Vertical Integration

Idea In Short

Vertical integration is a strategy that allows a company to streamline its operations by taking direct ownership of various stages of its production process rather than relying on external contractors or suppliers.

When a business chooses to expand by either acquiring another company or developing expertise in an unchartered area itself, it uses either of two strategies:

1. Horizontal Integration, and
2. Vertical Integration

Understanding these two concepts is critical to make sense of the strategy behind decisions made by companies and make a reasonable prediction1 about their future.

Horizontal Integration

Put simply, Horizontal Integration is when a company tries to expand by acquiring a similar one in their industry at the same level of the supply chain.

> Marriott Hotels' acquisition of Starwood Hotels & Resorts for $13 billion in 2015, which created the world's largest hotel chain, is a classic example of Horizontal Integration.

Vertical Integration

Vertical integration is an organizational strategy that prioritizes the incorporation of more stages of a product or service's supply chain into the organization's own processes and management. As economist Kenneth Arrow writes:

> An incentive for vertical integration is replacement of the costs of buying and selling on the market by the costs of intra-firm transfers, with the anticipation being that the latter would ultimately be more cost effective.

Vertical Integration is when a company acquires another company that operates before or after it in the supply chain. For instance, a business that relies on another for its supplies may find that it is unreliable, which is affecting business. In turn, it may vertically integrate with its supplier to reduce late deliveries and increase efficiencies. Businesses integrate to obtain greater control of the supply chain. Suppliers need buyers and vice-versa. Yet, there is a competitive aspect involved. There is nothing to stop either the supplier or buyer from doing their business elsewhere. By vertically integrating, the supplier no longer worries about having control, and the buyer no longer worries about unreliable deliveries.

> Carnegie was a massive steel manufacturer in the late 19th century. It vertically integrated by acquiring companies before itself in the supply chain. The process of making steel requires raw material extraction – iron ore and coal. It then requires those materials to be refined before it is then sent to Carnegie Steel to manufacture into the final goods. Not only did the company own the mills where it made steel, but it also owned mines from where iron ore was extracted, coal mines that supplied the coal, ships that transported iron ore, railroads that transported coal to the factory, and coke oven where coal was coked. Carnegie Steel owned both the miners that extract the raw materials, as well as the refineries – thereby owning virtually the whole supply chain.

Vertical Integration is further divided into two main types:

1. Forward Integration
2. Backward Integration, and
3. Balanced Integration

Forward Integration

Conglomerate integration is another form of integration that involves the combination of firms that are involved in unrelated business activities If a vertically integrating company acquires a company ahead of it in the supply chain or builds in-house expertise of the same process, it is called Forward Integration. In other words, when a company at the beginning of the supply chain controls stages farther down the chain, it is referred as forward integration. In its most basic form, the supply chain contains the raw material extractors, the manufacturers, and the retail distributors. Forward vertical integration is where the company essentially mergers or buys its customer.

Also known as upstream integration, this type of vertical integration is not so common. Generally speaking, it is the big retailers and the companies at the end of the chain that has the greatest purchasing power. This allows them to be the predator rather than the prey – meaning the firms at the end of the chain have the money to purchase companies behind them, whilst the opposite is true for firms earlier in the supply chain. Part of the reason forward vertical integration is not common is because the companies at the end of the supply chain are usually very condensed. By contrast, there are thousands of suppliers that could only dream of integrating upwards. For example, thousands of cocoa bean farmers supply Mondelez. Yet, there is no way a small farming business in Columbia could afford to purchase or merge with Mondelez.

> In 2011, direct-to-consumer sales accounted for 16% of Nike's revenue. By fiscal 2020, direct-to-consumer sales accounted for 35% of Nike's revenue. Nike reducing dependence on wholesalers, distributors & retailers, and prioritizing direct-to-consumer sales is an example of Forward Integration. However, in this case, Nike is pursuing a Forward integration strategy without acquiring external players.

Backward Integration

If a vertically integrating company acquires a company behind it in the supply chain or builds in-house expertise of the same process, it is called Backward Integration. In other words, Backward Integration takes place when businesses at the end of the supply chain take on activities that are upstream of its products or services.

Backward vertical integration is where a company joins with another that is at a stage before itself in the supply chain. In other words, it integrates with one of its suppliers. It is known at backward vertical integration because the firm is behind in the supply chain. So, in a basic supply chain of raw material extraction, manufacturing, and distribution – the distributor could merge with the raw material extractor or the manufacturer and be classed as backward vertical integration. This is because they are at the stage behind in the supply chain.

Also known as downstream integration, this type of vertical integration is quite common. This is because big businesses at the end of the supply chain tend to have the purchasing power to consume their suppliers.

> Netflix originally started renting DVDs through the mail but later pivoted to providing on-demand entertainment using the internet. As a streaming service, the company would entirely rely on licensed shows to fill up its content library in its early days. Later, Netflix employed the backward integration strategy, starting their own production house to make Netflix original shows.

Balanced Integration

There is a third type of integration – balanced integration. This is quite simply a combination of both backward and forwards integration. For instance, balanced integration would be where a company mergers' with both a company that is before it in the supply chain, as well as one that is after.

Therefore, balanced integration involves two transactions – one downstream, and another upstream. For example, Hershey relies on cocoa bean suppliers to provide it with its raw materials – it also relies on distributors such as Walmart and Target to sells its products.

> An example of balanced integration would be if Hershey's were to acquire both its coca bean suppliers AND a distributor such as Target. Obviously, this is a very rare type of integration that infrequently occurs – mainly due to the cost, but also due to potential legal disputes that may arise due to monopoly control of the vertical supply chain.

Degrees of Vertical Integration

According to the Corporate Finance Institute2, four degrees of Vertical Integration exist:

1. Full Vertical Integration

2. Quasi Vertical Integration
3. Long-term Contracts, and
4. Spot Contracts

Full Vertical Integration

Obtaining all the assets, resources, and expertise needed to replicate the upstream or downstream member of the supply chain.

Quasi Vertical Integration

Obtaining some stake in a supplier in the form of specialized investments or an equity stake to obtain agency benefits by increasing the ownership interest in the outcome.

Long-term Contracts

A diluted form of vertical integration in which some elements of procurement are held constant to reduce inconsistencies in product delivery while holding costs constant to a certain extent.

Spot Contracts

The point at which a firm is not vertically integrated is when the firm relies on spot contracts to receive the immediate input necessary for its production.

Case Study - Apple

Apple is one of the most successful examples of both Forward and Backward Integration with sustained success. Apple integrates backward by manufacturing the chips it uses in the Apple phones. By doing so, Apple can control chip quality and manufacturing costs. Apple integrates forward by running its own Apple stores to sell its products. By doing so, Apple saves commission it would have to otherwise pay to retail partners & maintains a uniform sense of aesthetics across stores worldwide.

Case Study - ZARA

Another successful example of vertical Integration is the globally renowned brand ZARA.

The company manufactures the clothes it sells in its retail stores as well designs them in-house. This backward vertical Integration ensures ZARA can keep up with changing fashion trends and update inventory quickly relative to competitors, resulting in higher profitability3 and a competitive advantage in the clothing industry.

Case Study - McDonalds

McDonald's, the world's largest restaurant company, also employs Vertical Integration. The company integrates backward by running manufacturing plants to procure raw materials used to prepare its eatables. Other than this, the company also grows its agricultural products to maintain a uniform quality standard.

Case Study - Amazon

Amazon has vertically integrated much of its business. Not only does it act as a marketplace for buyers and sellers – but it also offers its own products and services, as well as its own distribution channel. So in effect, it has 3 stages in the supply chain. It sources the products, markets and sells them on its website, and then distributes them.

Case Study - IKEA

IKEA is known as a flat-pack retailer that sells mostly wooden furniture, but also other fixtures and fittings. It is the last in the supply chain as it directly sells to the final consumer. In 2015, IKEA made a huge step in ensuring complete vertical integration by purchasing a Romanian forest. The company added to this by purchasing forestland in Alabama in 2018 – aligning the companies aim to create a sustainable supply chain. Not only does it now control much of the raw material production, but it also controls the manufacturing process through its subsidiary – Swedwood, which was renamed in 2013 to IKEA Industry. So it controls the production of the wood, the manufacturing process, and the final distribution through its retail units.

Advantages

Economies Of Scale

Vertical integration gives a company better economies of scale. Large companies employ economies of scale when they are able to cut costs while ramping up productions—they take advantage of their size. For example, a company could lower the per-unit cost by buying in bulk or by reassigning employees from failing ventures. Vertically integrated companies eliminate overhead by consolidating management and streamlining processes.

Reliability

Many businesses face problems with their suppliers. This might be late deliveries, poor service, or failing to update and adapt to new trends. At the same time, suppliers may be situated in a location that is unfavourable – meaning deliveries take longer and are more likely to be late. Through vertical integration, firms are able to benefit from a close co-operation between both parties. It controls that part of the supply chain, so difficulties can be ironed out. For instance, proximity issues may be addressed by moving facilities closer to each other.

Power over Suppliers/Buyers

Suppliers and buyers of goods may find themselves in a position whereby they are negotiating disadvantage. In other words, the company they are dealing with has many other options, whilst the company itself only has a few. At the same time, certain players in the market might be difficult to work with, but are necessary in order to do business. By vertically integrating, businesses are able to avoid dealing with such companies, or at least better dictate terms and prices with them – after all, it owns one of its competitors.

Cost Control

The more the pieces of the supply chain companies own, the more money they can save. The removal of intermediaries from the supply chain leads to increased cost savings, some of which companies can keep to themselves and pass some of them to the customers. The decrease in prices leads to increased customer demand, leading to more sales and profits.

Increased Market Control

Imagine a scenario where a retailer integrates backward with a producer or a manufacturer. Now, suppose, for the sake of this example, that this vertical backward Integration occurs in an industry or market where one of two large producers controls much of the good needed to make the finished product. In this case, integration can lead to increased control over the competitive landscape and the market. Other than this, a backward integrating company could also inherit patents, resources & technology that could give it an advantage over competitors.

Better Product & Customer Knowledge

When a manufacturer integrates forwards by acquiring a retail company, it learns more about buyers and gets a better idea of customer behavior. Suppose the manufacturer has also integrated backward by owning raw material procurement. In that case, it can create products quickly based on changing consumer behavior. This way, the once manufacturer-only company can stay on top of the market.

Disadvantages

High Initial Costs

If a company vertically integrates by buying a company, it might have to shell out excessive money. If it is integrating vertically by setting up its operations internally, the company also has to spend a lot of money. In a worst-case scenario, if the vertical integration is unsuccessful, the company's balance sheet might go in the red.

Culture Mismatch

While cultural tensions might not seem like a problem, there have been multiple instances where vertical integration failed to materialize due to cultural and value-based conflicts. For example, a new-age technology-driven startup merging with an old-age sales-driven organization might face problems getting accustomed to the working methodology & culture of the parent organization.

Leads to Barriers of Entry

Controlling the entire supply chain is undoubtedly beneficial for a company. But if a company becomes harmfully dominant in a market by trying to monopolize, it can lead to unwarranted entry barriers, raising antitrust concerns.

Loss Of Focus

Running a successful retail business, for example, requires a different set of skills than a profitable factory. It's difficult to find a management team that's good at both. Integration can cause management to focus less on their core competencies, and more on the newly acquired assets.

Flexibility

Vertical integration reduces a company's flexibility by forcing them to follow trends in the segments they integrated. Suppose a company acquired a retailer for their product and created an outlet store that carried the old merchandise as well. That retailer's competition began using a new technology which boosted their sales. The new parent company would now need to acquire that technology to stay relevant in that market.

Summary

Vertical integration is when a firm extends its operations within its supply chain. It means that a vertically integrated company will bring in previously outsourced operations in-house. The direction of vertical integration can either be upstream (backward) or downstream (forward). It can be achieved either by internally developing an extended production line or by acquiring vertically.