The Asian Invasion

As we went to press, Jabil Circuit was busy snatching up the manufacturing arm of Varian Inc. The deal, which is scheduled to close later this month, will add about $200 million in annual revenues for Jabil, not to mention a healthy GAAP operating margin of 10.2%. More interesting, however, are the markets Varian Electronics Manufacturing serves: about 85% of its business is contract work for medical, communications, industrial and aerospace.

Those sectors are ripe for the EMS sector's picking. Unlike, say, consumer electronics or computers, high-rel electronics are in the early stages of outsourcing. As an article published last month in Circuits Assembly stipulated, defense and commercial aviation production made up just 3.4% of the EMS market in 2004 – this despite being more than 11% of the total electronics pie. In "Defense and Aerospace Outsourcing Trends," Jeff Kaylor cites an Electronic Trend Publications study forecasting a five-year compound annual growth rate of 7.2% through 2008 – solid, although shy of the total EMS forecast of 10.8%.

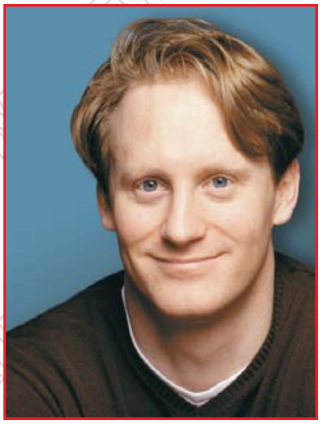
Some EMS vendors already realize this and are soaking up the gains. For instance, Nu Visions, an EMS company with plants in Massachusetts and Mexico, specializes in much of the same segments as Varian – high mix, high-rel products. Although the bulk of its revenue comes from customers within 250 miles of its Massachusetts plant, the company's sales jumped from $15 million in 2000 to $60 million last year, and the firm expects to top $100 million in 2005.

Kaylor's research found that for Class 3 OEMs the leading factors for choosing an EMS provider were design and engineering services, price and firm fixed prices. Historically, Asian vendors have held an edge in price. Thus, it's easy to see why Jabil president and chief executive Tim Main believes the Varian unit should flourish under Jabil's larger footprint. "Being a U.S.-only business hurt [Varian]. They couldn't scale."

Main makes an excellent point. But it's one not lost on his Asian competitors. While the success of Asian firms in winning high-volume, lower-end programs is well documented, less has been written of the investments Asian EMS and ODM companies have been making in expanding into high-tech products and higher-cost regions.

Indeed, EMS vendors are facing a new threat. Asian manufacturers are poised to open or acquire plants in strategic spots in North American and Europe, thus extending *their* footprint into what most firms took for granted as their home turf. According to a report by Deutsche Bank, some Asian ODMs are "increasingly competing with U.S.-based EMS vendors' core strength: higher-end assemblies and assemblies that are manufactured locally." One doesn't have to look far to find examples. Take Hon Hai. Over the past 24 months the Taiwanese ODM has moved into Mexico, the Czech Republic and Hungary. Other examples include First International Computer, Quanta, Wistron and Inventec, all of which have recently opened factories in Eastern Europe.

Tier 1 and 2 EMS suppliers have fought back, relocating plants to low-cost areas such as Malaysia, the Philippines, and, of course, China. Still, Deutsche Bank says, many North-American EMS companies "have bloated cost-structures in high-cost regions and limited differentiating services." To wit, excluding the estimated 2 million sq. ft. of manufacturing space it has closed or is closing, Sanmina-SCI has a reported 5 million sq. ft. of capacity in the U.S. The EMS provider generates roughly $3.3 billion in sales from those factories, according to Deutsche Bank, an efficiency level of $660 per sq. ft. Flextronics, by contrast, has 2.4 million sq. ft. of capacity and generates $2.1 billion in sales in the Americas. That adds up to about $875 of revenue per sq. ft., a 33% improvement over Sanmina.



With discrepancies like these remaining even after years of restructuring, it is little wonder Asian suppliers have North America and Europe in their sights. The Asians don't have excess capacity in high margin areas. Their strategy will be straightforward: put a few facilities in strategic high-cost locales. While analysts like Deutsche Bank deem the short-term threat as marginal, they predict Asian-based EMS and ODM firms will increasingly target North America and Europe. And that spells further rationalization (read: consolidations) by the incumbents. As Kaylor wrote, "Price means being competitive." That range can vary by customer "but it is rarely greater than 5%."

Decades ago, American auto buyers started switching to Asian-made imports, mostly for their lower costs. Eventually, many of those makers took up residence within U.S. borders. As OEMs turn over manufacturing to the supply chain, one has to wonder whether we are in for another pseudo exodus of programs once considered sacrosanct.

The harsh lessons for North Americans are these. Just because you are well positioned today does not mean you will be tomorrow. And, tomorrow may come sooner than you think.

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P.S. In the January issue we misreported the price BESI paid for Datacon. The correct price was 72.6 million euros. We regret the error.