Automotive industry tariff mitigation strategy

Trade and Customs Services

Over the last several months, the United States has, in an attempt by the Trump administration to rebalance the trade deficit, initiated a series of tariff measures against foreign-sourced goods and materials. Despite intense lobbying efforts, the administration continues to push forward with its trade agenda with no clear end in sight.

With tariffs on steel, aluminum, and certain goods and materials from China already in place, the U.S. trade team has negotiated the United States Mexico Canada Free Trade Agreement (USMCA) which tightens the rules on finished vehicles and automotive parts. There are also ongoing investigations into whether to extend tariffs to the auto industry more generally so auto manufacturers need to begin planning for a changing trade environment.

Several producers of finished vehicles and parts may not qualify under the new USMCA rules unless they make changes to their global supply chain to source products that "originate" in the USMCA region. Proper planning to include:

- Assess the potential impact
- Perform a strategic review of the existing supply chain under a new and developing regulatory framework
  - Optimization of existing infrastructure for product lifecycle management
  - Investments in property, plant, and equipment; R&D; and partner ecosystem
  - Development of transparent, flexible, and hyperefficient supply chain
- In performing review, identify:
  - Short- to mid-term mitigation opportunities – core trade strategies; for supplier pricing, use strong USD to push more to non-USD suppliers and source locally to avoid tariffs; for customer pricing, develop new market-based pricing strategies
  - Mid- to long-term mitigation opportunities – Supplier health check, supplier optimization, supply chain re-engineering for customs classification, replacement parts sourcing

KPMG's Intelligent Supply Design framework combines our global experience in tax and regulatory matters with our strategic and operational supply chain experience to provide a holistic approach to addressing the ever-changing landscape.

In recent months, the U.S. government has launched a series of tariffs to encourage manufacturing in the United States. Several automotive companies have endured significant increased costs because of their global supply chains. Automotive companies need to act quickly to avoid putting suppliers at financial risk, increasing costs of materials and loss of market share. Companies must be proactive to respond to tariffs from the highest strategic perspective—vehicle pricing and supply chain arrangement—and react to what's coming next to ensure they are on the right side of a division between winners and losers in the shifting trade landscape.

Tariffs on steel and aluminum

Under Section 232 of the Trade Expansion Act of 1962, as amended, the United States has implemented global tariffs of 25 percent on imported steel and 10 percent on imported aluminum, with limited countries granted an exception, including Argentina, Australia, Brazil, and South Korea for steel and Argentina and Australia for aluminum. The public policy basis of the tariffs is "national security," although many observers see the tariffs as punitive trade remedies with the aim of bolstering U.S. economic growth.

The countries subject to exemptions and quotas in lieu of the Section 232 tariffs changed rapidly from the onset of tariffs in March 2018 before remaining stable as of June 1, 2018, and the Trump administration on August 10, 2018, abruptly signaled a doubling of steel and aluminum tariffs against Turkey in particular. The pace of change with these tariffs is swift, and business leaders in vulnerable industries with heavy use of steel and aluminum—such as the automotive industry—are grappling with predicting what comes next.

Escalating tariffs with the United States' largest trading partner

Under Section 301 of the Trade Act of 1974, as amended, which authorizes trade actions in response to a country's discriminatory trade practices, the United States has implemented tariffs against goods originating from China as follows:

List	Effective date	Duty rate
List 1–818 products	July 6, 2018	25%
List 2–279 products	August 23, 2018	25%
List 3–5,745 products	September 24, 2018	10%
List 3–Rate increase	January 1, 2019	25%

Several automotive parts are listed. Given the potential two-year lead time for a new automotive part supplier to be validated for quality and financial purposes, there will almost certainly be major short-term costs until production is moved from China to another country. In addition to the automotive-specific parts identified above, there are hundreds of additional affected items that are used in the automotive industry, including indirect materials, universal components, machinery, and tooling.

Potential tariffs targeted specifically at vehicles and auto parts

Based on the same Section 232 law cited for the steel and aluminum tariffs, the Trump administration is formally considering a tariff on vehicles and automotive parts in particular. The associated agency for Section 232, the Department of Commerce, is conducting an investigation into automotive imports to determine recommended next steps for tariffs.

If these new tariffs go into effect, vehicles from outside North America or that don't qualify for NAFTA could be subject to a tariff unless an exception is negotiated between the United States and the country where the vehicle is produced.

Disruption to a critical trade agreement for auto makers

The USMCA includes new rules that are intended to level the playing field between the United States, Canada and Mexico, which was President Trump's campaign theme. Given the substantial, long-term planning required to establish automotive manufacturing locations, changes to USMCA will have a profound effect on automotive supply chain operations in North America. Proposed changes to USMCA may result in higher local content as well as higher wage requirements, including:

Proposed Rules for Passenger Vehicles and Light Duty Trucks

1. **Increased North American content requirement for finished vehicles and major components.**

   Up to 75 percent from the current 62.5 percent. Thus, North American plants may need to increase their sourcing from North American suppliers. There is also a new rule to increase local content for core parts such as engines, transmissions, suspension systems and steering systems.

2. **70 percent of steel and aluminum must originate in North America.**

   Vehicle producers may need to modify sourcing so that at least 70% of their steel and aluminum is North American.

3. **Labor requirement: 40-45 percent of the costs of eligible vehicles must be produced by workers earning $16/hour.**

   Vehicle producers will need to track the labor costs related to production, research and development, and technology to satisfy the requirement. U.S. and foreign-based companies with R&D centers in the United States may have an advantage. This requirement will have its greatest impact on operations in Mexico.

North American plants will need additional information and technology tools to collect data from suppliers, compile supplier data, and perform calculations to include labor and overhead. New process and global trade technology software will need to be developed for planning and purchasing purposes. Purchasing and engineering teams will need to decide which parts and services will be sourced in North America and which parts and services will no longer be sourced outside of the United States. Furthermore, part suppliers will also be subject to increased local content requirements for their parts, so they will experience their own struggles to make similar changes to their supply chains to meet these requirements.

How KPMG can help you get ahead

KPMG deploys a cross-functional framework and methodology to guide our clients, short-term and long-term, through assessing, managing, and mitigating the impact of the new tariffs on their financial value chain. Leveraging this framework and supporting tools will enable KPMG to assist an automotive industry client in defining its specific mitigation strategy in a thoughtful, methodical, and holistic manner.

1. **Impact analysis and collecting trade data:** How big is the financial impact on our client and what is the impact on its suppliers? Where is the pain coming from (direct imports or indirect imports) and on exactly which products? How does the financial impact change based on anticipated future trade negotiation scenarios?

2. **Identify and leverage core trade strategies:** There are numerous core trade strategies that will allow automotive companies to mitigate the impact of these duties either through eliminating the tariff on their products, reducing the tariff, seeking a refund of the tariff, or deferring the payment of the tariff. KPMG can help its clients to explore all of the available strategies, confirm the applicability of the tariffs, and recalculate the net impact of the tariffs post-trade planning.

3. **Enterprise-level thinking:** Depending on the net impact of the tariffs posttrade mitigation efforts, our client may need to consider more comprehensive enterprise strategies, including:

   — Consideration of manufacturing alterations to impact classification or country of origin, particularly with emerging automotive technologies.

   — Arranging manufacturing, distribution, and supplier sourcing to offset tariff impacts, balanced against competing costs such as pricing and tax implications—all in consideration of our client's unique supply chain. Where should our client locate its people, assets, and sourcing?

   — Strategic planning with a rapidly changing NAFTA, including regional value content and labor regulations critical to automotive companies.

   — Planning for secondary effects of any changes:

   – What is the amount of elasticity in your ability to price?

   – Will transfers of costs between your company, suppliers, and customers reduce your market share?

4. **Strategy execution:** Once strategies are identified, confidently execute them in a phased approach, continuously benchmarking against peer competitors in the automotive industry.

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