How big companies must respond to localisation

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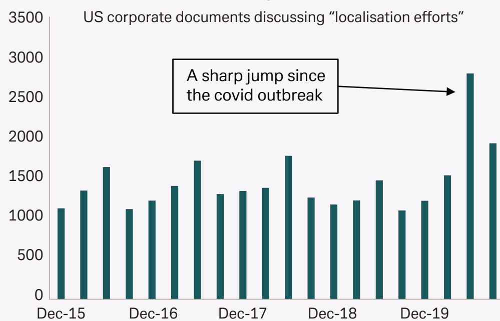
It is easy to debate whether the most important trend that covid has thrust upon corporates is the shift towards online shopping, or the increased focus on ESG principles. But in years to come, we may look back on the pandemic and realise that the biggest effect it had on corporates was to force the shift to localisation.

The push back against globalisation is already happening. The supply chain chaos witnessed at the onset of the pandemic in March and April has caused companies to talk about reshoring operations to either their home countries or to the countries where they generate their sales.

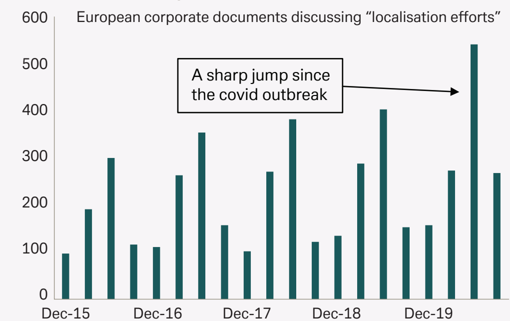
The effect has been the most acute in the US. The amplification of geopolitical tensions with China has sent companies scrambling to figure out how to manufacture at home. Indeed, the number of US corporate documents that discuss "localization efforts" has doubled this year. In Europe there is a similar but more muted effect.

Localisation is a hot topic in the US...



Source: AlphaSense, Deutsche Bank

... and in Europe



Source: AlphaSense, Deutsche Bank

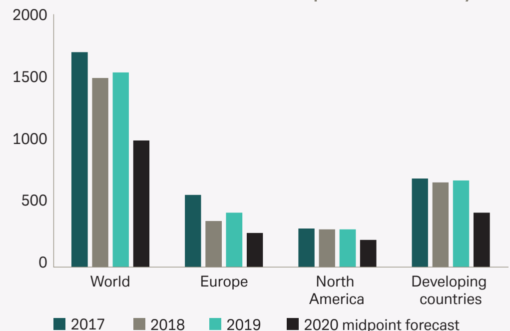
The trend towards localisation (and away from globalisation) will be particularly rough for large companies. That is because globalisation has gifted large companies benefits that have not accrued to smaller firms. They had the means to invest in facilities and relationships in countries with low cost labour. They also used their scale to establish international supply chains that reduced their costs of inputs and manufacturing.

The five forces working against large companies

The pandemic turbocharged five deglobalisation forces that are now all working against large companies and in favour of small ones.

First, falling foreign investment. The drop in FDI this year will be brutal. The UN's World Investment Report predicts global FDI will fall 40 per cent to 2005 levels of below $1tn. The following table shows that the damage will be wrought across the globe.

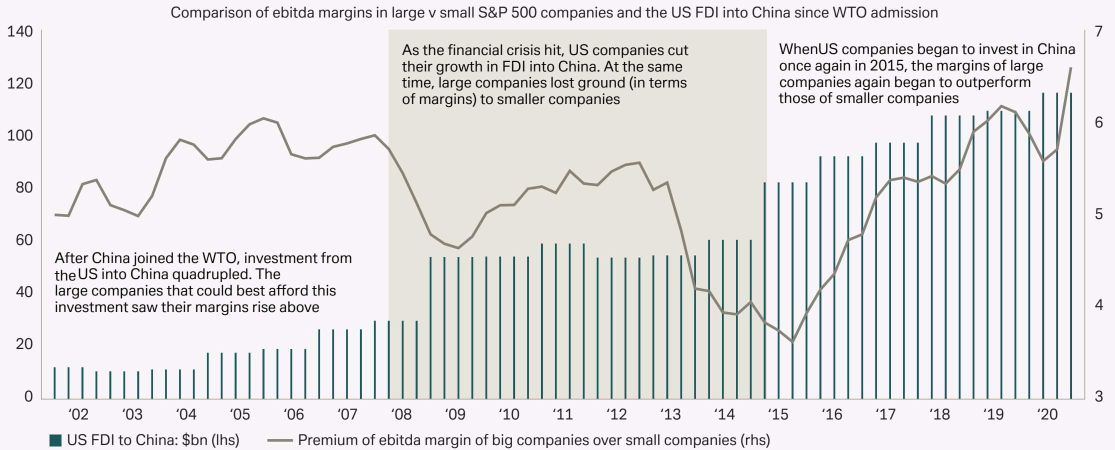
Global FDI is set to fall 40 per cent this year



Source: UNCTAD, Deutsche Bank

That is a worry for large companies as they have depended upon foreign investment to boost their margins compared with small companies. To calculate by how much, we looked at companies in the five sectors that commonly have international supply chains with China. We then examined the difference in operating margins between the largest half of those companies and the smallest half. The following chart shows how, in periods of rising foreign investment, the margins of large companies tend to rise, and vice versa.

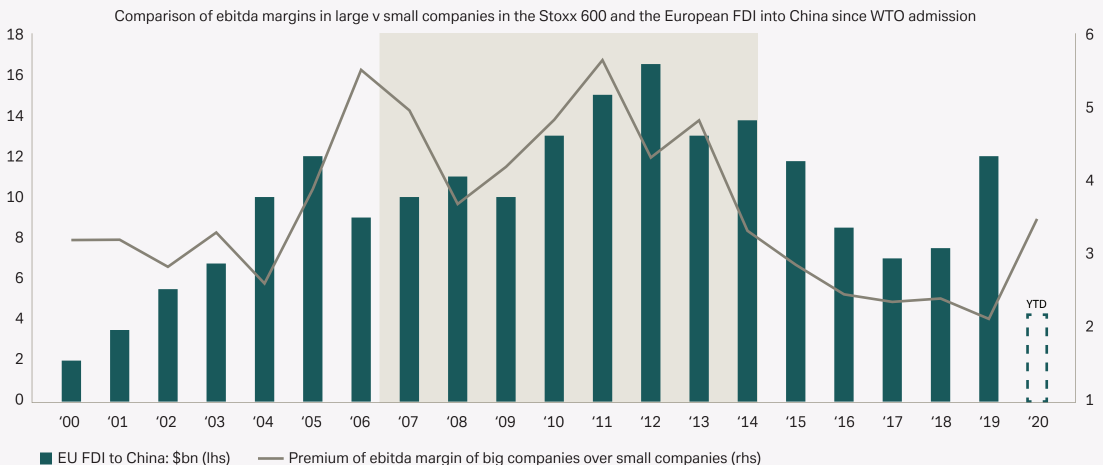
Large US companies rely on FDI to China to outperform smaller companies



Source: Factset, Haver Analytics, Deutsche Bank

In Europe, large companies appear to be similarly dependent on FDI into China. While these charts show how important investment into China has been for large companies there is a bigger point. In this specific analysis, China can be thought of as a proxy for globalisation itself.

Large European companies have been similarly dependent on FDI to China to drive their profits relative to small companies



Source: Factset, Haver Analytics, Deutsche Bank

[1] Consumer discretionary, consumer staples, industrials, technology, communications

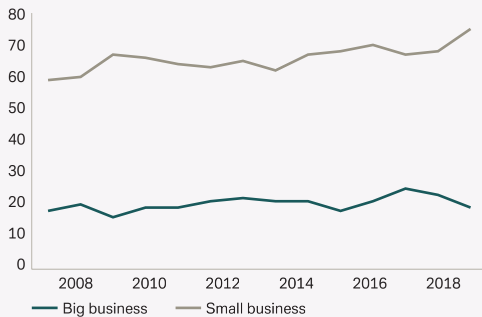
The second factor working against big companies is the rise in Chinese wages. Indeed, this is related to the growth in FDI in that the significant investment, combined with changing demographics in China, mean the labour force is highly utilised. Indeed, manufacturing wages in China are now almost $1,000 per month, higher than rates in Malaysia and Thailand. As Chinese demography continues to decrease the working-age population, corporates should expect wage growth to continue.

The third deglobalisation factor is the sudden escalation in ESG investors. These issues disproportionately affect large companies and these are the ones that are generally the focus of attention by large investors with the clout to demand change. Large companies are also far more likely to find themselves in the media for ESG-related reasons.

The fourth force is politics. Across many countries, both rich and poor, leaders are being elected on promises to reinvigorate domestic economies. During the campaign for the US presidency this year, both candidates talked a big game on stopping US companies from "shipping American jobs overseas". Corporate tax is also in the cross-hairs of politics and supranational organisations, most notably, the OECD.

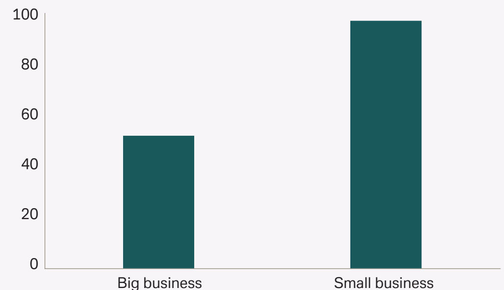
The fifth force pushing back against large companies is customers themselves. Indeed, before the pandemic, customers were already rebelling against large companies. That trend has only accelerated since the pandemic outbreak.

Proportion of Americans who have a "great deal" or "quite a lot of confidence in big and small business"



Source: AlphaSense, Deutsche Bank

Proportion of people who have a positive image of large and small business



Source: AlphaSense, Deutsche Bank

The steps large companies must consider

The holy grail for large companies is to localise an appropriate level of their operations without losing the benefits of a globalised brand and the scale the gives them an advantage on costs. As they consider the long and expensive process of doing this, small companies have a natural advantage. They are already more likely to use local sources for their goods and labour. They are also nimble enough, and order and hire in small enough quantities, that they can find alternative suppliers more easily than can large corporates. Compounding these 'reverse scale' advantages is that they come right at the time that customer sentiment has turned against big companies.

Large companies must therefore adjust their businesses or risk conceding market share to small firms. Yet, only 35 per cent of companies have begun to implement plans to localise their business[2]. That is because the costs of localisation are significant. Committing to them will take courage and incentives may have to change as recouping the costs may take longer than the tenure of many chief executives.

To start, localisation does not necessarily mean bringing all manufacturing back to a firm's home country. For European companies it may mean moving production from outside to inside the EU. Regardless, localisation invariably means that

[2] AT Kearney

the average company will have to assume more responsibility for its manufacturing and labour, rather than relying on outsourcing as it takes a long time for countries to develop local companies capable of handling large outsourced requirements.

As large companies localise production, they have access to some benefits that smaller companies do not. First and foremost, there are growing political benefits and tax incentives for insourcing production. Just one example is South Korea, which offers incentives to domestic companies that restore operations. Many other cities, states, and countries will agree bespoke deals with companies to incentivise them.

The next step large companies must take is to leverage their advantage in technology. Big firms are far better placed to provide ESG-conscious customers with transparency information about their products. Blockchains are beginning to be used to prove the provenance of inputs. Just one example is JBS, the world's largest meatpack which will now use blockchain throughout its supply chain to prove the provenance of its cattle. Furthermore, large companies are harnessing big data in ways that smaller companies cannot.

Acquisition strategies are another potential response of large companies. This has been used to good effect in the beverage sector. Consider that Diageo owns over two dozen Scotch whisky labels. Many of these maintain a level of independence over their operations and have different styles, branding, target demographics, and fans. While this strategy can be successful, there is a fine line to walk as some customers actively seek out brands that are truly independent.

Some companies, therefore, will have no choice but to compete with the idea of independence. That involves giving customers the 'feeling' that they experience when they purchase from an independent or small company. This feeling comes in several forms and can be that they have benefited the local community, that they have done business with 'ordinary' people , or that by consuming a certain product, they have had an experience that is unusual and different from those in their peer group.

In the search for the unusual, large companies are better placed to deliver customisation. The last mass attempt at this strategy occurred in the 1990s (just one example being customised jeans). The experiment failed in part due to customers being unwilling to wait for their products to be manufactured.

Today that has changed. Customers are more willing to wait for certain types of products to be delivered. The rise of internet retail has proved that customers are now willing to wait to receive their products. In the case of fashion, they are now willing to buy items without trying them on. That opens up the opportunity for companies to experiment with widespread customisation once more. This is something that large companies may be better placed to do relative to smaller firms as they can afford the significant additional inventory costs which allows a reduced manufacturing time relative to small companies that may have to order components.

Finally, how local is local?

The most difficult question for corporates is "What is localisation?" Does it mean a company basing its operations in a nearby country, in its home country, or in its home state/county/département etc? Or will the trend of multi-localism take off with companies establishing 'bases' in various places and sourcing their inputs as such?

The answers to these questions depend, in large part, on customers and shareholders. Although it can be difficult to predict how the thoughts of these two groups will evolve, what seems certain is that the forces driving localisation will continue to gather momentum. That is because those forces come from both angles: top-down politics, and bottom-up customer preferences. Given these trends are only at the beginning of unwinding decades of globalisation, it appears this process has a long way to go. That means that although the cost of localisation may be great, particularly for large companies, the cost of not doing may be greater still.