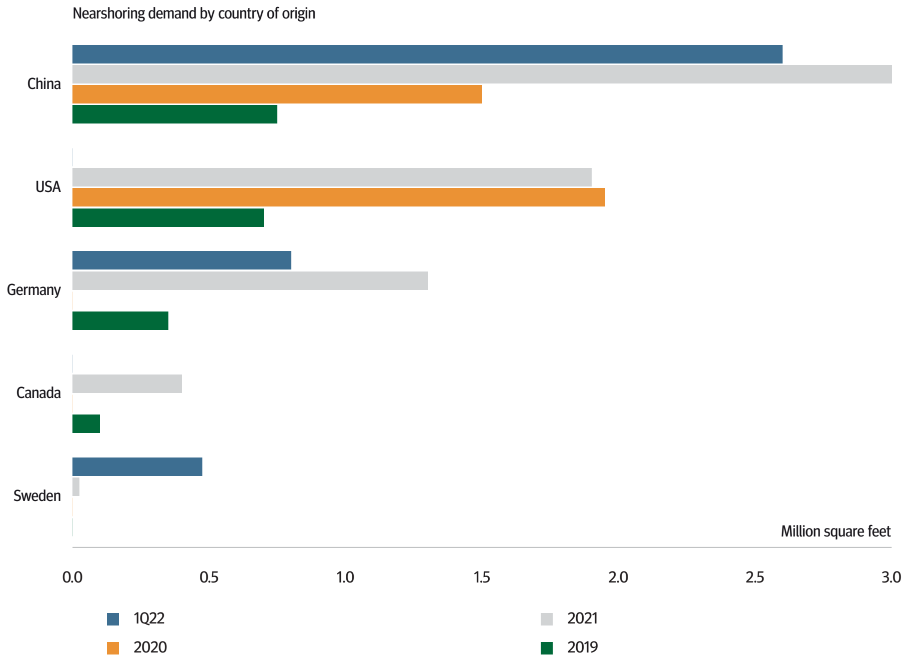
to Mexico-based Fibra Prologis, Chinese companies now account for 50% of the total nearshoring demand in Mexico, see figure 4 on the following page.

Investments in nearshoring would be even stronger in Mexico were it not for the adverse political environment. As a result of the policies and decisions of the AMLO administration in Mexico, the private sector has generally been very hesitant to undertake investments. Decisions such as the cancellation of the Mexico City airport project several years ago despite USD13 billion having already been invested, or energy nationalization, in which various projects – such as the Pemex refinery – are proving to be much more costly than initially budgeted. As a result of this uncertainty, overall GDP growth for Mexico is very low – hovering at around 1-1.5%.

However, looking at a single headline number for Mexico is quite misleading. Mexico is not one homogenous country and should rather be viewed as four Mexico's: (i) The industrialized and export-oriented North, (ii) the manufacturing hub of Bajio, (iii) the Central region in which Mexico City dominates, and (iv) the economically backward South region, where levels of education are low, poverty levels are high, and the informal sector significantly dominates, se figure 5 and 6 on the following pages..

Figure 4

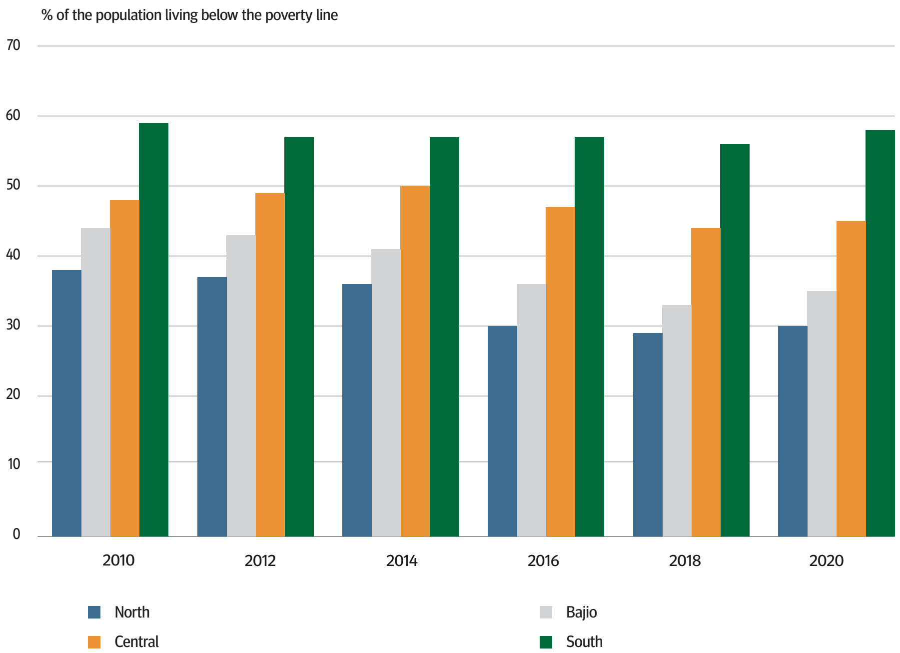
Nearshoring activity picking up in earnest in Mexico



Source: Fibra Prolois as of March 2022

Figure 5

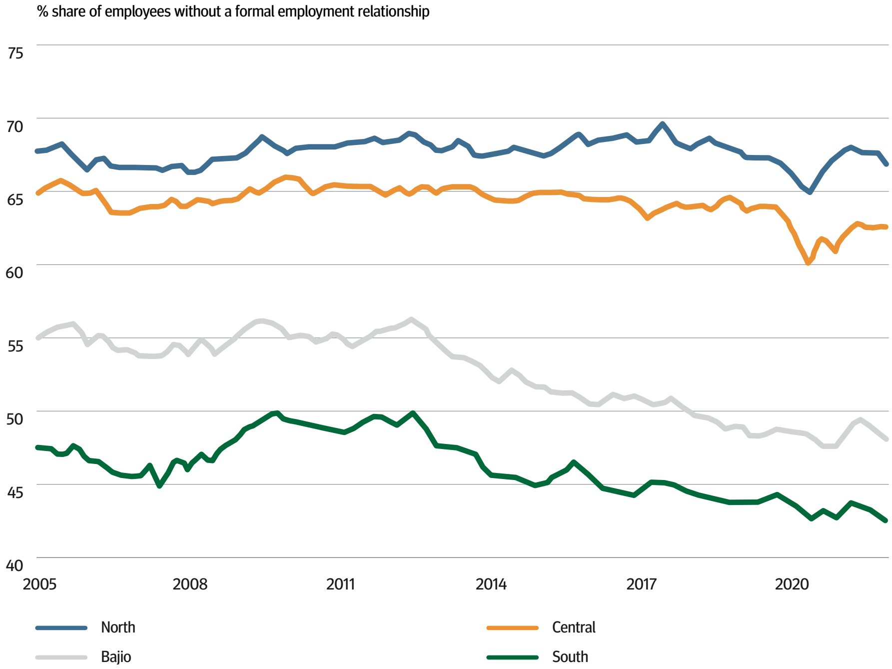
Stark differences across Mexico



Source: CONEVAL, INEGI, BTG Pactual as of May 2022

Figur 6

Labor informality across Mexico



Source: CONEVAL, INEGI, BTG Pactual as of May 2022

"While the economic growth in the South is below 1%, it is around 4% for the North. This is important to keep in mind when identifying investment opportunities in Mexico."

The nearshoring opportunity impacts these regions quite differently with the North and Bajio regions being most positively impacted. So, while the economic growth in the South is below 1%, it is around 4% for the North – an attractive growth rate even in a global context. This is important to keep in mind when identifying investment opportunities in Mexico.

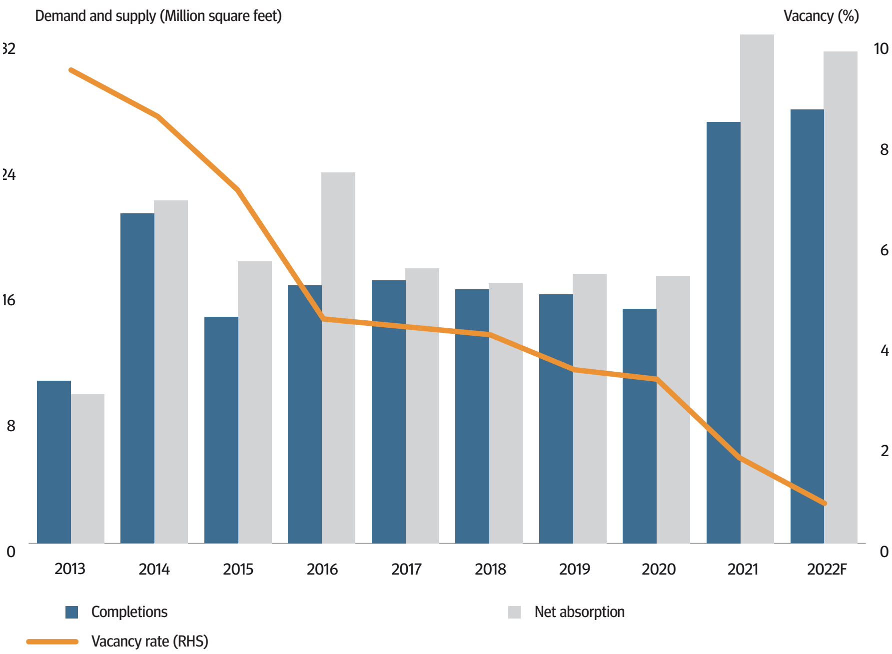
Where are the investment opportunities?

Even though Mexico is a very open economy, the number of investable opportunities in the stock market is limited. Many manufacturing-focused business groups are private and unlisted.

Nevertheless, there are select opportunities to gain exposure to the nearshoring theme. One way is to invest in banks that have a high degree of exposure towards the two Mexico's, i.e. the North and the Bajio. The publicly-listed airport operators also provide a degree of exposure to increased activity in these regions. Yet another way to gain

Figure 7

Real estate market fundamentals are tight



Source: Prologis Research as of March 2022

"Nearshoring is an example of a thematic opportunity that is flourishing actually due to geopolitical turmoil."

exposure is through the real estate investment trust (REITs)-like companies focused on logistics or manufacturing facilities, which are clear beneficiaries of the increasing manufacturing and export activity. Speaking with these companies on our trip, it became clear that deal flow was picking up meaningfully and that discussions with major international as well as Asian companies to set up operations in Mexico are quite active.

These REIT-like companies are also indirectly exposed to the significant growth of e-commerce in Mexico and the increased need for logistics assets. As a result, the real estate market for logistics and manufacturing assets is extremely tight given land constraints. The vacancy rates have declined significantly across various regions in Mexico, as shown en figure 7 above.

From a cyclical perspective, the risk of a potential recession in the U.S. is a risk, but the long-term theme of establishing local production in Mexico is clear and creates opportunities. Nearshoring is an example of a thematic opportunity that is flourishing actually due to geopolitical turmoil.

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