IMPACT OF GLOBAL TRADE TENSIONS AND TARIFFS ON CONSUMER AND INDUSTRIAL PRODUCTS

November 15, 2018
RSM’s consumer and industrial products focus

- RSM US LLP serves over 3,600 consumer products clients and over 3,000 industrial products clients
- CP serves companies from apparel designers to large retailers and everywhere in between. We have specialty practices focused on fashion and home furnishings, health and beauty, food & beverage, retail, restaurant and other consumer products sectors.
- IP serves companies from industrial manufacturers to chemical companies and everywhere in between. We have specialty practices focused on industrial manufacturing, automotive, and energy.
Poll Question #1

Which best describes your company’s industry?

- Apparel/textile/accessories manufacturer, wholesaler or distributor
- Retailer
- Food and beverage distributor
- Food and beverage retailer/restaurant
- Automotive manufacturer
- Other industrial manufacturer
- Other
Poll Question #2

Are you worried about how tariffs impacts your business?
- Tariffs? What tariffs?
- No, we’ll find a way to mitigate the impact.
- Yes, but hoping they are not here to stay.
- Yes, it’s keeping us up at night.
Agenda

• Overview of the current situation
• What tariffs mean for your business
• International tax implications
• How companies are responding
• How to stay updated
Presenters

Kevin Depew
Deputy Chief Economist
New York, New York
Kevin.Depew@rsmus.com

Nick Bova
Principal, Management Consulting
Alpharetta, Georgia
Nick.Bova@rsmus.com

John Tam
Partner, International tax
Los Angeles, California
John.Tam@rsmus.com
TARIFFS OVERVIEW
US-global economic relations: Difficult period ahead

Global trade friction: Major 2018-2019 policy issue

- **China trade war**
  - If tariffs fully implemented will shave 0.3-0.4 percent off U.S. growth
  - Basically offsets tax cut boost
  - Pricing to be impacted with upside risk to inflation

- **Reduction of purchasing power, competitiveness, rising prices**
  - Expect 25 percent from 10 percent tariffs on $250 bln in Chinese imports Jan. 1, 2019
  - Possible 25 percent on additional $267 bln in mid-2019
  - Long-term policy shift
  - No exit strategy

- **NAFTA Modernization: Few major changes, measures from TPP**
  - First treaty that raises trade barriers
  - Higher prices for Canadians and Americans
  - Small and medium enterprise accommodation
China trade deficit new high; timeline of tariffs

- **Trade in goods deficit with select trading partners**
  - March: Trump announced steel and aluminum tariffs on March 1, which went into effect on March 23.
  - $40.2B China
  - $10.7B EU
  - $7.7B Mexico
  - $1.8B Canada

- **Each country and the EU have set retaliatory tariffs on U.S. goods:**
  - China set tariffs on $3 billion of U.S. goods, which took effect on April 2. It set tariffs on an additional $34 billion of U.S. goods on July 6, mirroring U.S. tariffs of equal value.
  - On June 22, EU tariffs took effect on $3.3 billion of U.S. goods.
  - On June 5, Mexico set tariffs on $3 billion of U.S. goods; some of which increased on July 5.
  - On July 1, Canadian tariffs took effect on $12 billion of U.S. goods.

Sources: Bureau of Economic Analysis, USA Trade Database, U.S. Census Bureau
Biggest import trading partner for US

Source: US Census Bureau
Biggest export trading partner for US

Source: US Census Bureau
North American Intermodal Rail Network

Intermodal Rail Terminals:
- BNSF, KCS and UP
- CN and CP
- CSX and NS

Intermodal Trains per Year:
- Less than 250
- 250 to 500
- 500 to 1,500
- More than 1,500

Port Traffic, TEU (2015):
- Less than 500,000
- 500,000 to 1.0 M
- 1.0 M to 2.5 M
- More than 2.5 M

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US-China Economic Relationship

The **United States** runs a **Trade Service Surplus** of **$30.8 BILLION**

**U.S. Exports of Services** are up **908% since 2001**

**TOP EXPORT CATEGORIES ARE**

- INTELLECTUAL PROPERTY
- TRAVEL AND TRANSPORT
**US-China Economic Relationship**

- **The United States runs a goods deficit of $347 BILLION**
- **U.S. exports to China account for over 8% of all American global exports**
- **China is the 2nd largest export market for U.S. agricultural products**

**INVESTMENT**

- **U.S. foreign direct investment (FDI) in China was $92.5 BILLION IN 2016**
  - **AN INCREASE OF 9.4% FROM 2015**
  - U.S. FDI led by manufacturing, wholesale trade and nonbank holding companies
- **China FDI in the United States was $27.5 BILLION IN 2016**
  - **UP 63.8% FROM 2015**
  - China FDI led by manufacturing, real estate and depository institutions

- **Sales of U.S.-OWNED AFFILIATES IN CHINA were $55.2 BILLION in 2015**
- **Sales of CHINA-OWNED AFFILIATES IN THE UNITED STATES were $5.7 BILLION**
### Foreign Direct Investment in US Industries: 2017

<table>
<thead>
<tr>
<th>Industry</th>
<th>Investment (in billions)</th>
<th>Percentage change from 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing</td>
<td>$1,607.2</td>
<td>4.2%</td>
</tr>
<tr>
<td>Chemicals</td>
<td>$702.6</td>
<td>2.2%</td>
</tr>
<tr>
<td>Other manufacturing</td>
<td>$353.8</td>
<td>5.7%</td>
</tr>
<tr>
<td>Transportation equipment</td>
<td>$149.5</td>
<td>8.8%</td>
</tr>
<tr>
<td>Machinery</td>
<td>$101.7</td>
<td>7.0%</td>
</tr>
<tr>
<td>Food</td>
<td>$101.6</td>
<td>3.8%</td>
</tr>
<tr>
<td>Computers and electronic products</td>
<td>$81.9</td>
<td>1.8%</td>
</tr>
<tr>
<td>Primary and fabricated metals</td>
<td>$66.0</td>
<td>3.1%</td>
</tr>
<tr>
<td>Electrical equipment, appliances and components</td>
<td>$49.8</td>
<td>11.2%</td>
</tr>
<tr>
<td>Other industries</td>
<td>$672.4</td>
<td>10.9%</td>
</tr>
<tr>
<td>Finance (except depository institutions) and insurance</td>
<td>$538.9</td>
<td>5.9%</td>
</tr>
<tr>
<td>Wholesale trade</td>
<td>$425.4</td>
<td>13.7%</td>
</tr>
<tr>
<td>Professional, scientific and technical services</td>
<td>$212.0</td>
<td>2.4%</td>
</tr>
<tr>
<td>Depository institutions (banking)</td>
<td>$205.6</td>
<td>4.0%</td>
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<tr>
<td>Information</td>
<td>$184.1</td>
<td>6.5%</td>
</tr>
<tr>
<td>Real estate and rental and leasing</td>
<td>$90.8</td>
<td>13.0%</td>
</tr>
<tr>
<td>Retail trade</td>
<td>$88.6</td>
<td>17.3%</td>
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<tr>
<td><strong>ALL INDUSTRIES</strong></td>
<td><strong>$4,025.4</strong></td>
<td><strong>6.9%</strong></td>
</tr>
</tbody>
</table>
Top 10 countries most affected by US tariffs on Chinese goods via supply chains

Source: OECD, The Economist Group, Schroders Economics Group, 9 March 2018
Top 10 countries most affected by Chinese tariffs on US goods via supply chains

% of country GDP affected

Canada
Mexico
Colombia
Saudi Arabia
Ireland
Singapore
Taiwan
Chile
Switzerland
Costa Rica

Source: OECD, The Economist Group, Schroders Economics Group, 9 March 2018
Global financial conditions

Z-Score of Zero Indicates Neutral

Bloomberg Financial Conditions Plus = 1.432
Bloomberg EU Financial Conditions Index = -0.725
Bloomberg Asia Financial Conditions Index Excluding Japan = -1.757

Source: RSM US, Bloomberg
WHAT TARIFFS MEAN FOR YOUR BUSINESS
What do the tariffs mean to my business?

The new tariffs have companies asking two key questions:

**How does this impact my business?**

- Which products are impacted?
- Are the impacts short or long term?
- How will this impact my bottom line?
- Will this impact my competitiveness?

**What can my business do to adapt?**

- Can I pass the cost through to my customers?
- Is there a way to avoid the tariff?
- Is restructuring my Supply Chain an alternative?
- How do I preserve my market?
- How do I maintain profitability?
Tariff impact on item margin

- Tariff: 25%
- Assumes item(s) being considered all fall under tariff
- Assumes passing costs to customers is the only mitigation strategy pursued
- Key
  - Red: Negative Margin
  - Yellow: >50% Decrease in Margin
  - Green: ≤50% Decrease in Margin

Simplified, generic impact analysis
Communicate the estimated margin after taking tariffs into account

<table>
<thead>
<tr>
<th>Gross Margin Prior to Tariff (%)</th>
<th>Cost of Tariff Passed on to Customers (%)</th>
<th>Post-tariff Margin (%)</th>
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<tbody>
<tr>
<td>10</td>
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<tr>
<td>50</td>
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</table>
Projected tariff impact by industry

The table below models the change in margin (as a percent) by industry, the portion of the product portfolio that is imported, and the percentage of costs that can be passed on to the customer. It assumes that passing on costs is the only mitigation strategy utilized.

### Estimated Margin Change due to Tariff

| Percent of Product Portfolio Imported (%) | 30 | 60 | 100
<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Cost Passed to Consumer (%)</td>
<td>100</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Consumer Product Avg. COGS % of Revenue</td>
<td>63%</td>
<td>63%</td>
<td>63%</td>
</tr>
<tr>
<td>Industrial Products Avg. COGS % of Revenue</td>
<td>69%</td>
<td>69%</td>
<td>69%</td>
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<tr>
<td>Automotive Avg. COGS % of Revenue</td>
<td>74%</td>
<td>74%</td>
<td>74%</td>
</tr>
<tr>
<td>Retail Avg. COGS % of Revenue</td>
<td>75%</td>
<td>75%</td>
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<tr>
<td>100</td>
<td>0</td>
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<tr>
<td>60</td>
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<td>-19</td>
</tr>
<tr>
<td>100</td>
<td>-11</td>
<td>-19</td>
<td>-19</td>
</tr>
</tbody>
</table>
Assessment process

Understanding the impact of tariffs:

1. **IMPACT ASSESSMENT**: Understand which components and materials are affected, by the tariff code (HTC).

2. **COST IMPACT ASSESSMENT**: Gain visibility into the cost impact of increased tariffs by analyzing actual costs to current or planned costs and their respective timing.

3. **FINANCIAL MODELING**: Develop a ‘what-if’ analysis for increased material costs and the impact of pass-through pricing at the product level using Excel model(s).

4. **ROADMAP DEVELOPMENT**: Develop a ‘what-if’ analysis for increased material costs and the impact of pass-through pricing at the product level using Excel model(s). **Emphasize overall cost reduction.**

Areas covered

- Tariff analysis and market sensitivity
- Financial impact analysis
- Cost reduction
- International tax
- Supply chain restructuring
- Systems and reporting
What can be done?

Some of the strategies typically considered include:

0. Aggressive cost reduction and/or capacity right-sizing
1. Source materials from countries with no/lower tariff
2. Modify a material into a different tariff code (HTC) that does not fall under those impacted
3. Consolidate contract manufacturers within China to achieve cost savings and economies of scale
4. Consolidate product specifications and/or item counts to achieve cost savings and economies of scale
5. Evaluate impact of First Sale Rule
6. Pass along increased costs to consumers, depending on the competitive nature of the sourced material market
7. Identify materials and components that are currently under a tariff that could be legally challenged
8. File for an exemption with USTR through Section 301 process
Timing for a tariff impact assessment ranges from 2 to 6 weeks.

- Heavily dependent on scope and can be scaled to the desired level of detail

**Discovery**
- On-site Interviews
- Data Validation

**Analysis**
- Preliminary Analysis
- Strategic Option Review

**Roadmap Development**
- Conclusion Validation
- Roadmap Development

The Discovery process ensures the quantity and quality of data that is needed to produce a reasonable assessment. It generally requires 1-2 weeks.

Analysis focuses on using the available information to draw insightful conclusions and evaluate potential options. It takes about 1-2 weeks, and often overlaps with the Discovery and Roadmap phases.

Roadmap Development involves reviewing findings with management and building an actionable plan to mitigate tariff risks. It generally lasts 1-2 weeks.
What can you expect?

Tariff assessment provides a results-focused roadmap.

Roadmap

Prioritized
Time-Sensitive
Time-Phased
Practical

Results

Cost Avoidance
Cost Reduction
Risk Mitigation
Regulatory Compliance
Revenue Preservation
Service Improvement
Quality Enhancement
INTERNATIONAL TAX IMPLICATIONS
Changes to supply chain (e.g., moving all or partial production out of China) require review of international tax structure.

- When related parties are involved, transfer pricing may need to be re-examined
  - Tax footprint may change
  - Opportunities to change intercompany prices by changing how local businesses operate
- Indirect taxes are implicated – new, additional, decreased import duties, VAT, etc.
- Possibilities of using or designating free trade zones (FTZ) to optimize cash flow on goods temporarily in countries
- Customs classification still must be scrutinized
Reshoring Manufacturing Activities

• US Tax Reform – may provide companies with attractive environment (tax rates) to incentivize U.S. production
  - 21% federal tax rate generally
  - Effective tax rates may be lower if companies qualify for certain tax regimes (e.g., FDII)
  - Opportunity zones

• Transfer pricing must still be considered

• State tax incentives may be available
  - Tax credits for jobs & investments
WHAT COMPANIES ARE SAYING
Headlines in the news for industrial products companies

As Trump's tariffs bite, small U.S. manufacturers begin to tap the brakes

Potential tariffs tally: Half a billion for BMW; production move for Volvo

Trump's Tariffs Have Led to Layoffs at U.S. Manufacturers

Ford Prepares for Mass Layoffs After Losing $1 Billion to Trump's Trade Tariffs, Report Says

U.S. companies file thousands of China tariff exclusion requests
Impact of tariffs on US manufacturers

- Increase in materials imported from foreign sources, some of them concentrated in certain geographies.
- Increased demand for products from US sources that compete with Chinese suppliers – led to increased costs.
- General market reactions that increased prices in advance of tariffs.
- Accelerated buying in advance of tariffs. Lead to strong Q3 and expected Q4 in the manufacturing space.
- Company evaluating reshoring certain manufacturing activities.
- Strong manufacturing in US has put strain on labor force and employment.

Result

- Chinese exports jumped 15.6% in dollar terms in October from last year, beating the 11.7% estimate, as companies rushed to make deliveries before higher U.S. tariffs kick in. Imports surged 21.4% and the trade surplus widened to $34 billion.
- Material costs are up. Further imposition of tariffs will further increase prices.
- Labor costs may increase due to strong manufacturing environment and low unemployment.
- Margins are under pressure.
How IP companies are responding

- Chemical manufacturer increased prices as certain raw materials only available from China. China has acquired critical resources around the world.
- International company evaluating global supply chain and structure (ITAX, VAT, logistics)
- Companies disassembling and assembling products to avoid tariffs on finished goods.
- Companies evaluating reshoring certain manufacturing activities or moving to other countries
Retailers warn of price hikes as China tariffs take hold

Footwear & Apparel Group Responds to Trump’s New Tariffs: ‘This Is a Very Dangerous Game to Play’

The next round of tariffs will hit the U.S. fashion industry

Retail association: Tariffs on goods from China will cost American consumers billions

Apparel industry ranks trade policy, tariffs as top business challenge
How CP companies are responding

• PE companies evaluating their investments
• Apparel and footwear companies moving production out of China, even before tariffs announced
• CP companies look for cost cuts across their entire business, including—overhead, direct costs, as well as changes to sales channels
• Shared-loss approach with suppliers and customers
HOW TO STAY UPDATED
Have you visited RSM's tariffs and trade resource center?

rsmus.com/economics/rsm-tariff-resource-center.html
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