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Vertical Integration: A Preliminary Insight

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Abstract: - The article aims to explain the concept of vertical integration and its impact and implications on various companies like Dell, Amazon, Zara, Apple, Luxottica, Target, Netflix and Amazon. The study aims to show the pros and cons of vertical integration by sighting examples from real life cases and to help understand the implications of vertical integration better.

I. INTRODUCTION

Vertical integration has usually referred to the common ownership of multiple sequential stages of production and distribution which utilize what is widely regarded as a reasonably unified product and process technology (GOLD, 1986). Managers need a ready and timely supply of raw materials requirements and services, and a ready market for their outputs. The business arrangements that are aim to control these risks can be considered forms of vertical integration(Harrigan, 1984). In general, there are four phases in any manufacturing: commodities or raw material, manufacturing, distribution and the final step, retail. When two or more of these steps of this process are integrated by a company, it is called vertical integration.

Vertical integration can be of two types:

A. Forward Integration

Forward integration is when a company at the starting of the supply chain starts controlling stages that follow. It is usually expected to improve performance by creating greater control over the nature and the level of demand. It also aims to capture associated profit margins.

B. Backward integration

Backward integration is when a business at the end for the further step of the supply chain takes on the previous activities. It is usually expected to increase the efficiency due to easy and timely availability of the resources and cost advantage due to newly joined stages.

A lot of attention has been given to vertical integration in the literature for vertical integration in strategic aspects due to the fact that vertical integration might raise rivals costs strategy due to foreclosure effect: the integrated firm leaves the intermediate market and and non integrated firms enjoy more market power and raise intermediate price that they charge downstream firms.(Avenel, 2008)

II. REVIEW OF LITERATURE

Market imperfections create various incentives and opportunities for firms to integrate vertically. Studies have shown that vertical integration is induced by transaction costs, imperfect competition, imperfect distribution of information and other factors(Liebermen, 1991).

Vertical integration might just offer temporary state-of-the-art advantage but it must be weighed against the advantage of being flexible in order to exploit the next technological innovation that comes into the market and hence, early commitment to vertical integration might be risky and increase the cost substantially instead of decreasing the costs. (Harrigan, 1984). Vertical integration is more likely to be pro-competitive when there are small numbers of non-integrated rivals in the market and that a small amount of integration is almost always beneficial for the companies despite the free-riding problem that the integrated firms face.(Loertscher & Reisinger, 2014)

Supply chain integration is required to achieve superior performance. Two types of strategic orientation emerged as most critical to implementing supply chain process integration – cost orientation and customer orientation process integration presents a superior opportunity for firms to achieve cost advantage because redundancies can be reduced and efficiency can be improved. (Chen, 2007)

Vertical integration with less efficient retailers can raise consumer surplus and total welfare by improving productive efficiency of the producer. This output-shifting effect gives rise to a precompetitive outcome whenever the integrated firm engages in below-cost pricing at the wholesale level.(Chen, 2007)

A partially backward integrated firm can potentially increase the profit through gains in production efficiency and through a lower price for externally purchased inputs. One strategic rationale is development of a competitive fringe purchasing for competitive supplies (Love & Burton, 1999). Some backward principle is optimal if upstream production can be increased. (Riordan, 1989). If the competition amongst the upstream firm is strong, a merger of a downstream firm with the upstream firm will not allow its upstream competitors to raise cost and the effect on the rival firms will be low or marginal.(Avenel, 2008)

Forward integration by an input monopolist has been shown to be influenced or motivated by downstream industry's inefficient use of the input. By a forward vertical integration, a monopolist aims to internalize the deadweight efficiency loss. (Reisinger & Tarantino, 2015)

A moderate increase in a firm's competition will tend to reduce the incentive to integrate vertically as it would improve the outside options of their non-integrated suppliers, and motivate them to innovate too. On the other hand, too much competition will promote vertical integration. Thus, a U-shaped relationship between competition and vertical integration has been found.(Aghion, Griffith, & Howitt, 2006)

As understood by the review of Literature, Vertical integration has both advantages and disadvantages. It largely depends on the market competition, condition, changes in the technology and the degree of integration by the company. Some cases have been discussed below.

Examples :-

(Examples against vertical integration) Vertical integration was initially used most efficiently in the oil and petroleum industry. A report by McKinsey and company stated that, in the 1970s and 1980s, big companies such as BP and Shell were able to control the whole process of bringing crude oil to the end consumer. Initially, oil companies owned only crude oil exploration and extraction. But later, they acquired downstream refineries and distribution network. This gave them control over the whole process and be successful.

A. DELL Computers

The same report also stated Dell Computer, one of the most successful companies at that time, took vertical integration to a new level(Idea, 2009). They have termed the strategy adopted as Virtual Integration. It is not the same as the traditional vertical integration. In this, the firm maintains a more binding relationship with the suppliers. Dell did not own the suppliers, but through exchange of information and other loose associations, it controlled its supply chain. This helped them create $12 billion in just 13 years. Michael Dell founded the company with the vision of eliminating the dealer channel and selling directly to the consumer. This gave them a substantial cost advantage. This gave them access to a large pool of valuable data which helped them to leverage their relationships with suppliers and buyers. The company has used the information along with technology to blur the boundaries between the suppliers, manufacturers and the consumers.

In the computer industry, companies needed to be an expert in a wide area of goods to be able to manufacture the computer. They had to manufacture and assemble all the components. But this has changed since virtual integration was introduced. Thus, they went against vertical integration as it wouldn't have allowed them to be specialists in their industry. Virtual integration allows Dell to reduce the cost of capital for establishing new units for every component. They also can concentrate on areas that they are most efficient in to gain a better competitive advantage. They invest in the activities that they do the best and out-source the others. They still can retain control over the supply chain because of the information and technology resources. Virtual integration combines the benefits derived from both vertical integration and a virtual corporation (Magretta, 1998).

B. ZARA

(Lu, 2014) Zara is known for its fresh collection and efficient distribution of products. They produce around 450 million items a year. They produce them in small batches and supply the goods to retailers around the world twice a week. This is possible only because they control most of their supply chain. They have more control than most of their competitors in the market. Their main strategy has been to induce growth through vertical integration. This strategy allows them to diversify.

(Lu, 2014)The secret to their success is their centralised logistics systems. This allows them to make coordinated decisions. This allows every staff involved to know the timeline and how their activities pan out with respect to other functions.

(Lu, 2014)Their strong distribution network allows them to supply the products within 24 hours in European markets and 40 hours in American and Asian markets. The author states that "Its cross-functional operations strategy, coupled with its vertically integrated supply chain, enables mass production under push control, leading to well-managed inventories, lower markdowns, higher profitability, and value creation for shareholders in the short and long term". "relying on a contrarian strategy of vertical integration in retail apparel to introduce dramatically more new items each year. The virtuous circle this approach sustains includes more frequent shopper visits to stores, fewer sales on markdown and faster cash conversion cycles."(O'Marah, 2016)

C. APPLE Co.

Apple has for about 40 years has championed a vertical model when it comes to technology, which features an integrated hardware-and-software approach. For example, the iPhone and iPad have the hardware and software designed by Apple, along with its own in-house processors for the devices. This vertical integration has allowed Apple to set the pace for mobile computing. "Despite the benefits of specialization, it can make sense to have everything under one roof," said Wharton management professor David Hsu. (Knowledge@Warton, 2012)

D. LUXOTTICA

(Luxottica: How vertical integration has made it the world leader in eyewear, 2017)

Luxottica is an Italian company in the eyewear industry and holds a huge market share. Most people recognise it by its subsidiaries like Ray-Ban, Oakley and Persol. It is a benchmark to excelling because of its extensive vertical-integration model build over the years. Its business model is the group's biggest competitive advantage. Their founder and CEO, Leonardo Del Vecchio understood the importance of having complete and absolute control on every end of the business and he decided to backward integrate initially by manufacturing the entire frame and not just its parts. They incorporated 3D printing to build flexibility in their changing designs and the moulds. This gave them autonomy to manufacture in the desired quantity and rapidly change designs while maintaining quality standards.

Later they expanded into their distribution system by delivering straight to homes and establishing retail stores and distributors of their own. This level of forward integration benefitted them in multiple ways. They could understand first hand, the demand and preferences of the customers and hence stimulate cross-functional innovations. The overall integration from "design to distribution" has helped Luxottica add some very exotic and prestigious design houses on its portfolio. (Business Model, 2018)

E. TARGET CORPORATION

Multi-brand discount retail giant, Target Corporation is a typical example of Vertical Integration. It already had an established and reliable distribution system through its inventory management and stores. It decided to backward integrate by launching its own brands and private labels in various industries. "Archer Farms", "up & up", and "Market Pantry" are a few to name. Also to note that these brands compete with others as well as each other on the shelves of Target Stores. Every brand targets a specific segment of audience. They have their own furniture lime, home essentials label and even a private labelled meat line.

In 2007 they even branched out to vertical integration by offering their own financing options in the form of credit and debit cards. A presence in the heart of the market and primary data from their customers and also the sales charts of other brands on their shelves gives them competitive advantage and deeper understanding of customers' needs and purchasing patterns. They can even comprehend their competitors' moves.

Target will continue to venture into vertical integration by diversifying is manufacturing units. But it needs to ensure that it is able to maintain good public faith and does to fail to keep up its standards of quality. Because it does not hold expertise in all industries, it can be difficult to keep up with the market. They have excelled till now and hope to do so in the future as well. (Target & Vertical Integration, 2017) (Vertical Integration Strategies, 2016)

F. NETFLIX

The most famous movies and TV shows distributor, Netflix is working hard on its ventures into vertical integration. Having pooled in enough money from its revenues, it decided to invest huge amounts of money into exclusive series, starting with 'House of Cards' in 2013, to be the sole distributor of this content. They have released 120+ original series which gives them exclusive rights to display the content. No other media distributor can give access to these series. This helped Netflix establish originality and release itself from competitive pricing. There is no risk of breach by other distributors. There is a distinctive point of difference, Vertical Integration is to be able to own and distribute the media content that is available for streaming.

G. AMAZON

Amazon started off as a retail portal for books where I s sold books published by various publication houses. It decided to venture into backward integration when it stated selling its own books. It started publishing the books of other authors and eliminated an additional layer of profit sharing. Although it did not cease the sale of other publications, this move gives it a diverse basket of SKUs including ones where there is no profit distribution. This global e-commerce retail chain hit the book market with its launch of the Kindle which was a substitute to all printed versions of any book. Almost any and every book was made available in the electronic form. It had a fully integrated global publishing strategy. (Does Amazon Want to Monopolize The Entire Publishing Chain?)

III. CONCLUSION

Thus from the above examples we can clearly identify a few perks and risks of vertical integration.

- It gives exclusivity and autonomy of operations. There is no need to rely on a supplier or distributor.
- It allows branding and labelling over every element and hence adds to the marketing.
- There is no risk of incompatibility with external organisations whether suppliers or distributors, as the case may be.
- It provides economies of scale and logistics and gives scope to customisation. It also allows cheaper supply of goods and services without providing for profits along the value chain and minimizing costs.
- The company knows more about the market by standing in it on its own, rather than relying on other sources for data and information.
- But on the same time there are risks like huge investment and hence lack of capital for core operations, lack of expertise in the task of the supplier or distributor, and increase in overall expenses due lack of scale of business. So the trade-off must be weighed wisely.

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