WORLD

Why Auto Makers Are Building New Factories in Mexico, not the U.S.

Array of Free-Trade Pacts favors Mexico over U.S. South as site for North American Assembly Plants

By DUDLEY ALTHAUS and WILLIAM BOSTON
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CHATTANOOGA, Tenn.—A barren patch in the rugged hills along the Tennessee River is a sign of how Mexico has accelerated past the U.S. South in the global competition for auto investment.

The tract of cleared woodland lies alongside a factory Volkswagen AG set out to build in 2008. VW took an option on the adjacent 800 acres as a place where its Audi unit might build a North American plant someday.

But four years later, when Audi decided to move global production of its Q5 SUV to North America, the prize went to Mexico. Audi now is finishing a $1.3 billion factory in a gritty south-central Mexico town called San Jose Chiapa. The plant’s massive buildings rise like supertankers from dun-colored fields where families scrape by raising corn and beans.

Mexico’s low wages and improved logistics were part of the draw. But for Audi, which plans to ship the factory’s output all over the world, what tipped the scales was Mexico’s unrivaled trade relationships.

“Mexico had more than 40 different free-trade agreements,” said Rupert Stadler, Audi’s chief executive. The pacts give exporters from Mexico duty-free access to markets that contain 60% of the world’s economic output.

The U.S. is negotiating to expand its own array of free-trade agreements, but progress has been slow amid congressional opposition to giving the White House special trade authority known as “fast track.” Foes worry that the trade
agreements could drive jobs to low-wage countries.

With some luxury-car makers, at least, the reverse may be true. The Audi deal shows that besides its low-cost labor, Mexico’s trade pacts give it allure in the global car market, threatening the American South’s industrial renewal.

Seven Asian and European auto makers have opened new Mexican assembly plants, or disclosed plans for one, in little more than a year. Other car companies have financed significant expansions in Mexico, among them Nissan Motor Co., General Motors Co., Ford Motor Co. and Fiat Chrysler Automobiles NV.

Last week, VW said it would spend $1 billion expanding a Mexican plant to build a small SUV for the U.S. and some foreign markets. All told, auto makers and parts suppliers have earmarked more than $20 billion of new investments, Mexican officials say.

See Photos of the Region Where Audi Is Building Its New Plant »

Auto maker’s newest assembly plant promises to transform both the landscape and local economy of San Jose Chiapa, a town in south-central Mexico’s Puebla state.
While the bulk of Mexico’s auto exports go to the U.S. and Canada, its partners in the North American Free Trade Agreement, auto makers increasingly are turning to Mexico as a platform for selling world-wide.

The trade-related cost edge can be large. When Audi rival BMW AG ships cars to Europe from BMW’s two-decade-old Spartanburg, S.C., plant, it is hit with a 10% duty on each one. For a $50,000 vehicle, that $5,000 is a much bigger factor than differences in labor costs.

In July, BMW said it would build a factory in Mexico’s central San Luis Potosi state to produce 150,000 still-unspecified vehicles annually by 2019. Mexico’s “large number of international free trade agreements...was a decisive factor in the choice of location,” BMW said at the time.

The wave of investment has turned Mexico into the world’s seventh-largest producer of cars—it passed Brazil last year—and the fourth-largest exporter after Germany, Japan and South Korea. Mexico has just eclipsed Japan to become the No. 2 supplier of vehicles to the U.S. market after Canada. Industry analysts see Mexico’s current annual production of 3.2 million cars and light trucks rising more than 50% to five million by 2018.

That would still be far below U.S. annual production of 11.4 million. Of these, six Southeastern states produce about 3.9 million. Auto makers began flocking to the U.S. South in the 1980s for its largely nonunion labor, good transportation and energy grids, and the region came to be seen as the new Detroit of the North American auto industry. Now, as Mexico gears up, the stakes are high for Dixie.

The South continues to hold economic appeal for car companies. Daimler AG, BMW and others are expanding existing assembly plants in Alabama and South Carolina. Just this month, Daimler disclosed another investment, a planned $500 million expansion of an existing plant near Charleston, S.C.

But it has been more than six years since an auto maker picked the U.S. South for a “greenfield” plant, meaning one where the company didn’t already have facilities. Such projects have all gone to Mexico lately.

South Korea’s Kia Motors Corp., which six years ago picked Georgia for its first North American factory, passed on several U.S. sites for its second one and chose a location near Monterrey, Mexico. An alliance between Nissan and Daimler said in June it would build a $1.4 billion plant in Mexico’s Aguascalientes state to make Infiniti and Mercedes compacts. Nissan, which has three assembly plants
in the U.S. South plus North American headquarters in Nashville, also finished a $2 billion plant expansion in Mexico in late 2013.

“We see a number of wins, back to back, in Mexico that might have gone here,” said Greg Canfield, Alabama’s economic development secretary. “What we’re seeing in Alabama and the South is the recognition that we really have a new competitor.”

**Global supplier**

In Audi’s case, the company wanted a North American plant not only to feed the strong U.S. market for a midsize SUV such as the Q5, which it currently makes in Germany, but also to supply the model to Europe and much of the rest of the world.

From the start, Audi preferred to piggyback on parent VW’s North American infrastructure such as roads and suppliers. In the site competition, that meant largely a two-horse race between VW’s existing North American plants, one at Chattanooga and one in the south-central Mexican state of Puebla.

The place Audi chose, San Jose Chiapa, seems at first glance like the middle of nowhere, a cinder-block town of about 10,000 residents. But the port of Veracruz on the Gulf of Mexico is reachable in less than half a day by rail or truck, and the factories of suppliers to the VW plant are an hour’s drive west.

Puebla state officials sweetened San Jose Chiapa’s allure by agreeing to finance a training center and donate 1,200 acres of land. Plans are under way to build a model community with homes, shops, schools and cinemas for families of the 20,000 people expected to work at Audi’s assembly plants and parts suppliers.

“It’s like a bomb exploded here,” said Josue Martinez, a bricklayer who serves as mayor of San Jose Chiapa. “For this town, there is a before and an after the Audi plant.”

Producing the Q5 in Mexico isn’t without risk. The plant will assemble every Q5 sold world-wide except in China and India, so any factory glitch would interrupt global sales for a popular model.

Audi is taking some unusual steps to control its risk. First, to ensure quality, the company created a consultancy that fanned out to 160 parts suppliers in Mexico, encouraging some to change plant design or improve weak production processes.
Audi also developed a process to evaluate raw materials, a task normally left to suppliers. One goal was to have most of the plant’s raw materials priced in dollars, so costs wouldn’t be subject to exchange-rate swings, as they would if some materials were imported. “A natural hedge,” Audi calls this strategy.

The company created an inventory of local sources for every part and for all raw materials used in the Q5, and has required suppliers to source from its list. “We thought if every supplier does it by himself, it will fail,” said Bernd Martens, Audi’s procurement chief. “So, we did it at Audi.”

Audi now is training 600 people from Puebla state at its headquarters in Ingolstadt, Germany. Visiting on 18-month stints, the Mexicans, mostly supervisory level, study German, train on Audi systems and are indoctrinated with the company’s intense focus on quality.

Spanish conversations float through the air at cafes in the Bavarian town on the Danube. Once a week, Audi’s Mexican workers and German colleagues crowd into the Havana Bar for salsa dancing.
“When we have a problem in Mexico, we have to know who can help us in Ingolstadt,” said Isaul Lopez Gutierrez, who will run a team of system analysts in Puebla. His oldest daughter, a 7-year-old, attends a German school.

Audi figured that siting its Q5 plant in Mexico would enable it to save 50% on labor costs, compared with Tennessee, Mr. Stadler said. It also should save slightly more on parts in Mexico than in the U.S., said Mr. Martens.

A crucial factor was trade. Mexico has 10 free-trade arrangements encompassing 45 countries—counting EU members separately—plus other trade deals in Latin America and the Asian Pacific, according to the government’s trade office. In contrast, the U.S. has free-trade agreements with 20 countries, mostly smaller economies such as Chile, Jordan and Panama, said the U.S. trade representative’s office.

U.S. officials are negotiating with officials from Japan and 10 other Asian and Latin American countries in hopes of completing in coming months a framework known as the Trans-Pacific Partnership. But the agreement, which officials say would help the countries compete with China, needs the legislation known as fast track to ease its passage in Congress. If introduced and passed this year, fast track could also expedite the passage of a trade agreement with the EU that is in the early stages of negotiation.

**Tough for Tennessee**

Because of the free-trade agreements Mexico already has, Audi’s consideration of Chattanooga for the Q5 plant “never seemed real,” said Tennessee Republican Sen. Bob Corker. Mexico’s greater array of trade pacts “puts us at a disadvantage. This is something that is very important to our country,” he said.

But Obama administration officials have run into determined resistance from some fellow Democrats. “Bitter experience tells us that bad trade deals devastate jobs, devastate wages,” said Rep. Rosa DeLauro of Connecticut, who is leading opposition to fast track among Democrats in the House.

After Audi settled on Mexico in 2012, officials of the U.S. Commerce Department visited Chattanooga to meet with business and government leaders. Gathered around a long walnut-colored conference table at Chamber of Commerce offices, the locals said Audi’s decision needed to be a wake-up call about Mexico’s trade advantage. The discussion “wasn’t so much about the Audi project itself—it was about an example that could probably translate into other projects that are going to be looking at Chattanooga,” said Charles Wood, an executive with the
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Chattanooga Chamber of Commerce.

Six Southern states commissioned a study of how to compete with Mexico. The report by the Center for Automotive Research suggested tightening the density of parts suppliers and training workforces for higher-value production jobs.

In Tennessee, the auto industry accounts for three-quarters of manufacturing jobs, according to a Brookings Institution study. The state now offers adult residents free training to learn the advanced skills needed today by auto makers, said Tennessee’s economic-development commissioner, Randy Boyd.

Looking out his office window on downtown Nashville, Mr. Boyd came back to Mexico’s trade edge. “We’d love to compete on even terms,” he said. “This will definitely be an issue if Mexico has that advantage and we don’t.”

—William Mauldin contributed to this article.

Write to William Boston at william.boston@wsj.com