As seen in Business Facilities, September 2002

The New Rules for G7 Site Selection

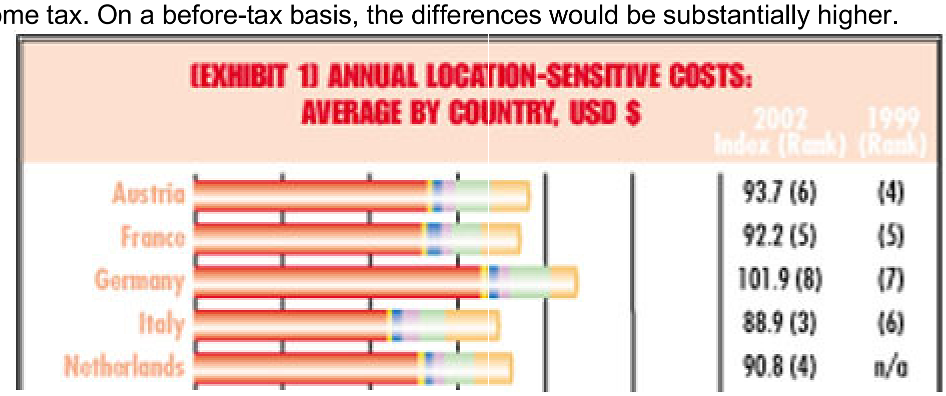
By Stuart MacKay,
President, MMK Consulting,
an associate of KPMG LLP

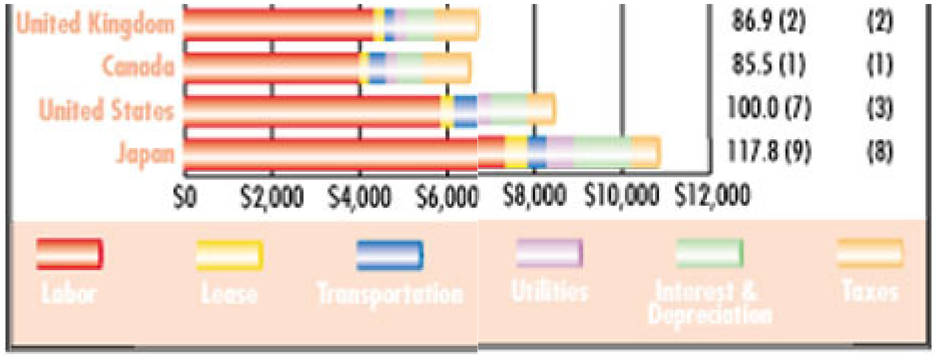
As business becomes more global, relocating and expanding firms like yours are enjoying an ever-increasing range of locational opportunities—and an ever-increasing range of challenges in assessing them. Many of the cost and other considerations that drive international site selection have been changing rapidly in recent years. To deal with these factors, your company not only needs to have reliable, up-to-date information, but you also need new tools to assess the implications for your locational decisions.

G7 COSTS HAVE CHANGED DRAMATICALLY

The 2002 edition of KPMG's Competitive Alternatives1 measured the dramatic changes in business costs in the G7 countries—Italy, the United States, Japan, Germany, the United Kingdom, France, and Canada—since 1991. Exhibit 1 (p. 22) illustrates that the cost indices and rankings for 2002 are very different from those in 1999. Canada (1) and the UK (2) are unchanged, but Italy (3) has greatly improved its position from 1999. France and Austria are closely grouped, as in 1999. The U.S. has dropped from third to seventh, falling behind most of the euro countries.

Italy's cost position (Exhibit 2, p. 22) has improved the most since 1999. Its manufacturing cost position improved 12% against the U.S., moving Italy up to third place among the G7. Manufacturing costs in France, Austria and Japan improved 8% to 9% against the U.S., and Germany's cost position improved almost 5% against the U.S. The size of the shift is all the more significant when one considers that they are calculated after corporate income tax. On a before-tax basis, the differences would be substantially higher.





The most significant factor behind the changes in relative business costs is the major shift in currency exchange rates. Following the euro's introduction in January 1999, it lost 24% of its value against the U.S. dollar over the next three years. (While the euro has strengthened in recent months, it is still much weaker against the U.S. dollar than it was in 1999.) The impact of the exchange rate shift has been dramatic; while in 1999 the U.S. enjoyed an after-tax cost advantage of 4% to 8% over the euro G7 countries, by early 2002 the U.S. was at a cost disadvantage of 6% to 12% to these same countries (except for Germany). The declining value of the euro has not just leveled the relative costs of euro countries against the U.S.—it has tilted the comparison in their favor! Average salary and wage levels (before the costs of providing benefits) vary dramatically among G7 countries. As illustrated in Exhibit 3, relative salary levels are lowest in Italy and Canada, and highest in Japan.

[EXHIBIT 2] IMPROVEMENT IN MANUFACTURING COSTS AND EXCHANGE RATE DECLINE, 1999-2002

	Cost Improvement	Exchange Rate Decline
Italy	12.0%	-24%
France	8.9%	-24%
Austria	8.6%	-24%
Japan	8.5%	-8%
United Kingdom	5.6%	-8%
Germany	4.9%	-24%
Canada	2.8%	-3%

There are also significant differences in G7 salaries by skill level. For example, junior-employees of a Japanese firm ($32,000) are paid (on average) approximately 82% more than their U.S. counterparts. However, for higher-value positions, Japanese salaries are approximately 12% less than those in the U.S. Among G7 countries, the U.S. has by far the greatest differential in the salaries paid to lower-value and higher-value employees. As a result, U.S. operations are more cost-competitive in business operations requiring a predominantly lower-skilled workforce, and less cost-competitive in operations requiring a more highly-skilled workforce.

[EXHIBIT 3] INDEX OF RELATIVE SALARY LEVELS, BY SALARY RANGE (US= 100.0)

Salary levels relative to U.S.	U.S. salary less than $32,000	U.S. salary $32,000-$47,999	U.S. salary $48,000-$74,999	U.S. salary $75,000-$95,999	U.S. salary $96,000 or more	All positions
# of positions in study	9	11	11	6	3	40
Austria	103.4 (6)	100.7 (8)	77.6 (5)	82.2 (6)	71.9 (6)	90.0 (5)

France	88.7 (4)	81.7 (3)	63.1 (2)	70.9 (4)	65.2 (3)	75.3 (3)
Germany	119.6 (8)	98.9 (6)	79.4 (7)	78.7 (5)	69.8 (5)	93.0 (7)
Italy	77.9 (1)	73.9 (1)	59.5 (1)	67.3 (1)	62.2 (2)	69.0 (1)
Netherlands	108.9 (7)	98.3 (5)	79.0 (6)	82.2 (6)	74.9 (7)	91.2 (6)
UK	88.1 (3)	87.5 (4)	68.5 (3)	68.9 (3)	61.3 (1)	77.7 (4)
Canada	86.3 (2)	75.7 (2)	69.6 (4)	67.3 (1)	65.7 (4)	74.4 (2)
U.S.	100.0 (5)	100.0 (7)	100.0 (8)	100.0 (8)	100.0 (9)	100.0 (8)
Japan	182.4 (9)	144.1 (9)	110.6 (9)	101.6 (9)	88.3 (8)	132.9 (9)

The relative costs of providing employee benefits have also changed greatly since 1999. As shown in Exhibit 4 (p. 25), the total costs to Italian employers of providing benefits has dropped from 82% of wages/salaries to 58%—still high, but no longer the highest among G7 countries. In contrast, Germany's average cost of providing employee benefits increased from 43% in 1999 to 72% in 2002, due in large measure to the extension of employer-sponsored benefits across a broader range of employees.

[EXHIBIT 4] TRENDS IN COSTS OF PROVIDING EMPLOYEE BENEFITS PERCENTAGE OF WAGES AND SALARIES

	1999[1]	2002[2]	Change
Austria	47% (6)	47% (6)	-
France	65% (7)	69% (8)	+4%
Germany	43% (5)	72% (9)	+29%
Italy	82% (8)	58% (7)	-24%
Netherlands	n/a	39% (5)	n/a
UK	30% (2)	35% (3)	+5%
Canada	26% (1)	25% (1)	-1%
U.S.	42% (4)	34% (2)	-8%
Japan	36% (3)	36% (4)	-

1-Nine-operation average
2-Twelve-operation average

Significant changes in corporate income tax rates for manufacturing occurred between 1999 and 2002, as shown in Exhibit 5 (p. 27). Germany's effective corporate tax rate, while remaining the highest among G7 countries, was reduced by more than 17%. Italy's manufacturing tax rate was reduced by more than 12%, bringing Italy's corporate tax rate into line with most other G7 countries. KPMG's Competitive Alternatives report also measured significant changes in many other business cost factors:

- Telecommunication costs in Europe have dropped with deregulation. Over the past eight years, the U.S. and Canada have lost their previous cost advantage over European countries.
- Electricity rates have been volatile, dropping about 20% in Austria and Germany since 1999, and by lesser amounts in France and Japan. Upward trends have occurred in most North American jurisdictions.
- Transportation costs have experienced the highest increases in North America, driven by higher fuel prices.

Personal costs of living are particularly relevant if the relocation involves paying to move a number of key management staff. Exhibit 6 (p. 58) illustrates the relative cost of living in different countries, as well as recent trends. One surprising study result is that the two countries with the highest absolute cost of living (Japan, UK) have recently experienced the lowest increase in consumer prices, while the two countries with the lowest absolute cost of living (Canada, the Netherlands) have experienced the highest increase in consumer prices. This result indicates that the relative costs of living in the G7 countries may be converging.

OTHER INTERNATIONAL BUSINESS FACTORS ARE CHANGING

Just as G7 business costs are changing rapidly, other significant changes are taking place in the business environment. Recent trends include:

- Improved international business support infrastructure. An increasing number of G7 and non-G7 countries have business support capabilities (communications, business-class accommodations, passenger air service, commercial and office facilities, standard support services, etc.), which are at or close to those in the U.S.
- Changing firm attitudes. Firms are becoming more willing to consider international locations. Many historical business and regulatory barriers to relocation (language/culture, currency, tariffs, etc.) have diminished in importance with the emergence of market economies in former Soviet countries, the establishment of free trade zones, and the adoption of a common currency in much of Europe.
- Increasing availability of reliable (and unreliable!) information. Thanks to the Internet, a huge volume of information is instantly available by visiting national, regional, and local economic development agencies' (EDAs) Web sites. Finding information about potential sites is increasingly becoming less of a challenge than validating its accuracy.
- Intensifying competition among jurisdictions. Government EDAs at all levels are taking an increasingly competitive attitude towards attracting business.

INTERNATIONAL SITE SELECTION RULES ARE CHANGING

With this rapidly changing international business environment, the rules for site selection are also changing. Exhibit 7 (p. 58) summarizes some key differences between the "old rules" and the "new rules" and how they affect your company at various stages of the site selection process.

[EXHIBIT 6] COST OF LIVING COMPARATIVE FACTORS

Country	Average annual % increase in consumer prices[1] (and ranking)	Cost of living index [2,3] (and ranking)
Austria	3.3 (5)	101.28 (5)
France	2.3 (3)	107.43 (7)
Germany	3.5 (6)	99.05 (4)
Italy	3.0 (4)	102.25 (6)
Netherlands	4.9 (9)	96.59 (2)
UK	2.1 (2)	114.78 (8)
Canada	3.9 (8)	92.67 (1)
United States	3.6 (7)	96.87 (3)
Japan	-0.5 (1)	158.48 (9)

1-OECD, Latest Trends in Consumer Prices, 2000-2001.
2-The World Competitiveness Yearbook 2001.
3-Cost of living index of goods in major cities, excluding housing, New York City = 100.

The first rule, of course, is to maintain a clear understanding and focus on your company's relocation objectives. Firms typically relocate to meet a combination of objectives—to lower production costs, to achieve improved labor quality and availability, to improve their access to existing and new markets, and to achieve other goals.

The difference here is not that the rules have changed, but rather that the effort required to stay focused on your objectives has increased. With the increasing range of potential locations and information available, the risk of losing sight of your relocation objectives through "information overload" has increased. You not only need to clearly define your relocation objectives at the beginning, but also make sure you stay focused on them throughout the selection process.

The second "new rule" of longlisting (initial identification of all potential locations) is to understand not only which geographical constraints are valid, but also to recognize which of these constraints are no longer valid. For example, the idea of locating telephone call centers for U.S.-based customers outside North America was almost unthinkable...until several were successfully implemented.

The third "new rule" is that you must not rely on your general impressions of comparative costs. Key cost factors are changing rapidly, and overall cost relationships are changing with them. Reliable and current cost information is essential, even in the initial longlisting stage.

[EXHIBIT 7] CHANGING SITE SELECTION RULES

Stage of Process	"Old Rules"	"New Rules"
Longlisting of Potential Locations	• Understand your relocation objectives • Understand geographic constraints • Rely on conventional wisdom on comparative costs	• Understand your objectives... and keep reinforcing them • Understand your geographic constraints... and opportunities • Revisit comparative costs
Evaluation and Shortlisting	• Compare a few factors (e.g., labor rates, energy rates, land costs, etc.) • Examine 3-4 non-cost factors (labor availability, language, access to markets, etc.) • Eliminate site options early, using a simple evaluation process	• Compare costs in detail (25+ cost factors) • Examine 10-20 non-cost factors • Keep site options "alive" much further into the evaluation process
Incentives Negotiation and Site Selection	• Pick your site, negotiate incentives • Develop and implement relocation plan • Confirm selection, commence implementation	• Negotiate incentives as part of the final selection process (knowing what others have received in each jurisdiction) • Develop implementation plan which includes realization of incentives • Confirm selection, commence implementation

Evaluation and shortlisting (narrowing down potential locations) methods traditionally define a limited number of key costs and other factors, and then evaluate each of them individually. This approach has the advantage of simplicity and clarity. It looks for a "fatal flaw" which provides a reason to exclude a longlisted site from further consideration. Unfortunately, this approach also runs the risk of excluding an otherwise leading candidate too soon, simply because of marginal results in one area. Using today's information sources and analytic tools, a much wider range of site options can be "kept alive" for evaluation in greater detail, much further into the selection process. For example:

- Cost factors—Independent data sources and analytic tools (e.g., KPMG's Competitive Cost Model) enable you to quickly compare the individual and combined impact of multiple cost factors in different operations and industries.
- Other factors—Most jurisdictions' EDAs have a wealth of information posted on the Internet, and respond quickly to external requests for additional information.

Using these tools, you can ensure that all of the relevant cost and other factors (typically 25+ cost factors, 10+ other factors) are properly considered during the evaluation and shortlisting stage.

Business incentives play a much greater role in site selection than they did 20 years ago. The traditional approach, identifying the preferred site prior to incentive negotiations, helps you stay focused on your relocation objectives, and not become sidetracked by incentives that may have little to do with the business reasons for relocating. For most businesses, the value of the business incentives offered tends to be small in relation to other cost differences among jurisdictions. The KPMG costing model enables licensed users to determine the sensitivity of relative costs to negotiated incentives. According to licensed users of the model, typically offered business incentives seldom have a significant impact on relative costs.

This is not to suggest that regional business incentives are not a key part of the site negotiation and relocation decision. They are important for many reasons:

- Where relative costs in two locations are very close, incentives may swing the cost comparison one way or the other.
- Special incentives make the prospect of investing more attractive to your company, increasing the likelihood that you will actually undertake the proposed relocation or expansion.
- Offering special incentives sends your company a message that this is a business-friendly jurisdiction, one that wants to support new firms. The emergence of negotiated incentives, while providing new opportunities, also creates new requirements:
- You need to know what types of incentives have been previously negotiated in each jurisdiction. Without knowing this, you are at risk of not asking for available incentives. While this information is normally confidential in G7 locations, location consultants (such as KPMG's Global Location and Expansion Services practice) are knowledgeable about jurisdictions, and regularly assist relocating companies in maximizing the value of negotiated incentives.
- You need to ensure that the collection mechanism for special benefits is established at the time of negotiation. Studies of negotiated incentives have found that more than 50% of negotiated benefits were never collected.

CURRENT TRENDS AND FUTURE RULES

The results of KPMG studies in recent years has identified the following major international cost trends:

- Standard business infrastructure and support services are emerging. In telecommunications, European G7 countries have eliminated their cost and service disadvantage to the U.S. In transportation, significant airport infrastructure investments have been undertaken in every G7 country, the convenience of international business travel is at an all-time high, and business travel volumes have largely recovered from the post-September 11 downturn. To attract new and relocating business operations, regional EDAs are establishing very high standards of business support services.
- In the longer run, business costs will converge in developed countries. As business becomes more global, international pressures will force less cost-competitive jurisdictions to align their cost structures more closely with their competitors. Germany's recent reductions of corporate tax rates, and Italy's recent reductions in the cost of providing statutory benefits are examples of this trend.
- Significant business costs and other differentials will still exist in the medium term. As the three-year cost shifts measured by Competitive Alternatives demonstrate, significant G7 locational cost advantages still exist in 2002—even though they are not always in the same locations as in 1999! For relocating firms, in the future the winners will be those firms who not only can assess the recent trends in international competition, but can also successfully anticipate which countries and regions are best poised to improve their competitive position.

Stuart MacKay was the founding partner of KPMG's international business cost comparison in 1994, and is the co-author of the 2002 published edition of KPMG's Competitive Alternatives. During his 22-year consulting career, he has assisted clients in choosing among alternate international locations. He can be reached at (604) 484-4621 or at http://www.mmkconsulting.com/.

Advertising | Contact | Site Map | Terms/Policies | Help? | Top of Page

BUSINESS FACILITIES • TODAY'S FACILITY MANAGER • THE TFM SHOW™ • FACILITYCITY • FACILITYCONNECT • GROUP C

<<Back || Close || Next >>