MIDDLE MARKET Growth

A Pathway to Resilience: Reshoring Shapes PE's Manufacturing Strategy

TBM Consulting shares considerations for PE investors in manufacturing as reshoring efforts grow

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As geopolitical tensions have increased and the pandemic has exposed the vulnera bilities of global supply chains, private equity firms are now looking at reshoring strategies for manufacturing businesses. So, what should they be considering? And what are the operational issues?

Even before the pandemic, some larger businesses with manufacturing exposure had started reviewing where they should locate their production bases and source their components. Among the triggers for this were new rounds of protectionist policies, plus poor intellectual property rights protection and rising costs in markets such as China. In the past 20 years, for example, hourly manufacturing labor costs in China have increased by over 500%, according to analysis of data from the U.S. Bureau of Labor Statistics and Statista.

The extreme test of supply chain resilience that stemmed from COVID-19, together with heightening geopolitical tensions, have sharpened many companies' focus on whether to bring manufacturing closer to home. According to a January report by manufacturing and industrial parts marketplace Xometry, 55% of CEOs in the U.S. whose companies rely on manufacturing plan to reshore operations—nearly all plan to do so this year.

As a result, private equity firms backing or looking to invest in manufacturing companies may need to examine the reshoring or nearshoring equation both at due diligence and ownership phases.

While this type of analysis may be new to many private equity investors, we at TBM Consulting are now seeing some leading firms start to shape a reshoring playbook as part of their risk mitigation work on potential and existing portfolio companies. This involves weighing issues such as costs and contingency plans, tariff threshold calculations, lead times and the extent to which components are critical to the end product.

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Are You Missing Out?

These are all important considerations. Yet it is also worth taking into account some of the benefits reshoring could bring, such as the potential for cost reduction. Total landed costs, for example, are frequently higher than is generally understood. They include not just items such as tariffs, but also total shipping costs, warehousing, shrinkage (or the loss or damage of items in transit) and sales lost as a result of not having the available stock to meet customer demand. Even if these do not tip the balance in favor of reshoring in every instance, they should be part of any comprehensive cost analysis exercise.

In addition, regardless of the decision they reach, private equity firms could also benefit at exit if they have conducted high quality analysis on reshoring in their manufacturing business. Given the pressures we see today on supply chains, buyers may be willing to pay a premium for a company if they understand the risks and the financial and business case for or against reshoring.

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Getting to the right answer of whether to reshore or not relies on accurate and complete information, while executing the strategy successfully requires significant forward planning.

What Should Evaluation Include?

The first step is to evaluate the business and financial case for or against reshoring. A general rule of thumb is that the more complex the situation, the less likely it is to be a cost-effective move. If manufacturing is contracted out, for example, the reshoring process will almost certainly be more straightforward than where the business owns the manufacturing facilities. Timeframes also matter, given the need to generate the returns that private equity fund investors expect.

Tariffs are clearly an important area and analysis should take into account both current and likely future charges to create tariff thresholds. This will determine the viability of maintaining manufacturing overseas. Private equity owners also need a clear grasp of how long it would take to reshore manufacturing and, importantly, which components are potential targets for reshoring. This latter point may depend on how critical the product is, the complexity of the tooling and the owner of the associated intellectual property. For global businesses, a key consideration may be whether to bring production closer to home for U.S.-based customers while maintaining local manufacturing for Asian customers to ensure continuity of supply and acceptable lead times.

There may also be a case for reshoring in some sectors that can take advantage of U.S. government incentives for local manufacturing. The Inflation Reduction Act, for example, **offers** tax credits, grants and loan facilities for clean technologies, while the CHIPS and Science Act **aims to bolster** U.S. production of semiconductors. And finally, if the plan is to launch new products, the decision to base manufacturing locally may be easier than if examining existing product supply chains.

Overall, the financial case should rest on total landed costs of components and goods versus local manufacturing, while the practical and operational case will require site visits and a close understanding of the manufacturing processes involved.

How to Execute Well

If the case for reshoring or nearshoring stacks up, precise project planning and an understanding of the risks involved are the most important ingredients for successful execution.

One of the first steps is to plan how the business will increase stock levels ahead of the transition to ensure that it has sufficient inventory to meet customer demand while local production is ramping up.

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Delays in building manufacturing capability locally can be costly. In our experience, one common pitfall is a lack of preparation for the manufacturing process. Companies and their backers should therefore take steps to understand the details of the process, including familiarizing themselves with the documentation that outlines the steps for manufacturing the components or products. They also need to validate that they can recreate the tooling required for production. And finally, plans should include the timeframes necessary to bring manufacturing capacity to the level required to meet customer demand.

Managing Complexity

Reshoring can help mitigate supply chain risks, reduce lead times and, in some cases, reduce overall costs. It can also help position companies for future growth. Yet it is a complex process that requires both sound decision-making based on accurate information and strong project management skills.

Managing this while also keeping the business running can stretch the resources, bandwidth and capabilities of many middle-market companies, which is why we always advocate bringing in third-party expertise.

The right outside knowledge and experience can help companies and their private equity investors challenge and test assumptions, highlight risks and opportunities that may not be immediately apparent and – vitally – speed up the process so that the business can remain focused on its growth plans.

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