For Companies, the Tariff Question Folds Back Into Competitive Advantage

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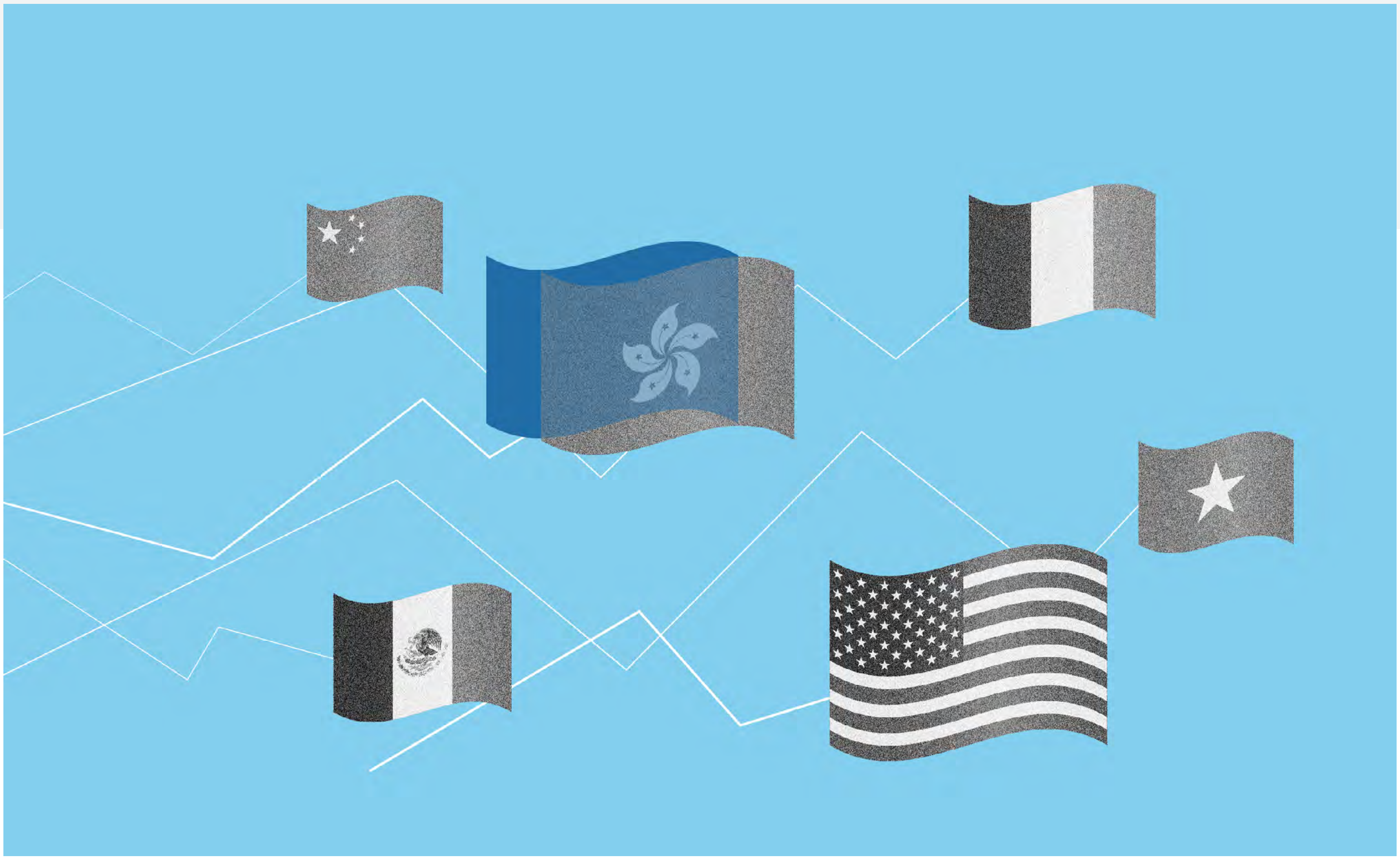

For investors trying to discern the effects of the Trump administration's tariff policies on their stocks, there is a quick-and-dirty way to perform their analysis: Look at the countries in which a company manufactures its products, look at the tariffs applied to that country, multiply the top line by the tariff rate, and subtract that from gross profits.

In doing that, investors are assessing the first-order (direct impact on companies) and second-order (impact on demand) effects of the tariffs. That is what investors seemed to do in the wake of Trump's April 2 announcement that the US would apply tariffs to virtually every country in the world. Shares of sporting-goods manufacturer VF Corporation, which has substantial operations in China and Vietnam, fell 41%. Hong Kong-based power-tools maker Techtronic Industries fell 23%. Polaris, which makes sports vehicles and has its largest factory in Mexico, fell 25%. French electrical-equipment manufacturer Schneider Electric fell 11%.

But the best indicator of how the tariffs will affect corporate profits comes from looking not at the first- or second-order effect, but at a third-order effect: The effect on companies' competitive position. Companies don't operate in a vacuum. They compete against each other. Yes, every company doing business in the US has to contend with the tariff issue. But some companies are better equipped to do so than others just by the nature of how their operations and supply chains have been set up. That is where the competitive advantages will become apparent. A foreign-domiciled company may not be at any disadvantage to a US-based one, and vice versa.

This is how we evaluate companies. The cornerstone of our analysis is the competitive-forces framework designed by Harvard University professor Michael Porter. Competitive strategy, as the field has come to be called, looks not just at a company's internal fundamentals, but also compares them to its peers across its industry.

Consider Schneider and its competitor Eaton Corp. Schneider Electric makes equipment for electricity distribution and industrial controls and is based in Rueil-Malmaison, France. Eaton, which also makes equipment for electricity distribution, has its operations based in Ohio. Ostensibly, that would give Eaton a leg up over Schneider. But these companies have virtually the same manufacturing footprint and supply chain despite the different domiciles. Schneider has about 20 factories in the US. So it isn't likely to lose any ground to Eaton, at least not due to tariffs.

An even better example is Techtronic and its competitor Stanley Black & Decker. Techtronic is based in Hong Kong and owns the Ryobi and Milwaukee brands. It was a pioneer in battery-powered, cordless power tools. Stanley is based in Connecticut and makes the Black & Decker, Craftsman, and DeWalt brands. Again, one company is based in the US and the other is based overseas. But both companies' manufacturing operations are based overseas so the real issue is *where* overseas they are.

Stanley Black & Decker has about 24% of its power-tools manufacturing capacity in Mexico, and 18% in China. Techtronic also has production in Mexico and China. But it is already in the process of moving its China production out of the country, which it plans to complete this year, and importantly already has a substantial portion of its power-tools manufacturing in Vietnam. Stanley is also planning to move production out of China, but is further behind in that process. It will likely take one to two years to complete. Currently, Vietnam's tariffs are at 10% while Mexico is at 25% for non-USMCA-compliant goods and China's now at 30%. Therefore, Techtronic has an advantage in already having production in Vietnam and in being further along in moving its production out of China. The advantage could of course shift if the tariffs increase or decrease, but the analytical framework remains in place.

Looking at the tariff question this way doesn't mean a company won't be affected by them. The economic consensus is that the steep tariffs will hurt everybody. But examining that potential pain through the lens of competitive advantage provides a clearer picture of how companies will be affected, and which ones will come out stronger.

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