Canada: Uniquely Similar?

By: George Schrijver

George Schrijver, of WCM Consulting Inc., is a facilitator and consultant specializing in the fields of economic development, manufacturing competitiveness and business analysis.

On behalf of of various provincial ministries and business associations, WCM has analyzed industrial sectors in Ontario, in Canada and in comparison to foreign competition. The information is key in the development of targeted and focused sector strategies.

WCM has clients in both the private and public sector and handles a wide range of assignments. George has also advised the Premier's Council Task Force On Economic Renewal on both plant rationalization and manufacturing competitiveness and he sits on the Boards of various companies.

George has an engineering degree from the U.K. and has worked for both large multinationals as well as indigenous operations in Canada, the U.S.A. and the U.K..

Introduction

Ontario has seen and will continue to see plant closures, but its manufacturing sector is competitive.

Two seemingly contradictory statements? No, since the conditions that cause the latter are not, in many cases, related to the former. Yet this is not well understood, causing a cloud of incapacity and doubt to descend whenever a plant closure is announced. For those affected directly this is a natural feeling; but for others who view this as a reflection of a Canadian failure to compete, then this misinterpretation carries with it severe ramifications.

Unfortunately, the media depends upon statements from management to explain closures and governments may not find it acceptable, politically, to amplify the issues. 'Why' will be addressed later. Yet this perpetuates the sense of inevitability and 'who's next' amongst the work-force and general public. A self-fulfilling prophecy begins to unfold as confidence is sapped and we can hypothesize that a significant portion of our current economic difficulties are related directly to these phenomena.

Statistical comparisons showing jobs created and jobs lost, or jurisdictional comparative advantages and disadvantages, are not presented here. These analyses depend upon who is doing the assessment and the shape of the axe being ground. Instead, this discussion is a series of arguments and hypotheses; readers can weigh and apply them to their particular situation as appropriate. Canadian competitiveness, plant rationalization and a process for understanding 'what we are good at' are discussed.

The entire purpose of this article is to open and clarify these issues; it is directed towards the Economic Development Community for use in dealing with communities and companies in their purview who are subjected to this process of restructuring or rationalization.

Plant Rationalization or Restructuring

Rationalization (or restructuring or consolidation) is a mechanism that occurs under certain business conditions and with results that can leave a given plant with more work, less work, different work or, in some cases, can result in the closure of the factory. Although applicable between any countries or regions, the Canada-U.S. case will be used as the basis. With a large multi-national enterprise presence, Ontario is the principal jurisdiction in which this effect may be most be visible.

In order to assess why a plant has closed requires that each case be analyzed. Over the past two years the author has reviewed over thirty instances in which the closure of a multinational subsidiary has occurred or is likely and in over 70% of the instances **plant rationalization,** and *not* lack of competitiveness, was the cause.

Background - creation of the 'branch plant'

The branch plant is created when it is more economical for a foreign manufacturer to invest in factories local to a market as opposed to importing from it's home base. This situation arises when, for example, tariffs are imposed upon imported goods that, in combination with the relative local costs, are sufficient to make local manufacturing business-competitive.

The raison d'etre of the branch plant is tied to the economic benefits of local manufacturing.

Rationalization - weighing the value of the 'branch plant'

If the above economic factors change then the benefits of having a branch plant are called into question. For example, if the relative costs are no longer advantageous (due to inherent local factors or currency changes) or if the imposed tariffs are removed. Often, no single factor is sufficient and a combination of elements must be in force.

As an everyday analogy the example of the Two Couples, **Figure 1**, explains the mechanics where the two 'houses' are the same size. The savings for the newly combined household are derived from the elimination of rent whereas food and entertainment costs vary with the number of people and have not changed.

Now consider the equivalent financial situation in manufacturing. Household income is analogous to sales revenue, Food & Entertainment to variable costs (that vary with amount sold, such as labour costs and raw materials) and Rent compares to fixed manufacturing costs, which are relatively constant over reasonable changes in sales volume (such as management, administration, fixed assets, etc.)

Figure 2 describes the manufacturing equivalent. A size ratio of two-to-one is used in order to make the analysis simple; the precise figures matter less than the principles involved. The question *'Why have two plants when one will do?'* is germane since the parent can now supply

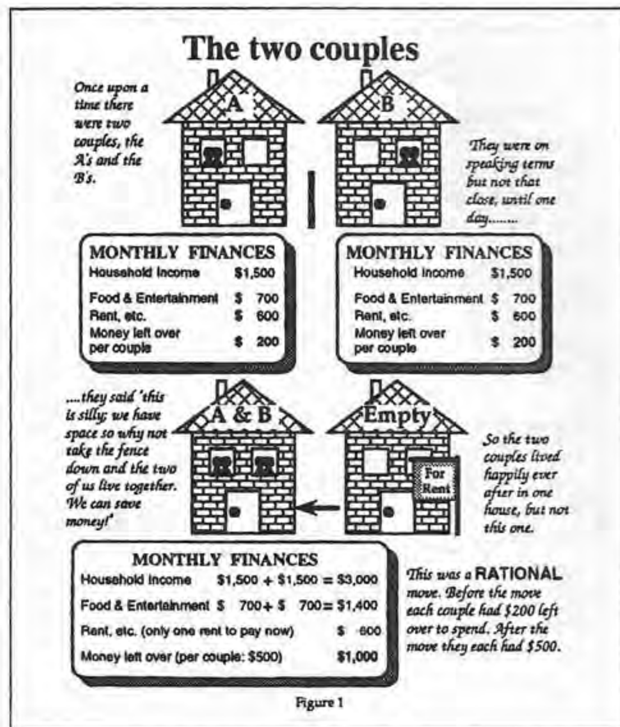


Figure 1

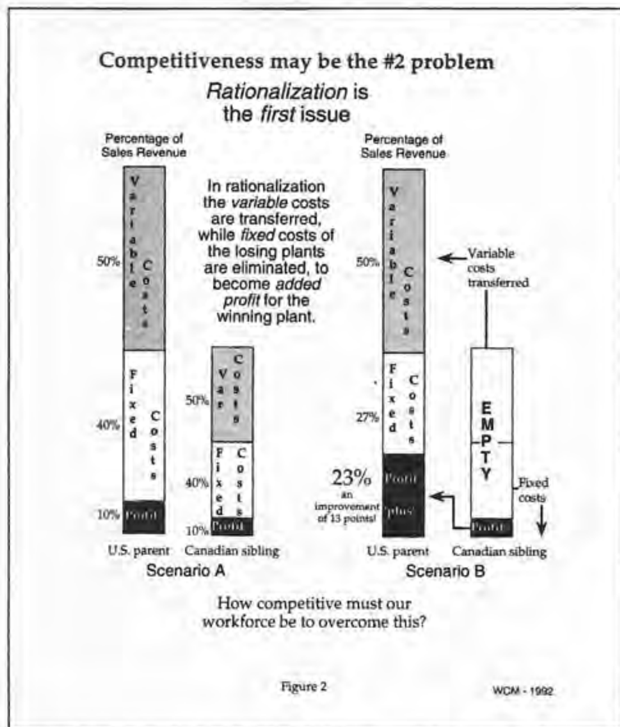


Figure 2

the Canadian market without a local presence thus saving significant fixed costs. It already has a company infrastructure in place at home base and the addition of more direct production labour will have only a minimal affect on fixed costs. In the limit, the direct labour costs are transferred to the parent **(and with it the production jobs)** while the fixed costs are eliminated and transferred to the profit line of the parent **(and the administrative and technical jobs are forfeit)**. The consequent increase in parent company profitability can be dramatic and may turn an overall loss into a gain.

The question *'how competitive must our work-force be to overcome this?'* is rhetorical. Since labour costs represent, typically, no more than 20% of revenue, each worker would have to take no pay and donate an additional half as much again from their own pockets to counter this.

Note that the Canadian operation is assumed to be as equally competitive as the U.S. operation since all costs and profits are of comparative percentages. I*n essence, being competitive has not saved the day.*

Incidentally, the material purchased by the local plant also forms part of the direct costs that are now unlikely to be sourced in Canada with a consequent ripple effect on local industries.

Excess capacity (over-capacity)

Does the parent have the excess capacity to absorb this Canadian manufacturing? Especially during recessionary times, this is likely to be true.

High levels of capacity are reached in plants during boom times and with a certain level of productivity. In times of recession this maximum capacity is no longer needed and plants are hungry for work. Further, productivity improvements continue to free up more capacity for the same level of output and there may be losses to a competitor if market share erosion takes place. **See Figure 3a.** The net effects may range from a 10% to a 50% or more overcapacity.

Although Figure 2 calls for a two-to-one ratio in plant capacity more typical ratios are between 5:1 and 10:1 (U.S.:Canada). *This makes it even easier to absorb the Canadian operation.* **Figure 3b** uses a 6:1 ratio in which U.S. plants would need to add less than half a shift of production work to absorb fully their Canadian counterpart's production. In times of recession and relatively high unemployment in the South, it is very tempting to bring home the jobs to the local constituency.

Rationalization within the borders of the U.S. has been occurring on an ongoing basis as companies shift their operations. According to U.S. executives this has often occurred as they sought refuge from higher wages and strong unions and major industrial shifts have been seen in the U.S. over the past two decades. In Canada we rarely hear of this phenomenon since it has not affected us to nearly the same extent due to the insulating effects of tariff barriers. This insulation is no longer available and we are now drawn readily into the process. Few *Canadians seem aware of or prepared to cope with the potential ramifications.*

The parent will consider closing the Canadian operation if spare capacity is available and there is not a compelling reason to remain (cost advantages, market presence, etc.).

Being competitive is not a guarantee of survival; simple economies of scale and the elimination of fixed costs to improve overall parent competitiveness are the financial drivers.

Not all firms having sister plants with excess capacity will be rationalized. There are factors that increase the risk and some of these characteristics are shown in the **Profile of an Endangered Species** below. If the company has many of these characteristics it does not mean that it will close. However, just as with a disease, there are risk factors that increase the likelihood of becoming a victim. Unfortunately, it is not a great measure of security if not every risk

factor is checked. A combination of two or three may be sufficient depending upon the parent and their business philosophy.

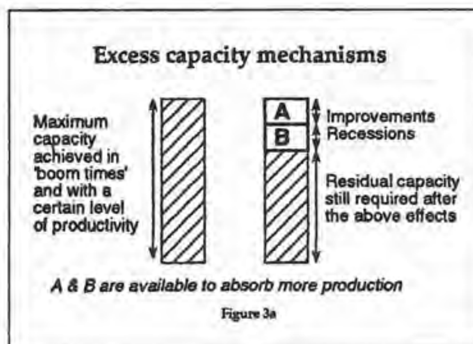


Figure 3a

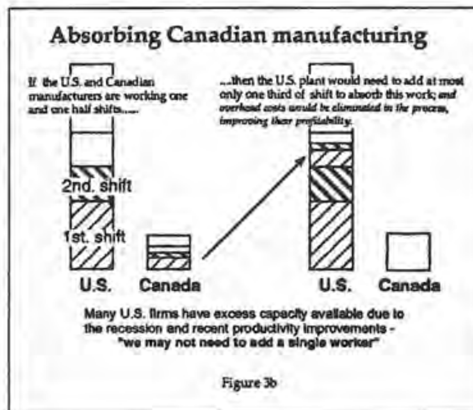


Figure 3b

Profile of an Endangered Species

• Plants that have developed world product mandates for their companies are unique within that company and are in a much stronger position. Those who have not are just one of the crowd.

• If the product is a generic commodity and with low customization then it may be produced anywhere and at a distance from customers.

• Mid-sized companies may not need more than one plant making the same product; market demands can be met from one location.

• If the company is U.S. owned then local constituency considerations will be a pull to move south. Also, it can be easier to service Vancouver from Seattle than it is from Toronto.

• If the company is not Canadian owned there is less of an emotional tie to Canada - this may not be worth a great deal anyway since many Canadian firms are gradually moving some operations south of the border where the market is larger.

• If the type of industry requires a low level of capitalization then hand-in-hand with that goes a higher labour intensity. Less capital is easier to move and the perception may be that equally good labour can be found elsewhere.

• If the plant lacks a local design capability it must always rely upon the parent. This eliminates a degree of freedom and is a serious hamper to uniqueness. It is very hard to move ahead in an innovative product environment without your own design capability.

• If the industry has been recently deregulated then the plant may have lost it's prime raison d'etre. Similar effects come from harmonization of standards (e.g.: electrical industry) and if the U.S. adopts metric food packaging then our local food-processor subsidiaries may be more at risk. A perfect example of how uniqueness protects us since our market size, although large, may not be sufficient to warrant setting up new parallel lines in U.S. factories.

• If tariffs are coming down more quickly then the fixed costs of the local operation increase and are a more attractive target for rationalization.

• If the product has a high 'dollar density' (high value compared to physical weight and volume) then transportation costs are not a major factor and local manufacturing is not pre-ordained.

• If, for any reason, manufacturing in proximity to the customer is not critical then production may take place anywhere.

If the company does not produce consumer goods (from any location) then a nationalistic backlash to job loss is not likely.

• If the Canadian plant is unionized and the parent is not there may be a tendency for the parent to choose it's own plant as the survivor. If the jobs are relatively unskilled then the training costs associated with rehiring in a different jurisdiction will be minimal and no deterrent.

• If the parent has been hit severely by the recession then it will have lost jobs locally and be under profit pressure. It will not wish to carry a subsidiary through the down-turn.

When dealing with a potentially 'negative' issue it may be thought that any biases in the paper will be critical of policies that have had a contributing effect. **This is not the intent.** Trade globalization and the recession are not policies but the environment in which we find ourselves.

Figure 4 shows two components, trade globalization and over-capacity. Individually neither of these are sufficient to cause the rate of rationalization witnessed over the past few years. Even with trade globalization, if excess capacity does not exist then plants cannot be combined. Alternatively, in jurisdictions with barriers, even when spare capacity exists, local operations are required.

However, **if these two conditions are combined** the result is an environment in which time is compressed. Instead of occurring over twenty years, rationalization takes place over five and the economy cannot adjust to this sudden change without pain.

The Canada-U.S. Trade Agreement (C-US-TA) is simply a manifestation of trade globalization. Yet it is clear that, were it not for C-US-TA the attrition rate of jobs in Canada versus the U.S. would have been less in the current recession and this was exacerbated by the high dollar. On their own neither the recession nor C-US-TA could have caused the effects that we are seeing today but together they have, and the high Canadian dollar simply made our costs jump by 15 points or more over a short period of time.

Imagine the U.S. H.Q. at Operations Review time. The U.S. V.P. sees low sales due to the North American recession. Profits are down or negative and they are looking for ways to save money; local unemployment is rising. The Canadian operation has fixed costs, which could be eliminated if the production was absorbed by the existing U.S. plants and jobs brought home!

In the early eighties this was also the case but then it was known that, after the recession, they would still need the Canadian branch plant since the barriers were not removed. In the early nineties, however, they know that they can ship to Canada from their U.S. locations. Eliminating the Canadian operation saves them significant fixed costs and better utilizes their U.S. operations as well as bringing home the jobs. Add to this the sudden jump in Canadian content costs (probably a profit erosion of 5-8% for this reason alone) and it appears as if the Canadian operation, it's fixed costs and Canadian content are standing up screaming for attention! But of the wrong sort.

Rationalization was taking place long before the C-US-TA. However, the combined effects of the **recession, the relatively high Canadian dollar** ***and*** **the FTA** have caused an acceleration of this process. In all prob-

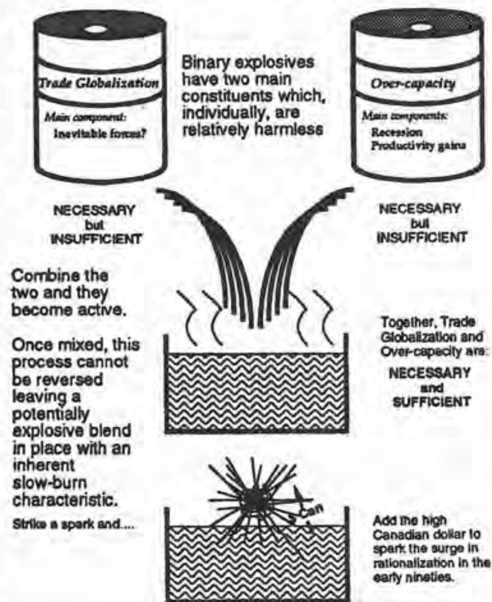
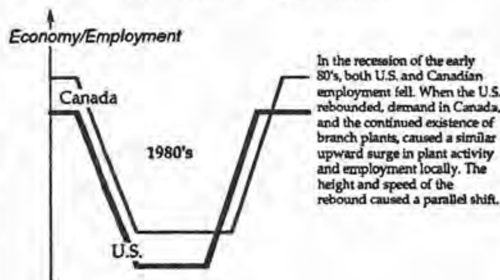


Figure 4



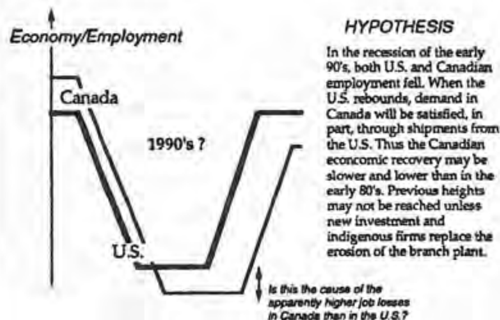


Figure 5

ability the most severe cases have already taken place but no matter what the economic indicators may say this process is still present and will remain so until those plants with no reason to exist are rationalized. The depth and length of the recession in the U.S. may have more of an effect than Canadian economic doldrums and it is a process over which we have little control, except at the branch plant level. The branch plant managers deserve all of the support that can be mustered.

This is not competitiveness; equally competitive plants will lose if they are significantly smaller than their U.S. counterparts; small into big won't go but the other way around is easy. Fixed cost elimination is the issue. In Canada few large or comparable-to-U.S. size Canadian plants have lost. The best examples are the auto-body plants that are the same size throughout North America; in these cases Canadians seem to win more than they lose. In comparable size plants we do well; on a level playing-field with the same equipment and product volumes we are as or more competitive. **Value obtained outweighs the cost incurred.**

Canadians do not understand this issue, primarily since it is not explained to them. This is for two reasons. It is not in the interest of the companies to say *'yes, you are competitive but we just don't need you any more'* - better to quote the misleading 'Canadians just aren't competitive' statement. Nor is it seen to be in the interest of governments to differ from this tired and misleading explanation since to state the facts would imply a criticism of the C-US-TA.

Yet by not speaking clearly on this issue we are creating a self-fulfilling prophecy; that Canadians are not competitive.

To continue to do so will lead Canadians to make serious decisions based on this fallacy, opt for a security blanket and create the potential for far-reaching and severely negative consequences.

Whatever the long term benefits that may accrue, the better understanding of the short term impacts will permit an educated and more effective response to any difficulties that may arise. *Simply, can and how do we bridge our economy through rationalization in order to qualify for the race for competitiveness?*

Ironically, as we move closer to the U.S. from a business perspective, the likelihood of being drawn into a recovery on their coat-tails diminishes. In the recovery phase U.S. manufacturers will be able to fill their own order books first and not see a corresponding effect on those of the subsidiary. More Canadian destined products can now be made in U.S. plants whereas in former times this was not possible. **Figure 5** provides a hypothesis that may explain, in part, the relative unemployment effects experienced in the U.S. and Canada.

Canada has never faced quite such a combination of factors and our past experience may not serve us well here. Statistical analyses and predictions are of little use since their accuracy requires that the variables of the past are the variables of the future. **This is no longer true and new, well-considered strategies are required.**

Many Canadians seem unwilling to accept that such dramatic changes are underway. Our social nets are in full effect, cushioning many from the most severe impacts, but these same programs are being rapidly stretched and depleted as more people use them and less taxes are received to replenish them. *Does it require a severe level of pain be felt before our complacency is erased?* Appropriate actions can be taken to mitigate the effects through the exploitation of our inherent Canadian advantages.

At Canadian Corporate Headquarters

A subtle change has been taking place on company organization charts. Since the primary purpose of a branch plant is to facilitate selling in the local market it is natural for the plant to report to the Canadian sales arm of the company. In this situation it is recognized as being part of and tied to the Canadian market. My correspondents tell me that over the past few years more and more Canadian branch plants have become divorced from the local sales operation and now appear as reporting to the overall company manufacturing arm.

On the surface this is valid recognition

of their stature as a bona fide manufacturing operation within the company; beneath that may lurk the danger of being *just* that and subject to the same rationalization process that their U.S. sisters have experienced of late. It can be tough in the big league. Specific cases can also be cited where, by their own admission, companies have replaced their Canadian citizen C.E.O's with U.S. nationals since the former were thought to be unable to effectively carry out the rationalization process locally. There are also cases where the U.S. manager has been so impressed with what they have found in a failing Canadian branch plant that a turn-around has been effected.

In turn, the Canadian sales arm becomes part of the North American sales group. At this point Canadian Corporate Headquarters becomes a shell, dealing with local government and human resource issues. More frequently they will disappear entirely. Although this final loss of jobs is relatively small, there is now no voice to support the branch plant manager who may be ill-equipped to deal with the task of promoting the survival of the local plant. Some have had no experience in dealing outside of the local environment.

Canadian plants do not always suffer in the process of rationalization but such successes follow, in every case, a major effort on the part of strong plant leadership. Their branch plant managers have taken the steps necessary to ensure the survival and prosperity of the Canadian operation; ***mandates*** are their primary and most effective mechanism. They are improving competitiveness and demonstrating that having a Canadian manufacturing presence is vital to the interests of the U.S. firm. They are **quite right** but the benefits are in the longer term and the 'Western World' is notorious for a short term view.

Mandates

It was mentioned at the outset that rationalization could result in more or less work or different work as well as the shut down of local plants. Often the company will go through a product focusing exercise with each plant taking a product and uniquely manufacturing it for the world market - this is a *mandate*.

Mandates give a strong element of uniqueness, making it harder to absorb the plant, and are probably the single most important factor in staving off rationalization. *However these mandates are not easy to come by and must be fought for.* Many Canadian operations never go through this battle and remain a true branch operation. Others win a mandate but have a suspicion that the product so gleaned has a short life expectancy or is in some other way a leftover. There is no reason why Canadian firms cannot win the rationalization battle and there are some local operations that are regarded as the best in their field by the parent company. These will be given products in preference but unfortunately, at the present time, this does not appear to be the majority.

Companies that close down Canadian manufacturing may do so in a subtle manner. There will be a need for some product distribution mechanism such as a warehouse and possibly some minor manufacturing capability to suit last minute Customer demands. This will enable them to claim a Canadian presence although it is likely to be less than quarter of the jobs that were previously supported.

Americans: the 'bad guys'?

Americans have been large investors in Canadian manufacturing and other nations have also played their part. This money has provided employment and enabled us at one time to reach a higher standard of living than those south of the border. **However the result is that Canadians own less of Canada-located manufacturing than nearly any other developed country owns of theirs**; the development and progress of our production base are largely in the hands of those outside of the country. Perforce, this is changing as Canadian manufacturing is being handed back (through closures) to Canadians; the question is whether Canadians are ready to take up this challenge? Does Canada or Ontario have a pro-active manufacturing strategy or are we continually reacting to forces impinging from outside?

The comments have focused on the U.S. issue since that is where the action is today but it matters not whether the owners are Americans, Europeans, Japanese or Canadians. The critical factor is: *Is there a similar plant elsewhere, with spare capacity?*

Canadian multinationals fit this characteristic as much as foreign owners and the local talent think along the same lines.

'NAFTA' may have an *indirect* impact on Canadian jobs. The trend in the U.S. is to move large scale, labour intensive manufacturing to Mexico leaving the higher skilled jobs in the U.S. On average, Canadian manufacturers have a higher ratio of skilled jobs since we have not recently manufactured components en masse to the same extent as the U.S.; thus the *direct* job loss is likely to be less. **However,** the transfer of some production from the U.S. to Mexico will free up *manufacturing capacity* and we have already belaboured the fundamental effect of this factor in rationalization. Hence we may see *indirect* effects. *This can occur whether we participate in NAFTA or not.* We have no control over this since the U.S. will be the first to see the effects and Canada is only indirectly tied to it by our existing 'Can-U.S. FTA'.

Does 'Made in Canada' mean less to Canadians than 'Made in the U.S.' means to Americans? Check the border line-ups. Even if this is not true, the company that could afford only one plant may tend to choose the U.S. since the potential market share loss would be ten times as great than if it was located in Canada. Of course, this will eventually be self-defeating through a deleterious effect on our ability to buy U.S. goods but those effects are in the future and our past success is still providing buoyancy. The recent placement of a German automobile manufacturer factory in the southern U.S. was made on this basis and not due to a lack of competitiveness on the part of interested Canadian jurisdictions. They can supply Canada equally well from south of the border.

An Oxymoron

Canada is uniquely similar.

No two countries in the world are more alike than Canada and the U.S. especially from a manufacturing and business perspective. We must face the fact that Canada has developed much of its manufacturing base on borrowed capital that was obtained largely through the mechanism of tariffs. We have been uniquely positioned adjacent to the largest market in the world and it has been easy to follow their lead. This has been a boon in the past but our industrial similarity to the U.S. may now backlash. **In the past Canadian manufacturing has supplemented the United States; now it must learn to *complement* it.**

Through mandates branch plants can be unique and avoid the absorption in an open global economy. We need to do things differently and develop our uniquely Canadian capabilities (there *are* some!) in order to compete effectively in the arena of our choosing. Waiting for others to do this is not the way - *aggressive action is vital.* ❐