



# Can big companies survive localisation?

The trend towards 'localisation' leaves few easy options for large companies. Their huge advantage from global supply chains and businesses, built up during the last few decades of globalisation, may unwind unless they adapt to local- or multi-local business models. The urgency to adapt has been turbocharged by covid-19.

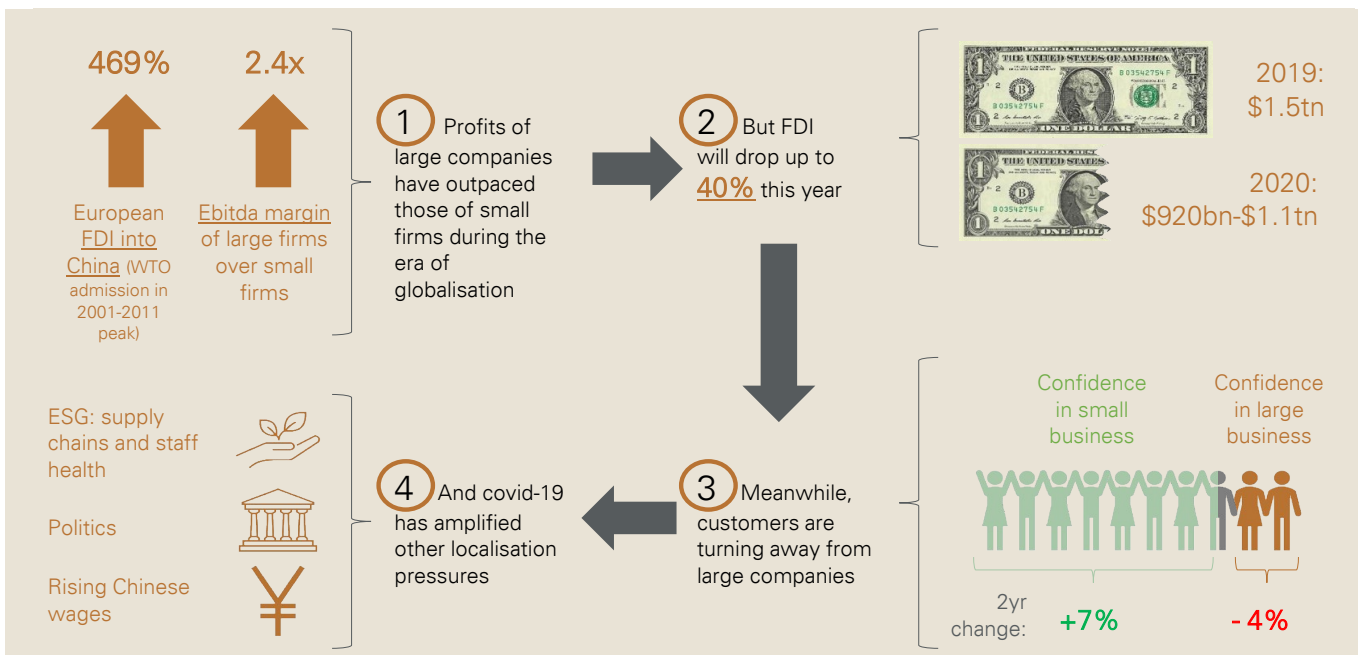
In this piece, we examine five localisation forces that now conspire against large companies and favour small ones. These include plummeting foreign investment, wage rises in outsourced locations, the escalation in ESG focus on global supply chains, and growing political and customer pressures for 'local' products.

Ultimately, large companies must adapt. We outline some potential avenues that large companies can take that smaller ones cannot.

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Figure 1: Several forces conspire against large companies



Source: Factset, Haver Analytics, European Commission, UNCTAD, Gallup, Deutsche Bank



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## Summary on a page

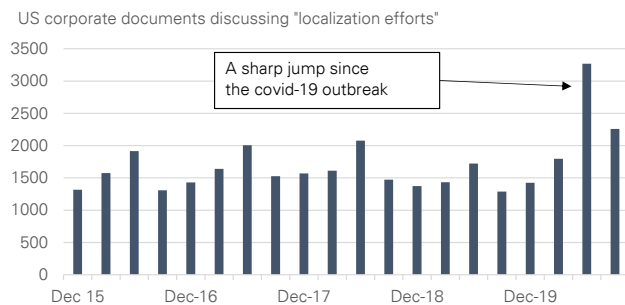
- Large companies have enjoyed the last few decades of globalisation as they have been the ones with the resources to invest in global supply chains and businesses.
- Covid-19 has turbocharged the deglobalisation movement as supply chains have been upended, geopolitical risk has risen, and ESG-conscious customers and investors have pushed companies to be more 'resilient' and local.
- Yet, only 35 per cent of companies have begun to implement plans to localise their business.
- Profit margins of large companies are sensitive to foreign investment. As FDI increased after China joined the WTO, so too did the margins of large companies relative to their smaller rivals. However, when FDI decreased, large company margins fell and smaller firms caught up.
- A 40 per cent drop in global FDI is expected this year (source: unctad.org, World Investment Report). That is a serious concern for large companies that depend upon it (either directly or indirectly).
- While the pandemic and the drop in FDI will challenge the supremacy of large companies, several other forces are conspiring against them. These include rising wages in China and the lack of outsourcing alternatives that have China's scale.
- Customers increasingly prefer small businesses. Indeed, less than 20 per cent of people now have "confidence" in large businesses, while 75 per cent of people have a favourable opinion of small businesses.
- Political opinion is moving against large companies as leaders respond to populism. Corporate tax increases are on the horizon as are greater regulations in some industries.
- This year, large companies have become the focus of attention for ESG investors who have brought supply chain resiliency within their remit. In particular, these investors are concerned about the dependence on a narrow set of suppliers and supplier countries. The extent of this oversight is far greater for large companies than small ones.
- Small companies will find it easier to adapt to localisation. They are not burdened by the scale of investment in global supply chains as are large companies. As they purchase inputs and labour in smaller quantities than do large companies, they will have more options to source locally. Small companies are typically under less investor pressure to build expensive spare capacity into their supply chain. Of course, this spare capacity is extremely useful during a supply shock, but it may be some time before this occurs again.
- Large companies have several options but they all involve cost and change. The first is an acquisition strategy to purchase 'local' brands and maintain them as independent business units. Another is to reform centralised global operations and supply chains into a multi-local configuration.
- Large firms can use some advantages from their existing scale. In particular, they can use data more effectively than can small companies. They are also better placed to respond to the growing trend of customisation.



## Big companies have enjoyed globalisation. That may now reverse.

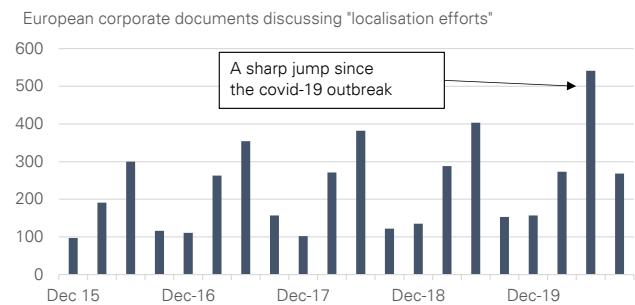
Globalisation has gifted large companies benefits that have not accrued to smaller firms. However, as the world begins to deglobalise, those advantages may reverse. While some companies have been aware of this for some time, a response has suddenly become far more urgent as the momentum powering the shift to localisation has been turbocharged by covid-19. Indeed, localisation has become one of the most discussed topics by both US and European companies since the outbreak of the pandemic this year as shown in the following charts.

Figure 2: Localisation is a hot topic in the US ...



Source : AlphaSense, Deutsche Bank

Figure 3: ... and in Europe



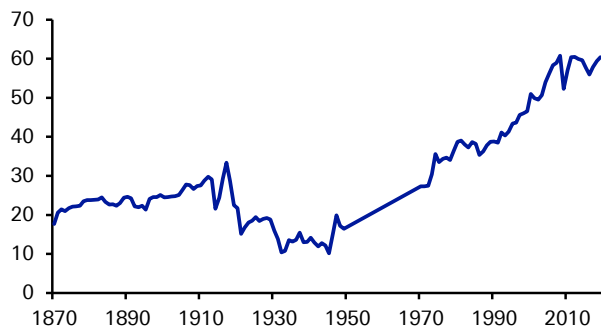
Source : AlphaSense, Deutsche Bank

Before we examine the localisation forces that are pushing large companies to change, it is worth briefly discussing how globalisation has helped large companies. Essentially, the benefits stemmed from their means to invest in facilities and relationships in countries with low cost labour. In addition, corporates with scale established international supply chains that reduced their costs of inputs and manufacturing.

Consumers benefited. In fact, the savings due to globalisation and commoditisation meant that the cost of US goods has fallen 11 per cent since China joined the WTO. Of course, this is not the only reason, but it is a significant factor.

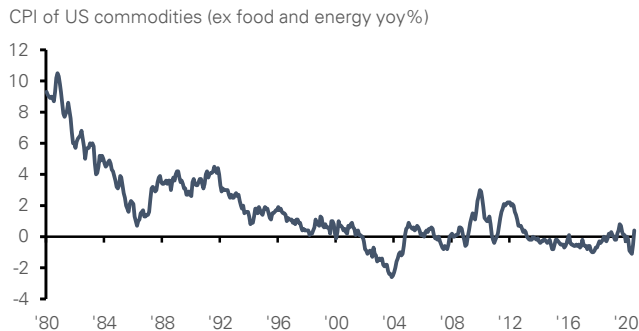


Figure 4: World Trade (% of GDP)



Source : World Bank, Haver Analytics, Klasing and Milionis, Deutsche Bank

Figure 5: Goods have been unusually cheap for the last few decades



Source : Haver Analytics

Today, the era of globalisation is waning. Jim Reid's recent Long-Term Asset Return Study predicted that the world is entering an 'Age of Disorder' in which several factors will collide to roll back globalisation. Already, there are signs that deglobalisation is taking place and the above chart shows that world trade has plateaued over the last decade. On top of this, technological advances may reduce trade by themselves. By one estimate, global merchandise trade could fall up to 30 per cent over the coming decade<sup>1</sup>. That could stem from the increase in automation and the steady reduction in parts needed to make products.

As large companies consider the long and expensive process of localisation, 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. As 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.

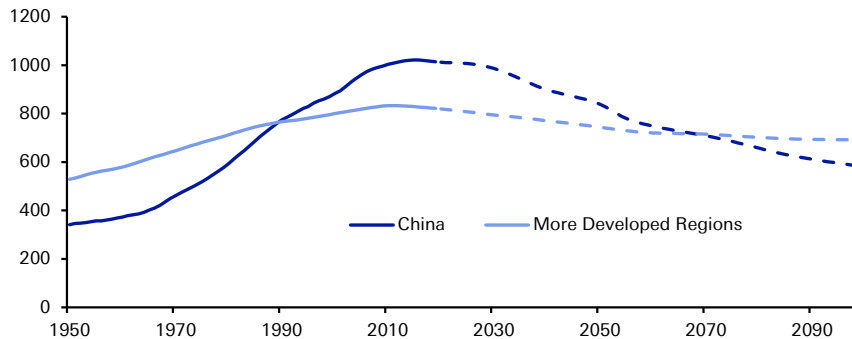
## How large companies depend on foreign investment

Of the many advantages afforded to large companies over the last few decades, there are two that stand out. The first is that since the 1980s, countries have competed to loosen regulations and encourage corporate growth. The second was the Chinese economic reopening which saw an explosion of labour onto the global market. For the companies with the scale to invest in China, this resulted in vastly cheaper costs.

<sup>1</sup> Finbarr Livesey, "From Global to Local", 2017



Figure 6: Labour force of the more developed world and China (15-64 year old population, millions)



Source : Deutsche Bank, Haver Analytics, United Nations

The corporate advance into China accelerated after the country gained admission to the WTO in late 2001. Since then, annual foreign direct investment from the US into China has increased by a factor of 12 to \$120bn. Similarly, European FDI into China has been more variable but has roughly tripled. As this FDI was plunged into China with a view to taking advantage of cheap labour and inputs, it led to increased operating margins.

In many ways, this helped large companies more than small ones. To calculate by how much, we looked at companies in the five sectors that commonly have international supply chains with China<sup>2</sup>. We then examined the difference in operating margins between the largest half of those companies and the smallest half.

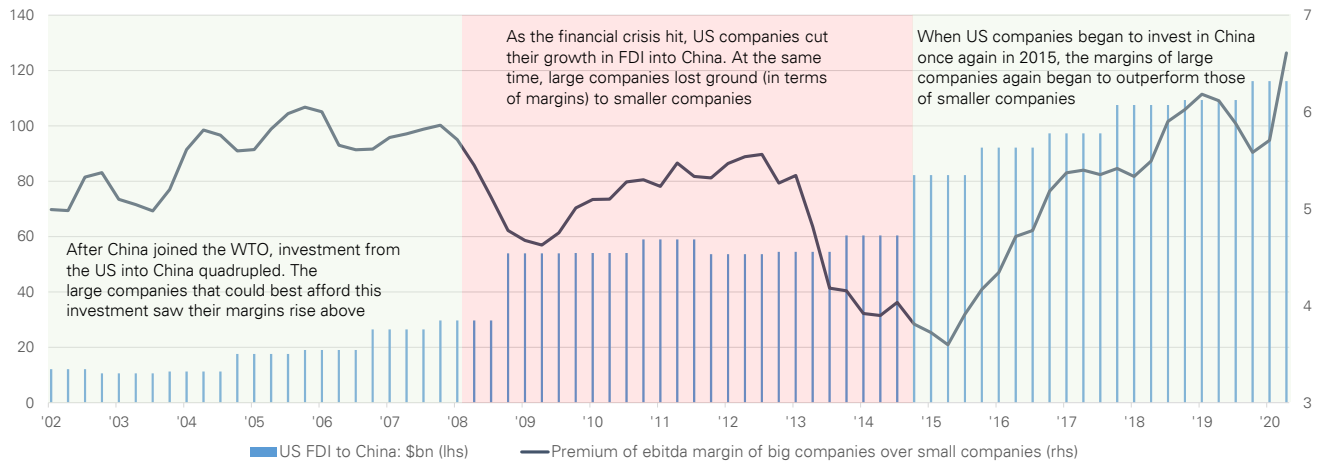
The following charts show the period since China joined the WTO for US and European companies. They track FDI by the US and Europe into China and overlay the *additional* ebitda margin that large companies generated over small companies for the same period.

<sup>2</sup> Consumer discretionary, consumer staples, industrials, technology, communications



Figure 7: Large US companies rely on FDI to China to outperform smaller companies

Comparison of ebitda margins in large v small S&P 500 companies and the US FDI into China since WTO admission



Source: Factset, Haver Analytics, Deutsche Bank

For the US, the above chart shows three distinct periods. Between the time of China’s admission to the WTO and the financial crisis, US FDI into China doubled and the ebitda margins of large companies outpaced those of small companies by a fifth.

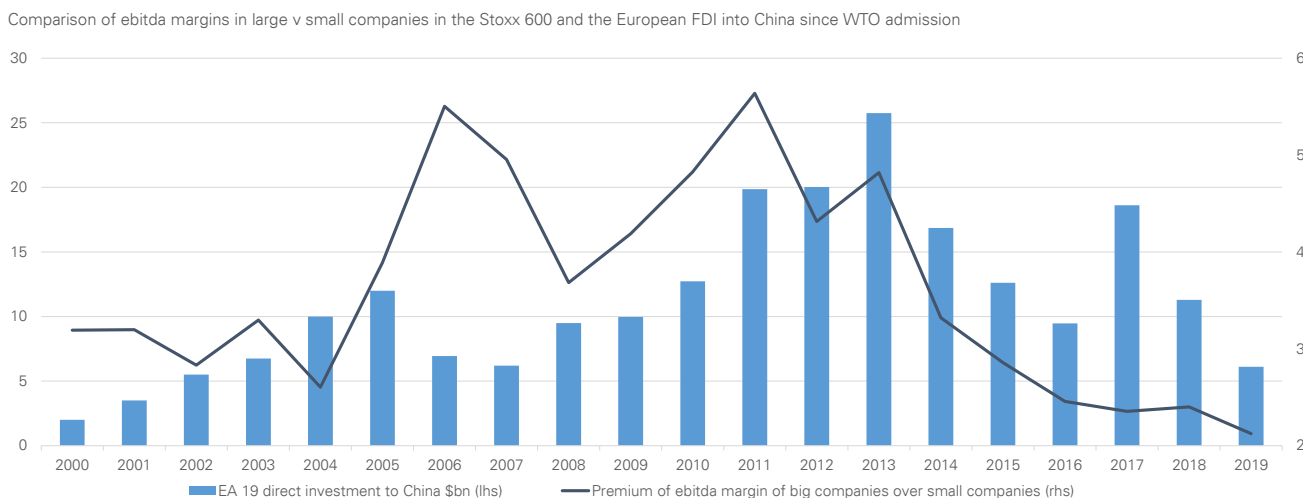
Then came the financial crisis and US FDI into China stalled. For the next six years, corporations were conservative and FDI levels remained flat. During this period of stagnant FDI, large companies lost ground to small companies. Indeed, the ebitda margin premium of large companies shrank and hit its lowest point in 2015.

Finally, corporate animal spirits returned in 2015 and investment into China resumed apace. In fact, it almost doubled over the next five years. Profit margins for large companies surged; between 2015 and 2020, the ebitda margin ‘premium’ generated by large companies relative to small companies almost doubled.

In Europe, large companies appear to be similarly dependent on FDI into China. The following chart shows that as European FDI into China increased, so too did large companies' operating margins relative to those of small companies. Then, as FDI into China fell after the continent's sovereign debt crisis, so too did operating margins.



Figure 8: Large European companies have been similarly dependent on FDI to China to drive their profits relative to small companies



Source : Factset, Haver Analytics, Rhodium Group for the European Commission, Deutsche Bank

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. Of course, many other factors have contributed to the difference in performance of large and small companies, but China's rise has been a key phenomenon over the last few decades. Below, we discuss how the pendulum is swinging from globalisation back to localisation. As it does, large companies have much to do if they are to maintain their competitive advantage.

### Several forces are conspiring against big companies

Just as large companies have benefited from globalisation over the past few decades, so too are they set to be hurt as this unwinds. This section details five forces that are propelling the shift towards corporate localisation at the expense of global businesses. These five factors will affect large corporates in different ways; however, it is almost certain that all firms will feel some impact from these factors.

Before we begin, there is no question that each of the forces pushing against large companies have been amplified by the pandemic. What is more worrying, though, is that disruptions like this are becoming more common. In fact, disruptions lasting a month or longer now occur every 3.7 years on average, estimates McKinsey<sup>3</sup>. Furthermore, the financial toll associated with the most extreme events has been climbing as global networks offer more “surface area” for shocks to spread and cause greater damage.

This increased business risk from future pandemics is directly proportionate to the increase in the value that society places on human life. Assuming this continues to rise, the threshold for implementing economic restrictions to control disease will fall.

3 McKinsey Global Institute; “Risk, resilience, and rebalancing in global value chains”



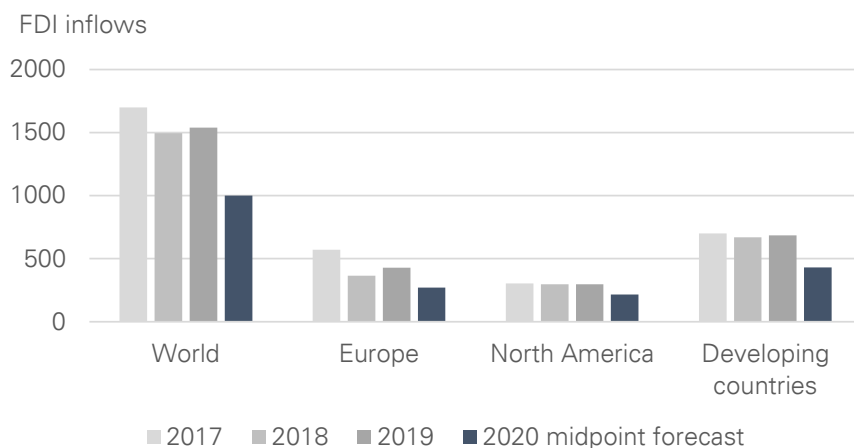


The consequences for localisation of similar future events are therefore likely to be increasingly severe. This is particularly the case for companies with direct or indirect reliance upon international supply chains and labour. As this is greatest advantage for many large companies, this will also be their biggest risk in a deglobalising world.

The first force acting against large companies is falling foreign direct investment. As the last section explained, increasing FDI, and particularly FDI into China, has gone hand-in-hand with large companies increasing their profitability relative to small companies. Conversely, when FDI falls, so too has the additional margin earned by large companies.

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. Furthermore, both new greenfield investment and cross-border mergers and acquisitions dropped by more than 50 per cent in the first months of 2020 compared with last year. The following table shows that the damage will be wrought across the globe.

Figure 9: Global FDI is set to fall 40 per cent this year



Source : UNCTAD, Deutsche Bank

This drop in FDI seems almost certain to drive down the ebitda margins of large companies. We have begun to see this effect this year as international supply chains have broken down. Of course, many have resumed; however, investors are now pushing management to build in additional capacity to their supply chain. This means diversifying from reliance upon a single international supplier. As companies endure the operational costs of doing this (on top of the capital costs) their operating margins will be hurt in the short and medium term.

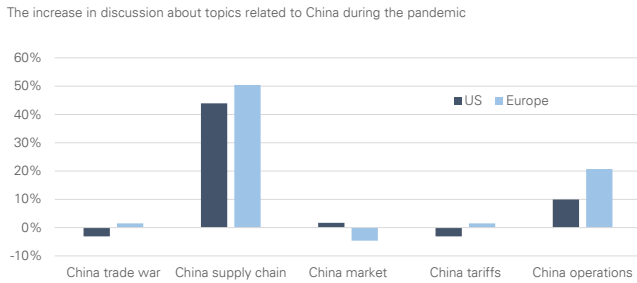
Given China has been the world's manufacturing powerhouse during the era of globalisation, it should not be surprising that, so far this year, corporate leaders have spent a lot of time discussing the topic. The following chart shows the growth in corporate documents that discussed various Chinese issues since the outbreak of the pandemic.

The second factor working against big companies is the rise in Chinese wages. 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. Thus, the



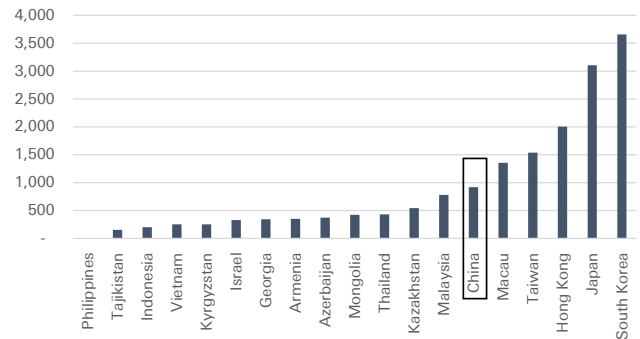
benefits of sourcing labour from China have fallen. As Chinese demography continues to decrease the working-age population, corporates should expect wage growth to continue.

Figure 10: There has been large growth in the discussion of Chinese supply chains during the pandemic



Source : AlphaSense, Deutsche Bank

Figure 11: Chinese wages are now higher than several rival countries



Source : Deutsche Bank

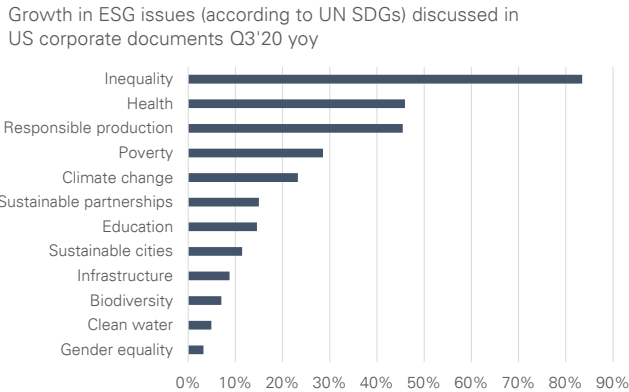
Wage rises in China means the cost of manufacturing in the country has risen significantly. Indeed, once energy costs are included, the cost of manufacturing is only five per cent below that in the US, according to BCG’s cost-competitive index<sup>4</sup>. Countries that are cheaper than China (including energy costs) include Mexico, Ireland, India, Thailand, and Romania. Furthermore, countries such as Hungary and Poland are only slightly more expensive than China. Given their geographical proximity for European corporates, this makes for a compelling discussion.

The third deglobalisation factor pushing against large corporates is the sudden escalation in ESG investors focussing on supply chains and employee-related pandemic issues. 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.

4 BCG: “How shifting costs are altering the math of global manufacturing”

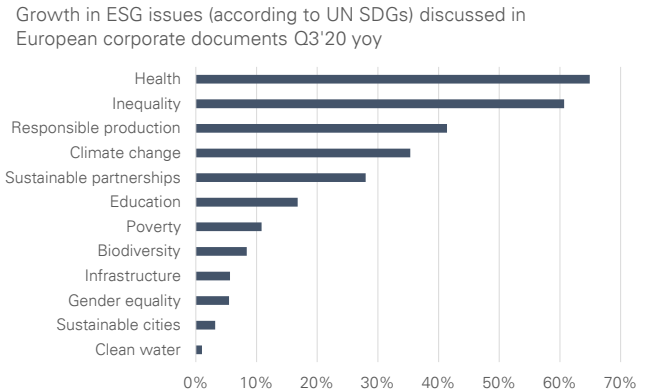


**Figure 12: ESG issues have surged in the US corporate discussion ...**



Note: Excludes SDGs with very low mentions  
Source : AlphaSense, Deutsche bank

**Figure 13: ... as they have in Europe**

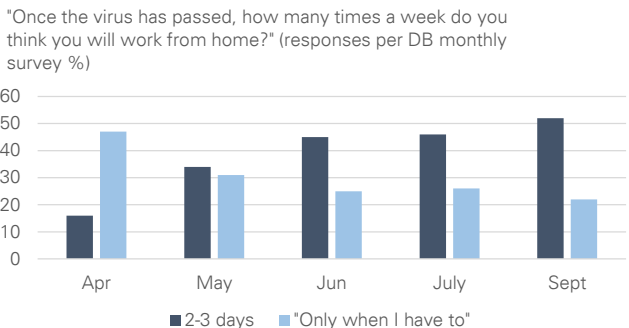


Note: Excludes SDGs with very low mentions  
Source : AlphaSense, Deutsche bank

The above charts show how health and inequality have become the hottest growth topics in company reports this year. Of course, the ethical treatment of people should go without saying; however, with regards to health, and in the context of the pandemic, it has become difficult to assess 'good' and 'bad' practice. Indeed, the issue probably exists on a spectrum and depends on details about a person's specific relationship with the company.

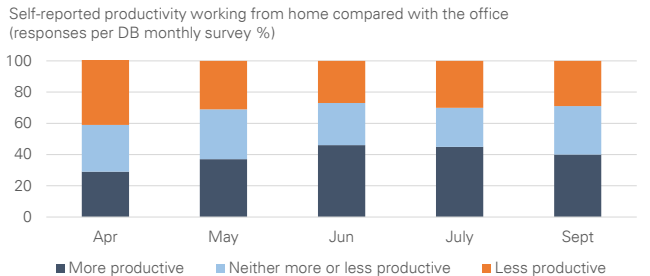
The ESG spotlight tends to fall on large companies more heavily than small ones. Many corporates therefore feel sandwiched. For example, on one side, some governments have encouraged corporates to send staff back to the office as 2020 has worn on and thus support city-centre economies. On the other side, staff feel increasingly comfortable working from home. The following charts show that employees are increasingly keen to work from home after the pandemic recedes. In addition, employees are increasingly figuring out how to be productive as they work from home. Hence why assessing ESG issues is becoming increasingly difficult for the large companies that are most in the spotlight.

**Figure 14: Workers increasingly want to be at home ...**



Source : DB Primary Research

**Figure 15: ... and they are increasingly productive**



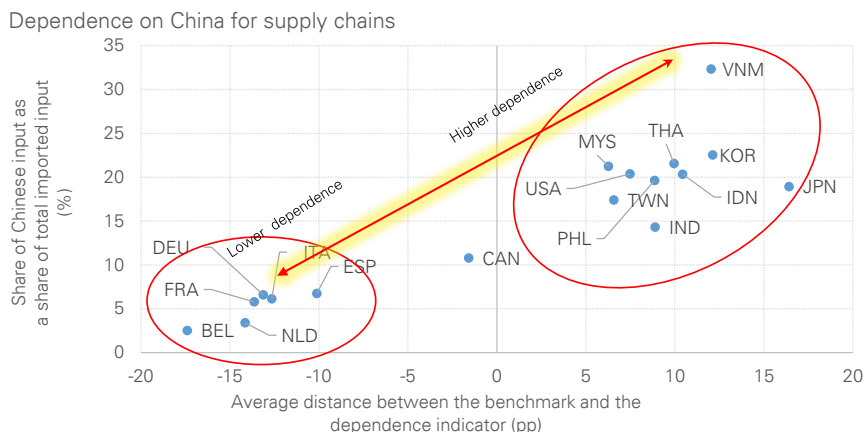
Source : DB Primary Research

On both sides of the Atlantic, there has been a strong increase in the discussion of supply chain as an ESG issue, particularly supply chains that involve sourcing from single countries, in many cases China.



Analysing the dependence of a country's supply chain on China is complex, however; one factor we examine is the level of general imports less intermediate inputs. This gives us an idea of the dependence of first-order supply chain effects. As the following chart shows, European supply chains are less dependent on China than are those in the US, Canada, Japan, and all the major Asian countries. As a result, the direct impact of the covid-19 will likely be lower for the euro area than for other major countries.

Figure 16: Dependence on China depends party on geography



Source : Deutsche Bank, OECD

As large companies build more resilience into their supply chains they will move away from just-in-time approaches, where various steps in the supply chain are perfectly timed to reduce overhead. Meanwhile, many small companies will maintain their JIT strategies as they are not subject to the same ESG scrutiny as big companies. Of course, this leaves them more exposed to a future shock, however, in the meantime, they will be faster to market.

Forces pushing for deglobalisation have also coincided with forces pushing companies to improve their environmental impact. Many large companies are finding this harder than are smaller firms. That is because smaller firms tend to have a small number of suppliers and the more limited scale of their operations means it is easier for them to track their environmental impact and make quick changes. For example, ESG investors are currently pushing large companies to disclose their 'Scope Three' emissions. This is extremely complex and involves a company understanding the carbon emissions generated at every level of their supply chain, including by outsourced providers.

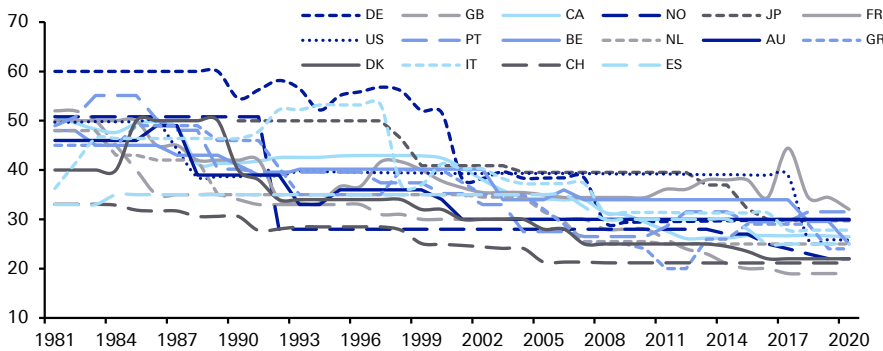
The fourth force pushing localisation on large companies is politics. Across many countries, both rich and poor, leaders are being elected on promises to reinvigorate domestic economies. Ahead of the US election this year, both candidates are talking a big game on stopping US companies from "shipping American jobs overseas" and forcing US companies to think about more local supply chains. Leaders in many other countries have made similar promises.

Corporate tax is also in the cross-hairs of politics. Although this affects all companies, it will impact large companies more. Specifically, an increase in corporate tax rates will have an outsized impact on large companies that have arranged their operations to take advantage of low-tax domiciles.



The OECD is pushing to implement new tax rules over the coming 12 months that aim to negate the tax advantage for corporates shifting between countries (see our piece 2020: An inflection point in global corporate tax?“).

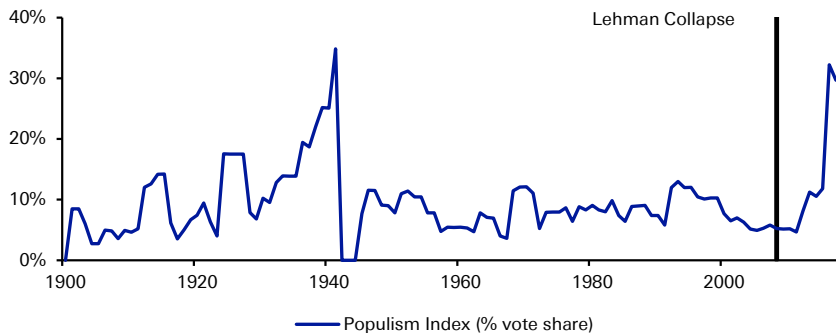
Figure 17: Statutory corporate income tax rates (%)



Source : OECD, Deutsche Bank

The shift in these issues is being turbocharged by the political desire to ‘level up’ those that have been disadvantaged by globalisation. Whilst the recent trend towards populism has several causes, just one is the desire for change shared by those who have been hurt by globalisation.

Figure 18: Populism index (% of vote across key countries, population weighted)



Source : Deutsche Bank calculations

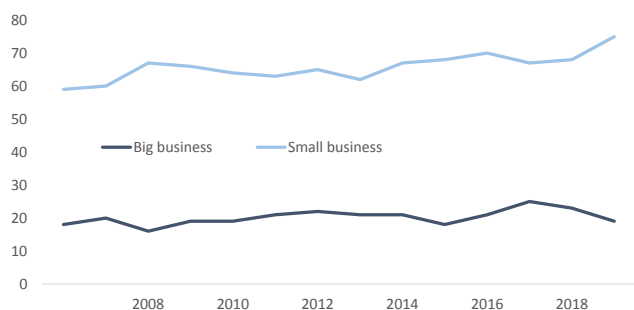
Large companies are set to be the most hurt by the jump in populism. As localisation has become politicised, the threat of tariffs has risen. High-profile companies are finding themselves in the firing line. Just one example is Harley Davidson which was caught in the middle of the US/EU/China trade spat. In contrast, smaller motorcycle brands have fewer worries.

It is not only tariffs that large companies should be worried about with respect to populism. Rather, it is that politicians have begun to push large companies to take more social responsibility. Of course, this may be a good thing but, as with environmental responsibility, it comes at a price for the company. And that hands a competitive advantage to smaller companies.

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.

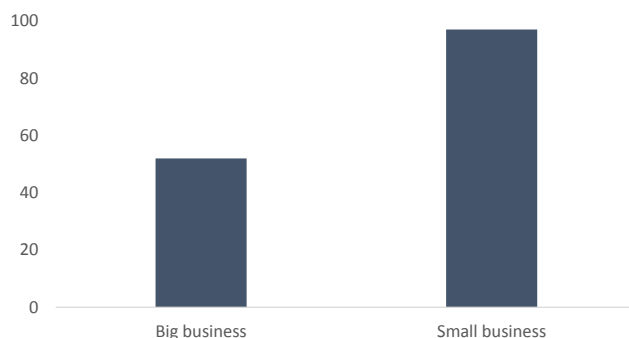


Figure 19: Perception of Americans who have a "great deal" or "quite a lot of confidence in big and small business



Source : Gallup, Deutsche Bank

Figure 20: Proportion of people who have a positive image of large and small business



Source : Gallup, Deutsche Bank

It is not just that customers feel disenfranchised from large companies per se. It is that customers trends are changing such that they prefer the product, feeling, and peer signaling ability that is offered by smaller companies and cottage industries.

This is a push back from the era of globalisation. This was a time when lower-cost manufacturing meant lower-cost products. And this was right at a time when the internet and technology were allowing for a large range of new products. Smart phones are just one example. But now that the price point of a phone has fallen to levels that have made them affordable by many across the globe, these products have become something of a commodity.

Therefore, customers have moved from a mindset of "I want to have that thing" to, "Everyone has that thing, I want something different".

This is a difficult proposition for large companies which, naturally, produce many standardised products. Some companies have responded by acquiring smaller companies and maintaining their brand identity. However, these products are still generally sold through regular distribution channels and these have begun to experience pushback from customers who are seeking out more local or openly independent stores.

## Large companies have been slow to react

While the trend to deglobalisation has certainly accelerated since the virus outbreak this year, some of the factors have been in the making for several years. Indeed, in 2012, BCG noted that seven industries had already reached tipping points in their global cost structure that meant localisation was increasingly attractive. Those industries included transportation goods, computers and electronics, machinery and others<sup>5</sup>.

Despite the warning signs most companies have been slow to explore localisation. In fact, by 2018, only 35 per cent of companies had or were implementing localisation practises, according to AT Kearney.

<sup>5</sup> BCG; "US manufacturing nears the tipping point" 2012



The biggest reasons for the inertia are the cost and time to localise large businesses. For example, it can take ten years for a chemical company to build a new factory in a developed country. Given that the incentive plans of many chief executives can be five years or less, wholesale localisation may be unlikely. Furthermore, an increasing number are zombie companies which cannot cover their interest costs with their cash flow. They will certainly not invest the big money needed to localise supply chains.

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## Smaller companies will find it easier to adjust to the new world

It is not just that external forces appear set to make life harder for large companies. It is also that smaller companies are also better placed to adjust themselves to the new deglobalised world.

The first reason why small companies will have an easier time adjusting to deglobalisation and localisation is somewhat counterintuitive. Essentially, it is that they are not burdened by their economies of scale. That is, they do not have large investments in supply chains, factories, and personnel across various geographies that need to be moved.

That makes it much cheaper for small companies to adjust. Not only do they have a substantial degree of local operations and connections, they also deal in lower volumes and so have a wider choice of local suppliers.

The 'problem' of large economies of scale is that it decreases the speed at which large companies can adjust to deglobalisation. Compounding this problem is that new technologies and manufacturing processes are reducing the minimum economies of scale in a factory which helps small companies catch up. As industrial 5G applications grow in scope (and possibly 3D printing) the old fixed systems of production and rigid processes that have defined manufacturing over the last century may evolve into more fluid systems which can be driven by even simple forms of artificial intelligence.

The second factor that benefits small companies is that they are under less pressure to build resilience into their operations in the form of expensive spare capacity. Of course, there are good reasons why shareholders are currently pressuring large companies to increase their resilience. Yet, smaller companies may look at the risk/reward equation. For example, a company may take the risk that there will not be another 2020-style supply shock for say, another 20 years. As such, they will not subject themselves to the burden of spare capacity. If this risk pays off, that business will outperform others that did invest in spare capacity.

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## What can large companies do?

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 that gives them an advantage on costs. Many will not achieve this perfect outcome but there are various benefits that large companies do have in their quest to localise.

For starters, localisation does not necessarily mean bringing all manufacturing back to a firm's home country. For European companies it may mean moving production to somewhere in the EU. Regardless, localisation invariably means that



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

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. For example, South Korea 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 advantage large companies have is 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. This strategy can obviously be successful; however, there is a fine line to walk as some customers actively seek out brands that are truly independent.

This means that many companies 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.





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## 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 costs of localisation may be great, particularly for large companies, the cost of not doing may be greater still.



# Appendix 1

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