When a supplier becomes a competitor

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The offshoring drive in manufacturing has led to lower costs and access to new markets, but it also creates a new problem for big companies if they end up competing with their suppliers.

In what's known as value-chain climbing, some contract manufacturers gain enough expertise to make their own products and compete in the same market with their customers. For example, Samsung and HTC both began as contract suppliers before launching their own successful products.

New research by University of Michigan strategy professor Brian Wu and Zhixi Wan, assistant professor at the University of Oregon, sheds some light on how to handle this emerging phenomenon.

"It's a very dynamic situation, and any reaction to value climbing has to be considered in a full context—in the industry, your situation and the supplier's situation," Wu said.

The automatic responses are to either dump the supplier or accommodate by paying more. But that doesn't take into account the risks of each action or market conditions.

Their study shows a third way that's often more optimal—building a sort of apprentice-type relationship with a supplier. In that case, the supplier accepts lower margins early in the relationship while being allowed to learn design and marketing know-how.

This gives the buyer time to design the next generation of the product. At that point, both supplier and buyer can decide if it's worth it to continue the relationship.

"Our model shows that it's not a question of whether to dump or accommodate, but when," Wu said. "What are the market conditions, and what is the right time?"

The full picture of risk often isn't considered when reacting to a supplier becoming a competitor. Dumping the supplier means either making the components in-house—politically popular but expensive when done hastily—and finding new suppliers, which is also expensive with an uncertain outcome.

But the future also is uncertain for suppliers who wish to enter the market with their own products. It's a risky move, and more will fail than succeed.

"It's costly to climb up the value chain, and there's no guarantee of a payoff," Wu said. "It's like any other entrepreneurial activity in that most of them will fail. If you can pay them enough, maybe they won't take that risk. But you have to measure that against your own business interests."

Their study, "When Suppliers Climb the Value Chain: A Theory of Value Distribution in Vertical Relationships," will be published in a forthcoming edition of the journal *Management Science*.

More information: Zhixi Wan et al. When Suppliers Climb the Value Chain: A Theory of Value Distribution in Vertical Relationships, *SSRN Electronic Journal* (2014). DOI: 10.2139/ssrn.2438489

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