Onshoring and the implications for UK commercial property

Has a combination of Brexit and COVID-19 strengthened the case for 'onshoring', and, if so, what are the implications for real estate?

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Executive summary

1. The supply chain disruption caused by COVID-19 has accelerated a re-evaluation of supply chains, particularly with respect to resilience
2. The costs of onshoring are likely to limit its widespread utilisation
3. But we believe that a combination of Brexit and COVID-19 will cause an increase in onshoring activity in certain industries, such as chemicals, pharmaceuticals and medical equipment
4. These industries are strategically important and could also benefit from favourable government support
5. We believe that a trend towards onshoring could provide further support for industrial property asset prices in specific locations

Onshoring in context: Globalisation

In modern history, the first wave of globalisation began towards the end of the 18th century following the British Industrial Revolution, with global export value as a percentage of GDP rising to 14% by 1913.[1] By 1945, this had fallen to 5% due to protectionist measures. Despite this, the ending of World War II marked the start of a new era. Globalisation gathered pace in the 1980s, particularly as China became a more open market economy.[2] During this time, '**offshoring**' heavily increased, with competitive forces driving corporations to exploit labour cost arbitrage overseas to produce goods more cheaply, made viable by declining transportation costs. Global trade surged and by the eve of the global financial crisis in 2008, global export value as a percentage of GDP hit a peak of 26%.

However, following the financial crisis, globalisation lost momentum. Global trade fell significantly during 2009 and, as a proportion of GDP, has flat-lined in the years since. Globalisation had been met by headwinds of economic slack in domestic markets, a rise in protectionist policies, and increasing political populism.[3] At present, there is clear pressure for at least a partial reversal of globalisation.

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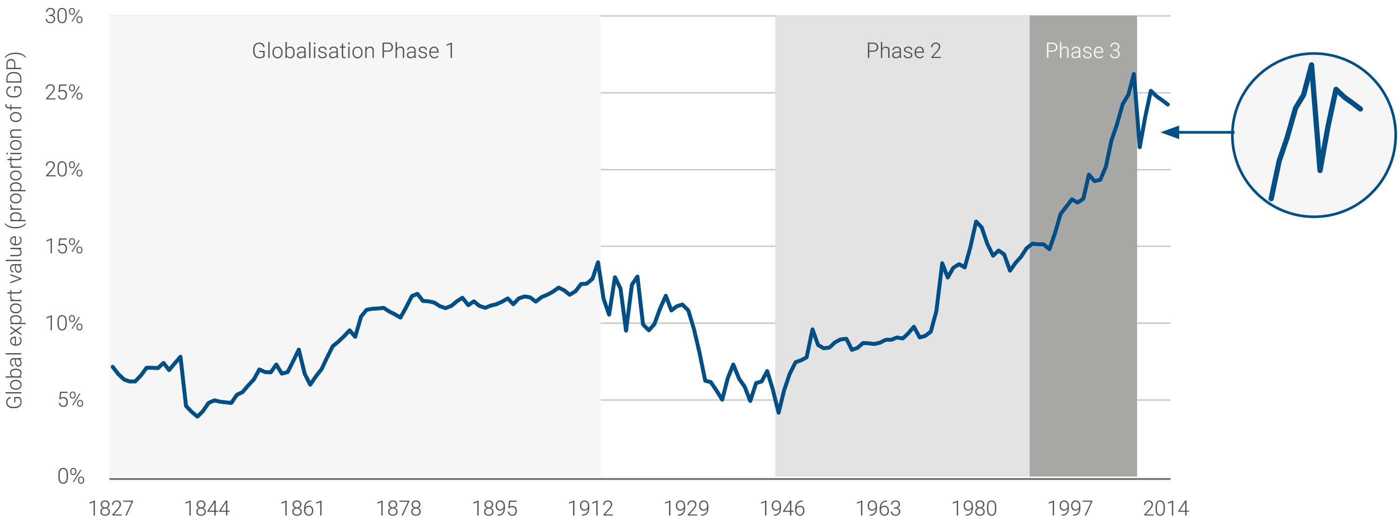
The COVID-19 pandemic has highlighted the problems of an overdependence on other economies for the procurement of goods. The impact on supply chains exposed the fragilities of businesses focused almost solely on cost optimisation. Meanwhile, the risks of increased border friction from Brexit have alerted some to the benefits of bringing more of their supply chain onshore. As a result, governments and corporations have started to re-evaluate their supply chains, with greater importance placed on resilience.

Value of exported goods as a share of global GDP



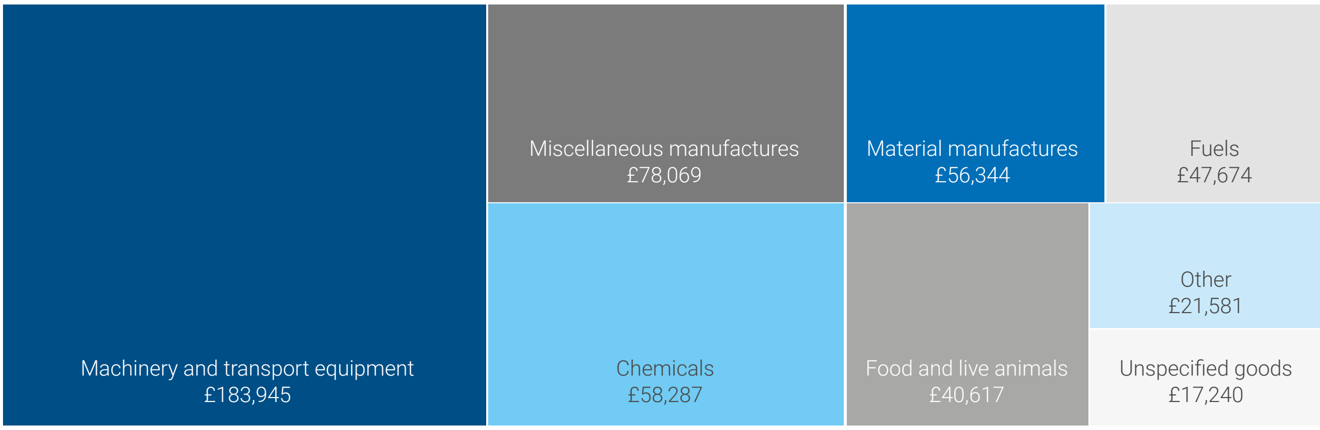
What is driving the return to onshoring?

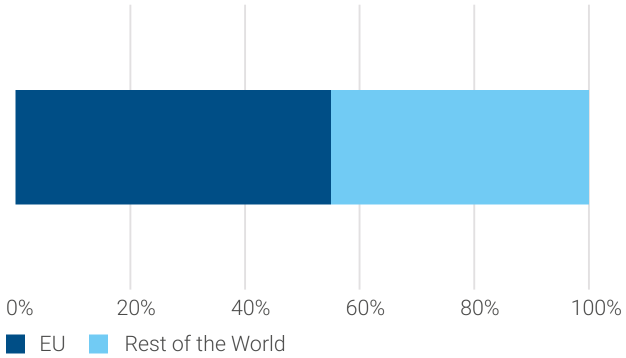
- Rising input costs overseas have reduced the relative attractiveness of offshore production. This is largely due to the economic development of emerging economies, which has reduced labour cost arbitrage. In 1980 the nominal average annual wage in China was only 2.6% of the average wage in the UK. By 2020 this had risen to 20.5%,[4] with the wage differential narrowing significantly after the global financial crisis.

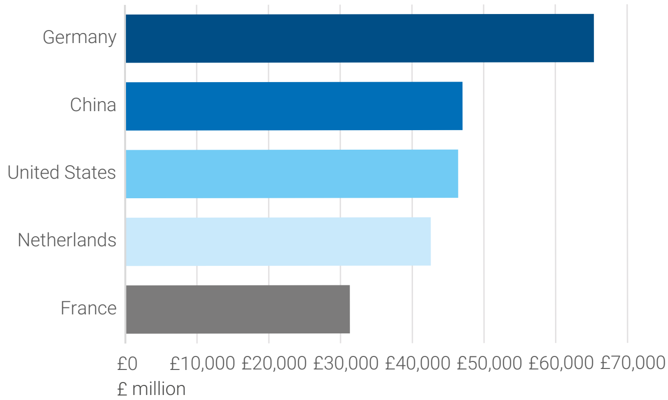
- Resilience to overseas supply chain disruption has been highlighted by the pandemic. COVID-19 led to factory closures and shipping delays in China which significantly impacted global production capabilities. Industrial production in China fell -13.5% year-on-year during January and February,[5] with textile exports falling -33%.[6] This was particularly disruptive for the UK fashion industry, as 22% of total UK clothing imports are sourced from China.[7]

- Brexit could increase the relative attractiveness of onshoring. Although a deal has been struck with the EU, changes in requirements for many importers and exporters have added to handling costs irrespective of trading arrangements.[8] Initial "teething" frictions will dissipate but some new and permanent hurdles will remain. The graphs below illustrate the value of the UK's imports in 2019.

Value of UK imports, 2019, £ millions. By type, broad source, and top five countries







- **Improved access to strategically important goods** is a government-level consideration that could lead to partial onshoring. Geopolitical tensions can lead to unstable trade relations and to countries exploiting supply chain vulnerabilities, potentially impacting the provision of critical goods. Examples could include chemicals, pharmaceuticals, medical equipment, and IT infrastructure.
- In response to pandemic disruption, the **UK government has initiated an inquiry coined 'Project Defend'**. The inquiry will highlight areas of supply chain weaknesses for critical goods and could lead to recommendations for supply chain diversification. Medical supplies and technology are likely to be critical goods within scope of the project. Notably, 80-90% of the UK supply of generic medicines are imported, with India alone manufacturing 25% of all medicines used in the UK[10]. To some, this suggests an overdependence, with problems highlighted at the onset of the pandemic when India curbed the export of certain generic drugs.
- **Government initiatives**, separate from strategically important goods, have the potential to create long-term structural drivers that boost the relative attractiveness of producing in the UK. As part of a post-Brexit economy, the UK outlined plans in 2017 for a 'Modern Industrial Strategy'. A core part of this plan is to make the UK a more attractive location for industrial sectors, with the aim to boost productivity and innovation. The key pillars include an increase in R&D spending to 2.4% of GDP[9] (currently 1.7%), upgrading infrastructure, and delivering low-cost, clean energy.
- Lastly, **ESG considerations** could also be a meaningful driver for onshoring, as they are a crucial determinant of the long-term viability of a business. Onshoring has the potential to decrease environmental impact by reducing the physical distance travelled by goods and thus reduce demand for international freight shipping. It could also positively impact **social** and **governance** factors, as it should result in greater scrutiny of business practises while increasing transparency for stakeholders.

Relocation viability

The costs and benefits of onshoring differ meaningfully across sectors. However, for most, the benefits are likely to be outweighed by the costs.

The most significant costs include:

- **Relocation costs** include the initial costs of moving operations onshore. This could encompass the shipping or purchase of machinery and the acquisition and re-fitting of business space. Indirect relocation costs could also include the challenge of developing new supplier relationships onshore.
- **Input costs:** Every input cost to production is likely to be higher onshore as factor prices are generally greater in a more developed economy. In addition, overseas locations typically benefit from industrial clusters which provide economies of scale and specialisation to further reduce average costs.
- **Regulatory adherence:** UK regulatory standards are likely to be stricter, with more stringent business practice standards.
- **Lack of skilled workers:** In the UK, this could be a significant barrier to onshoring manufacturing. For example, in China 54% of workers are employed in manufacturing versus only 8% in the UK.[11]

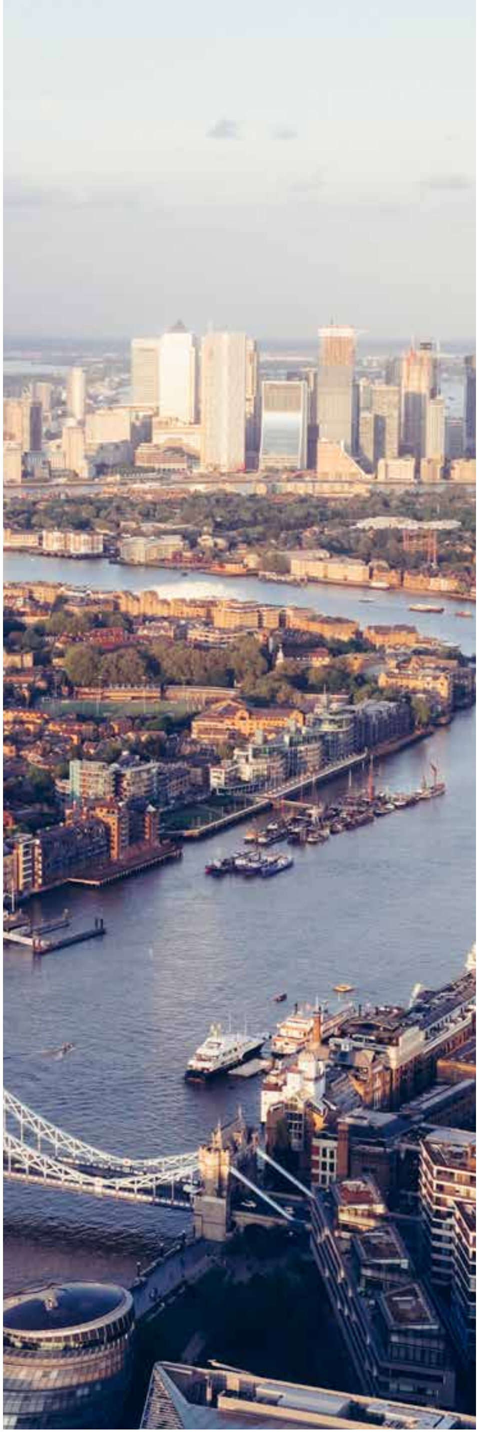
In the absence of significant government intervention, the above costs are likely to preclude a broad-based structural shift towards onshoring. Additionally, it is unlikely that every aspect of production could be brought onshore, for example raw materials are typically location constrained. Despite this, there are specific examples of sectors that could move onshore. A study undertaken in August 2020 by McKinsey highlighted that some labour-intensive sectors, such as **apparel**, and innovation-based sectors such as **pharmaceuticals** and **communication equipment** have meaningful potential for relocation. This can be driven by economic factors such as wages, or non-economic factors such as the strategic importance of an industry.

	Value of global activity with "shift feasibility"[12]	Shock exposure	Economic Drivers	Non-Economic Drivers
Pharmaceuticals manufacture	0.6	1.7	6.0	13.1
Communication equipment	0.1	0.6	3.9	11.3
Apparel and textiles manufacture	0.6	1.1	2.0	1.6

UK case studies

Building materials:
Brexit, rising overseas costs, "just in time" requirements, and environmental considerations have driven increased geographical diversification of supply chains within the construction industry. COVID-19 has re-affirmed the importance of this. There is continued pressure for materials and finished M&E to be brought onshore. China currently manufactures most M&E components and represents specific risk.

Despite this, there is yet to be significant evidence of onshoring and in many cases feasibility can be limited as raw materials are typically location constrained.



Chemicals and pharmaceuticals:
The supply chain disruption caused by the pandemic has bolstered the sentiment to onshore chemicals to the **North East of England**.

Many UK chemicals companies are seeking to mitigate disruption risks by onshoring to internalise supply chains. The North East is a regional cluster for Chemicals and Pharmaceuticals, accounting for 50% of the UK's foundation chemicals manufacturing supply.[16]

Pharmaceuticals are likely to be within scope for the UK's 'Project Defend' initiative. This inquiry could recommend a strategy of 'parallel supply chains'.[17] Under this scenario, the UK would predominantly utilise overseas locations to take advantage of lower costs but also ensure that domestic producers are able to significantly increase production of critical medicines in times of crisis. This strategy could require greater onshore capacity, although the impact could be limited to regional production clusters.

Service sector:
Anecdotal evidence suggests that some offshore service sector jobs could be viable in the UK, such as call centres. Companies with outsourced customer services have suffered from falls in customer satisfaction and have lost market share to competitors with onshore service functions.

- **BT** recently completed their long-term strategy to relocate all customer support functions to the UK and Ireland.[14] **Virgin Media** also relocated 500 support jobs in March.[15]

Evaluation

The disruption caused by COVID-19 has exposed the fragilities of lean supply chains and the problems of an overdependence on overseas suppliers. The impact is likely to cause supply chain adjustments, with McKinsey undertaking a survey in August that indicated 93% of supply chain leaders are planning to increase resilience due to the disruption.[12]

Onshoring is a strategy that could have UK real estate impacts. While the costs are likely to preclude a broad structural shift, certain industries are expected to utilise onshoring, benefitting from relatively low relocation costs and tailwinds such as government support while mitigating Brexit trade frictions. We have identified the following sectors to have the greatest onshoring potential: **pharmaceuticals, medical equipment, technological infrastructure** and **chemicals**. Each of these sectors are critical to the national security of the UK and suffered meaningful disruption during the pandemic. In addition to these sectors, **customer service** functions could move onshore, with BT and Virgin Media recently demonstrating feasibility.

In other industries, a strategy of '**near-shoring**' is more likely to be implemented. Pre-COVID-19, near-shoring was driven by costs. However, improved resilience through geographical diversification could accelerate this. The apparel industry is particularly likely to utilise near-shoring, with a focus in Eastern Europe.

A trend towards onshoring will affect certain UK property sectors and locations. The sectors most likely to onshore have a manufacturing and innovation-based focus, which will concentrate the impact to industrial property and life science labs.

Industrial and factory space is likely to benefit from the onshoring potential of chemicals, pharmaceuticals, and medical equipment. Existing production clusters are expected to benefit most.

Logistics could benefit if firms decide to re-evaluate lean supply chain methods. This could involve increasing supply chain slack by maintaining greater inventory.

Life science lab space and corporate offices could benefit if there is increased demand for lab space from re-located pharmaceutical and chemicals companies. Indirectly, COVID-19 could also influence government strategy to increase laboratory and research capacity to ensure better preparedness for future pandemics.

Offices have the potential to benefit from the relocating of certain customer service functions, however the evidence of this is currently small scale. There could be some impact on relatively low-cost markets outside London and other core city centres.

Overall, we believe that a combination of Brexit and COVID-19 will cause an increase in onshoring activity in certain industries for reasons of resilience, quality, costs, ESG and government initiatives. However, the extent of this remains unclear and its potential is limited by cost. Nevertheless, we believe that a trend towards onshoring could provide further support for industrial property asset prices in specific locations, with some investors likely to cite it as a justification for lower yields.

Sources:
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