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Contract Manufacturing: Is Geopolitical Risk An Undervalued Opportunity?

CONTRACT MANUFACTURING: IS GEOPOLITICAL RISK AN UNDERVALUED OPPORTUNITY?

As I watched the massive evacuations from the firestorms in Los Angeles, I was once again struck by another catastrophe; the inability of one ecosystem to take on the needs of a larger ecosystem in a crisis. Think of the massive complexity and strain on the people, supply chains, trades, public services and resources (financial and real) necessary to rebuild lives and tens of thousands of homes and businesses in a foreseeable timeframe. When seismic shifts overwhelm the status quo, *spare capacity* is worth its weight in gold.

This reminded me of a situation I've been mulling for months about US contract manufacturing. This is a market our M&A practice is active in, so we are regularly speak with owners and buyers on their views and concerns. The market is healthy at the moment, with attractive valuations driven by conventional motives for merger activity. Rarely, however, does geopolitical risk factor significantly into the conversation. We think it should.

Supply chain security rising in importance

About 18 months ago, I came across a survey conducted by the Atlantic Council (Scowcroft Center for Strategy and Security). It surveyed 167 senior policy advisors, strategists and foresight practitioners (60% US/40% foreign) about their greatest concerns. Two questions stood large:

*More than **70%** percent of respondents felt it likely or very likely that China would attempt to retake Taiwan **by force**, within the next 10 years.*

By comparison, *less than **40%** of respondents felt it likely that NATO and Russia would enter into direct conflict in the same period*.

That nearly twice the event risk was assigned to China/Taiwan was astounding considering this survey was conducted a year after the Ukraine invasion began.

Around the same time, one of my FOCUS colleagues with a long pedigree in global contract manufacturing, had an informal private lunch with a senior DOD official focused on procurement. The message was confirmed that critical domestic manufacturing and supply chains (electronics, defense, technology, critical materials, etc.) are a "top of the list" worry for the DOD, particularly eyeing Asia.

The concern is not just the *functionality* of the supply chain but also the *security* of the supply chain. The trust issue is especially topical considering Mossad's success in infiltrating the Taiwanese supply chain of pagers and walkie talkies and concerns about Huawei technology. Many of the bipartisan investment initiatives of the current Congress are responses to these concerns.

The insurance value of domestic capacity

It is clear that those in the business of risk assessment are deeply worried—and on a short enough time scale that capital decisions such as production investment and M&A will be affected.

Prior to November, I thought alternatives such as Vietnam, India, Mexico, and to some degree the US, would pick up some increased share in a pre-crisis world. Now with the new administration threatening broad-based tariffs, we have to mix in an additional possible risk front. It's no secret that President Trump loves a fight. There is no predicting how this will turn out, but "pretty ugly" is not completely out of the question for the internationally exposed—even if we believe cool heads are more likely to prevail. Between Taiwan, tariffs and trade sanctions—and other head-butting—there is a lot of volatile fuel here lying in wait for a spark.

An orderly adjustment of supply chains in contract manufacturing has been underway for some time, but what happens if lightning strikes? What happens when everyone isn't just looking for but *needs* an alternative simultaneously? It's not just China and Taiwan. If the survey respondents are correct, other countries reliant on the South China Sea are in the potential theater of disruption and won't be spared from the risk. Do secondary supply chains have the spare capacity to absorb major disruption to the prime suppliers?

Consider one example. Many years ago, the US gave up the vast majority (around 90%) of its domestic printed circuit board manufacturing (the raw boards) to China based on cost. Taiwan is in second place. I venture to guess that attempting to move just 15% of that lost volume back to the US would overwhelm any remaining available US capacity. It's a chemical business, and the permitting hurdles alone make it problematic and time consuming, not to mention the procurement and workforce requirements. Imagine the economic value of US production facilities (and the margins available) should these events unfold. Consider the impact and economic disruption across any US industry reliant on moving electrons around.

This applies in our mind across all contract manufacturing to varying degrees based on foreign dominance whether metal, plastic, electronics, assembly, etc.

To take another example, we recently sold a couple of EMS businesses, both with exceptional margins compared to the industry standard. In both cases, their managements had designed into their business model an aggressive approach to procurement (ie production reliability) as a competitive weapon. With the COVID pandemic being the supply chain disruptor, both businesses did exceptionally well because their production capacity remained *available*, whereas many others faced shortages and excess capital tied up in stalled work in progress. Margins responded to necessity meeting scarcity.

In our world of M&A, buyers typically place most value on the present steady state: EBITDA margins, customers, target industries, and modernity of the facility. OEMs are biased toward cost before security, since we are accustomed to orderly trade. Not much incremental value is placed on spare capacity and strategic value of location. By contrast, in real estate it's location that determines value, and the smart money always seems to be ahead of the events that drive a revaluation of a property, not trailing. On Wall Street, the option value of a potential upside scenario is always considered. The contract manufacturing capacity of the US deserves more of this thinking.

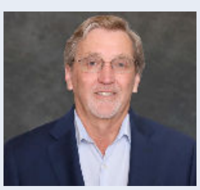
Geopolitical threats may offer a competitive edge

What I know is the people whose job it is to opine on geopolitical and supply chain risks are very worried and increasingly so by the day—and critical manufacturing capacity is Exhibit A.

History repeatedly tells us that when orderly flow transitions to a stampede, it tends to happen suddenly. Inevitably, when too many people are chasing the few available chairs, the value of those available chairs becomes very pricey. Since alternative supply chains are generally right sized for current business, there are likely not enough extra chairs to go around when several top global suppliers suddenly become compromised simultaneously.

The owners of US contract manufacturing facilities, particularly those with spare capacity or expansion potential, are in possession of an undervalued optionality, which could turn the worlds geopolitical threats into reward in a big way. For most of the sectors involved, the base growth forecasts are already healthy. However, if production utilization, gross margins and valuation multiples all expand under the umbrella of newfound scarcity, it could become very valuable real estate indeed.

If contract manufacturing is an area of interest for you, please feel free to contact Craig Ladkin at craig.ladkin@focusbankers.com.



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ABOUT THE AUTHOR

Craig Ladkin, a FOCUS Managing Director since 2015, has 25 years of experience managing complex financial and development transactions between private, public and non-profit sectors in a variety of industries and international jurisdictions. He is a senior member of our Advanced Manufacturing team.