Contract manufacturing

FACTSHEET // APRIL 2021

Contract manufacturing[1]

1. Introduction

Many firms, especially those that focus on design and problem-solving, sub-contract the manufacture, and maybe other functions as well, to specialist contract manufacturers.

A contract manufacturer (“CM”) is a manufacturer that enters into a contract with a firm to manufacture or assemble products for that firm. It is a form of outsourcing. In a contract manufacturing business model, the hiring firm approaches the contract manufacturer with a design or formula. The contract manufacturer quotes based on processes, labour, tooling and material costs. Typically, a hiring firm will request quotes from multiple CMs. The hiring firm will select a manufacturer and then, for the agreed price, the CM acts as the hiring firm’s factory, producing and shipping units on behalf of the hiring firm.

2. Benefits

Contract manufacturing offers several benefits:

- **Cost savings:** Companies save on capital costs because they do not have to pay for a facility and the equipment needed for production. They can also save on labour costs such as wages, training and benefits. Companies often aim to contract manufacture to low-cost countries, such as China, to benefit from the low cost of labour.
- **Mutual benefit:** A contract between the manufacturer and the company for which it is producing may last several years. The manufacturer will know that it will have a steady flow of business at least until that contract expires.
- **Advanced skills:** Companies can take advantage of skills that they may not possess, but the contract manufacturer does. The contract manufacturer is likely to have relationships formed with raw material suppliers or methods of efficiency within their production.
- **Quality:** Contract manufacturers are likely to have their own methods of quality control in place that help them to detect counterfeit or damaged materials early.
- **Focus:** Companies can focus on their core competences better if they can hand off base production to an outside company.
- **Economies of scale:** Contract manufacturers have multiple customers for which they produce. As a result, they can offer reduced costs in acquiring raw materials by benefiting from economies of scale. The more units there are in one shipment, the less expensive the price per unit will be.

---

[1] This factsheet is based on material originally prepared by Le Sai Gon of Simex Training Centre and used with permission.

3. Risks

Balanced against the above benefits of contract manufacturing are several risks:

- **Lack of control:** When a company signs the contract allowing another company to produce their product, they lose a significant amount of control over that product. They can only suggest strategies to the contract manufacturer; they cannot force them to implement those strategies.
- **Relationships:** It is imperative that the company forms a good relationship with its contract manufacturer. The company must keep in mind that the manufacturer has other customers. They cannot force them to produce their product before a competitor's. Most companies mitigate this risk by working closely with the manufacturer and awarding good performance with additional business.
- **Quality:** When entering into a contract, companies must ensure that the manufacturer's standards are congruent with their own. They should evaluate the methods in which they test products to make sure they are of good quality. The company has to ensure the contract manufacturer has suppliers that also meet these standards.
- **Intellectual property loss:** When entering into a contract, a company is divulging their formulas or technologies. This is why it is important that a company not give out any of its core competencies to contract manufacturers. It is very easy for an employee to download such information from a computer and steal it. The recent increase in intellectual property loss has corporate and government officials struggling to improve security. Usually, it comes down to the integrity of the employees at the CM firm.
- **Outsourcing risks:** Although outsourcing to low-cost countries has become very popular, it does bring along risks such as language barriers, cultural differences, and long lead times. This could make the management of contract manufacturers more difficult, expensive, and time-consuming.
- **Capacity constraints:** If a company does not make up a large portion of the contract manufacturer's business, they may find that they are de-prioritized over other companies during high production periods. Thus, they may not obtain the product they need when they need it.
- **Loss of flexibility and responsiveness:** Without direct control over the manufacturing facility, the company will lose some of its ability to respond to disruptions in the supply chain. It may also hurt their ability to respond to demand fluctuations, risking their customer service levels.
- **Economy:** Firms seek to manufacture through sub-contractors based in other countries to benefit from lower labour costs. As wages rise in that country, it may become less cost-competitive, so you may find yourself on a merry go round chasing the cheapest price all the time. It may be more productive to consider how you can differentiate your product in ways other than price.

website

contact@profit-accelerator.com

email

PROFIT is an initiative of the Asian Development Bank, managed by a partnership of IMC Worldwide, ASSIST Asia & Bombay Chamber of Commerce & Industry.

ADB

PROFIT
promoting regional opportunities for investment and trade