

Too high a price

BY CHARLIE BARNHART

One of the hardest-to-explain aspects of outsourcing is that pricing has remained a top concern of OEMs, even as EMS providers have dramatically reduced their operating margins and expanded their service offerings. The pressure to cut costs is so pervasive it has come to define the contentious EMS/OEM relationship.

Why the emphasis on price? During the past two decades, OEMs have shifted manufacturing to outside contractors. As a result, the EMS industry enjoyed substantial growth, which yielded massive economies of scale. That lowered their costs—a savings that was not always shared with OEMs. As the portion of product costs derived from buying rather than building rose, OEMs focused on driving EMS costs as low as possible.

OEMs' constant push for the lowest price became a bone of contention between them and their EMS providers. As a result, OEMs became increasingly wary of service providers' intentions. OEMs began demanding ever-more-detailed cost information, which led to the practice of "granularizing" every element of their EMS suppliers' pricing and cherry-picking line items across multiple supplier quotations to justify questionable pricing expectations.

In an attempt to preserve their shrinking margins, EMS providers invented creative ways to cloud the issue. This resulted in the OEMs' losing visibility



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because they had to rely on secondhand information provided by their EMS providers. Some cynics call it disinformation.

And for good reason. In the vast majority of quotations provided by EMS companies, "materials markup"—or some such additions by other names—is typically added to the cost of materials. Usually, this is explained as the cost of procurement or procurement-related functions, such as supply-chain management, component engineering and quality assurance.

OEMs rightly question this practice. In fact, all of these markup costs are already accounted for and included in the cost-of-goods. It doesn't matter where in the world the transaction takes place, or whether

workers get paid 10 cents or 10 dollars per hour, the accounting is done the same way: Operating overhead is absorbed by burdening direct labor. And by coupling these costs with the actual cost of material, the three elements of direct labor, overhead and materials define cost-of-goods sold.

Simply put, there is no such thing as a materials markup. It is a creation of the outsourcing industry designed to circumvent the unpleasantness of discussing actual margins when negotiating pricing with OEMs. Sad but true.

Clearly, the EMS outsourcing model is seriously flawed, if not actually broken. So what should an OEM do? Demand suppliers be more forthcoming with data, even though they know it will be used against them? Hire more people to further scrutinize and harass their already disillusioned EMS suppliers? Abandon EMS and embrace ODM solutions? Perhaps OEMs should just give up on outsourcing and start shifting production back in-house?

These are impossibly hard questions to answer, since every solution will be unique to each OEM's circumstances. There is no silver bullet. The outsourcing landscape is a complex, opportunity-rich environment where the proactive flourish and the timid become consumed by circumstances of their own making.

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