New Approaches To Contract Manufacturing Open Doors For Manufacturers

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As global economic activity continues, there’s a slow but steady rebound, as more and more manufacturers are turning to contract manufacturing. According to our recent study, “Flexibility is the Key to Growth: Accenture Global Manufacturing Study 2013,” a large majority (76 percent) of original equipment manufacturers plan to increase their use of contract manufacturing in the coming year.

Although many global manufacturers may have a limited view of contract manufacturing, seeing it as a safety valve to handle the pressures of excess demand, manufacturing leaders identified in the Accenture study are outperforming their peers and making contract manufacturing a core part of their long-term strategy. They recognize the many benefits that can be derived from using contract manufacturing as part of their overall production strategy. These benefits can be particularly important in an economic environment characterized by rising customer expectations, growing complexity, and ever-increasing volatility.

The basic parameters of contract manufacturing have not changed. A contract manufacturer is a company that manufactures (and may design, prototype and/or distribute) finished products under the name of the original equipment manufacturer or OEM. Contract manufacturers typically provide production plants,

processes and production labor, but they typically are not involved in the product design. What has changed is that more recently we have seen the emergence of the original design manufacturer (ODM), a company which designs and manufactures a product which is specified and eventually branded by another firm for sale. The ODM can allow the brand firm to produce without having to engage in the organization or running of a factory.

What has changed – drastically – is the range of benefits that contract manufacturers and ODMs can provide to the OEM. These include:
Cost Reduction. Contract manufacturers can help lower direct and indirect labor costs, as well as some overhead costs related to establishing facilities, buying and maintaining equipment, and distribution logistics. By aggregating demand and centralizing purchases, contract manufacturers can realize some significant savings on materials; and, by focusing on specific industry areas, they can establish and maintain a high-quality IT infrastructure.

Increased Flexibility. The provision extra capacity during peak production periods is one of the most well-known benefits delivered by contract manufacturers. These manufacturers, however, can also provide flexible manufacturing models to meet varied customer demand segments. Production costs become more variable depending not just upon the volume of demand, but also upon the type of products ordered.

Faster Time to Market. Many companies, frustrated by slow growth (or no growth) in their home markets, seek to enter emerging markets with higher growth rates. Contract manufacturing can make it easier to offer new products in new markets and to transfer experience with one product in one market into another market. Many contract manufacturers offer reference design models and product design support, along with a readily available supply base and an established presence in the desired market.

Global Reach. Contract manufacturers have already established near-shore and off-shore production facilities. They likely have knowledge of local government policies and have already gone through the legal and regulatory procedures needed to begin operations. With facilities in place, they may be in a position to offer value-added services such as reverse logistics and distribution.

Focus of Core Competencies. Many companies see manufacturing as a necessary competency, not as a core competency. They tend to focus their energies on research, development, design and marketing, and leave non-core production activities to others. Contract manufacturers can free up resources to allow OEMs to concentrate on the areas that matter most to them and to their customers.

Unfortunately, many manufacturing companies fail to take full advantage of these benefits. They deal with contract manufacturers as they do with other vendors, possibly making many decisions on the basis of cost without exploring the possibilities offered by a more collaborative relationship with the contract manufacturer. We have found that a more strategic approach to contract manufacturing can significantly enhance operational flexibility while reducing the

substantial costs associated with building or buying new facilities and investing in new equipment and personnel.

This approach involves five key steps.

1. The manufacturer would conduct a cross-functional analysis to determine which capabilities should be kept in-house or outsourced. Leading companies identify a capability as “core” if it offers a competitive advantage. Core capabilities, typically, are difficult for competitors to imitate, and they provide differentiation that is highly valued by customers. All capabilities not meeting these criteria can be considered “non-core.”

The manufacturer then completes a “make versus buy” analysis of non-core capabilities. Those that can be produced at lower cost or more effectively by external resources are candidates for outsourcing.

2. The next step is to determine how to partner with a contract manufacturer. It is important for OEMs to decide in advance upon the type of relationship they want to have with their manufacturing partners. Do they desire a highly strategic, collaborative partnership in which the manufacturing partner may bring new capabilities to the table, or even co-invest in a product? Or do they desire a more transactional relationship in which the partner is focused on supplying a “standard” product at the lowest cost of ownership?

OEMs should also think about the level of control they want to exert on these relationships, and what kind of resources they have to manage the day-to-day aspects of production. One company may want to be intimately involved in all aspects of the relationship and have deep visibility into where things stand at any given point in the supply chain. Another company may prefer a “hands-off” approach in which it is expected that the parts or materials will be available when they are needed. Others might be comfortable somewhere in the middle.

3. The third step is to conduct a capability scan of manufacturing partners, based upon their capabilities, assets, locations, and value provided to the OEM’s manufacturing network. Targeted capability areas may include design skills, manufacturing locations, manufacturing models, IT infrastructure, relationships with local authorities, production planning, materials management, productions scheduling and execution, and logistics and/or fulfillment capabilities.

The capabilities are analyzed using a scorecard, and a business case is developed using desired capabilities as they measure up against potential partners under consideration. The business case also helps identify value targets to track initial and ongoing efficacy of outsourced operations.

4. Once the evaluation is completed, negotiation of outsourcing agreements with the chosen partner can begin. This involves establishing a contract with the partner. Best-in-class companies invest time and resources to consider more than time and materials when formulating and negotiating their manufacturing partner agreements to fulfill a strategic need. Some keys to successful negotiations involve

understanding the manufacturing partner's cost structure, risk profile, limits of liability and profit generation centers. During the negotiation process, a contingency plan is also developed and business case assumptions are updated.

5. With the contract in place, the final step is to set up and maintain the outsourced operation. The OEM should have the right people, processes, and tools in place to help ensure partners are delivering what they have committed to deliver, and that potential issues can be identified and addressed well before they become problems.

Contract manufacturing can be an effective way for companies to extend capacity and add flexibility to their production network. These are critical benefits in a highly volatile business environment. Contract manufacturing can, however, provide much more. A properly executed agreement with a contract manufacturer can provide access to processes or intellectual property rights that can speed production runs or, in some cases, improve the product itself.

Contract manufacturing can also open strategic doors for OEMs, helping them gain entry to new markets or meet rapidly changing customer demands. Companies with a clear understanding of how they want to go to market can gain important competitive advantages by choosing the right contract manufacturing partner.

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