



# SUPPLY CHAIN TRANSFORMATION FOR INDUSTRIALS

LEVERAGING COST AND CAPABILITY  
ADVANTAGES OF CONTRACT MANUFACTURERS

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**>US\$700  
BN**  
**Size of contract  
manufacturing  
market expected  
by 2025**

As contract manufacturers enter new areas of the industrial value chain as original design manufacturers (ODMs), established industrials fear that they will eventually be displaced by the ODMs. It is time for industrial leaders to look at the supply chain more holistically: they need to determine the core value proposition to their customers, select the right strategic ODM partner and business model, and overcome the internal resistance to change. This will allow them to convert a big threat into an even bigger opportunity.

Towards the end of the 20<sup>th</sup> century, most Western industrials were vertically integrated. As low-cost countries in Asia and Latin America opened their markets, and shipping costs dropped, companies started outsourcing parts of their manufacturing operations to overseas suppliers and contract manufacturers. But in recent years, industrials have largely exhausted this cost saving lever: Shifting production from one supplier or contract manufacturer to another may keep costs under control, but the savings yielded are only incremental.

On the other side, suppliers and contract manufacturers have continuously improved their cost structures through economies of scale and productivity gains. Contract manufacturers in particular have built more advanced capabilities and product know-how: Companies that started off as a “simple” manufacturing site in a low-cost country have now emerged as original design manufacturers, capturing larger parts of the value chain. They offer a range of services from product design, engineering services, and mass production, to end-customer shipping. By 2025, the overall contract manufacturing market is expected to grow to more than US\$700 billion.

Traditionally, ODMs have focused on consumer electronics such as computers and communication devices. But recent trends – such as the Internet of Things, big data, and artificial intelligence – have opened opportunities to partner with or even compete with traditional industrials in the automotive, aerospace, energy, and packaging sectors. Foxconn, the world’s largest contract manufacturer and ODM, has significantly increased its R&D investment into these sectors, and created a new business division for industrial clients. Magna Steyr, an Austrian automotive contract manufacturer, is providing engineering services for systems and modules, but is also licensed to produce complete vehicles for BMW, Daimler, and Jaguar Land Rover.

Many industrial leaders perceive this development as an imminent threat and struggle to find the right response. To meet the challenge, they will need to transform their operations by determining the core value proposition to their customers, selecting the right blended model of existing contract manufacturing and more advanced ODMs, and finding the right strategic partner in parallel with the organizational change-management, activities to support the transformation.

## KNOWING YOUR VALUE PROPOSITION

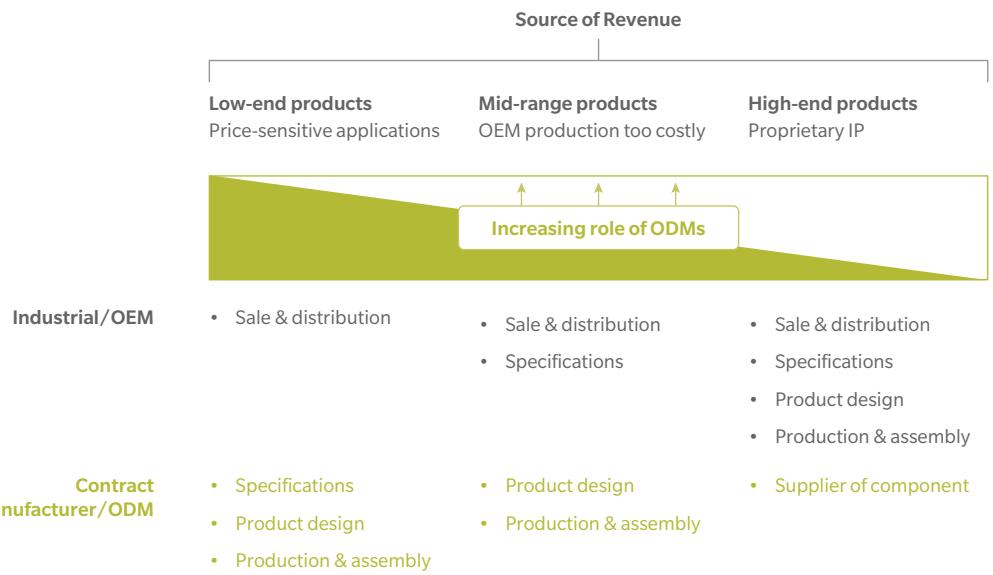
According to Gartner, 16 percent of global server sales to hyperscale data centers in 2018 will come from ODMs and will be directly supplied to end customers. Lower cost, an innovative and efficient design, along with options for product customization, are the main reasons for customers to choose the ODM over the original equipment manufacturer (OEM) product.

This example from the computer industry illustrates the threat to OEMs. It also showcases where OEMs need to increase their efforts: understanding their customers' true needs and requirements. For OEMs and industrials alike, recognizing the value proposition to customers, and closely preserving their relationships, is key. In many cases, they either overestimate the strength of their distribution relationships and brand equity, or underweight the attention that they should be dedicating to maintaining their advantage.

Another frequent concern of industrial leaders is the potential loss of intellectual property to the ODM. The fact is that the capabilities of ODMs have increased substantially over the past years: patents filed in China outnumber those filed in the United States and in Europe, according to the World Intellectual Property Organization. Foxconn filed 5,060 patent families from 2011-2014. In comparison, Google filed 5,333 patent families during the same timeframe.

To create outstanding products, the OEM should focus on the customers' requirements, the key differentiating product elements to best meet these requirements, and the resulting service offering (including product distribution and end-customer service). The ODM should address the best designs for the non-differentiating elements and the most cost-effective manufacturing. Successful industrials increasingly use a blended operational model: ODMs design and manufacture product line extensions, particularly those midrange products needed to complete the product portfolio, while the OEM retains design for the heart of the high-end product line with contract manufacturers delivering components in their traditional role. (See Exhibit 1.) To get there, leaders will need to transform their supply chains and focus on choosing the right strategic partner.

Exhibit 1: Increasingly, industrials are seeing their revenue derived from not only traditional in-sourced operations but from contract manufacturing sources



Source: Oliver Wyman analysis

## FINDING THE RIGHT PARTNER

As industrials look for an ODM partner, it is essential to sell the supply chain transformation as a genuine opportunity and to offer scale by moving large chunks of spend. However, the latter can be very challenging, as it often means obtaining price quotes on thousands of complex components. Successful transformation projects have leveraged representative subsets of products and components that allowed for extrapolation to the whole business. This method helped in obtaining initial quotes, in order to shortlist two to three potential partners and to focus on enhancing their value proposition.

Additional selection criteria are important for a sound partnership: ODMs offer engineering services, continuous material cost reductions, distribution services, and more. ODMs are also oftentimes much larger than their industrial clients. This will mean treating them as a strategic partner, rather than the usual supplier. Industrial leaders need to ensure their organizations are ready for this.

## OVERCOMING INTERNAL RESISTANCE TO CHANGE

Industrials are usually mature organizations that have grown over decades. Leaders face significant internal resistance when steering into the new direction, particularly when it involves a different operating model. Pushback stems from

strong legacy relationships with suppliers developed over many years. A general fear of new ways of doing business is yet another concern to many employees.

In transforming the supply chain, it will be essential to select a “neutral” project management team that can entirely focus on the transformation and is not wedded to the status quo. A transparent process limits speculation and hearsay.

To gain organizational buy-in, risk management workshops have proven useful, as they provide a forum to identify and manage legitimate concerns. They also provide a structured method to allow stakeholders to express concerns and air frustrations. Systematically engaging stakeholders to be part of the solution and developing plans to logically address their concerns helps the project management team identify and address issues. And it allows stakeholders to vent their more emotional concerns before moving forward. The opportunity to simply be heard often diffuses some of the resistance to change.

At the end, if the process is done right, the industrial will be very well positioned to succeed in this new market environment. Rather than hiding from a threat that will happen one way or another, industrials need to act and move forward now. This will allow them to turn a threat into an opportunity.

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