



# UNDERSTANDING MEXICO'S NEW SHELTER MODEL

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Mexico is on the move, taking advantage of its unique geographic, economic, and demographic advantages to position itself as the leading power in Latin America. Central to this change are new federal reforms that are transforming the landscape in critical sectors such as energy, banking, telecommunications, and education. In these areas and others, Mexico is sending a strong signal that it expects growth to increase beyond the 2.6 percent average seen in the past two decades. To get behind this plan is a two-pronged approach that not only includes economic liberalization, but that also involves an increase in government spending in critical areas such as infrastructure and human capital. It appears to be working: the median projection of economists surveyed by Bloomberg is that growth in Mexico will accelerate to 3.8 percent in 2015.

This ambitious strategy is being spurred by a recovering U.S. economy, with exports growing to critical sectors. Mexico sends nearly 80 percent of its exports to the United States, and trade between the two countries is now at US\$500 billion annually. Ernesto Revilla, head of Mexico's Finance Secretariat Economic Planning Unit, has noted that the country's non-petroleum exports are

improving with "important velocity". As well, Manuel Sanchez, one of five governors on the Bank of Mexico's board, has confirmed what is now common knowledge: that Mexico's economic growth is being supported by additional "signs of firmer domestic consumption and more investment."

This transformation is no coincidence. It is a direct result of the Pact For Mexico, a historic agreement in which the leaders of Mexico's three major parties found compromise on no less than sixteen constitutional amendments, all approved within the first year in office of Mexico's new president, Enrique Peña Nieto. Though not without controversy, the consensus in the business community is that the overall effect will be to increase private investment while boosting performance and accountability in both the private and public sectors.




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# A PLACE IN THE SUN

How might a foreign company take advantage of the opportunities now present in Mexico, especially with regard to Mexico's close proximity to the United States? Companies looking to capitalize on the changes afoot in Mexico can opt to contract out work, set up a joint venture, outsource tasks, establish a wholly-owned subsidiary, or work with a shelter operation.

Contracting might be a good option for small, intermittent jobs. Joint ventures can be effective for those foreign companies looking for distribution channels and access to the Mexican market, though they can present legal and cultural challenges without the advantage of a shelter partner. A wholly-owned subsidiary, which can be both risky and costly, is the most complex; it can be well-suited to large corporations in that it requires significant expertise, and involves a long-term commitment. However, it does ensure complete control.



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# A NEARSHORE SHELTER

## The Old and New of Sheltering

This brings us to the shelter model, which in many ways is the best of all options. Sheltering oneself can take many forms, including non-core manufacturing tasks, and tends to have a services focus in areas such as real-estate management and leasing, payroll and benefits administration, human resources, procurement, legal, and logistics. A shelter allows for complete control while also benefitting from the provider's expertise in the local market. It saves the client from large-scale investments in physical assets or human capital, without the requirement that a legal presence be established in Mexico. The term "shelter" refers to the protection provided from the liabilities that might be incurred with direct incorporation.

That protection is important because, despite the many advances made by Mexico, the country still faces challenges with regard to government bureaucracy, inefficiency, and corruption. Without the benefit of a shelter, foreign interests could find themselves slowed or even blocked by the idiosyncrasies of the Mexican market. More importantly, a shelter future-proofs an investment from any changes to legislation, and from the sometimes inconsistent and convoluted interpretation and implementation of local, state, and federal law. Mexican nationals, with their knowledge of the country's business culture, have the means and ability to navigate these waters. By contrast, non-Mexicans might find the required levels of engagement and patience to be a significant barrier to investment.

As a result of sheltering's obvious benefits, the model has entered the world of Information and Communication Technology, positioning itself as a viable alternative to

Sheltering in Mexico is not a new concept. The stage was set in the 1960s after the National Border Industrialization Program was introduced. The idea was to attract foreign investors to Mexico, and resulted in the beginning of the Maquiladora Program in 1964, which allowed for 100% foreign ownership of manufacturing plants. The sheltering model itself was conceived early in 1970, with some operators assuming the responsibility for compliance with Mexican regulations and for dealing with Mexican authorities. There was then a new maquiladora decree in 1989, which further relaxed Mexico's foreign investment laws and allowed maquiladoras to sell up to half of their production into the domestic market. And of course in 1994 NAFTA came into effect, which opened free trade between Canada, the United States, and Mexico.

Now, the shelter concept is being applied to ICT via virtual captive units (VCUs). VCUs allow a customer to set up a development or R&D center in Mexico while maintaining full control and transparency related to all operation-incurred costs. The provider builds out the center to fully comply with the customer's guidelines - everything from development methodologies and processes to team structure and corporate culture. This can be done within the provider's existing facilities, or it can be built from the ground up for the client at a designated site.

those firms that have previously seen delivery models as being a choice between traditional outsourcing and incorporation. Outsourcing has the advantage of speed and cost-effectiveness, but can result in reduced operational control and risks associated with a third-party workforce. Incorporation allows for full control, and closer attention to costs, but it is slower, and requires a long-term commitment and substantial market knowledge.

By contrast, sheltering can be the best of both worlds. It is fast, without requiring large investments. It allows for full control, with an opportunity to build long-term employee loyalty and lower turnover. Customers can visit the facility, and the workforce can be adjusted to reflect the right mix of local and expat workers, with a path to bringing talent onboard. Options include a joint venture with the shelter, or a build, operate and transfer (BOT) model, in which a nearshore operation can be put together and operated by the Mexican shelter, with an eye to a timely transfer to a client's own Mexico-based corporation. Clients can also choose more selective engagements with a virtual captive nearshore delivery center, or the use of offshore staffing services – a flexible option in which a client can manage a remote development team as if it were their own.

## FACT BOX

### Mexico is...

The **third** largest exporter of advanced manufactured goods in the G20

The **fifth** largest exporter of computers in the world

The **number one** destination for direct foreign investment in aerospace

The North American giant that manufactures more goods than the rest of Latin America combined

Where natural gas prices are tied to those in the U.S. – and are substantially lower relative to the rest of the world

Source: Mexico Today

# THE MEXICO DIFFERENCE

When discussing opportunities in the Americas, observers often speak generically about Latin America and the Caribbean. In fact, the region has 47 countries, many of them tiny, and is dominated by the two biggest players: Portuguese-speaking Brazil in South America, and Spanish-speaking Mexico in North America. Together, these two giants account for almost US\$4 trillion of GDP. This is far ahead of the combined GDP of the other large Latin American economies: Argentina, Colombia, Peru, and Chile, which have approximately US\$2 trillion in cumulative GDP.

Being in North America, Mexico has the distinct advantage of sharing a land border with the United States, which allows for quick movement of products by road and rail. The North America Free Trade Agreement (NAFTA) ensures that goods and services can move freely, making the country an excellent launch pad and transit point for companies looking to access the U.S. market. NAFTA has now been in place for over 20 years, with Mexico proving itself as a trusted location for advanced manufacturing and services. In fact, Mexico now exports about US\$1 billion worth of goods per day, more than ten times what it did when NAFTA came into effect in 1994. In total, Mexico has 44 trade agreements. This is not only more than any other country in the world – it is more than the United States and China combined. Moreover, if the Trans-Pacific Partnership comes to fruition, the Baker Institute’s Mexico Center says that the agreement, which includes 40 percent of the global population and 60 percent of the world’s aggregate GDP, could surpass NAFTA in its ability to “allow for the diversification of markets and real developmental growth.”

## MEXICO AT A GLANCE

GDP: US\$**1.261** trillion (2013)

Population: **122.3** million (2013)

Income per capita: US\$**9,940** (2013)

Life expectancy at birth: **77** years

Source: The World Bank



# A GLOBAL ADVANTAGE

Mexico's advantage is also evident as China becomes less competitive, with more activities being reshored to North America. Wage and currency inflation, as well as increased energy and transportation costs, have reduced China's viability as a supplier of manufactured goods to the United States. According to a study by the Boston Consulting Group, average electricity costs in Mexico are about 4 percent below those in China, with industrial natural gas being a dramatic 63 percent cheaper.

Overall, non-partial observers like the Boston Consulting Group have expressed impressive confidence in manufacturing in Mexico, noting that this sector will continue to add billions of dollars to the economy. The backbone of this sector is the auto industry, with Mexico poised to surpass Brazil in 2014 as the top producer in Latin America, according to consultancy IHS Automotive. That would put Mexico in the number seven spot globally for auto production. Importantly, eight of every ten cars produced in Mexico are for export, with over half of those going to the United States, where, according to PricewaterhouseCoopers, production costs are 20 percent higher. Overall, IHS Automotive forecasts Mexican output of almost 3.2 million units in 2014, ahead of Brazil's 3.17 million.

As a result of this surge in economic activity, and the supporting legislative reform, Mexico

is increasingly separating from Brazil to stand alone as a leader in Latin America, with the smaller economies in Peru, Colombia, Chile, and Argentina representing a second tier. Mexico's robust economy, helped by the Congress's recent approval of 34 reforms to financial and banking laws, is now moving with unprecedented dynamism and speed. Certainly, Mexico's smaller neighbors in Latin America cannot support the kind of IPO activity now observed in Mexico, as exemplified by Grupo Financiero Santander Mexico's record-breaking and successful US\$4.3 billion offering, and by a private equity market approaching US\$15 billion – a 50 percent increase from the turn of the century. As well, the recent banking reforms have resulted in opportunity for pension funds, which can now invest in IPOs. With about US\$150 billion in assets, these funds now have more options to participate in a diversified economy.

As a result of all this confidence, early in 2014 Moody's granted Mexico an A3 rating for government bonds, its highest ever classification. This in turn allowed for a successful float of 100-year British pound bonds valued at US\$1.66 billion. Clearly, the business community has bet that Mexico's economic and political stability is real, and good for the long haul.

# A WORLD OF TALENT

One of the notable achievements in Mexico in the past hundred years has been the advancement of the country's education system. Mexico has national a literacy rate of 97%, with major urban areas averaging 99%. At the primary and secondary level, new reforms have been brought in to make teachers and schools more accountable. At the post-secondary level, the public system includes the country's flagship National Autonomous University (UNAM) – the largest university in the Americas with 325,000 students – and the National Polytechnic Institute (IPN) with 166,000 students. This is complimented by 38 universities at the state level and, importantly, 36 branches of the National Technology Institute.

The more recent trend toward a strengthening of the private educational system in Mexico – a reflection of the country's growing middle class – has also boosted Mexico's talent pool, particularly with regard to technological skill, business acumen, and English language capabilities. There are scores of private colleges supporting this trend, but the most notable are perhaps Mexico City's Autonomous Institute of Technology (ITAM), and the two Technological Institutes for Advanced Studies, one in Guadalajara (ITESO) and one in Monterrey (ITESM). Of these, ITESM is by far the largest, with about 90,000 students.

This young, educated workforce does not exist in a vacuum. Mexico leads Latin America in smartphone penetration, at over 25 percent of the population, compared to 23 percent in Brazil, 19 percent in Chile, and 17

percent in Peru. The larger shift to mobility is also impressive, with over 63 percent of the Mexican population expected to have a mobile device in 2015, up from 45 percent in 2009. This connected population, keen to embrace higher education, is also well-placed to learn and add value within those organizations serving the culturally diverse US market, where over 52 million people are Latino.

And this advantage, in which talent can come onboard to provide sustained organizational value, is happening in a cost-competitive environment. The Boston Consulting Group has found that in 2015 average manufacturing-labor costs in Mexico are expected to be 19% lower than in China. This represents a dramatic shift from the turn of the century, when Mexican labor was 58 percent more costly than in China..

It is important to realize, too, that the advantage of labor cost competitiveness does not equal labor arbitrage. Manufacturing in Mexico requires a highly skilled, reliable workforce that can deliver on the demands of global players in the automotive, aerospace, and high technology sectors. These manufacturing sectors are reliant on the latest technologies, with employees required to work with advanced computing and software. The result is a working culture with a global view that offers flexible, highly differentiated value to customers. This translates directly into the services sector, given that Mexican workers must interface with clients in the United States and abroad at the highest level, often supporting administrative functions.

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