San Diego County Manufacturing Industry Report
"What's Happening in Manufacturing??"
November 2008

Economists are now admitting that the country as a whole fell into a recession in the third quarter, although several segments of San Diego's manufacturing industry have been experiencing a recession for more than a year.

According to Tatum's November Survey of Business Conditions, "the recession that began in the third quarter, deepened and widened in October, and is expected to deteriorate further for at least the remainder of this year." Tatum's Index of Business Conditions dropped 0 .4 from 0.9 in September. "To put this in perspective, the 12-montha average through November 1 was 1.75, and the average since January 2003 is 7.12."

However, according to the Manufacturing Institute for Supply Management's Report on Business, economic activity in the manufacturing sector contracted in October for the third consecutive month, while the overall economy grew for the 83rd consecutive month. The PMI registered 38.9 percent, down from 43.5 percent in September. A reading of 50 percent indicates that the manufacturing economy is generally expanding and below 50 percent indicates that is generally contracting. "This is the lowest level for the PMI since September 1982 when it registered 38.8 percent. In this report, we see inflationary pressures dissolving as the Prices Index fell to 37 percent, the lowest since December 2001 when it registered 33.2 percent. Export orders also contracted for the first time following 70 months of growth," said Norbert J. Ore, C.P.M., chair of the Manufacturing Business Survey Committee. Backlog of orders dropped down to 29.5 percent for a six-month downward trend. Supplier deliveries are becoming faster, and inventories are increasing. On the plus side for manufacturers, prices for materials and commodities, such as aluminum, copper, steel, nickel, diesel fuel, and natural gas have started to drop.

According to the Cybercities 2008 report, released by AeA on June 24, 2008, California is the epicenter of the high-tech industry and home to nine of the nation's top 60 cybercities, more than any other state. These nine cybercities accounted for 91 percent of California's 940,7800 tech industry jobs in 2006. The nine cybercities are: Los Angeles, Oakland, Orange County, Riverside-San Bernardino, Sacramento, San Diego, San Francisco, San Jose/Silicon Valley, and Ventura. . San Diego ranked 13th in high-tech employment out of the 60 cybercities with 106,400 jobs and ranked 23rd in high-tech job growth. The average high-tech wage was $92,328 in 2006, over double the $45,100 average non high-tech private sector wage.

Of course, not all high-tech jobs are manufacturing jobs. AeA's definition of the high-tech industry is based on the U. S. government North American Industrial Classification System (NAICS) for companies, not individual occupations. AeA uses 49 NAICS codes to define the high-tech industry, which fall into two broad categories – high-tech manufacturing and high-tech services. AeA's definition does not include biotechnology because it is not discernable in the NAICS codes and it is difficult to determine where biotechnology ends and the pharmaceutical industry begins. Thus, to be included in AeA's core definition of high tech, an industry had to be a maker/creator of technology, whether in the form of products or services.

As an example, there were 41companies that were finalists for the AeA High Tech Awards presented October 31, 2008, but only 23 companies manufacture a hardware or software product.

For purposes of this report, the definition of a manufacturer is a company that makes, creates, or produces a product, whether it is hardware, software, biotechnology, pharmaceutical, foodstuffs, etc. in contrast to a company that provides a service.

San Diego's Manufacturing Industry Continues Slow Down

San Diego County's manufacturing industry continued to slow down during the first three quarters of this year, with only slight flurries of activity when companies needed to replenish inventories or got new contracts.

While the slow down has become more pervasive than it was in 2007, there are still companies that are growing and flourishing as evidenced by some of AeA High Tech Award winners: ID Analytics, Inc., Breach Security, Inc. H20 Audio, Inc., Networkfleet, Inc., Vektrex, Alphatec Spine, Inc., ISE Corporation, and Nextivity, Inc. (see www.aeanet.org for complete list of finalists)

Another AeA member company, Outsource Manufacturing, Inc., a contract manufacturer located in Carlsbad, was the number one fastest growing privately held company in San Diego County for 2007. They have even been able to recapture some of the business that previously went out of the country to Mexico and offshore to China.

San Diego's technology industry has greatly diversified since the recession of the early 1990s when defense and electronics/instruments dominated. Today, San Diego has several technology-based segments: telecommunications, information technology, energy/environmental, computer and electronics, biotech/biomedical, and defense/national security. on the

Biotech and medical device manufacturers have been the most insulated from the slow down, while manufacturers producing products for the consumer, recreation, and the housing market have been the most impacted.

Manufacturers in the aerospace and defense industry who produce products for the "war on terrorism" continued to be busy this year up through the third quarter. However, other defense and aerospace companies continued to experience an adverse affect from the war from less R & D spending and fewer new programs being funded as a result of so much of the Federal defense budget being spent on supporting the troops and supplies, weapons and munitions.

Based on industry contacts, San Diego's ship repair industry is now in its sixth year of recession. When Navy ships are out to sea longer, the Navy only contracts out the repairs that are absolutely necessary while in port and delays doing any major overhauls so the ships can go back out to sea as soon as possible. General Dynamics NASSCO's contracts to build new ships have been the only bright spot in San Diego's ship building/repair industry. Unfortunately, the small ship repair companies haven't benefited from these contracts for new ships. Several small shops have closed down since 2003 when the war started, and the rest have survived by diversifying their products or services into other markets.

The mortgage crisis caused by sub prime loans and the high rate of foreclosures has made things worse in the past year for San Diego's off road vehicle industry. As first mentioned in my report of November 2007, the reasons behind this slow down are complicated. Inquiries revealed that a majority of people who purchase off road vehicles (dune buggies, quad wheelers, and dirt bikes) work in the building industry or related industries. With the housing market in a big slump, fewer homes, condos, and apartments are being built so people working in this industry are experiencing a tight money situation and don't have the money to purchase off road vehicles or even keep the vehicles they have already purchased.

Over the last 15 years, the industry changed from low-cost home "kit" models to expensive "custom-built vehicles made by companies specializing in this field. Today, the price of new custom-built off road vehicles ranges from $50,000 to $70,000. There have been so many used off road vehicles for sale that the market for new vehicles has virtually died, causing the slow down in the industry. Everyone is hoping business will pick up as the off road season begins with cooler weather. Attendee traffic at the fall off road trade shows was down for the second year in a row. Inventories on parts and assemblies have taken more than a year to deplete at some companies in this industry.

Thus far, the meltdown and radical transformation that the financial industry has undergone this year has left the San Diego's high-tech industries relatively unaffected. How long this will continue remains to be seen. Recessions that start with one industry eventually trickle down to other industries. The banking problem can very easily affect all other industries if companies can no longer borrow money, leading to excessive layoffs. And, if companies cannot borrow money, there would be more layoffs in the banking sector, as well as every other industry.

Temporary to permanent staffing companies are the first to feel a slow down as companies terminate their contracts for temporary workers before laying off any of their permanent employees. San Diego's staffing companies have reported that this has been increasing for the past several months, after starting last year. In addition, retained executive search firms are reporting an increase in resumes being submitted to them by laid-off executives.

Some Business is Coming Back from Offshore

We are hearing about more companies coming back from doing business in China. The main problems these companies encountered were:

- Substitution of materials from those specified
- Inconsistent quality
- Stretched out deliveries
- Communication problems
- Inability to modify designs easily and rapidly
- Unfavorable purchase order and credit terms
- Difficulty in returning defective products for replacement or credit

Silk Road International, an international procurement and project management company that specializes in helping clients find the right factories in China, Hong Kong, Thailand and the U.S., featured an article entitled "Returning Products to a Factory in China" on their blog (http:silkroadntl.net/blog). In the article, David Dayton, who leads SRI from the Shenzhen, China office, offered a client the following advice with regard to returning products to a Chinese vendor:

1. "This will kill any good will you may have developed with your supplier. You will need to find a new supplier . . ."
2. "You may not get the product back into the country—especially if it's defective or already opened because of import restrictions. . ."
3. "You must decide who will pay and where the cash will come from before you take any unilateral action . . ."
4. "There is really no such thing as "credit"—the cash for the redo has to come from somewhere . . ."
5. "You will see the returned product again, somewhere . . ."
6. "What will it really cost you in terms of time, shipping costs, lost clients due to the production flaw, etc? . . ."

In his opinion, the bottom line was that if you have received the product in your home country and have already paid for it, it's too late to be finding problems. His recommended solution is to not allow product to "ship before you (you personally or someone other than the factory) approve it." In other words, this is what is referred to as "source inspection," which means that you as the customer must pay for someone from your company to travel to the vendor to inspect the parts before shipping or you have to hire an independent person or company to do the inspection before shipping.

It was interesting to find a commentary on this article on the China Law Blog, written by Dan Harris of Harris & Moore, PLLC, a boutique international law firm. Dan commented on the "you will see the returned product again, somewhere" with the experience that one of their clients had when they returned a product to their Chinese vendor with explicit instructions to destroy the inferior product. Some time later, however, a Seattle retailer called the client to ask why a distributor was able to sell the client's normal $100 item (wholesale) for $35. After considering whether they would need to honor their warranty on "gray market" defective goods, the client chose to honor their warranty on the defective product. (posted March 25, 2008, www.chinlawblog.com) Manufacturers outsourcing their whole product need to be prepared to absorb warranty costs in order to keep customers' good will.

In mid-2007, we were able to get an order for a new part for the American plastic injection molder we represent from a San Diego-based company that had gone to China for parts for their new product and had such an unpleasant experience that they decided to source domestic for the last part needed for the new product. Our molder finished the tooling in only three weeks and provided first articles of the part that met the customer's quality standards without any tooling rework. A few months later, the manufacturer pulled three tools that made other plastic injection molded parts for the same product from their Chinese vendor and transferred them to our U. S plastic injection molder. Two of the tools had to be reworked by our molder before they were able to make good parts.

This story from San Diego County is just a microcosm of what's happening nationwide. Exxel Outdoors Inc. is hiring workers, adding machines, and increasing output at their 250,00 sq. ft. plant in Haleyville, Alabama. Exxel makes sleeping bags, tents, and ski vests. Exxel's CEO Harry Kazazian said, "In 2005, China's cost advantage began to erode as the yuan appreciated. In the first half of 2008, wages in urban China jumped 18 percent from a year earlier, and new minimum-wage and overtime rules will add more to his costs." Costs in Haleyville run three percent those in China, and the company can deliver a sleeping bag within three days from its Haleyville plant, while shipping one form China might take as long as two months.

In 2007, 60 percent of Exxel's sleeping bags were made in Shanghai, while the Haleyville plant produced the rest. By 2009, only a third will come from China, and by 2010, Haleyville will account for 90 percent. Kazazian projects his company's revenue will rise as much as 20 percent to $42 million from $35 million in 2007, helped by the Wal-Mart order for Disney-themed kids' sleeping bags. "Labor is China's advantage and our weakest link," Kazazian said. But they can't compete with me on my just-in-time production cycle. Customers pay as much as 10 percent more to get deliveries as needed rather than incurring expenses to store inventory."

Barbara Garrison, V.P. of Operations, said, "Now that we've become more competitive, more people are looking at us. We're getting more inquiries." ("China Loss is Alabama Gain as Sleeping-Bag Firm Adds U.S. Jobs," October 14, 2008, www.bloomberg.com)

Harder to Compete for California Companies

California's manufacturers find it harder to compete because the business environment grows increasingly unfriendly. In 2005, California dropped to 50th in ranking in the Small Business Survival Index by the Small Business & Entrepreneurship Council (SBE Council), and its rank did not change in the 2006 and 2007 reports. However, California's rank rose one point to 49th in the 2008 report, with New Jersey dropping to 50th. This low overall ranking was based on California's anti-business environment in the following areas:

- Highest personal income tax rates
- Highest state gas taxes
- Highest capital gains tax
- 5th highest cost of worker's compensation premiums
- 6th highest electric utility costs
- 8th highest corporate capital gains tax rates
- 9th highest corporate income tax rates
- High state and local property tax rates

California will undoubtedly drop to 50th when the SBE Council takes into account the increases in taxes passed by the state legislature to address California's estimated $11-12 billion deficit for the fiscal year 2008-09. The California Chamber estimates that businesses and investors will be paying $5.8 billion more in taxes in 2008-09 and $1.6 billion more in 2009-10. A brief description of the changes in tax law regarding penalty for reasonable disputes, tax credits limit, net operating loss, accelerated tax payments, and Limited Liability Company (LLC) fees is available at www.calchamber.com ("Business Tax Bill Higher in State Budget Plan," October 7, 2008)

Since taking office in late 2003, Governor Schwarzenegger vetoed 10 out of 10 of the California Chamber's identified "job killer" bills in 2004, seven of eight in 2005, and nine of the eleven in 2006. In 2007, the California Chamber of Commerce reported that Governor Schwarzenegger vetoed all 12 "job killer" bills sent to his desk for action by the legislature. This year, the California Chamber reported that the Governor vetoed nine of the 10 "job killer" bills.

In contrast, only two of the three bills identified by the California Chamber as "job creators" because they would help boost the state's economy and create jobs were signed into law this year. These bills were:

AB 1394 (Krekorian, D-Burbank) Trademark Protection – improves protections of trademark owner rights and consumer health and safety by strengthening California laws against trafficking of fake products such as auto parts, prescription drugs, and children's toys.

SB 1608 (Corbett; D-San Leandro) Advancing Disability Access – comprehensive reform that increases public access for individuals with disabilities while reducing unwarranted litigation, including use of state-certified disability access specialists and establishing court procedure for early judicial review of lawsuit claims.

Only four months into the 2008-2009 fiscal year, the state budget is already out of balance, with an estimated $3 billion deficit. To address this growing budget deficit, Governor Schwarzenegger's proposed taxes and cuts on November 8th that would make matters even worse for businesses and other taxpayers. His proposal includes the following tax/revenue increases:

- A temporary increase in the state sales tax, from 5 percent to 6.5 percent for three years.
- Broadening the sales tax and use tax to include certain services, such as vehicle and appliance repairs and sporting and entertainment events.
- Imposing an oil severance tax on any oil producer that extracts oil from earth or water in the state.
- Increasing the alcohol excise tax by 5 cents a drink.
- A $12 increase in annual vehicle registration fees.

The California Chamber of Commerce responded to these proposed tax increases with a letter outlining why they opposed such industry-specific taxes, concluding, "These industry-specific taxes kill good jobs and harm industries unique to California." ("Industry-Specific Taxes Hurt Economy, Budget Solution," November 14, 2008, ww.calchamber.com)

For three San Diego County cities, an increase in the state's sales tax would mean 10 percent or higher sales taxes when added to their city's sales taxes. La Mesa's sales tax would be 10 percent, while El Cajon and National City would be paying 10 ¼ percent. Vista would pay 9 ¾ percent, and the rest of the county would be paying 9 ¼ percent.

Every year there is a budget deficit; the Democrats controlled legislature wants to raise the income tax rate. The proposal this year would increase the marginal income tax rate from 10.3 percent to 12 percent and repeal indexing for inflation on income tax brackets. This tax rate would be the highest in the nation and double the national average. They also want to raise the corporate tax rate from 8.4 percent to 9.3 percent, which would be the second highest in the nation next to Massachusetts' 9.5 percent.

Since the top ten percent of income earners pay 75 percent of California's income taxes according to Franchise Tax Board data, an increase in taxes would encourage those already contributing the most to consider leaving our state. It won't be limited to the extremely wealthy – small businesses and the middle class would make up a large portion of those who may leave. A report called "Rich States, Poor States" by economists Arthur Laffer and Stephen Moore states "Out of the 25,000 or so seven-figure-income families, more than 5,000 left in the early 2000s, and the loss of their tax payments accounted for about half the budget hole."

Data from the U. S. Census Bureau indicates that between 1996 and 2005, 1.3 million more Americans left than came to California. Those who are leaving are disproportionately those with higher incomes who pay the lion's share of taxes that the state uses to support its spending. According to the U. S. Department of Labor, most mass job relocations are from one state to another, and one of the primary reasons for that relocation is for business tax savings.

Businesses are exiting in high numbers, taking with them the high-paying jobs and the tax revenues they generate. Among the major manufacturers that have left California are Nabisco, the household name when it comes to cookies and other snacks, and Nissan Motors Corporation, which relocated to Tennessee.

It isn't just wealthy people and businesses that want to leave California – the city of Needles wants to secede from California and join either Nevada or Arizona. Needles is situated on the western side of the Colorado River across from Nevada and near the intersection of the borders of California, Arizona, and Nevada. Brad Mitzefelt, A San Bernardino supervisor who represents Needles said, "Needles may be better served in another state, but that's because California has a disadvantageous business climate that hurts them when they try to compete against Nevada or Arizona." ("Needles casts an envious eye elsewhere," May 26, 2008, *Los Angeles Times*)

California's unemployment rate shot up from 5.7 percent in October 2007 to 8.2 percent in October 2008, which is the highest rate since the recession of the early 1990s when it peaked at 8.7 percent. This was the third highest rate in the nation after Michigan and Rhode Island, which were tied at 9.3 percent. The national average was 6.5 percent.

If this trend continues, the unemployment fund will be $2.4 billion in the red by the end of 2008, which would force the fund to borrow from the federal government for the second time in its history. The Governor's proposal cited above includes a provision to require employers to pay more money into the unemployment fund while reducing the amount workers can receive.

San Diego County's unemployment rate rose to 6.8 percent, up from 4.8 percent in October 2007. This rate is the highest point since summer 1995, when military contractors were closing their doors after the end of the Cold War.

Governor Schwarzenegger hosted California's first ever Governor's Conference on Small Business and Entrepreneurship held in Los Angeles on November 18 and 19. Governor Schwarzenegger said, "Small businesses have always provided innovative products and services that drive our state's diverse economy. As we deal with the global economic crisis, my administration is committed to listening to our small businesses and entrepreneurs for their ideas on how we can best partner wit them to unleash the power of their creativity, ingenuity, and work ethic to maintain California's leadership in the global economy."

The Governor had invited leaders of small business organizations and entrepreneurs representing the spectrum of the state's economy to make recommendations on improving the partnership between the private sector and state government to stimulate the economy. Since May, a number of individuals from these groups have been preparing draft proposals for consideration and prioritization by the conference participants. Their work has yielded over 100 separate recommendations and the final proposals will be developed and voted on by the conference participants.

If I had been invited to participate in offering my recommendations, I would have proposed the following actions to be taken to help improve the business climate of California and stem the tide of companies leaving California or going out of business:

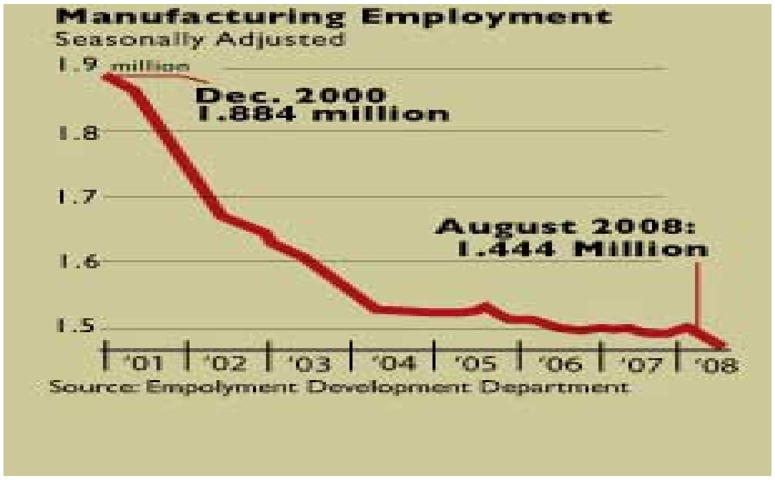
- Lower corporate and personal income taxes
- Restore the capital equipment investment tax credit
- Eliminate burdensome regulations on small businesses
- Reform workers' compensation to address the issues of fraudulent claims and frivolous lawsuits
- Provide reliable water supplies
- Reduce costs for energy

Now is not the time to raise taxes or fees. This is not the time to implement regulations that kill jobs. We need to make some drastic changes in California's business climate so that we can maintain as much as possible of our manufacturing base in California.

San Diego has always been a "start-up business" area where companies grew to a certain size and were acquired by mostly out-of-the area companies. The new owners usually kept the division or subsidiary in San Diego because they were afraid of losing key people if they moved have taken a look at their bottom line for their San Diego-based acquisition and decided they couldn't afford to stay in California.

This line of thinking has changed as the costs of doing business in California have escalated over the past several years and the overall business climate became more unfavorable. San Diego companies have been moved to such former business unfriendly states as Ohio, Minnesota, Maryland, and New York. The California Employment Development Department reported that

California lost another 1,430 manufacturing jobs in August. The following chart shows that a total of 442,000 jobs have been lost in this sector since the decline started in December 2000, nearly a 24 percent decline.



The initial list of 40 companies that had gone out of business or moved out of California that accompanied my first report of March 2003 more than doubled to 85 by the end of 2003. The mass exodus of companies moving out of San Diego County slowed down after the Schwarzenegger reforms in early 2004. Even so, another 65 companies have either gone out of business or moved out of state since 2004 for a total of 150 companies no longer in business or located in San Diego County. Based on employment data for companies listed in the 2000 Technology Directory for San Diego County and estimating 20 employees for companies not listed in the directory, the current list of companies represents a loss of nearly 8,000 jobs.

The economic data indicates that each manufacturing job creates three to four other jobs while service jobs only create one to two other jobs. Therefore, the loss of over 400,000 manufacturing jobs may have caused more than one million other jobs to vanish. Nationwide, a staggering 3.2 million manufacturing jobs have disappeared since the year 2000. The U. S. Department of Labor predicts that another 1.5 million manufacturing jobs will be lost between 2006 and 2016. If this trend is not reversed, it is only a matter of time before California's economy and America's economy becomes primarily a service and retail one. It will be virtually impossible for the United States to remain a superpower if this trend becomes a reality. We need to restore California and our country to the "land of opportunity" they once were.

Background: As background for how this series of reports came to pass, ElectroFab Sales is a manufacturers' sales representative agency for "job shop" companies that perform custom fabrication services. Our primary market is OEM's (Original Equipment Manufacturers) in San Diego County that utilize sub-contract manufacturing services.

We began losing customers and prospective customers in early 2001 because of the adverse business climate in Caifornia and the effects of the recession. We started keeping a record of the companies that moved out of state or had gone out of business since January 2001. This list evolved into an analytical report that I have been e publishing periodically since then in an effort to make key policy makers aware of the seriousness of the situation. This15th report provides an update on the state of various San Diego industry sectors, along with a focus on the effects of outsourcing offshore and California's competitiveness in the challenging global economy.

About the Author: Michele Nash-Hoff is President of ElectroFab Sales, an independent manufacturer's representative agency, which she founded in 1985. She is past president of the San Diego Electronics Network, the San Diego Chapter of the Electronics Representative Association, and The High Technology Foundation, as well as several other community and non-profit organizations. She was a candidate for San Diego City Council in 1996 and the California State Assembly in 2000. She has a B.A. from San Diego State University and later earned a certificate in Total Quality Management. Prior reports are accessible at Michele's website of www.electrofab.com