"SURVIVAL STRATEGY" FOR THE ORIGINAL PRODUCT MANUFACTURER IN DEALING WITH CONTRACT MANUFACTURERS

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ABSTRACT

Contract manufacturing has become a popular strategy by which the Original Product Manufacturer (OPM) is able to fill excess orders which are beyond his normal factory capacity. This strategy is very useful to enable the (OPM) to satisfy and retain his customers. However, engaging a Contract Manufacturer (CM) to provide the best of services to the original product manufacturer can be a hazardous business. This kind of contract engagement has recorded good measure of successes as well as numerous failures and betrayals. The breach ranges from inability of the contract manufacturer to perform adequately to wholesale take-over of the product brand by the contract manufacturer. It is therefore advisable that the original product manufacturer should be cautious in revealing his top business secrets, core competencies and intellectual property to the contract manufacturer. As much as possible, the production contract should be in writing and must be made to cover all possible eventualities. Under thoroughly-framed contract agreement, contract manufacturers have been found to stay on course if they realize that a breach or betrayal will tell adversely on them.
Key words: Manufacturing, Contracting, Intellectual Property, Betrayal, Profit

INTRODUCTION

Every manufacturer of products, equipment or fixtures and fittings at sometime makes use of contract manufacturer to help produce the finished goods. The outstanding advantages are that contract manufacturing cuts down the Original Contract Manufacturer's costs and frees up capital of the company for alternative uses. But dishonesty is today creeping into this "symbiotic business alliance." Contract manufacturers are beginning to bite the finger that feeds them. What should the Original Product Manufacturer (OPM) do when the Contract Manufacturer (CM) betrays this business trust and goes on to compete with the original product manufacturer on the same product brands and in the same market. The original product manufacturer survives by following strategies designed to shield him from apparent dangers.

WHAT IS CONTRACT MANUFACTURING

Contract manufacturing is a special manufacturing arrangement in which the original manufacturer of a product or machinery contracts out (out-sources) the production of a product or products to an outside agent manufacturer. That outside may be an individual or another organization that has the expertise to produce that product.

REASONS FOR CONTRACT MANUFACTURING

There are many reasons that could force the original producer of a product to contract out the production of a product brand or range of brands to an outside producer on contract basis. Some of these reasons are discussed below:

1. Low cost to the original product manufacturer: In most cases, the original product manufacturer enjoys low cost under contract manufacturing arrangement. This is due to the fact that the contract manufacturer may have special expertise, idle installation, adequate labourforce and cheap raw material he will use in the execution of the contract job. In this scenario, the contract manufacturer will charge a cost that is lower than what the original product manufacturer will spend if he decides to produce the product himself. A good example is where a tomato plantation farmer agrees to prepare first-level tomato crushing in containers for a tomato puree factory.

2. Free capital available to the original product manufacturer: When the original product manufacturer gives out manufacturing non contract basis, he preserves his capital and can use it for other businesses before it is time to pay the contract manufacturer upon the execution of the production contract.

3. Too many orders to fill: When a producer of a product receives too many orders from his customers to supply the product, he may decide to give out a part of the production on contract for two reasons. First, he will not like to disappoint his customers by not filling the orders on time. Second, chances are that he could be gaining something too from the contract business since, in a situation of high demand for a product, a producer can push up his price a little without serious complaints from his customers, while maintaining the same production cost for his contract manufacturer.

4. Beating trade barriers: In international trading, a home manufacturer can contract out the production of a particular product to a manufacturer in a foreign land. This is more applicable to hardware products. This practice will save the home producer the problems associated with international business which include; language barrier, foreign exchange, cultural and labour management issues. Generally, outsourcing the entire manufacturing of a product allows the original product manufacturer to reduce labour costs, free up capital, and improve workers productivity. The original product manufacturer can then concentrate on the things that most enhance a product value, such as, research and development, design improvement and marketing. Facilitating these gains are the contract manufacturer's special strengths, which may include location in a low-wage region, gaining economies of scale, deploying special manufacturing prowess, and gaining exposure to the engineering and development processes of products he handles for other original product manufacturers. Such exposure puts the contract manufacturer in a position to propose improvements to different clients' products (Arrunada, 2006).

CONTRACT MANUFACTURING – A DOUBLE-EDGED SWORD

In spite of the gains and advantages of contract manufacturing, many companies have realized that contract manufacturing is a two-edged sword. For one thing, a contract manufacturer is privy to the business secrets, distinctive competencies and intellectual property of the original product manufacturer which it can leak to other clients and competitors. For another thing, an ambitious upstart contract manufacturer can claim for his own business the very advantages he provides to the original product manufacturer. Having manufactured the original product manufacturer's product in its entirety, the contract manufacturer may decide to build his own brand and forge his own relationships with retailers and distributors, even including those of the original product manufacturer.

When this wholesale betrayal of trust takes place, the original product manufacturer may find himself facing, not only more dangerous incumbents, but also a competitor of a new kind - the once under-estimated contract manufacturer. More painful is the fact that it was the money the servant (i.e. the contract manufacturer) made during his contractual relationship with his master (i.e. the original product manufacturer) that he (the servant) is now using to challenge his master (Lysons, 2003). Although, launching a brand of his own would not be an easy undertaking for the contract manufacturer who betrays his master. However, a brand identity rooted in the contract manufacturer's production prowess would have immediate credibility. Moreover, a contract manufacturer working for several original product manufacturers will have experience in making a wider range of products. This knowledge and experience gives him the advantage of concentrating on the production of the most profitable products. And his cost structure will not necessarily bear the burden of investments in research and development.

MANAGING RELATIONSHIP WITH YOUR CONTRACT MANUFACTURER

It is usually the issue of modularization, codification of manufacturing processes, diminished transaction costs, among others factors that make contract manufacturing irresistible to less well-capitalized original product manufacturers. However, the original product manufacturer can manage his relationship with the contract manufacturer in such a way that the original product manufacturer does not become weak or the contract manufacturer himself becoming too strong.

To manage the relationship successfully, the original product manufacturer will require to take the following actions:

1. Modesty about revealing one's business secrets to the contract manufacturer
2. Caution on the part of the original product manufacturer on whom to trust
3. Judicious degree of intimacy, loyalty and generosity towards one's partners and customers.
4. The original product manufacturer can use his surplus or extra intellectual property to enter new markets beyond those for his core products. .
5. Contract manufacturer's hidden secrets or barrier-breaking abilities, which he used to invade the original product manufacturer's markets can now offer the same original product manufacturer access to new markets (Arrunada, 2006).

HEIGHTENED COMPETITION

Few manufacturing companies still consider manufacturing an essential part of their business. Traditional brand owners, what we know today as original product manufacturer, prefers to focus on product research, design, and sales leaving production to the new specialists – the contract manufacturers. Contract manufacturing involves outsourcing an entire manufacturing process to the point where, in many instances, none of an original product manufacturer's employees would have physically touched the product they are marketing. This practice began a few decades ago with the manufacture of the first IBM PCs but some good time passed before it reached every day products, such as, toys, clothing, foot-wear, beer and pharmaceuticals. Today even the automobile industry has embraced it. For example, Austria's Magna Steyr assembles cars for Mercedes, BMW and Saab. In Nigeria, the Peugeot Automobile Assembly plant in Kaduna contracts out part of its assembly functions to experienced private automobile technicians (Arrunada, 2006). The increasing use of contract manufacturing by producers to produce various types of products has heightened competition in some industries in four ways:

1. The creation of new companies: Contract manufacturing facilitates the creation of new firms and divisions. Businesses that outsource do not have to raise, invest, and risk the capital necessary to develop their own production facilities. Thus, they can by-pass the traditional deterrents to entering new markets. Indeed any firm even one selling low volumes, can decrease its unit costs simply by retaining the contract manufacturer with the biggest scale.

2. The creation of new brands: Contract manufacturer's evolving situation encourages them to develop their own brands. It happens as follows: As contract manufacturers reach efficient scale, their cost levels converge. At the same time, the products they make begin to commoditize. In response, contract manufacturers will attempt to regain a sustainable competitive advantage by undertaking the value-adding activities that their patrons have handled themselves, such as, Research and Development and Marketing. If contract manufacturers find

out that they cannot get all the knowledge they need to sell and brand a new product from customers, they can purchase entire division owned by the original product manufacturers. Taiwan-based BenQ did just that, buying Siemens's mobile phone business in 2005. By doing so**,** BenQ acquired not only Siemens's intellectual property but also many decades worth of Siemens's managerial experience, its highly-developed talent pool, its widely-known brands and its global operations platform. Once they have achieved manufacturing mastery, contract manufacturers can begin innovating. This is something they have been doing for some time (Arrunada, 2006).

3. Movement up the value chain: The most powerful retailers and distributors can engage the largest, most efficient contract manufacturers to produce (under the retailers' or distributors' own name-plates) items equal in quality with those produced by the original product manufacturers. These products share shelf space with the original product manufacturers' products but sell at only half the price. Contract manufacturer Solectron developed its manufacturing expertise in the course of working for IBM, Hewlett-Packard, and Mitsubishi. Later a distributor asked Solectron to custom build PCs servers and other computer equipment under its own brands. Retailers, too, such as Best Buy, Carrefour, Sears, and Wal-Mart are selling electronic products under their own brands, thereby diluting original product manufacturer's marketing clout. Contract manufacturers that have established their own brands suffer as well because their products have difficulty improving on the retailers' quality, innovativeness and pricing. However, if an enterprising contract manufacturer threatened to stop making items for a retailer, it would only drive its client into the arms of another contract manufacturer – one that could translate the additional business into improved or even superior economies of scale.

4. Leakage of intellectual property: Contract manufacturing puts the original product manufacturer's proprietary intangible assets into play. A contract manufacturer can exploit, for the benefit of his own brands the knowledge he acquired in the course of working for a given original product manufacturer. The contract manufacturer can also transfer this knowledge to other client original product manufacturers. Such leakage may occur even if the contract manufacturer does not do anything more than assembling components made by others. For instance, three dimensional scanning, computer-aided design, and computer-aided manufacturing allow companies to copy in a matter of hours components that may have taken years to design. The potential for abuse is very high in contract manufacturing.

AN INEVITABLE RELATIONSHIP

Contract manufacturing is inevitable, though it entails inescapable hazards some of which are discussed below:

First of all, original product manufacturers that embrace contract manufacturing can reduce their direct costs even if the number of units they sell is well below the level otherwise required to achieve meaningful economies of scale. Consider Flextronics: The contract manufacturer's plant in Mexico, can assemble for Royal Philips Electronics a device for connecting TV sets to the internet at very low unit cost because it is simultaneously producing a similar device for Sony on an adjacent production line. In turn, working for many original product manufacturers gives the contract manufacturer the revenue to keep making essential investments in factory automation. It would be more difficult for IBM, Hewlett-Packard, or contract manufacturer Sanmina to obtain equivalent economies of scale if their products were made in their own factories, and if those factories produced exclusively for their own brands.

Second, contract manufacturing allows the original product manufacturer to concentrate on his most profitable activities – Research and Development, for instance, or sales and marketing. IBM certainly had the money and the knowledge to invest in factory automation and the company was glad that its relationship with Sanmina let it match Dell's prices. But IBM's points of difference are its outstanding engineering and services. These are forms of specialization that outsourcing had made possible.

Third, firms can communicate and coordinate among themselves more efficiently than ever before. Consequently, the economic logic that once impelled original product manufacturers to perform almost every specialized function in-house no longer applies. The internet is driving most of these efficiencies, as are the standardized production methods, management procedures, electronic communication protocols, and digital design formats promoted by the International Organization for Standardization, a Federation of National Standard Bodies. HP, for instance, can use technologies, such as, electronic data interchange to transmit specifications directly from its design department to machines and robots at a contract manufacturer's plant. Such measures free the original product manufacturer to separate his innovation activities from his production activities.

Fourth, Flexible manufacturing systems allow original product manufacturer to replace one product with another on short notice. Velvet Automotive, for example, was able to start assembling Porsche Boxster vehicle within seven months of landing the production deal with the auto-maker. And Ford makes three different chassis in its factories, each of which can accommodate nine different car models, allowing the company to shift production rapidly to the models generating the greatest market demands.

Finally, the combination of standardization and flexible manufacturing lets original product manufacturer to replace under-achieving or uncooperative contract manufacturer about as easily as they can replace ebbing products. The reciprocal nature of these relationships – and, conversely, the ability of either party to withdraw at the first sign of a hold-up by its partner – makes them easy to embrace. Leading original product manufacturers cannot afford to retreat to

the safety of vertical integration; the benefits of specialization are too great. The better alternative is to master the present stage of outsourcing's development while guarding against opportunistic, self-serving conduct by contract manufacturers and other partners (Chopra, 2004).

HOW TO COPE WITH CONTRACT MANUFACTURING

The original contract manufacturer has no choice but to co-exist with the contract manufacturer. Fortunately, a few strategies (or defensive moves) are available to assist the master producer (original product manufacturer) to cope with the dangers inherent in the relationship between him and his agent producer (the contract manufacturer). Some of these defensive strategies are discussed below:

Be careful what you outsource: Processes that are part of an original product manufacturer's core competencies or that embody critical corporate assets should not be outsourced at all. Moreover, a company that has outsourced all its manufacturing jobs will in time lose most of its manufacturing knowledge, which, if nothing else, it needs to oversee and monitor the work of its contract manufacturer. One might expect that managers would be aware of the risk of externalizing core competencies**.** Why then do they seem so eager to outsource the same core competencies? The answer lies in several countervailing influences. First is management's penchant for off-loading tangible assets in order to raise the company's return on assets and return on investment, and to be richly rewarded for doing so. Furthermore, by downsizing the workforce, managers can usually improve productivity ratios and avoid long and arduous negotiations with trade unions (Arrunada, 2006).

Tie the relationship to prevailing circumstances: When an original product manufacturer's product is not novel and unique, its degree of innovativeness, complexity, and maturity in the market place should dictate the duration of the relationship between the contract manufacturer and the original product manufacturer. If a product novelty and complexity require a contract manufacturer to devote time and other resources to mastering its manufacture, the contract manufacturer will need the inducement of a long-term contract to make those investments.

A long-term contract will also protect the original product manufacturer's own investment in the contract manufacturer's mastery of the production process. In situations where the original product manufacturer's product is novel and complex, it becomes nearly impossible for the original product manufacturer to quickly replace the contract manufacturer.

Advantage of a long-term contract: A long-term contract is valuable because it hinders the contract manufacturer from abandoning the original product manufacturer or introducing prohibitive terms as the price of remaining to serve the original product manufacturer. An additional consideration for an original product manufacturer is what a contract manufacturer will do with the original product manufacturer's intellectual property when the two parties are no longer legally bound to each other. The contracts that are drawn up to anticipate and deal with such eventualities cannot avoid being complex themselves, though the cost and difficulty involved in preparing them is justified by the seriousness of the stakes (Lysons, 2003).

When to prepare a contract of shorter duration: In a situation where the original product manufacturer can easily switch contract manufacturers because the product is simple to make or has been around long enough to have become generic, a contract of shorter duration would be practical – even advantageous – for the original product manufacturer. In such cases, nothing should prevent an original product manufacturer from pursuing more attractive terms from a different contract manufacturer, or vice versa. In 1999, DaimlerChrysler (then doing business as Daimler-Benz) asked contact manufacturer Magna Styr to assemble its Mercedes – Benz M-Class SUV. The first unit left the factory within only eight months of the initial venture agreement. In that case, a contract of limited duration was all both parties needed to protect their investments. Organizational arrangements between original product manufacturer and contract manufacturer range from one-off contracts – known as market agreements – to more interdependent and on-going pacts, such as, framework arrangements, joint ventures, and other kinds of partnerships. A market agreement which might or might not be renewable, would involve the manufacture of a distinct or particular type of product. The market agreement will contain very precise technical and design details. By contrast, a framework arrangement could require the contract manufacturer to produce several related models of a product in a given year (Lysons, 2003).

Turnkey contract and Shelter agreement: There are two varieties of short-term agreement. Elamex, a contract manufacturer of electronic components, lets customers choose either a turnkey contract or a shelter agreement. In the former arrangement, an Elamex customer shares the assembly line with other customers, each pays Elamex according to the number of units the company has produced for it. In the latter arrangement, a portion of the plant is dedicated to the production of a given customer's products and the customer pays a proportional share of the overhead, even bringing in its own managers to oversee processes. Because Elamex lacks design capabilities, it enters into few long-term alliances. It follows that the company prefers to work with experienced manufacturers rather than start-ups (Arrunada, 2006).

Why strategic alliances devolve into market-agreement relationships: Curiously, many strategic alliances end up devolving into temporary market-agreement relationships. This happens for three main reasons: First, many original product manufacturters seem to lose tract of the ultimate purpose of their long-term arrangements and start pressing contract manufacturers hard fort savings. As a result, the contract manufacturers begin to feel that their investments in learning how to make and improve a specialized or unique product will not generate a return. Perhaps understandably, contract manufacturers under this pressure shed whatever qualms they may have had about, for example, selling directly to the original product manufacturer's customers. This is an especially dangerous development for the original product manufacturer when it cannot easily find another capable contract manufacturer – one of the main reasons for forming a long-term partnership in the first place. A second reason for the devolution of strategic alliance into temporary market-agreement relationships is the eventual devaluation of

whatever was new and unique about the product. This problem is especially pronounced in the high-tech arena, where products have such short life spans. The third reason strategic alliances weaken is the increasing modularization of components. Automation demands fewer judgments calls and less improvisation from workers. And assembly has become simpler for contract manufacturers now that original product manufacturers are transferring ever large portions of manufacturing jobs from contract manufacturers to suppliers, which are responsible for tu5rning parts into a single piece of equipment, such as, the seat of a car. Both developments make it less important for contract manufacturers to have special skills and knowledge (Arrunada, 2006).

Give trustworthy partners their freedom: Original product manufacturers should seek close relationships with trustworthy contract manufacturers to minimize the risk of intellectual property leaks and protect their investments. Such closeness would have the incidental benefit of making contract manufacturers dependent on original product manufacturers for funding and technical guidance. But such relationships should not be exclusive, otherwise original product manufacturers will become isolated from industry innovators.

Long-term relationship preferable in non-commodity situation: In non-commodity situations, original product manufacturers and contract manufacturers should commit themselves to long-term relationships so that their investments will have enough time to pay off. Naturally, the greater the duration of a contract, the more contingencies there are that can arise over its course, and the less predictable those contingencies become. Consequently, such contracts must be highly-detailed, with the meanings of terms fully elaborated so that nothing is ambiguous and nothing is misunderstood. How then does an original product manufacturer foster a contact manufacturer's good faith and commitment to the alliance when the contract manufacturer has other masters as well? An original product manufacturer might begin by trying to gain a sense of the prospects for long term trust. The best way to do this is to examine a contract manufacturer's past record and behaviour; that might mean talking to other original product manufacturers, trade association representatives and the contract manufacturer's suppliers. An original product manufacturer can also investigate the contract manufacturer's record of commercial disputes (McLean, 2003).

Watch out for betrayal attitude: If a contract manufacturer tries to persuade you to retain his services by offering to share other clients' trade secrets or intellectual property with you, it is a fair guess that, somewhere down the road, the contract manufacturer will do the same thing with your intellectual property in his relationship with another original product manufacturer. Be very careful with such "willing to serve" contract manufacturer (McLean, 2003). Even if a contract manufacturer's good intentions have been established, an original product manufacturer must still determine reliability on his servant manufacturer. Before Toyota retains a supplier, for instance, it scrutinizes the supplier's production process and cost structure. After the supplier

has been selected, the auto-makes sends him monthly questionnaire eliciting a performance history – quality and quantity of outputs, timeliness of delivery, the occurrence of any irregular incidents. Toyota's engineers may them spend several months at the supplier's facilities using the information obtained to solve problems and improve processes.

And finally, an original product manufacturer needs to practice good communication. This involves more than just conducting surveillance and reacting to the responses it engenders. Both sides need to share their goals for the alliance and to agree on norms, values and procedures. Exchanging personal helps facilitate those things. Original product manufacturers not only can send their engineers to contract manufacturers' facilities, but can also create "guest engineer" programmes, whereby original product manufacturers send their design engineers to contract manufacturers' offices for two to three years. An original product manufacturer whose product's commercial viability rests on proprietary technology and processes needs to be close to his contract manufacturer to know the business well. The original product manufacturer must take steps, both at the inception of the partnership and throughout its course to ensure that the contract manufacturer's competence, currency of knowledge and good faith remain intact at all times (Arrunada, 2006).

Fighting contract manufacturer's disloyalty: The original product manufacturer can fight contract manufacturer's disloyalty by deepening distributors' and customers' loyalty. It may be that the contract manufacturers have certain advantages, such as, superior manufacturing prowess a broader variety of products to offer and lower costs being the most important. But the rise of contract manufacturing has also brought with it some challenges for contract manufacturers that decide to retail the products they make. Original product manufacturers can strengthen their ties with customers by offering rewards or special discounts to those that buy products frequently, by personalizing customer relationships and by providing strong technical support. Some original product manufacturers advertise professional products directly to end users in the hope that the end users will express a preference to the actual purchasers. Fundamentally, however, customer loyalty must rest on what distinguishes an original product manufacturer's products from those of his competitors. Loyalty cannot be based on low prices since consumers looking for the best price will be perpetually ready to switch – and contract manufacturers are almost always in a better position than the original product manufacturers to offer the best price. The same thing goes for quality, which contract manufacturers' operational excellence assures and product range which is a feature of contract manufacturer's scale. In fact, the products contract manufacturers provide to other brands will be similar in quality and cost precisely because they were made by the same company. By contrast, a contract manufacturer that made unique products for a given original product manufacturer would be tied down by a long-term agreement which would remove him as a competitive threat.

Re-building distributors' loyalty: Original product manufacturers can also try to re-build distributors' loyalty. Distributors may be unusually receptive to contract manufacturers' overtures because they resent being squeezed by original product manufacturers seeking short-term savings. Even in cases where original product manufacturers act generously, distributors' fears of disintermediation and ultimate replacement by electronic channels tempt them to embrace whichever company that provides them with fair treatment and long-lasting relationships. Original product manufacturers that make credible commitments to distributors, though these may entail higher costs, can help tie the distributors to the original product manufacturers' brands and keep aggressive contract manufacturers at bay. These commitments may include; paying to train a distributor's personnel in servicing and repairing the original product manufacturer's products, underwriting the cost of a processing system fitted to both parties' requirements or incorporating the distributor's identity into an original product manufacturer's marketing campaigns. The last commitment in particular should help discourage the distributor from thinking about becoming the brand himself. Original product manufacturers might also want to consider granting a distributor territorial exclusivity, which would improve the distributor's revenues and encourage him to specialize in the original product manufacturer's products (Chopra, 2004).

RESCUE STRATEGIES WHEN THE UNEXPECTED HAPPENS

A dishonest and ambitious product manufacturer can turn to a tiger producer overnight to challenge his master (the original product manufacturer) as a competitor on the same product brand. When this unexpected scenario emerges, experts recommend the following extra survival strategies to be followed by the original product manufacturer:

(a) Giving special incentives to old customers

Extra incentives could be worked out for the key customers who are not being poached by the former contract manufacturer. The incentive may include, special discounts, free delivery services and longer trade credit duration. The incentive could also include premium gifts, such as, free branded T-shirts and caps, and drinking glasses.

(b) Improving the quality of the product brand

The original product manufacturer can improve the quality of his product and its packaging in order to add new value and create new attraction. These quality improvement approaches will, however, mean additional cost but increase in the volume of sales will, in the long run, justify the additional cost

(c) Aggressive advertising

Undertaking aggressive advertising could create fresh awareness of the product brand. This will be more effective in a situation where the original product manufacturer has made new changes to the original product. It is important for the advertisement to emphasize the distinctive features of the product and other selling points that would interest buyers.

CONCLUSION

If we put contract manufacturing on the scale of values, chances are that the gains would outweigh the losses. As long as technological innovations keep increasing, the benefits of specialization, contract manufacturing will continue to be a popular choice for original product manufacturers. Unfortunately, managers' incentives encourage a wholesale, uncritical approach to decisions about whether to outsource, which products to outsource, which contract manufacturers to engage, and in what form – market agreement, a strategic alliance, or something in-between. When original product manufacturers share sensitive intellectual property with contract manufacturers, it is important that the relationship be trusting and close but not so close that contract manufacturers lose touch with the market and other original product manufacturers' contributions. Since these techniques are not infallible, original product manufacturers should treat their customers and distributors well enough that they become immune to the appeals of upstart contract manufacturers, and they should spread their risk by diversifying their portfolio of products.

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