



Preparing For Trade Policy Disruption

Trade Wargaming



Retail Council of Canada
October 18, 2017

A.T. Kearney Ltd.

Agenda

- 1) Discuss potential scenarios resulting from NAFTA termination
- 2) Translate possible tariff increases into direct impact on cost of goods sold for Canadian retailers
- 3) Identify the indirect impact on overall economy, consumer spending and category share of wallet
- 4) Establish guidelines for retailer self-assessment and action

Together with RCC, A.T. Kearney assessed the impact of different scenarios on your business and your customers' spending behavior

Canada-US bilateral trade under NAFTA is the second-largest trading relationship in the world



2016 Canada-US bilateral goods trade was \$700 billion+¹

Tariff-free access to 94% of goods²

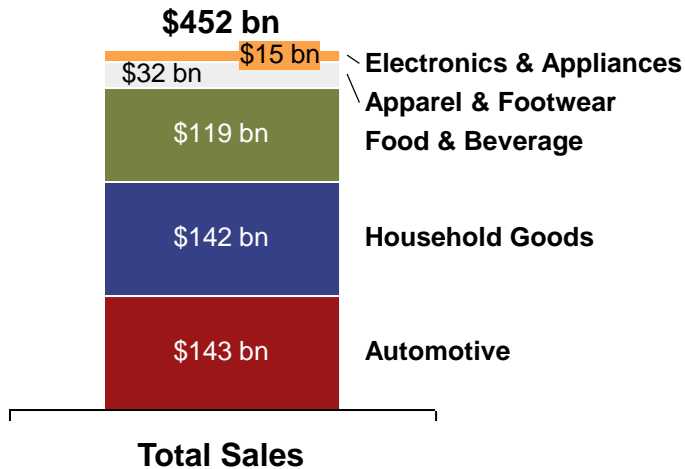
38% real increase in trade value since 1994³

2016 US trade deficit of \$16 billion with Canada was driven by cars, natural gas and softwood lumber exports⁴

1. US goods exports to Canada = \$365 bn and Canadian goods exports to USA = \$381 bn
2. Estimate based on tariff-free 6 digit HS code product lines
3. Adjusted for inflation
4. 2016 US trade deficit with China US\$347 bn; with Mexico US\$64 bn
Source: Office of the United States Trade Representative

Retail is a critical driver of the Canadian economy

2016 Canadian retailer sales (CAD\$ bn)



Retail sector employs 2.7 million+ Canadians or 12% of Canada's workforce

Fragmented - 20 largest retailers in Canada make up <50% of retail sales

Retail comprises 5% of Canada's GDP and is one of the chief drivers of the economy



The Retail Council of Canada partnered with A.T. Kearney to assess the impact of NAFTA termination on Canadian retail

Background

- Rising nationalism in United States and discontent in manufacturing states on job losses due to NAFTA
- Donald Trump promised to renegotiate a better deal for the United States or “terminate it”

Issues

- Trade deficits
- Rules of origin
- Labour and environment standards
- Government procurement
- Protected local industries
- Dispute Resolution

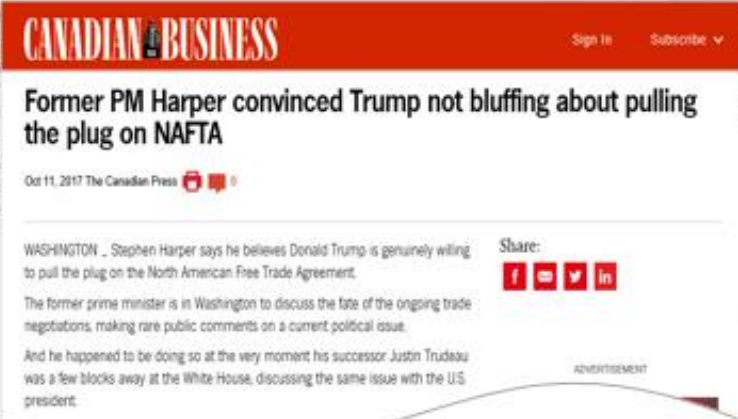
Timeline

- United States and Mexico want to conclude renegotiations by end of 2017 ahead of key elections in each country next year
- 4 rounds of renegotiations completed so far with no reported breakthroughs on contentious themes



Risks of NAFTA termination have increased and the outlook is very uncertain

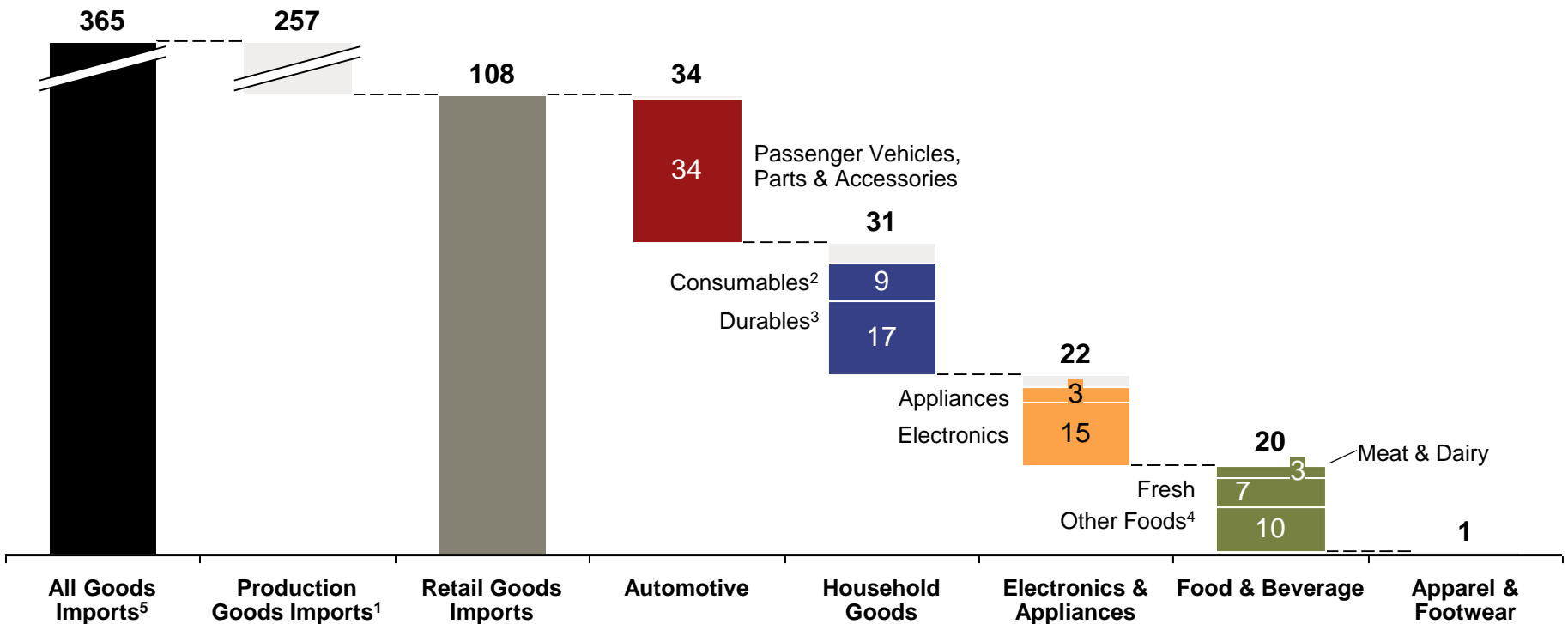
Recent press commentary



Retail goods imports from USA are worth ~\$108 bn and are concentrated in eight main sub-categories

Retail goods imports from USA (CAD \$ bn, 2015)

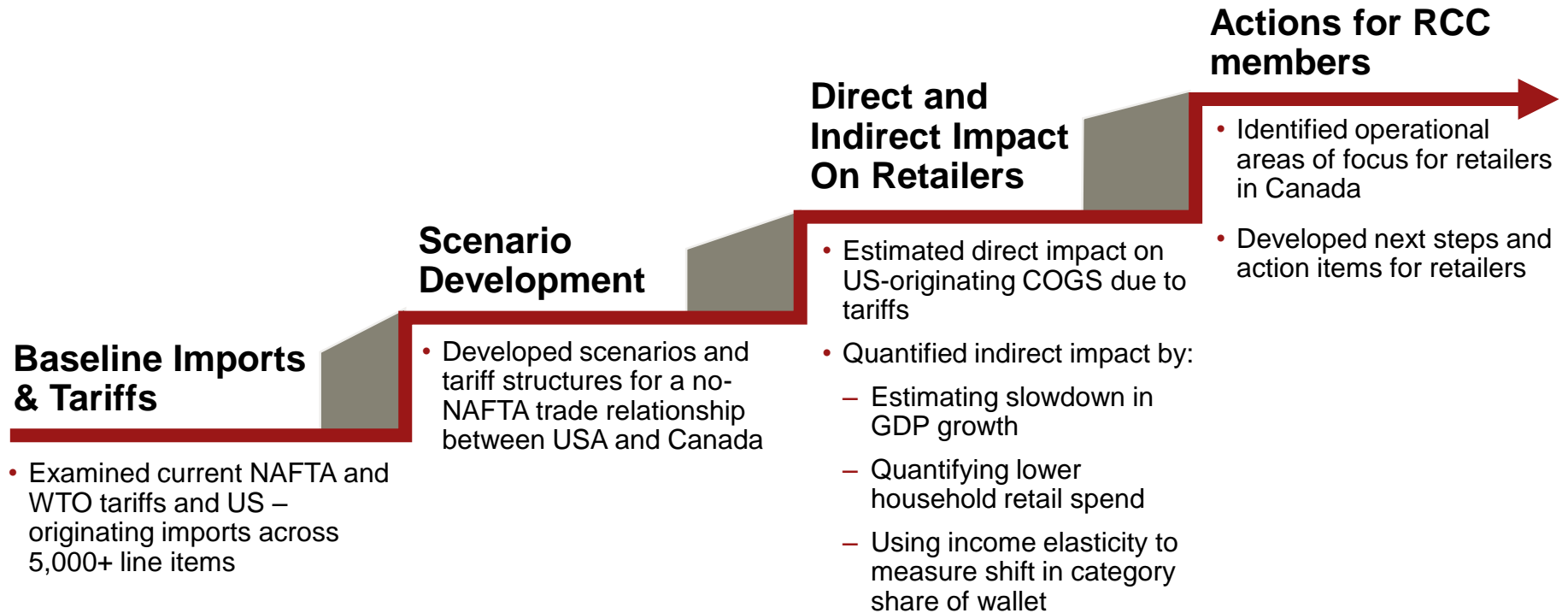
Detailed breakdown in Appendix



1. Production imports (~\$257 bn) e.g. machinery & equipment, commodities, chemicals, etc
 2. Household items with high purchase frequency e.g., soap, paper towels, toilet paper, toothpaste, garbage bags etc.
 3. Household items with low purchase frequency e.g., furniture, mattresses, drapes, linen etc.
 4. Other foods is comprised of baked goods, fish & shellfish, food oils, cereal, alcohol, etc.
 5. Canadian goods exports to the United States was \$381 bn leading to a trade deficit of \$16 bn; bilateral trade is worth \$746 bn (= \$365 bn + \$381 bn)
- Source: US Exports Data 2015, A.T. Kearney analysis

This assessment has quantified the impact on gross margins for retail in Canada through the lens of direct and indirect costs

Details of assessment



If NAFTA were terminated, there are three possible scenarios for Canada’s trade relationship with the United States

Scenarios overview

Most Likely



Scenario 1: Revert to Canada-US Free Trade Agreement (FTA)¹

- Canada and USA agree to their own bilateral free trade agreement similar to the current NAFTA agreement



Scenario 2: End of North American Free Trade

- Tariffs on US imports change to rates applied on other nations’ exports to Canada under World Trade Organization (WTO) rules

Extreme



Scenario 3: Protectionism Returns

- Rising nationalism and protectionism might see United States breaking with the WTO treaty and raise tariffs as they see fit, prompting Canadian retaliation in kind

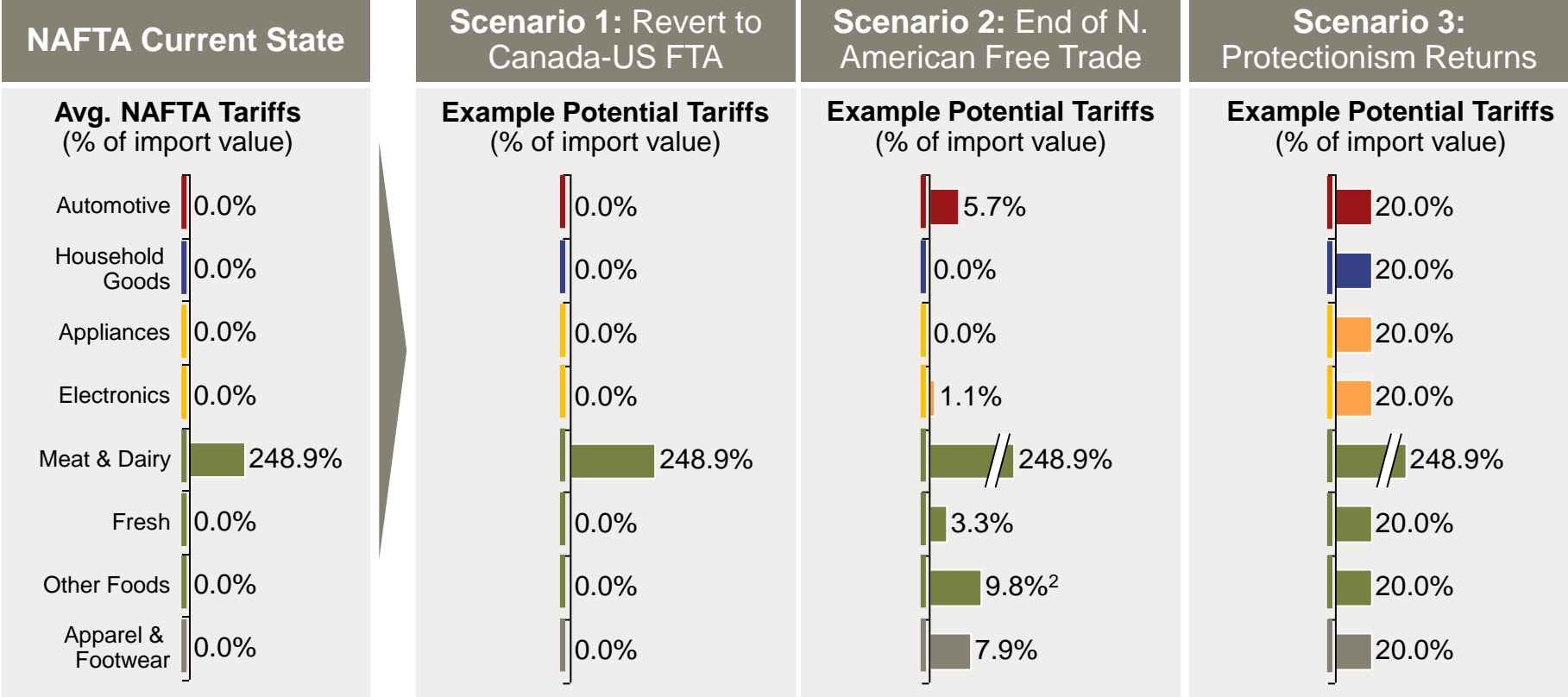
1. Canada-US Free Trade Agreement (CUFTA), preceded NAFTA and was effective 1989 – 1994; Scenario proposes a bilateral free-trade agreement at current tariff levels is agreed upon
Source: A.T. Kearney



The direct impact of different scenarios depends on the tariff increase in each sub-category

Overview of tariff scenarios

Sample Tariff Increase



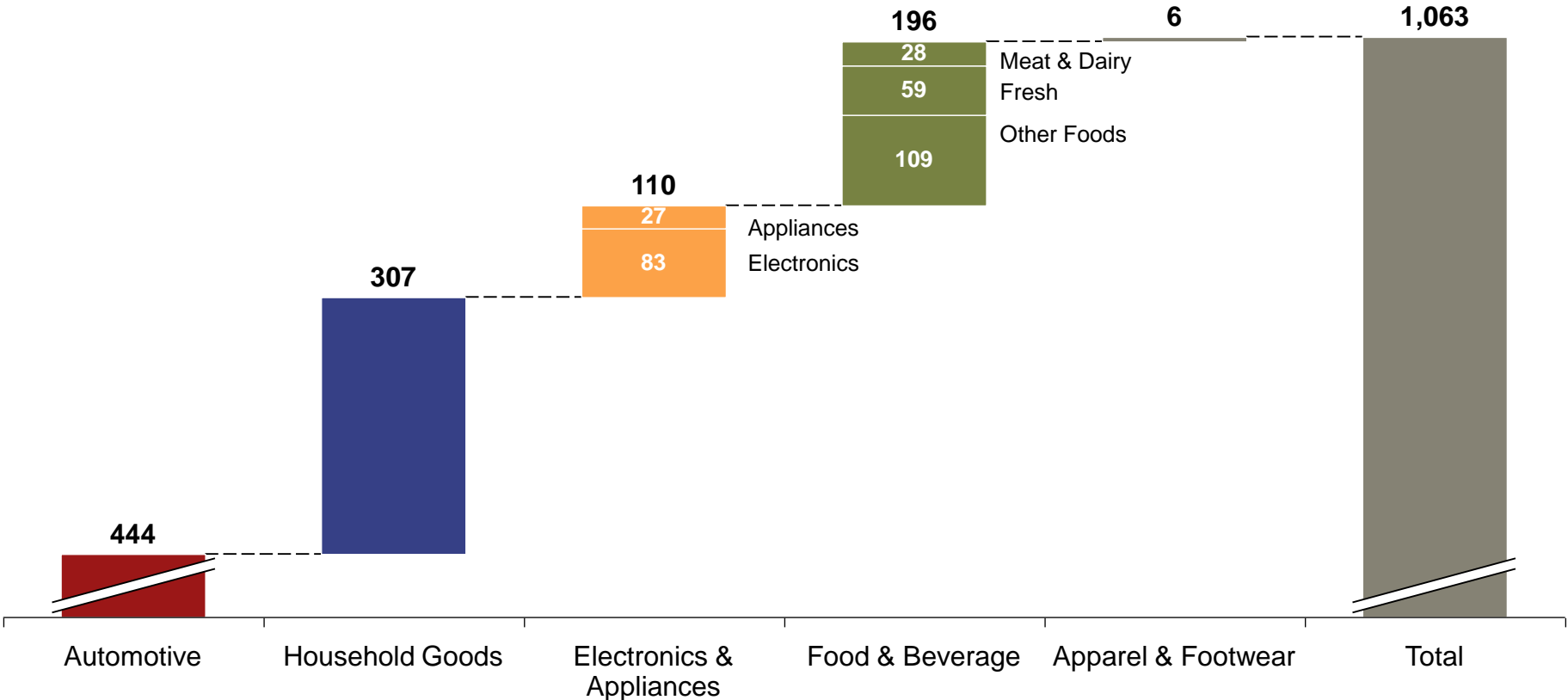
■ Automotive
 ■ Household Goods
 ■ Electronics & Appliances
 ■ Food & Beverage
 ■ Apparel & Footwear

1. Other foods is comprised of baked goods, fish & shellfish, food oils, cereal, alcohol, etc.
 2. This has been calculated as a weighted average of the avg. MFN applied duties for the following retail categories: Alcohol(3.8%), Baked Goods (0%), Cereals (20.5%), Fish & Shellfish (0.9%), Food Oils (3.8%), Other Foods (3.5% to 10.4%)
 3. Other NAFTA categories (non-retail) with MFN applied tariffs include petroleum (0.9%), chemicals (0.8%), transport equipment (5.7%), manufactures (2.5%) and wood, paper, etc. (0.9%)
 Source: A.T. Kearney



As a reference, every one percentage point increase in tariff rates increases 2019 COGS for retailers in Canada by ~\$1 bn

Incremental retail COGS due to 1 ppt increase in tariffs
(CAD\$ mn, nationwide)



Source: US Exports Data 2015, CBSA Tariff Schedule September 2017, A.T. Kearney analysis

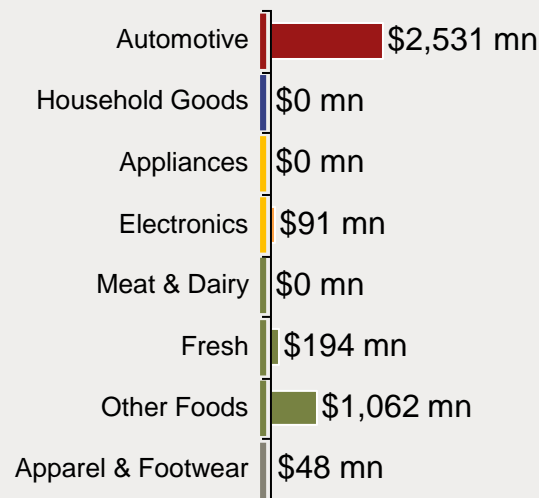
The direct impact of rising tariffs will be a ~\$4-20 bn increase in costs for retailers in Canada

Increase in US originating COGS (CAD\$ mn)

Scenario 1: Revert to Canada-US FTA

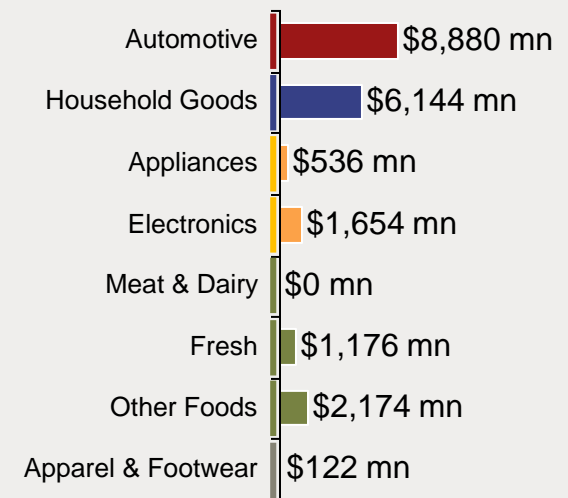
- Minimal long-term impact
- Uncertainty during transition period in case NAFTA renegotiation fails and new Canada-US FTA has to be agreed upon
- Little to no impact on current retailer supply chains and supplier relationships

Scenario 2: End of N. American Free Trade



- Cumulative impact of ~\$4 bn
- Automotive is most impacted, however, high tariffs threaten low margin categories such as Fresh and Other Foods

Scenario 3: Protectionism Returns



- Cumulative impact of ~\$21 bn
- With automotive and household goods importers most impacted, 5 of the 8 categories suffer \$1 bn+ in incremental COGS

There are also *indirect* impacts with the ‘flywheel’ effect of lower consumer spending and change in category share of wallet

Indirect impact of higher tariffs

(1) Canadian economy begins to slow down due to higher tariffs and reduced access to US market

(3) Reduced spending changes category share of wallet due to elasticity spend categories e.g., discretionary electronics more impacted than food

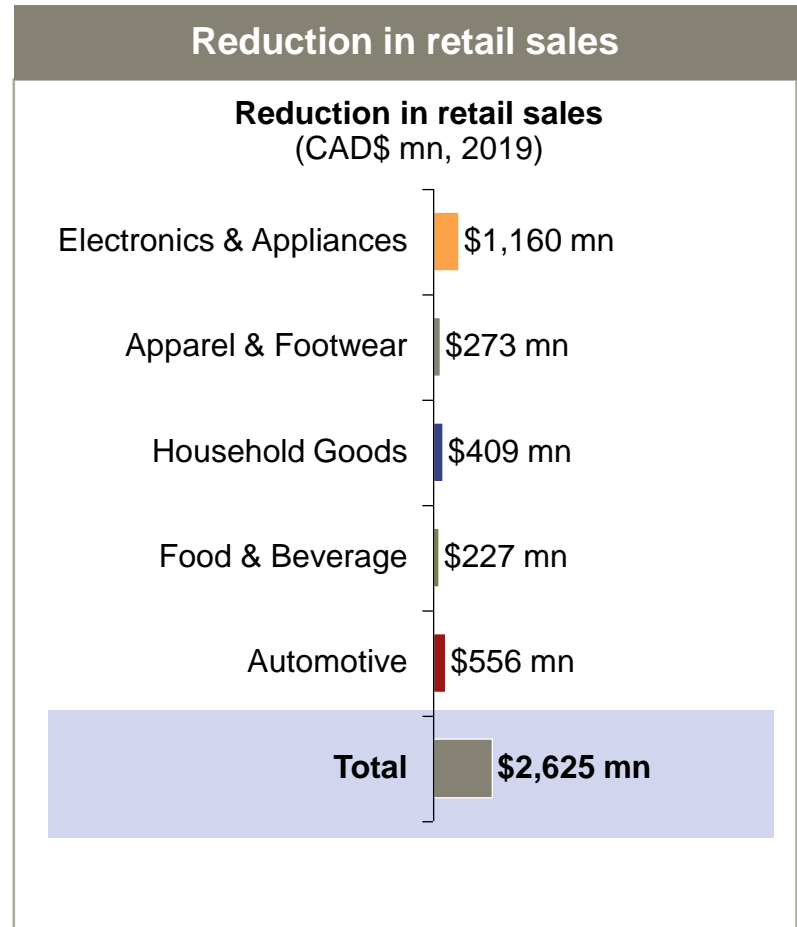
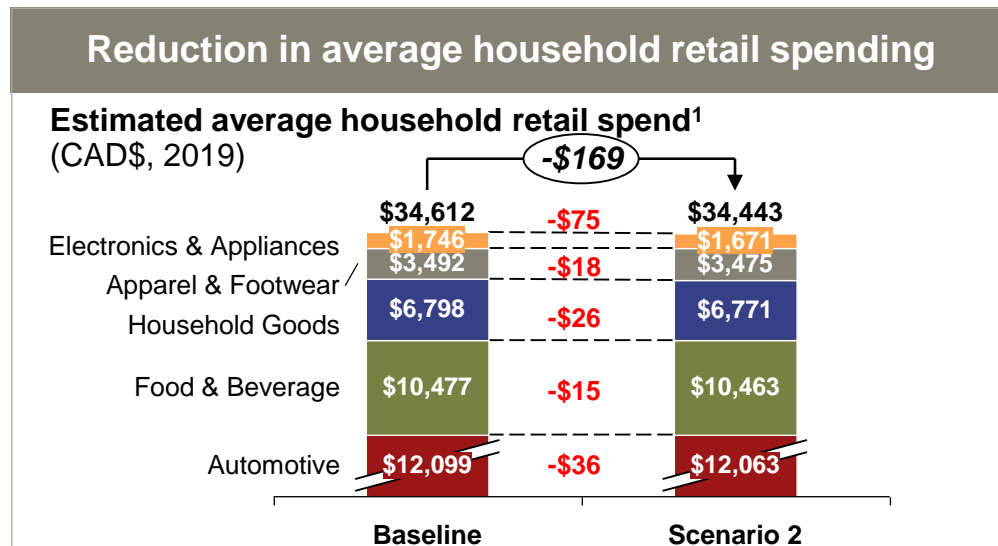
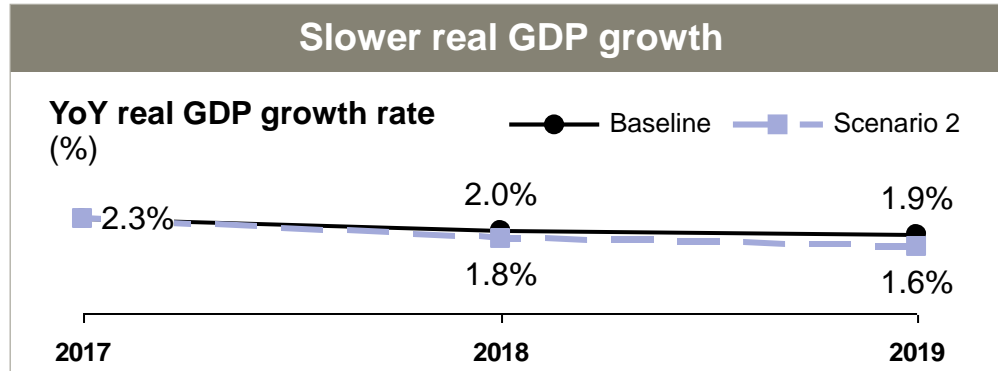


(2) Slower growth and higher tariffs translate to lower consumer spending because of lower disposable income and higher inflation

Scenario 2 Indirect Impact: GDP growth is 30 basis pts lower; ~\$170 drop in household spending; ~\$2.6 bn lower retail sales

Return of Canada-US free trade scenario

Preliminary

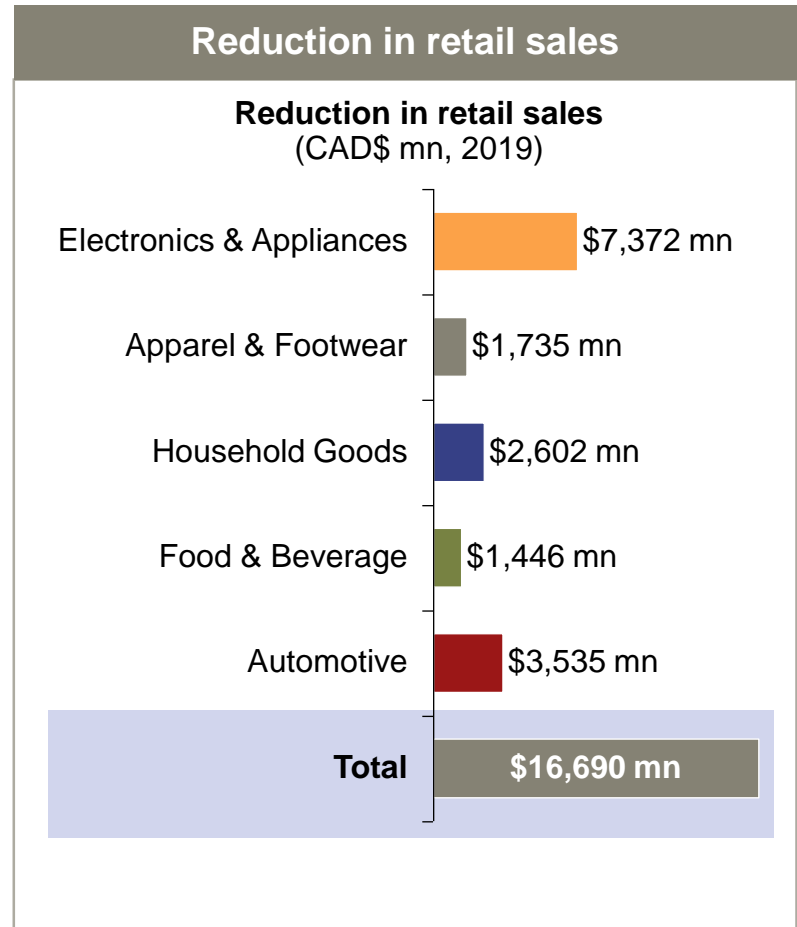
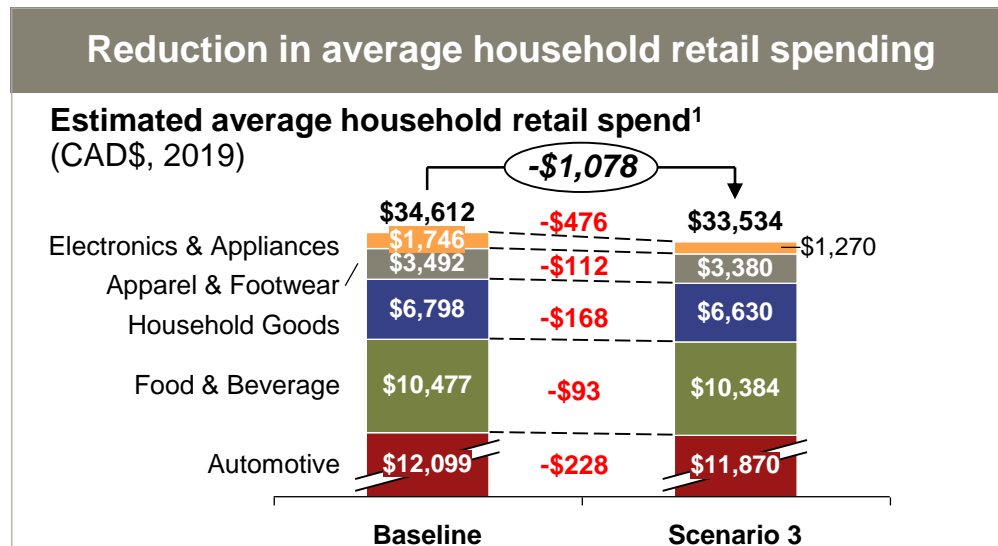
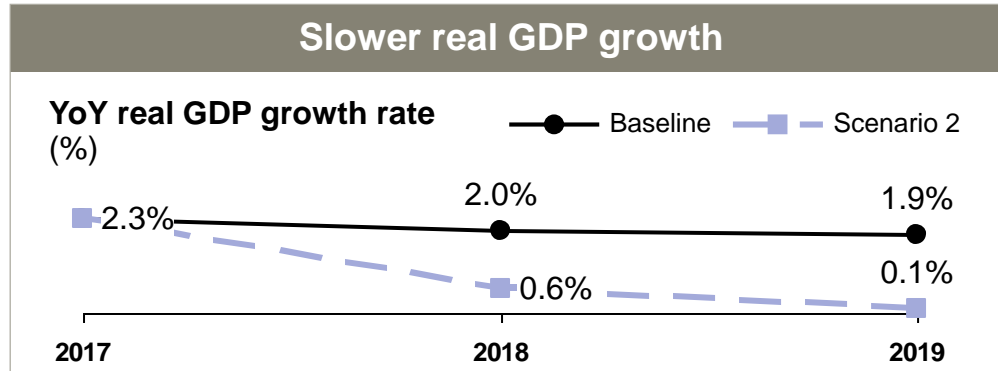


1. Based on USDA defined price elasticities of demand across expenditure categories for developed countries; data specific for Canada
 Source: A.T. Kearney analysis, Statistics Canada (Canadian household spend), Scotiabank (GDP reduction), World Bank (Baseline growth), USDA (elasticities)

Scenario 3 Indirect Impact: GDP growth is 180 basis pts lower; ~\$1,100 drop in household spending; ~\$17 bn lower retail sales

Protectionism returns scenario

Preliminary

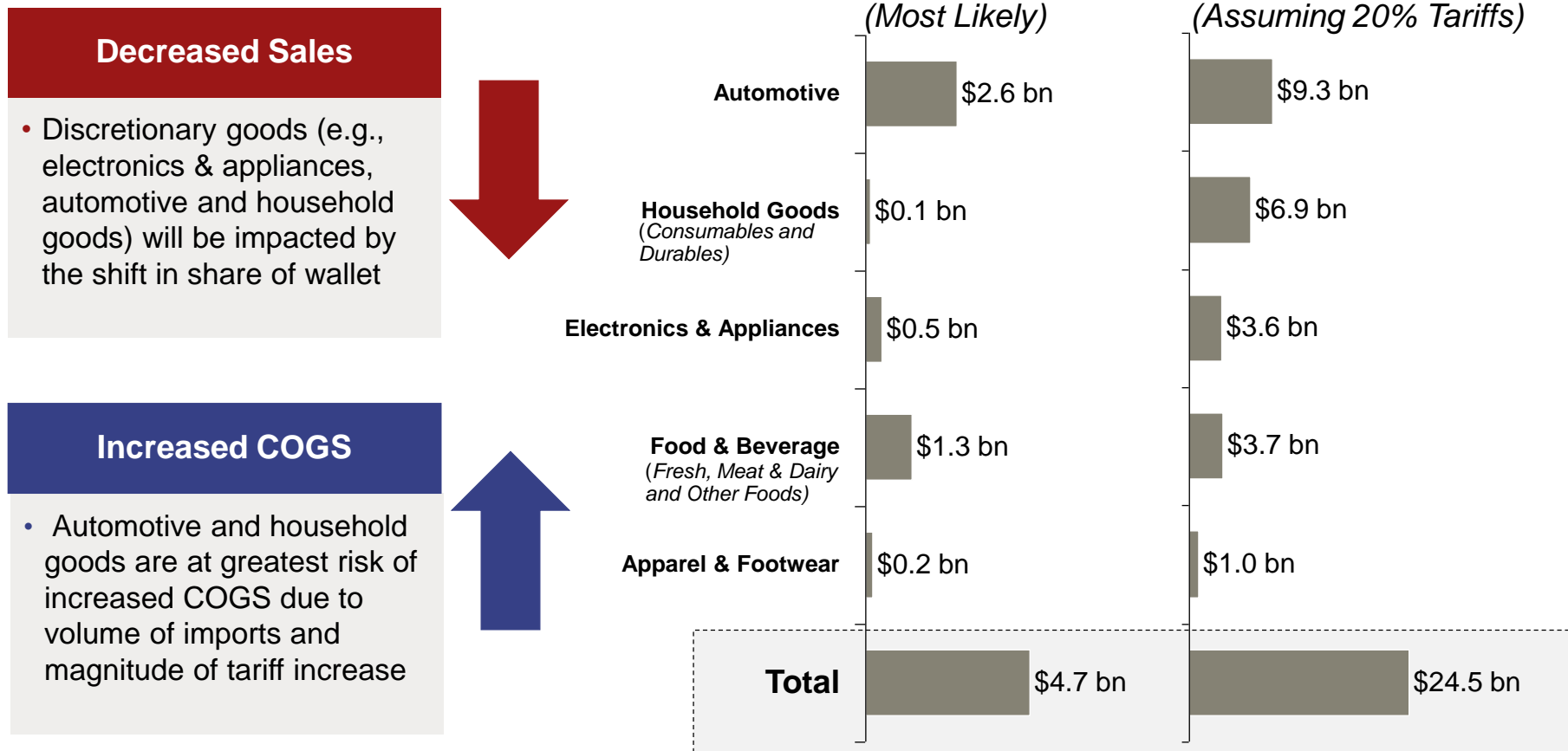


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 Source: A.T. Kearney analysis, Statistics Canada (Canadian household spend), Scotiabank (GDP reduction), World Bank (Baseline growth), USDA (elasticities)

Key Takeaway: The cumulative impact of Scenarios 2 and 3 is to potentially reduce gross margins in retail by ~\$5-25 bn

Reduction in baseline category gross margins (CAD\$ bn, 2019)

Preliminary



Gross margin impact for retailers will depend on their exposure to US-originating COGS and the scenario under consideration

Hypothetical impact calculator for “Diane’s General Store” (2019, Scenario 2)

Customized impact
available on request

	Sales (\$ mn)	COGS (\$ mn)	Current Gross Margin (\$ mn)	% COGS US-Originating	Gross Margin Impact (\$ mn)¹
Household Goods	\$3,750 mn	\$2,475 mn	\$1,275 mn	25%	-\$3.2 mn (-0.2%)
Apparel & Footwear	\$750 mn	\$533 mn	\$217 mn	15%	-\$7.8 mn ² (-3.6%)
Food & Beverage (Packaged)	\$500 mn	\$350 mn	\$150 mn	80%	-\$27.7 mn (-19%)
	\$5,000 mn	\$3,358 mn	\$1,642 mn	29%	-\$38.7 mn (-2.4%)

1. Gross Margin Impact = [Current GM * % Nationwide Sales Decrease] + [Current COGS * % US-sourced*(1-% Nationwide Sales Decrease)*Tariff Rate Increase]

2. Example: In Scenario 2, % decrease in nationwide apparel sales is 0.7% and tariff increase is 7.9%; Therefore GM impact = [\$217 mn * 0.007]+[\$533 mn*0.15*0.993*0.079] = \$7.8 mn

3. National sales decrease is measured as reduction in retail sales under scenario as a proportion of national retail sales in that category

These scenarios have the potential to impact retailers in Canada in three major areas

Profitability

- Higher tariffs and reduced sales will impact bottom-line of retailers unless costs are passed onto customers or cost reduction is achieved
- Smaller retailers with greater exposure to US-originating imports are disproportionately impacted



Supply Chain

- Tighter rules of origin on embedded content may prompt companies to buy outside of NAFTA suppliers
- This may necessitate re-working of complex supply chains and re-design of distribution networks



Organization

- Organizational capabilities on trade compliance, sourcing and supply chain will need to be enhanced
- Retailers may need enhanced capabilities to analyze bill of materials and product classifications to assess origins and tariff impacts



What are next steps for a retailer?



Step 1: Understand risk exposure

- Quantify potential impact to internal and competitor COGS under different scenarios
- Primary factors to consider are category COGS spend, proportion of imports from the United States and Mexico and current versus future tariff structure



Step 2: Outline potential response

- Frame options to respond to different scenarios (pass-through of costs to consumer, internal cost improvement to off-set increases, explore alternative sources of supply outside the USA, etc.)
- Response should factor potential impact vis-à-vis competitor response



Step 3: Join with the RCC in making an impact

- Be an active voice with government and the media to advocate for retail in Canada
- Participate in upcoming discussions to share real impact on your company and your customers
- Be prepared to share confidential data with government to demonstrate impact

Appendix

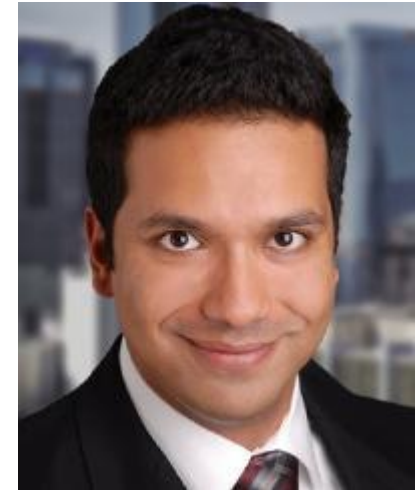
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Key Assumptions – Calculation Inputs

Spend as a % of GDP	
2015 Canada Real GDP (CAD)	\$2,018,649,947,620
2015 Population of Canada	35,848,610
2015 Real GDP per capita	\$56,310.41
2016 Average people per household	2.4
2015 Average GDP per Canadian household	\$135,144.99
2015 Average Household Spend	\$60,516
2015 Avg Household Spend as a % of Avg Household GDP	45%

Sources / Methodology
1990 - 2016 Canadian GDP (World Bank)
1990 - 2016 Canadian Population Estimates (World Bank)
Calculated using current year GDP / current year population estimates
2016 Census - Avg. Household Size (Statistics Canada)
Calculated using 2015 GDP per capita * 2016 avg people per household
2015 Distribution of Avg Household Spend (Statistics Canada)
Calculated by taking 2015 Avg Household Spend / 2015 Avg GDP per Canadian household

- Derived Avg. Household spend as a % of GDP as a way of deriving spend for 2017 through 2019 given GDP growth projections

Current State		
2016 Canada Real GDP (CAD)	\$2,027,729,657,383	1990 - 2016 Canadian GDP (World Bank) 2016 Exchange Rate (Canadian Forex)
2016 Average people per household	2.4	2016 Census - Avg. Household Size (Statistics Canada)

- 2016 GDP used as base for GDP projections
- Avg household size used to determine avg. GDP per household

Calculating Avg Household Retail Spend as a % of Total Avg. Household Retail Spend		
Revised Categories	% of Total Average Spend	Source
Household Goods	10.9%	2015 Distribution of Avg Household Spend (Statistics Canada)
Apparel & Footwear	5.6%	
Electronics & Other	2.8%	
Food & Beverage	16.8%	
Automotive	19.4%	
Total	55.50%	

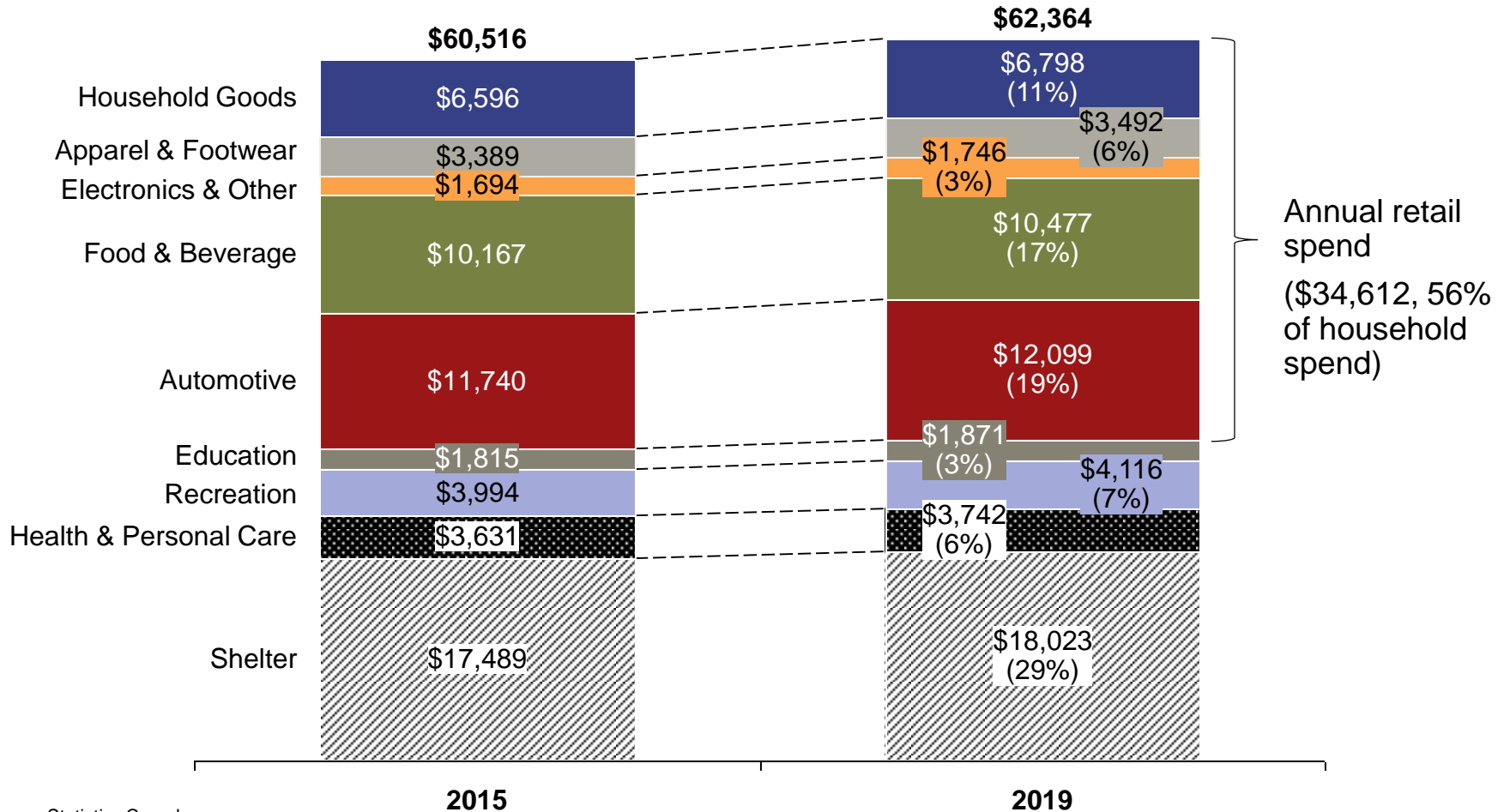


% of Retail Household Spend	
Household Goods	20%
Apparel & Footwear	10%
Food & Beverage	30%
Automotive	35%
Electronics & Other	5%
Total Retail Portion of Avg. Household Spend	100.0%

- Used to determine what % of avg. household spend is attributed to retail categories
- Used to determine the distribution of baseline retail avg. household spend across retail categories

Retail spend represent 56% of average household spend

Comparison of Average Household Spend (\$CAD)



Price Elasticities: Determining Distribution of 1 unit reduction in spend

Distribution of 1 unit of spend across all categories

	Baseline (distribution of \$1)	Sources
Food & Beverage	0.05	2010 Price Elasticities Report (USDA)
Apparel & Footwear	0.06	
Gross rent, fuel & power	0.20	
Household Goods	0.09	
Medical Care	0.12	
Education	0.08	
Transport & Communication	0.15	
Other - Discretionary	0.26	
Total Reduction per Year	1.00	

Distribution of 1 unit of spend across retail categories

Retail Related Portion of Incremental Unit	
0.58	
% of Transport vs Com.	Source
84%	Transportation Sub-Categories (Statistics Canada)

	Baseline (distribution of \$1)
Food & Beverage	0.09
Apparel & Footwear	0.10
Household Goods	0.16
Automotive	0.21
Electronics & Appliances	0.44
Total	1.00

Methodology

- Took distribution of one unit of spend based on price elasticities across all categories
- Focusing on retail, identified distribution of 1 unit of retail-specific spend across retail relevant categories
- For transportation, divided percentage to only include retail relevant subcategories like vehicle and auto part purchases

Sample line items with high tariff rates under NAFTA

Selection of High Tariff Items

Selection

Meat & Dairy

HS Code	MFN Tariff	Description of Goods
40610	245.5% but not less than \$4.52/kg	(0406.10.20) Cheese and curd. - Fresh (unripen or uncured) cheese, including whey cheese, and curd
40640	245.5% but not less than \$5.33/kg	(0406.40.20) Cheese and curd. - Blue-veined cheese and other cheese containing veins produced by Penicillium roqueforti
40721	163.5% but not less than 79.9¢/dozen	(0407.21.20) Birds' eggs, in shell, fresh, preserved or cooked. - Other fresh eggs: - Of fowls of the species Gallus domesticus
160100	154.50%	(1601.00.32) Sausages and similar products, of meat, meat offal or blood; food preparations based on these products. - Of turkeys, other than in cans or glass jars

Other Foods

HS Code	MFN Tariff	Description of Goods
210690	212% but not less than \$2.11/kg	(2106.90.32) Food preparations not elsewhere specified - Milk, cream or butter substitutes, containing 50% or more by weight of dairy content
210690	212% but not less than \$2.11/kg	(2106.90.34) Food preparations not elsewhere specified or included - Preparations, containing more than 15% by weight of milk fat but less than 50% by weight of dairy content, suitable for use as butter substitutes
210690	\$1.45/kg	(2106.90.52) Food preparations not elsewhere specified or included - Egg preparations
210690	274.5% but not less than \$2.88/kg	(2106.90.94) Food preparations not elsewhere specified or included - Containing 50% or more by weight of dairy content

Baked Goods

HS Code	MFN Tariff	Description of Goods
180690	265% but not less than \$1.15/kg	(1806.90.12) Chocolate and other food preparations containing cocoa - Chocolate ice cream mix or ice milk mix

Food Oils

HS Code	MFN Tariff	Description of Goods
151790	218% but not less than \$2.47/kg	(1517.90.22) Margarine; edible mixtures or preparations of animal or vegetable fats or oils - Substitutes for butter

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Details of other categories that make up retail relevant and non-retail relevant imports

Retail	
End-Use Code	U.S. Exports to Canada Value 2015 (\$CAD, K)
(30000) Passenger cars, new and used	\$18,601,504
(41050) Cell phones and other household goods, n.e.c.	\$6,038,436
(21300) Computers	\$5,310,705
(40120) Toiletries and cosmetics	\$4,568,646
(41120) Toys, games, and sporting goods	\$4,547,209
(21301) Computer accessories	\$3,902,473
(40140) Other consumer nondurables	\$3,737,109
(41030) Household appliances	\$3,432,572
(40000) Apparel, household goods - textile	\$3,059,063
(41000) Furniture, household goods, etc.	\$2,959,272
(40110) Books, printed matter	\$2,727,231
(12270) Precious metals, other	\$1,714,401
(40030) Apparel, household goods-nontextile	\$1,600,430
(12260) Nonmonetary gold	\$1,487,681
(41310) Jewelry, etc.	\$1,183,407
(41200) Televisions and video equipment	\$1,054,635
(41220) Recorded media	\$968,358
(00370) Wine, beer, and related products	\$817,237
(41110) Pleasure boats and motors	\$815,325

Retail	
End-Use Code	U.S. Exports to Canada Value 2015 (\$CAD, K)
(41210) Stereo equipment, etc.	\$802,786
(41040) Rugs	\$793,399
(41020) Cookware, cutlery, tools	\$641,510
(40130) Tobacco, manufactured	\$632,353
(41140) Musical instruments	\$521,167
(12640) Finished textile supplies	\$492,181
(01010) Alcoholic beverages, excluding wine	\$332,131
(41010) Glassware, chinaware	\$303,784
(41320) Artwork, antiques, stamps, etc.	\$296,695
(42100) Gem diamonds	\$288,887
(40050) Sports apparel and gear	\$258,487
(12650) Leather and furs	\$44,184
(41300) Numismatic coins	\$35,265

Details of other categories that make up retail relevant and non-retail relevant imports (cont.)

Not Retail	
End-Use Code	U.S. Exports to Canada Value 2015 (\$CAD, K)
(30100) Trucks, buses and special purpose vehicles	\$17,657,946
(21180) Industrial machines, other	\$13,088,340
(11120) Petroleum products, other	\$10,997,073
(22090) Civilian aircraft, engines, equipment, and parts	\$10,814,007
(11100) Crude oil	\$9,590,289
(20005) Electric apparatus	\$8,734,149
(60000) Minimum value shipments	\$8,480,761
(12500) Plastic materials	\$7,855,692
(12770) Other industrial supplies	\$7,648,761
(21100) Industrial engines	\$7,272,554
(30200) Engines and engine parts (carburetors, pistons, rings, and valves)	\$6,893,868
(12300) Finished metal shapes	\$6,597,928
(21400) Telecommunications equipment	\$6,113,936
(12550) Chemicals-other	\$6,071,103
(40100) Pharmaceutical preparations	\$5,914,099
(12100) Iron and steel mill products	\$5,343,748
(21170) Materials handling equipment	\$5,207,212
(21030) Excavating machinery	\$5,177,935
(12430) Newsprint	\$4,614,515

Not Retail	
End-Use Code	U.S. Exports to Canada Value 2015 (\$CAD, K)
(21160) Measuring, testing, control instruments	\$4,330,465
(12540) Chemicals-organic	\$3,945,715
(21610) Medicinal equipment	\$3,769,571
(21190) Photo, service industry machinery	\$3,599,226
(20000) Generators, accessories	\$3,273,754
(21200) Agricultural machinery, equipment	\$3,270,150
(13210) Shingles, molding, wallboard	\$3,168,086
(12510) Chemicals-fertilizers	\$2,965,234
(11200) Gas-natural	\$2,899,192
(21320) Semiconductors	\$2,864,722
(12110) Iron and steel products, other	\$2,819,135
(12200) Aluminum and alumina	\$2,650,814
(11110) Fuel oil	\$2,379,096
(12530) Chemicals-inorganic	\$1,907,476
(21120) Metalworking machine tools	\$1,848,500
(12750) Industrial rubber products	\$1,752,391
(21500) Business machines and equipment	\$1,743,182
(11130) Natural gas liquids	\$1,649,250
(00220) Animal feeds, n.e.c.	\$1,640,087

Details of other categories that make up retail relevant and non-retail relevant imports (cont.)

Not Retail	
End-Use Code	U.S. Exports to Canada Value 2015 (\$CAD, K)
(22100) Railway transportation equipment	\$1,598,709
(13100) Logs and lumber	\$1,530,396
(11020) Coal and fuels, other	\$1,488,752
(12000) Steelmaking materials	\$1,227,710
(12620) Manmade cloth	\$1,195,449
(12290) Nonferrous metals, other	\$1,165,423
(12760) Mineral supplies-manufactured	\$1,085,133
(12210) Copper	\$1,072,739
(21600) Laboratory testing instruments	\$1,067,508
(21140) Wood, glass, plastic	\$1,061,633
(21110) Food, tobacco machinery	\$1,026,579
(13110) Wood supplies, manufactured	\$982,006
(21000) Drilling & oilfield equipment	\$888,555
(60010) Miscellaneous domestic exports and special transactions	\$867,711
(13200) Glass-plate, sheet, etc.	\$774,812
(12700) Synthetic rubber-primary	\$774,259
(10150) Agriculture-manufactured, other	\$741,696
(10140) Agric. farming-unmanufactured	\$666,437
(10130) Agric. industry-unmanufactured	\$634,980

Not Retail	
End-Use Code	U.S. Exports to Canada Value 2015 (\$CAD, K)
(11010) Metallurgical grade coal	\$627,281
(21150) Pulp and paper machinery	\$587,116
(12420) Pulpwood and woodpulp	\$478,361
(21040) Nonfarm tractors and parts	\$392,687
(22220) Marine engines, parts	\$360,097
(13220) Nontextile floor tiles	\$333,289
(11400) Electric energy	\$313,466
(42000) Nursery stock, etc.	\$279,724
(21130) Textile, sewing machines	\$255,381
(50050) Tanks, artillery, missiles, rockets, guns and ammunition	\$237,488
(12720) Nonmetallic minerals	\$232,588
(21010) Specialized mining	\$232,051
(10120) Hides and skins	\$214,539
(50070) Parts for military-type goods	\$158,465
(12630) Hair, waste materials	\$133,305
(12600) Cotton fiber cloth	\$132,964
(11300) Nuclear fuel materials	\$110,756
(50030) Military trucks, armored vehicles, etc.	\$58,091
(22210) Commercial vessels, other	\$56,610

Details of other categories that make up retail relevant and non-retail relevant imports (cont.)

Not Retail	
End-Use Code	U.S. Exports to Canada Value 2015 (\$CAD, K)
(22200) Vessels, excluding scrap	\$34,748
(10100) Tobacco, unmanufactured	\$24,346
(12765) Tapes, audio and visual	\$18,130
(50010) Aircraft launching gear, parachutes, etc.	\$6,575
(30210) Bodies and chassis for passenger cars	\$3,428
(10000) Cotton, raw	\$941
(22300) Spacecraft, excluding military	\$36
(50060) Military apparel and footwear	\$20
(50020) Engines and turbines for military aircraft	\$8
(50000) Military aircraft, complete	\$0
(60040) Undocumented exports to Canada	\$0

Mixed	
End-Use Code	U.S. Exports to Canada Value 2015 (\$CAD, K)
(30230) Other parts and accessories of vehicles	\$29,150,131
(00360) Other foods	\$6,450,943
(00320) Fruits, frozen juices	\$5,084,707
(00330) Vegetables	\$4,265,504
(00350) Bakery products	\$3,947,822
(00300) Meat, poultry, etc.	\$3,286,498
(30220) Automotive tires and tubes	\$2,094,444
(01000) Fish and shellfish	\$1,526,871
(00340) Nuts	\$1,199,424
(00110) Oilseeds, food oils	\$769,506
(00310) Dairy products and eggs	\$541,081
(00200) Corn	\$451,693
(00010) Rice	\$277,211
(01020) Nonagricultural foods, etc.	\$154,005
(00100) Soybeans	\$121,944
(00000) Wheat	\$93,406
(00210) Sorghum, barley, oats	\$45,083

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