

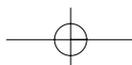


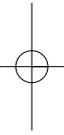
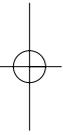
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CORPORATE STRATEGY



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Vertical Integration and the Scope of the Firm



The idea of vertical integration is anathema to an increasing number of companies. Most of yesterday's highly integrated giants are working overtime at splitting into more manageable, more energetic units – i.e., de-integrating. Then they are turning around and re-integrating – not by acquisitions but via alliances with all sorts of partners of all shapes and sizes.

—TOM PETERS, LIBERATION MANAGEMENT

OUTLINE

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Introduction and Objectives

Chapter 2 introduced the distinction between *corporate strategy* and *business strategy*. Corporate strategy is concerned primarily with the decisions over the *scope* of the firm's activities, including:

- **Product scope.** How specialized should the firm be in terms of the range of products it supplies? Coca-Cola (soft drinks), SAB Miller (beer), Gap (fashion retailing), and Swiss Re (reinsurance) are specialized companies: they are engaged in a single industry sector. General Electric, Samsung, and Bertelsmann are diversified companies: each spans a number of different industries.
- **Geographical scope.** What is the optimal geographical spread of activities for the firm? In the restaurant business, Clyde's owns 12 restaurants in the Washington DC areas, Popeye's Chicken and Biscuits operates throughout the US, McDonald's operates in 121 different countries.
- **Vertical scope.** What range of vertically linked activities should the firm encompass? Walt Disney Company is a vertically integrated company: it produces its own movies, distributes them itself to cinemas and through its own TV networks (ABC and Disney Channel), and uses the movies' characters in its retail stores and theme parks. Nike is much more vertically specialized: it engages in design and marketing but outsources many activities in its value chain, including manufacturing, distribution, and retailing.

Business strategy (also known as *competitive strategy*) is concerned with how a firm competes within a particular market. The distinction may be summarized as follows: corporate strategy is concerned with *where* a firm competes; business strategy is concerned with *how* a firm competes.¹ The major part of this book has been concerned with issues of business strategy. For the next four chapters, the emphasis is on corporate strategy: decisions that define the *scope of the firm*. I devote separate chapters to the different dimensions of scope – vertical scope (*vertical integration*), geographical scope (*multinationality*), and product scope (*diversification*). However, as we shall discover, the key underlying concepts for analyzing these different dimensions – economies of scope in resources and capabilities, transaction costs, and costs of corporate complexity – are common to all three.

In this chapter we begin by considering the overall scope of the firm. We then focus specifically on vertical integration, since it takes us to the heart of the determinants of firm boundaries – in particular, the role of transaction costs. Moreover, vertical integration has been a central issue in corporate strategy in recent years as outsourcing, alliances, and e-commerce have caused companies to rethink which parts of their value chains they wish to include within their organizational boundaries.

By the time you have completed this chapter, you will be able to:

- Identify the relative efficiencies of firms and markets in organizing economic activity and apply the principles of *transaction cost economics* to explain why boundaries between firms and markets have shifted over the past two hundred years.
- Assess the relative advantages of vertical integration and outsourcing in organizing vertically related activities, understand the circumstances that influence these relative advantages, and advise a firm whether a particular activity should be integrated within the firm or outsourced.
- Identify alternative ways of organizing vertical transactions – including spot market transactions, long-term contracts, franchise agreements, and alliances – and advise a firm on the most advantageous transaction mode given the characteristics and circumstances of the transaction.

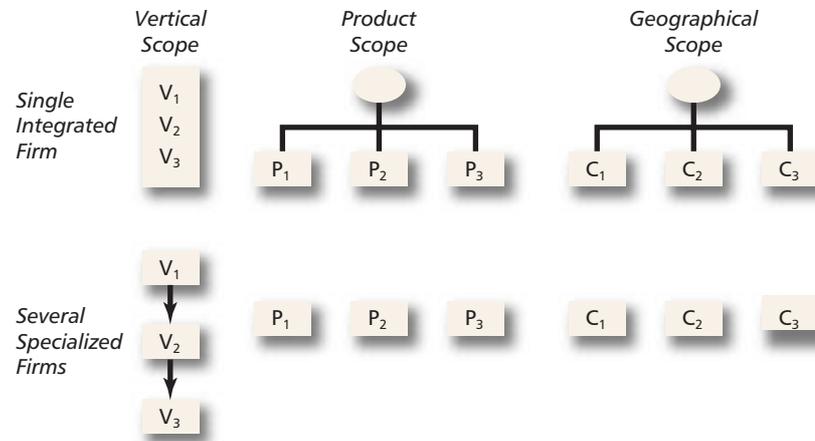
Transaction Costs and the Scope of the Firm

In Chapter 6, we noted that firms came into existence because they were more efficient in organizing production than were market contracts between independent workers. Let us explore this issue and consider the determinants of firm boundaries.

Firms, Markets, and Transaction Costs

Although the capitalist economy is frequently referred to as a “market economy,” in fact, it comprises two forms of economic organization. One is the *market mechanism*, where individuals and firms make independent decisions that are guided and coordinated by market prices. The other is the *administrative mechanism* of firms, where decisions over production, supply, and the purchases of inputs are made by managers and imposed through hierarchies. The market mechanism was characterized by Adam Smith, the 18th-century Scottish economist, as the “invisible hand” because its coordinating role does not require conscious planning. Alfred Chandler has referred to the administrative mechanism of company management as the “visible hand” because it is dependent on coordination through active planning.²

Why do institutions called “firms” exist in the first place? The firm is an organization that consists of a number of individuals bound by employment contracts with a central contracting authority. But firms are not essential for conducting complex economic activity. When I recently remodeled my basement, I contracted with a self-employed builder to undertake the work. He in turn subcontracted parts of the work to a plumber, an electrician, a joiner, a drywall installer, and a painter. Although the job involved the coordinated activity of several individuals, these self-employed

FIGURE 13.1 The scope of the firm: specialization versus integration

In the integrated firm there is an administrative interface between the different vertical units (V), product units (P), and country units (C). Where there is specialization, each unit is a separate firm linked by market interfaces.

specialists were not linked by employment relations but by market contracts (“\$4,000 to install wiring, lights, and sockets”).

What determines which activities are undertaken within a firm, or between individuals or firms coordinated by market contracts? Ronald Coase’s answer was *relative cost*.³ Markets are not costless: making a purchase or sale involves search costs, the costs of negotiating and drawing up a contract, the costs of monitoring to ensure that the other party’s side of the contract is being fulfilled, and the enforcement costs of arbitration or litigation should a dispute arise. All these costs are types of *transaction costs*.⁴ If the transaction costs associated with organizing across markets are greater than the *administrative costs* of organizing within firms, we can expect the coordination of productive activity to be internalized within firms.

This situation is illustrated in Figure 13.1. With regard to vertical scope, which is more efficient: three independent companies – one producing steel, the next rolling the steel into sheet, and the third producing steel cans – or having all three stages of production within a single company? In the case of geographical scope, which is more efficient: three independent companies producing cans in the US, UK, and Italy, or a single multinational company owning and operating the can-making plants in all three countries? In the case of product scope, should metal cans, plastic packaging, and domestic appliances be produced by three separate companies, or are there efficiencies to be gained by merging all three into a single company?

The Shifting Boundary between Firms and Markets

The answers to these questions have changed over time. During the 19th and for most of the 20th century, companies grew in size and scope, absorbing transactions that had previously taken place across markets. As we observed in Chapter 6, companies that once were localized and specialized grew vertically, geographically, and across different industry sectors. This trend can be attributed to a fall in the administrative

costs of the firm as compared with the transaction costs of markets. Two factors have greatly increased the efficiency of firms as organizing devices:

- *Technology.* The telegraph, telephone, and computer have played an important role in facilitating communications within firms and expanding the decision-making capacity of managers.
- *Management techniques.* Developments in the principles and techniques of management have greatly expanded the organizational and decision-making effectiveness of managers. Beginning with the dissemination of double-entry bookkeeping in the 19th century,⁵ and the introduction of scientific management in the early 20th century,⁶ the past six decades have seen rapid advances in all areas of management theory and methods.

Observing this growth in large corporations at the expense of markets, several leading economists of the late 1960s declared that the *market* economy had been replaced by a *corporate* economy. In 1969, J. K. Galbraith predicted that the inherent advantages of firms over markets in planning and resource allocation would result in increasing dominance of capitalist economies by a small number of giant corporations.⁷

During the 1980s and 1990s, these predictions were refuted by a sharp reversal of the trend toward increased corporate scope. Although large companies have continued to expand internationally, the dominant trends of the past 20 years have been “downsizing” and “refocusing,” as large industrial companies reduced both their product scope through focusing on their core businesses, and their vertical scope through outsourcing. The result, as shown in Figure 13.2, was that the largest companies began to play a declining role in the US economy. These changes are associated with the more turbulent business environment that followed the oil shocks of 1973 and 1979, the end of fixed exchange rates (1972), the invention of the integrated circuit, and the upsurge of international competition. The implication seems to be that during periods of instability, the costs of administration within large, complex firms tend to rise as the need for flexibility and speed of response overwhelms traditional management systems.

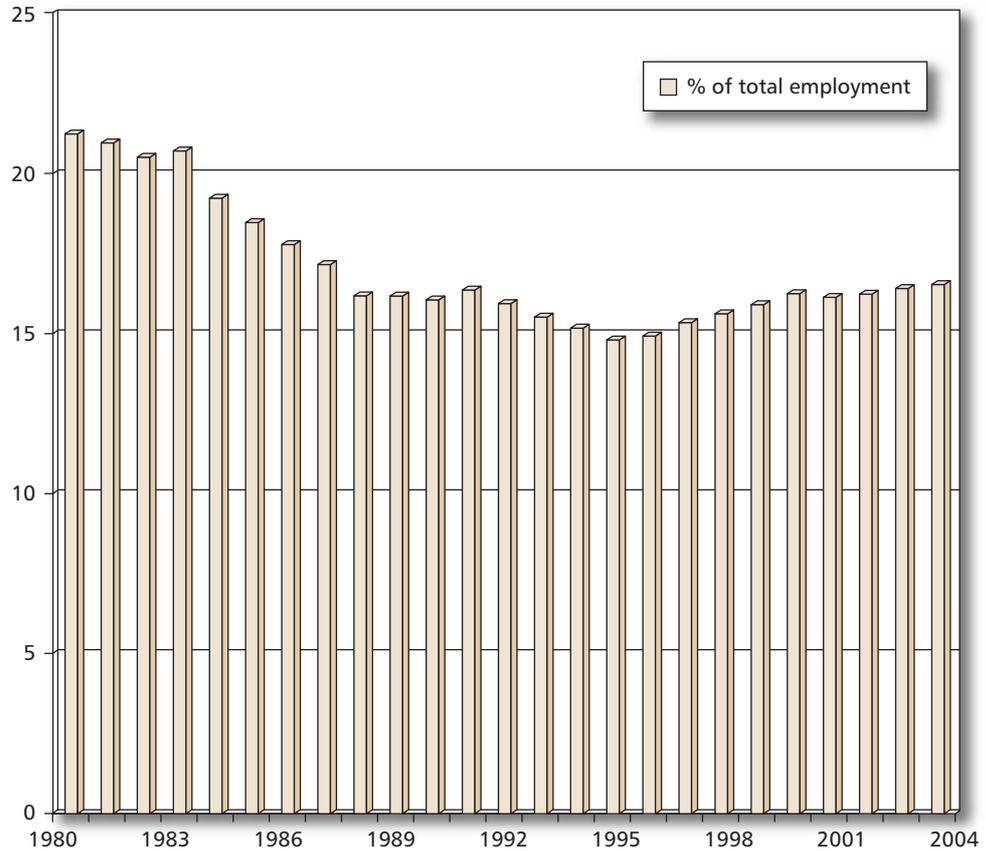
Let us focus now on just one dimension of corporate scope: vertical integration. The question we will consider is this: is it better to be vertically integrated or vertically specialized? To answer this question, we shall draw in particular on Oliver Williamson’s analysis of transaction costs, which forms the basis for a theory of economic organization that is particularly useful in designing vertical relationships.⁸

The Costs and Benefits of Vertical Integration

Strategies towards vertical integration have been subject to shifting fashions. For most of the 20th century, the prevailing wisdom was that vertical integration was generally beneficial because it allowed superior coordination and security. During the past 20 years there has been a profound change of opinion and the emphasis has shifted to the benefits of outsourcing in terms of flexibility and the ability to develop specialized capabilities in particular activities. Moreover, it has been noted that most of the coordination benefits associated with vertical integration can be achieved through interfirm collaboration.

However, as in other areas of management, fashion is fickle. In the media sector, vertical integration between content and distribution has become viewed as a critical

FIGURE 13.2 500 biggest US companies' share of total US private sector employment



SOURCES: L. J. WHITE, "WHAT'S BEEN HAPPENING TO AGGREGATE CONCENTRATION IN THE U.S. (AND SHOULD WE CARE?)," STERN SCHOOL OF BUSINESS, NEW YORK UNIVERSITY, 2001; FORBES 500 AND FORTUNE 1000 (VARIOUS YEARS)

advantage in the face of rapid technological change. The resulting wave of mergers between content producers and distributors (TV broadcasters, cable companies, and internet portals) has transformed the industry (see Strategy Capsule 13.1).

Our task is to go beyond fads and fashions to uncover the factors that determine whether vertical integration enhances or weakens performance.

Defining Vertical Integration

Vertical integration refers to a firm's ownership of vertically related activities. The greater the firm's ownership and control over successive stages of the value chain for its product, the greater its degree of vertical integration. The extent of vertical integration is indicated by the ratio of a firm's value added to its sales revenue. Highly integrated companies – such as the major oil companies that own and control their value chain from exploring for oil down to the retailing of gasoline – tend to have low expenditures on bought-in goods and services relative to their sales.

Vertical integration can be either *backward*, where the firm takes over ownership and control of producing its own components or other inputs, or *forward*, where the

STRATEGY CAPSULE 13.1**Vertical Integration in the Media Sector: Value Creating or Value Destroying?**

Considerable vertical integration has occurred between content companies (film studios, music publishing, newspapers) and distribution companies (TV broadcasting, cable, satellite TV, telecom providers). News Corp. has expanded from newspapers into movie production (20th Century Fox), broadcast TV (Fox), satellite TV, and other sectors of the media business; Disney acquired TV broadcaster ABC; Viacom, formerly a cable company, acquired Paramount and Dreamworks; Vivendi Universal combined music publishing and studios, with cable and broadcast TV; and AOL merged with Time Warner, a leading magazine, film, and music company. In 2004, Comcast, America's biggest cable operator, made a \$54 billion hostile bid for Walt Disney Company.

Does vertical integration between media content and media distribution create or destroy value? Here are two contrasting views:

**Steve Rosenbush, *Business Week*,
February 11, 2004:**

The economics of the TV-distribution business have been under siege for some time. That's why many of the business' smartest operators, like Liberty Media's John Malone and Viacom's Sumner Redstone, started shifting their investments into media years ago. Under Redstone, Viacom has been transformed from a cable operator into a media hothouse that includes everything from MTV to CBS. Buying Disney "shouldn't be a surprise. It's the logical next step," Comcast CEO Brian Roberts said at his Feb. 11 press conference announcing his bid for the Mouse House.

It isn't enough to be just a media company, either. Most content providers benefit from

having a certain amount of distribution, which helps lower their costs. That's why, in the future, media and communications will be dominated by hybrids such as News Corp. which recently acquired satellite-TV operator DirecTV.

Comcast's Roberts has embraced this future. The question now is whether Disney CEO Michael Eisner – who spurned an offer for a friendly deal – can accept the same future. For decades, Disney and other programmers have held the balance of power in distribution deals. That's changing. The cable-TV business isn't just a collection of small family companies running regional outfits anymore. Comcast, which began life in Tupelo, Miss., in 1963, now has national reach. It has a greater market cap than Disney.

And it's competing with satellite-distribution companies like DirecTV that are also national in scope. Now that DirecTV is under Rupert Murdoch's control, it would be folly for Disney to pretend that it can still compete without a distribution partner of comparable stature. Comcast fits the bill.

**John Kay, *Financial Times*,
March 3, 2004**

Media content needs delivery, and vice versa. And the same channels can often be used to disseminate text, images and music. This discovery was made at least 1,000 years ago by people who developed religious services, still among the most moving and spectacular multi-media displays.

But this old idea is frequently rediscovered by visionary chief executives, excitable consultants, and greedy investment bankers: the

people who proclaimed the AOL–Time Warner deal a marriage made in heaven. And it was revealed with Damascene force to Jean-Marie Messier, a humble French water carrier.

But activities can converge without requiring that the companies that undertake them

converge. The erstwhile maître du monde might have drawn a useful lesson from his experience at Compagnie Générale des Eaux before his apotheosis as chief executive of Vivendi Universal: sewers and the stuff that goes down them do not need common ownership.

firm takes over ownership and control of activities previously undertaken by its customers.

Vertical integration may also be *full* or *partial*:

- *Full integration* exists between two stages of production when all of the first stage's production is transferred to the second stage with no sales or purchases from third parties.
- *Partial integration* exists when stages of production are not internally self-sufficient. Among the oil and gas majors, “crude-rich” companies (such as Statoil) produce more oil than they refine and are net sellers of crude; “crude-poor” companies (such as Exxon Mobil) have to supplement their own production with purchases of crude to keep their refineries supplied.

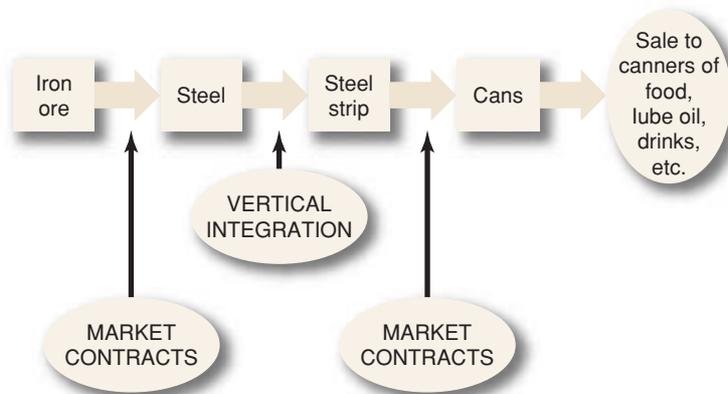
Technical Economies from the Physical Integration of Processes

Analysis of the benefits of vertical integration has traditionally emphasized the *technical economies* of vertical integration: cost savings that arise from the physical integration of processes. Thus, most steel sheet is produced by integrated producers in plants that first produce steel, then roll hot steel into sheet. Linking the two stages of production at a single location reduces transportation and energy costs. Similar technical economies arise in pulp and paper production and from linking oil refining with petrochemical production.

However, although these considerations explain the need for the co-location of plants, they do not explain why vertical integration in terms of *common ownership* is necessary. Why can't steel and steel sheet production or pulp and paper production be undertaken by separate firms owning facilities that are physically integrated with one another? To answer this question, we must look beyond technical economies and consider the implications of linked processes for *transaction costs*.

The Sources of Transaction Costs in Vertical Exchanges

Consider the value chain for steel cans, which extends from mining iron ore to delivering cans to food processing companies (see Figure 13.3). Between the production of steel and steel strip, most production is vertically integrated. Between the production of steel strip and steel cans, there is very little vertical integration: can producers such as Crown Holdings and Ball Corporation are specialist packaging companies that purchase steel strip from steel companies on contracts.⁹

FIGURE 13.3 The value chain for steel cans

The predominance of market contracts between steel strip production and can production is the result of low transaction costs in the market for steel strip: there are many buyers and sellers, information is readily available, and the switching costs for buyers and suppliers are low. The same is true for many other commodity products: few jewelry companies own gold mines; few flour-milling companies own wheat farms.

To understand why vertical integration predominates across steel production and steel strip production, let us see what would happen if the two stages were owned by separate companies. Because there are technical economies from hot-rolling steel as soon as it is poured from the furnace, steel makers and strip producers must invest in integrated facilities. A competitive market between the two stages is impossible; each steel strip producer is tied to its adjacent steel producer. In other words, the market becomes a series of *bilateral monopolies*.

Why are these relationships between steel producers and strip producers problematic? To begin with, where a single supplier negotiates with a single buyer, there is no equilibrium price: it all depends on relative bargaining power. Such bargaining is likely to be costly: the mutual dependency of the two parties is likely to give rise to *opportunism* and *strategic misrepresentation* as each company seeks to both enhance and exploit its bargaining power at the expense of the other. Hence, once we move from a competitive market situation to one where individual buyers and sellers are locked together in close bilateral relationships, the efficiencies of the market system are lost.

The culprits in this situation are *transaction-specific investments*. When a can maker buys steel strip, neither the steel strip producer nor the can maker needs to invest in equipment or technology that is specific to the needs of the other party. In the case of the steel producer and the steel roller, each company's plant is built to match the other party's plant. Once built, the plants have little value without the existence of the partner's complementary facilities. Once transaction-specific investments are significant then, even though there may be a number of suppliers and buyers in the market, it is no longer a competitive market: each seller is tied to a single buyer, which gives each the opportunity to "*hold up*" the other.

Hence, where a vertical relationship between companies requires one or both companies to make investments that are specific to the needs of the other party, a market contract will be inefficient due to the costs of negotiating and enforcing a contract, plus bargaining, monitoring, and dispute resolution. The basic case for vertical integration is that by bringing both sides of the transaction into a single administrative structure, these transaction costs may be avoided.

Empirical research gives considerable support to these arguments:

- Among automakers, specialized components are more likely to be manufactured in-house than commodity items such as tires and spark plugs.¹⁰ Similarly, in aerospace, company-specific components are more likely to be produced in-house rather than purchased externally.¹¹
- In the semiconductor industry, some companies specialize either in semiconductor design or in fabrication, while other companies are vertically integrated across both stages (e.g. Intel, ST Microelectronics). Which is more efficient? Again, it depends on the characteristics of the transaction between the designer and the fabricator. The more technically complex the integrated circuit and, hence, the greater the need for the designer and fabricator to engage in technical collaboration, the better the relative performance of integrated producers.¹²

If companies recognize that transaction-specific investments give rise to opportunism, why don't they write a contract that eliminates the potential for opportunism and misinterpretation by fully specifying prices, quality, and terms of supply? The problem is uncertainty about the future. When the steel producer and the steel sheet roller are agreeing to build their integrated plant, it is impossible to anticipate all the circumstances that might arise over the 30-year life of the plant. Hence contracts are inevitably incomplete.

Administrative Costs of Internalization

Just because there are transaction costs in intermediate markets does not mean that vertical integration is necessarily an efficient solution. Vertical integration avoids the costs of using the market, but internalizing the transactions means that there are now costs of administration. The efficiency of the internal administration of vertical relations depends on several factors.

Differences in Optimal Scale between Different Stages of Production

Suppose that Federal Express requires delivery vans that are designed and manufactured to meet its particular needs. To the extent that the van manufacturer must make transaction-specific investments, there is an incentive for Federal Express to avoid the ensuing transaction costs by building its own vehicles. Would this be an efficient solution? Almost certainly not: the transaction costs avoided by Federal Express are likely to be trivial compared with the inefficiencies incurred in manufacturing its own vans. Federal Express purchases over 40,000 trucks and vans each year, well below the 200,000 minimum efficient scale of an assembly plant. (Ford produced two million commercial vehicles in 2005.)

The same logic explains why specialist brewers such as Anchor Brewing of San Francisco or Adnams of Suffolk in the UK are not backward integrated into cans and

bottles like Anheuser Busch or SAB Miller. Dedicated can-making plants involve specific investments, creating problems of opportunism that vertical integration can avoid. However, small brewers simply do not possess the scale needed for scale efficiency in can manufacture.

Developing Distinctive Capabilities A key advantage of a company that is specialized in a few activities is its ability to develop distinctive capabilities in those activities. Even large, technology-based companies such as Xerox, Kodak, and Philips cannot maintain IT capabilities that match those of IT services specialists such as EDS, IBM, and Accenture. The ability of these IT specialists to work with many different customers stimulates learning and innovation. If General Motors' IT department only serves the in-house needs of GM, this does not encourage the rapid development of its IT capabilities.

However, this assumes that capabilities in different vertical activities are independent of one another. Where one capability builds on capabilities in adjacent activities, vertical integration may help develop distinctive capabilities. Thus, IBM's half-century of success in mainframe computers owes much to its technological leadership in semiconductors and software. The efficiency of Wal-Mart's retailing operations depends critically on specialized IT and logistics from its in-house departments.

Managing Strategically Different Businesses These problems of differences in optimal scale and developing distinctive capabilities may be viewed as part of a wider set of problems – that of managing vertically related businesses that are strategically very different. A major disadvantage to FedEx of owning a truck-manufacturing company is that the management systems and organizational capabilities required for truck manufacturing are very different from those required for express delivery. These considerations may explain the lack of vertical integration between manufacturing and retailing. Integrated design, manufacturing, and retailing companies such as Zara and Gucci are comparatively rare. Most of the world's leading retailers – Wal-Mart, Gap, Carrefour – do not manufacture. Not only do manufacturing and retailing require very different organizational capabilities, they also require different strategic planning systems, different approaches to control and human resource management, and different top management styles and skills.

Strategic dissimilarities between businesses have encouraged a number of companies to vertically de-integrate. Marriott's decision to split into two separate companies, Marriott International and Host Marriott, was influenced by the belief that *owning* hotels is a strategically different business from *operating* hotels. Similarly, Britain's major brewing companies have all de-integrated: Whitbread plc divested its breweries and specialized in pubs, restaurants, and hotels; Scottish & Newcastle sold off most of its pubs and hotels to become a specialist brewer.

The Incentive Problem Vertical integration changes the incentives between vertically related businesses. Where a market interface exists between a buyer and a seller, profit incentives ensure that the buyer is motivated to secure the best possible deal and the seller is motivated to pursue efficiency and service in order to attract and retain the buyer. Thus, market contracts give rise to what are termed *high-powered incentives*. Under vertical integration there is an internal supplier–customer relationship that is governed by corporate management systems rather than market incentives. Performance incentives exist, but these are *low-powered incentives* – if Shell's tanker fleet

is inefficient and unreliable, then employees will lose their bonuses and the head of shipping may be fired. However, these consequences tend to be slow and undramatic.

One approach to creating stronger performance incentives within vertically integrated companies is to open internal divisions to external competition. As we shall examine more fully in Chapter 16, many large corporations have created *shared service organizations* where internal suppliers of corporate services such as IT, training, and engineering compete with external suppliers of the same services to serve internal operating divisions.

Competitive Effects of Vertical Integration Monopolistic companies have used vertical integration as a means of extending their monopoly positions from one stage of the industry to another. The classic cases are Standard Oil, which used its power in transportation and refining to foreclose markets to independent oil producers; and Alcoa, which used its monopoly position in aluminum production to squeeze independent fabricators of aluminum products to advantage its own fabrication subsidiaries. Such cases are rare. As economists have shown, once a company monopolizes one vertical chain of an industry, there is no further monopoly profit to be extracted by extending that monopoly position to adjacent vertical stages of the industry. A greater concern is that vertical integration may make independent suppliers and customers less willing to do business with the vertically integrated company, because it is now perceived as a competitor rather than as a supplier or customer. After Disney's acquisition of ABC, other studios (e.g. Dreamworks) became less interested in collaborating with ABC in developing new TV programming.

Flexibility Both vertical integration and market transactions can claim advantage with regard to different types of flexibility. Where the required flexibility is rapid responsiveness to uncertain demand, there may be advantages in market transactions. The lack of vertical integration in the construction industry reflects, in part, the need for flexibility in adjusting both to cyclical patterns of demand and to the different requirements of each project. Vertical integration may also be disadvantageous in responding quickly to new product development opportunities that require new combinations of technical capabilities. Some of the most successful new electronic products of recent years – Apple's iPod, Microsoft's X-box, Dell's range of notebook computers – have been produced by contract manufacturers. Extensive outsourcing has been a key feature of fast-cycle product development throughout the electronics sector.

Yet, where system-wide flexibility is required, vertical integration may allow for speed and coordination in achieving simultaneous adjustment throughout the vertical chain. American Apparel is probably the fastest growing clothing *manufacturer* in the US with an internationally known brand – especially for T-shirts. Its tightly coordinated vertical integration from its Los Angeles design and manufacturing base to its 160 retail stores allows a super-fast design-to-distribution cycle. Vertical integration is also a central theme of brand identity. Figure 13.4 shows one of its advertisements.

Zara is another fashion clothing business that has cut cycle times and maximized market responsiveness through a vertically integrated strategy that challenges the industry's dominant model of contract manufacture (see Strategy Capsule 13.2).

Compounding Risk To the extent that vertical integration ties a company to its internal suppliers, vertical integration represents a compounding of risk insofar as problems at any one stage of production threaten production and profitability at all

FIGURE 13.4 An American Apparel Advertisement



SOURCE: WWW.AMERICANAPPAREL.NET/PRESSEINTERVADS2005/VERTICAL.HTML

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STRATEGY CAPSULE 13.2

Making Vertical Integration Work: Zara

Zara is the main division and brand of the Spanish clothing company, Inditex (Industria de Diseño Textil, S.A). Zara contributes 68% of Inditex’s sales. Between 2000 and 2006, Inditex achieved sales growth

of 30% a year, a net margin of 11%, and a return on average equity of 29% – well ahead of Gap, H&M, or Mango. By the end of 2006, Zara operated over 1,400 stores in 40 countries.

Zara's success is based on a business system that achieves a speed of response to market demand that is without precedent in the fast-moving fashion clothing sector. Zara's cycles of design, production, and distribution are substantially faster than any of its main competitors. For most fashion retailers there is a six-month lag between completing a new design and deliveries arriving at retail stores. Zara can take a new design from drawing board to retail store in as little as three weeks.

Products are designed at the Inditex headquarters in La Coruna on the northwest tip of Spain. Over 40,000 garments are designed annually with about one-quarter entering production. Designs are sketched, committed to the CAD system, then a sample is handmade by skilled workers located within the design facility. Working alongside the designers are "market specialists" who monitor sales and market trends in a particular country or region, and "buyers" who handle procurement and production planning. The three groups coordinate closely and jointly select which products go into production.

Close to half of Zara's products are manufactured within Zara's local network, which comprises Zara's own factories and subcontractors who undertake all sewing operations. The rest is outsourced to third-party manufacturers.

For its own production, 40% of fabric requirements are supplied by Comidex – a wholly owned subsidiary of Inditex. Most fabric is supplied undyed. Postponing dying until later in the production process allows colors to be changed at short notice.

Finished products are ironed, labeled (including tags with prices in local currencies), bagged in boxes or on hangers ready for retail display, then transferred by monorail to the La Coruna distribution center. Each retail store submits its orders twice a week and receives

shipments twice a week. Orders are dispatched within eight hours of receipt and are delivered within 24 hours in Europe, 48 hours in the US, and 72 hours in Japan.

Zara owns and manages almost all its retail stores. This allows standardized layout and window displays and close communication and collaboration between store managers and headquarters.

Zara's tightly coordinated system allows quick response to market demand. At the beginning of each season only small numbers of each new item are produced and are placed in a few lead stores. According to market response, Zara then adjusts production. Typically, Zara's products spend no more than two weeks in a retail store. Product market specialists provide critical feedback that is used both to adjust production levels and to make design or color modifications to existing items.

The close, informal information networks within Zara are critical to product design. Although designers begin working on new designs some nine months before each new season, continuous adjustments to designs are made in response to new information on fashion trends and customer preferences. Designers and market specialists are encouraged to be alert to the new ranges released by the fashion houses of Milan, Paris, London, and New York; to the styles worn by trendsetters on TV, in popular music, and in the leading-edge clubs; and to feedback from store managers and other employees.

Zara's compressed product cycles have induced changes in customers' retail buying behavior. Zara customers make more frequent visits to their local stores than is typical for other fashion retailers. They also make faster purchase decisions in the knowledge that garments move quickly and are unlikely to be restocked.

Sources: Kasra Ferdows, Jose Machuca, and Michael Lewis, *Zara*, ECH Case Number 602-002-01, 2002; www.inditex.com.

other stages. When union workers at a General Motors brake plant went on strike in 1998, GM’s 24 US assembly plants were quickly brought to a halt. When technology or customer preferences are changing quickly it is especially likely that poor decisions at one stage have knock-on effects throughout the firm.

Assessing the Pros and Cons of Vertical Integration

Is vertical integration a beneficial strategy for a firm to pursue? As with most questions of strategy – it all depends. We have observed that there are costs and benefits associated with both vertical integration and with market contracts between firms. The value of our analysis is that we are in a position to determine the factors that will determine the relative advantages of the two approaches to managing vertical relationships. Table 13.1 summarizes some of the key criteria. Yet, even within the same industry, different companies can be successful with very different degrees of vertical integration. Thus in low-end fashion clothing, Zara is much more vertically integrated than either Hennes & Mauritz or Gap, while in designer clothing, Armani is more vertically integrated than Donna Karan. The key issue here is that, even when external circumstances are the same, the fact that different companies have different resources and capabilities and pursue different strategies means that they will make different decisions with regard to vertical integration.

Designing Vertical Relationships

Our discussion so far has compared vertical integration with arm’s-length relationships between buyers and sellers. In practice, there are a variety of relationships through which buyers and sellers can interact and coordinate their interests. Figure 13.5 shows a number of different types of relationship between buyers and sellers. These relationships may be classified in relation to two characteristics. First, the extent to which the buyer and seller commit resources to the relationship: the arm’s-length nature of

FIGURE 13.5 Different types of vertical relationship

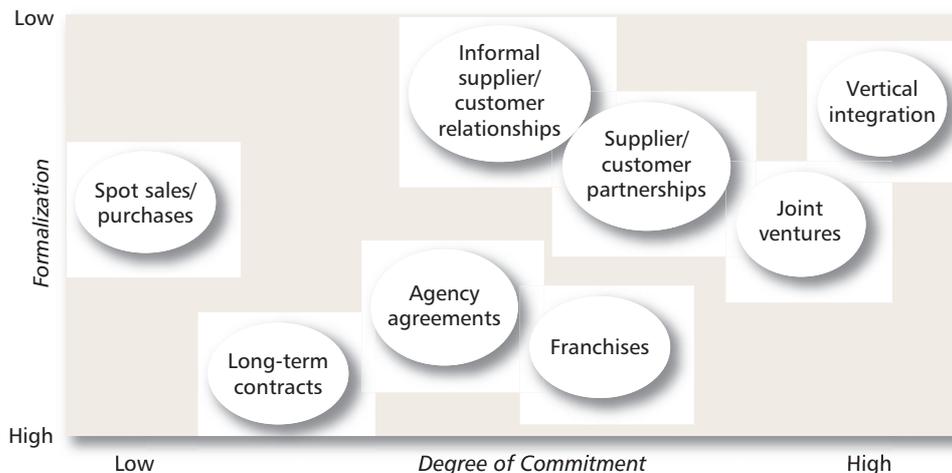


TABLE 13.1 Vertical Integration (VI) versus outsourcing: Some key Considerations

Characteristics of the vertical relationship	Implication
How many firms are there in the vertically adjacent activity?	The fewer the number of firms, the greater are the transaction costs and bigger the advantages of VI
Do transaction-specific investments need to be made by either party?	transaction-specific investments increase the advantages of VI
How evenly distributed is information between the vertical stages?	The greater are information asymmetries, the more likely is opportunistic behavior and the greater the advantages of VI
Are market transactions in intermediate products subject to taxes or regulations?	Taxes and regulations are a cost of market contracts that can be avoided by VI
How uncertain are the circumstances of the transactions over the period of the relationship?	The greater are uncertainties concerning costs, technologies, and demand, the greater the difficulty of writing contracts, and the greater the advantages of VI
Are two stages similar in terms of the optimal scale of operation?	The greater the dissimilarity, the greater the advantages of market contracts as compared with VI
Are the two stages strategically similar (e.g., similar key success factors, common resources/capabilities)?	The greater the strategic similarity, the greater the advantages of VI over outsourcing
How great is the need for continual investment in upgrading and extending capabilities within individual activities?	The greater the need to invest in capability development, the greater the advantages of outsourcing over VI
How great is the need for entrepreneurial flexibility and drive in the separate vertical activities?	The greater the need for entrepreneurship and flexibility, the greater the advantages of high-powered incentives provided by market contracts, and the greater the administrative disadvantages of VI
How uncertain is market demand?	The greater the unpredictability of demand, the greater the flexibility advantages of outsourcing.
Does vertical integration compound risk, exposing the entire value chain risks affecting individual stages?	The heavier the investment requirements and the greater the independent risks at each stage, the more risky is VI

spot contracts means that there is no significant commitment; vertical integration involves substantial investment. Second, the formalization of the relationship: long-term contracts and franchises typically involve complex written agreements; spot contracts may involve little or no documentation, but are bound by common law; collaborative agreements between buyers and sellers are by definition informal, while the formality of vertical integration is at the discretion of the firm's management.

Different Types of Vertical Relationship

Different types of vertical relationship offer different combinations of advantages and disadvantages. Consider for example the following:

- *Long-term contracts.* Market transactions can be either *spot contracts* – buying a cargo of crude oil on the Rotterdam petroleum market – or *long-term contracts* that involve a series of transactions over a period of time and specify the terms of sales and the responsibilities of each party. Spot transactions work well under competitive conditions (many buyers and sellers and a standard product) where there is no need for transaction-specific investments by either party. Where closer supplier–customer ties are needed – particularly when one or both parties need to make transaction-specific investments – then a longer term contract can help avoid opportunism and provide the security needed to make the necessary investment. However, long-term contracts introduce their own problems. In particular, they cannot anticipate all the possible circumstances that may arise during the life of the contract and run the risk either of being too restrictive or so loose that they give rise to opportunism and conflicting interpretation. The inflexibility problems of long-term contracts are particularly evident in IT outsourcing when the agreement may be for a period of 10 years or more.¹³
- *Vendor partnerships.* The greater the difficulties of specifying complete contracts for long-term supplier–customer deals, the more likely it is that vertical relationships will be based on trust and mutual understanding. Such relationships can provide the security needed for transaction-specific investments, the flexibility to meet changing circumstances, and the incentives to avoid opportunism. Such arrangements may be entirely *relational contracts* with no written contract at all. The model for vendor partnerships has been the close collaborative relationships that many Japanese companies have with their suppliers. During the late 1980s, Toyota and Nissan directly produced about 20 to 23% of the value of their cars, whereas Ford accounted for 50% of its production value and GM for about 70%. Yet, as Jeff Dyer has shown, the Japanese automakers have been remarkably successful in achieving close collaboration in technology, quality control, design, and scheduling of production and deliveries.¹⁴
- *Franchising.* A franchise is a contractual agreement between the owner of a trademark and a business system (the franchiser) that permits the franchisee to produce and market the franchiser's product or service in a specified area. Franchising brings together the brand, marketing capabilities, and business systems of the large corporation with the entrepreneurship and local knowledge of small firms. The franchising systems of companies such as McDonald's, Century 21 Real Estate, Hilton Hotels, and Seven-Eleven

convenience stores facilitate the close coordination and investment in transaction-specific assets that vertical integration permits with the high-powered incentives, flexibility, and cooperation between strategically dissimilar businesses that market contracts make possible.

Choosing between Alternative Vertical Relationships

Designing vertical relationships is not just a “make or buy” choice. Between full vertical integration and spot market contracts, there is a broad spectrum of alternative organizational forms. Choosing the most suitable vertical relationship depends on the economic characteristics of the activities involved, legal and fiscal circumstances, and the strategies and resources of the firms involved. Even within the same industry, what is best for one company will not make sense for another company whose strategy and capabilities are different. While most food and beverage chains have expanded through franchising, Starbucks, anxious to replicate precisely its unique “Starbucks experience,” directly owns and manages its retail outlets. While most banks have been outsourcing IT to companies such as IBM and EDS, US credit card group Capital One sees IT as a key source of competitive advantage: “IT is our central nervous system . . . if we outsourced tomorrow we might save a dollar or two on each account, but we would lose flexibility and value and service levels.”¹⁵

In addition to the factors that we have already considered, the design of vertical relationships needs to take careful account of the following:

- 1** *Allocation of risk.* Any arrangement beyond a spot contract must cope with uncertainties over the course of the contract. A key feature of any contract is that its terms involve, often implicitly, an allocation of risks between the parties. How risk is shared is dependent partly on bargaining power and partly on efficiency considerations. In franchise agreements, the franchisee (as the weaker partner) bears most of the risk – it is the franchisee’s capital that is at risk and the franchisee pays the franchiser a flat royalty based on sales revenues. In oil exploration, outsourcing agreements between the oil majors (such as Chevron, Exxon Mobil, and ENI) and drilling companies (such as Schlumberger and Halliburton) have moved from fixed-price contracts to risk-sharing agreements where the driller often takes an equity stake in the project.
- 2** *Incentive structures.* For a contract to minimize transaction costs it must provide an appropriate set of incentives to the parties. Thus, unless a contract for the supply of ready-mixed concrete to construction projects specifies the proportions of cement, sand, and gravel, there is an incentive to supply substandard concrete. However, achieving completeness in the specification of contracts also bears a cost. The \$400 toilet seats supplied to the US Navy may reflect the costs of meeting specifications that filled many sheets of paper. Very often, the most effective incentive is the promise of future business. Hence, in privatizing public services – such as passenger rail services or local refuse collection – the key incentive for service quality is a fixed-term operating contract with regular performance reviews and the prospect of competition at contract renewal time. Toyota and Marks & Spencer’s vendor partnerships depend on the incentive that satisfactory performance will lead to a long-term business relationship.

Recent Trends

The main feature of recent years has been a growing diversity of hybrid vertical relationships that have attempted to reconcile the flexibility and incentives of market transactions with the close collaboration provided by vertical integration. Although collaborative vertical relationships are viewed as a recent phenomenon – associated with Silicon Valley and Japanese supplier networks – closely linked value chains in which small, specialist enterprises collaborate are a long-time feature of craft industries in Europe, India, and elsewhere. These collaborative vertical relationships are evident in the industrial districts of northern Italy – notably in textiles,¹⁶ packaging equipment,¹⁷ and motorcycles.¹⁸ The success of Japanese manufacturing companies with their close collaborative relationships with suppliers – including extensive knowledge sharing¹⁹ – has exerted a powerful influence on American and European companies over the past two decades. There has been a massive shift from arm's-length supplier relationships to long-term collaboration with fewer suppliers. In many instances, competitive tendering and multiple sourcing have been replaced by single-supplier arrangements. Vendor relationships frequently involve supplier certification and quality management programs and technical collaboration.

The pace of outsourcing has been intensified by companies' enthusiasm for exploiting international cost differences. Large companies in North America and Western Europe are increasingly outsourcing manufacturing to China and services (including call centers and IT) to India. We shall return to these international dimensions of outsourcing in Chapter 14.²⁰

The mutual dependence that results from close, long-term supplier-buyer relationships creates vulnerability for both parties. While trust may alleviate some of the risks of opportunism, companies can also reinforce their vertical relationships and discourage opportunism through equity stakes and profit sharing arrangements. For example: Commonwealth Bank of Australia took an equity stake in its IT supplier, EDS Australia; pharmaceutical companies often acquire equity stakes in the biotech companies that undertake much of their R&D; and, as already noted, oilfield services companies are increasingly equity partners in upstream projects.

However, in this world of closer vertical relationships, some trends have been in the opposite direction. The internet has radically reduced the transaction costs of markets – particularly in pruning search costs and facilitating electronic payments. The result has been a revival in arm's-length competitive contracting through business-to-business e-commerce hubs such as Covisint (auto parts), Elemica (chemicals), and Rock and Dirt (construction equipment).²¹

While the form of vertical relationships has changed, the trend towards increasing outsourcing has continued. The result is that most companies have specialized in fewer activities within their value chains. Outsourcing has extended from components to a wide range of business services including payroll, IT, training, and customer service and support. Increasingly, outsourcing involves not just individual components and services, but whole chunks of the value chain. In electronics, the design and manufacture of entire products are often outsourced to contract manufacturers such as Hon Hai Precision Industry Co., which makes Apple iPods, Nokia phones, and Sony's Play Station.

The extent of outsourcing and vertical de-integration has given rise to a new organizational form: the *virtual corporation*, where the primary function of the company is coordinating the activities of a network of suppliers.²² Such extreme levels

of outsourcing reduce the strategic role of the company to that of a systems integrator. The critical issue is whether a company that outsources most functions can retain *architectural capabilities* needed to manage the *component capabilities* of the various partners and contractors. The risk is that the virtual corporation may degenerate into a “hollow corporation,” where it loses the capability to evolve and adapt to changing circumstances.²³ If, as Hamel and Prahalad argue, core competences are embodied in “core products” then the more these core products are outsourced, then the greater is the potential for the erosion of core competence.²⁴ Andre Prencipe’s research into aero engines points to the complementarity between architectural capabilities and component capabilities. Thus, even when the aero engine manufacturers outsource key components, they typically maintain R&D into those component technologies.²⁵

Summary

Deciding which parts of the value chain to engage in presents companies with one of their most difficult strategic decisions. The conventional analysis of vertical integration has looked simply at the efficiency of markets as compared with the efficiency of firms: if the cost of transacting through the market is greater than the cost of administering within the firm, then the company should vertically integrate across the stages. Transaction cost analysis does not, however, provide the complete answer. In the first place, vertical strategies are not simply make-or-buy choices – there is a wide variety of ways in which a company can structure vertical relationships. Secondly, the most critical long-run consideration is the development of organizational capability. If a company is to sustain competitive advantage, it must restrict itself to those activities where it possesses the capabilities that are superior to those of the other companies that perform those activities. If my company’s data-processing capabilities are inferior to those of IBM and its logistics capabilities are inferior to those of Federal Express, I should consider outsourcing these activities. The most difficult issues arise where there are linkages between value chain activities. Even though a

contract manufacturer may be able to manufacture my remote-controlled lawnmower more efficiently than I can internally, what would be the implications for my new product development capability if I no longer have in-house manufacturing?

Ultimately, vertical integration decisions revolve around two key questions. First, which activities will we undertake internally and which will we outsource? Second, how do we design our vertical arrangements with both external and internal suppliers and buyers? In the case of external relations, these may be conducted through spot contracts, long-term contracts, or some form of strategic alliance. Similar ranges of alternatives face the vertically integrated firm – including the option of arm’s-length negotiated contracts. Both types of decision are critically dependent on the firm’s competitive strategy and the capabilities it possesses. As we have already noted, the critical issue for the individual business is not to follow conventional wisdom but carefully to evaluate its strategic needs, its resources and capabilities at different stages in the value chain, the characteristics of the transactions involved, and the relative attractiveness of different stages of the value chain.

Self-Study Questions

- 1 The discussion of “The Shifting Boundary between Firms and Markets” argues that most of the developments in information and communication technology (e.g. telephone and computer) tended to lower the costs of administration within the firm relative to the transaction costs of markets. What about the internet? Has the impact of the internet been the same, or has the internet reduced the cost of market transactions to a greater extent than reducing the costs of internal administration?
- 2 Figure 13.2 notes that the large US companies account for a smaller percentage of total employment, a development which is attributed to greater specialization as a result of a more turbulent business environment. Explain why external turbulence encourages outsourcing and core business focusing.
- 3 In Strategy Capsule 13.1, Steve Rosenbush argues that integration between media content and media distribution companies (and, specifically, between Disney and Comcast) is strategically advantageous. John Kay suggests that there is little need for common ownerships between distribution channels and the content they carry. Explain the arguments of each. Who do you agree with?
- 4 Ford has narrowed its vertical scope by selling Hertz, its car rental subsidiary, and spinning off Visteon, its parts manufacturing subsidiary. Examine the pros and cons of Ford owning (a) a car rental company and (b) an auto parts manufacturer.
- 5 Zara manufactures close to half of the clothes sold in its retail stores and undertakes all of its own distribution from manufacturing plants to retail outlets. Gap outsources production and distribution. Should Zara outsource its manufacturing and distribution? Should Gap backward integrate into production and distribution?

Notes

- 1 In practice, determining the boundary between business strategy and corporate strategy is blurred. When Dell Computer expanded from PCs into servers, was this diversification or simply product line extension within the same business? It all depends on where we draw industry boundaries.
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- 3 R. H. Coase, “The Nature of the Firm,” *Economica* 4 (1937): 386–405.
- 4 The term *interaction costs* has also been used to describe “the time and money expended whenever people and companies exchange goods, services or ideas.” See J. Hagel and M. Singer, “Unbundling the Corporation,” *Harvard Business Review* (March–April 1999): 133–44.
- 5 The invention of double-entry bookkeeping dates back to the 16th century. See L. Zan, “Accounting and Management Discourse in Proindustrial Settings: The Venice Arsenal at the turn of the 16th Century,” *Accounting and Business Research* 32 (2004): 145–75.
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