Corporate Strategy:

Vertical integration, diversification and strategic alliances

Part 6

Vertical Integration, Diversification, and Strategic Alliances

- ***Introduction:***

  Corporate-level strategy is concerned with two main questions:

  – what business areas should a company participate in so as to maximize its long-run profitability; and what strategies should it use to enter into and exit from business areas?

  – With regard to the choice of business areas to compete in, a number of options are open to a company. The company may decide to vertically integrate into adjacent businesses or to diversify into a number of different business areas.

  – To add value, a corporate strategy should enable a company, or one of its business units, to perform one or more of the value-creation functions at a lower cost or perform them in a way that allows differentiation and brings a premium price.

Vertical Integration

- ***Vertical Integration:***

  Vertical integration means that a company is producing its own inputs (backward or upstream) or is disposing of its own outputs (forward or downstream integration).

  Example: for a company based in the assembly stage, backward integration involves moving into intermediate manufacturing and raw-material production. Forward integration involves movement into distribution. At each stage in the chain value is added to the product. What this means is that a company at that stage takes the product produced in the previous stage, transforms it in some way, and then sells the output at a higher price to a company at the next stage in the chain. Vertical integration involves a choice about which value-added stages of the raw material to consumer chain to compete in. In addition to forward and backward integration, it is also possible to distinguish between full integration and taper integration.

Vertical Integration

- ***Full Integration:*** A company achieves full integration when it produces all of a particular input needed for its processes or when it disposes of all of its output through its own operations.
- ***Taper Integration:*** Taper integration occurs when a company buys from independent suppliers in addition to company-owned suppliers or when it disposes of its output through independent outlets in addition to company-owned outlets.
- ***Creating Value through Vertical Integration:*** There are four main arguments for pursuing a vertical integration strategy. It enables the company to build barriers to new competition; it facilitates investments in efficiency-enhancing specialized assets; it protects product quality; and it results in improved scheduling.

Vertical Integration

- ***Building Entry Barriers:*** By vertically integrating backward to gain control over the source of critical inputs or to gain control over distribution channels, a company can build barriers to new entry into its industry.
- ***Facilitating Investments in Specialized Assets:*** A specialized asset is an asset that is designed to perform a specific task and whose value is significantly reduced in its next best use. Such assets allow them to lower the costs of value creation and/or to better differentiate their product offering from that of competitors.
- ***Protecting Product Quality:*** By protecting product quality, vertical integration enables a company to become a differentiated player in its core business. Example of McDonalds in Russia.

Vertical Integration

- ***Improved Scheduling:*** It is sometimes argued that strategic advantages arise from the easier planning, coordination, and scheduling of adjacent processes made possible in vertically integrated organizations.
- ***Argument Against Vertical Integration:*** First are cost disadvantages if a company becomes committed to purchasing inputs from company-owned suppliers when low-cost external sources of supply exist. Second, when technology is changing fast, vertical integration poses the hazard of tying a company to an obsolescent technology. Third, when demand conditions are unpredictable, it may be difficult to achieve close coordination among vertically integrated activities. Not all vertical integration opportunities have the same potential for value creation. Although vertical integration may initially have a favorable impact, the value created by additional vertical integration moves into areas more distant from a company's core business is likely to become increasingly marginal.

Strategic Alliances

- Under certain conditions, companies can realize the gains associated with vertical integration, without having to bear the associated bureaucratic costs, if they enter into long-term cooperative relationships with their trading partners. Such long-term relationships are often referred to as ***strategic alliances.***
- ***Short-term Contracts and Competitive Bidding:*** A short-term contract is one that lasts a year or less. A classic example is the automobile company that uses a ***competitive bidding strategy*** to negotiate the price for a particular part produced by component suppliers.
- ***Strategic Alliances and Long-Term Contracting.*** Long-term contracts are long term cooperative relationships between two companies. Both make a commitment to work together and seek ways of lowering the costs or raising the quality of inputs into the downstream company's value-creation process.

Strategic Alliances

- ***Building Long-Term Cooperative Relationships:*** How can a company achieve a stable, long-term strategic alliance with another, given the lack of trust, as well as the fear of holdup that arises in situation where one company has to invest in a specialized asset in order to trade with another? One way of designing long-term cooperative relationships to build trust and reduce the possibility of a company reneging on an agreement is for the company making investments in specialized assets to demand a hostage from its partner.

  Consider the cooperative relationship between Boeing and Northrop. Northrop is a major subcontractor for Boeing's commercial airline division. To serve Boeing's special needs, Northrop has had to invest in specialized assets. Because of the sunk costs associated with such investments, Northrop is dependent upon Boeing. Thus Boeing is in a position to renege on previous agreements and use the threat of switching orders to other suppliers as a way of driving down prices.

Strategic Alliances

- ***Boeing Example Continued:*** In practice, Boeing would be unlikely to do this since the company is also a major supplier to Northrop's defense division, providing many parts for the Stealth bomber. Boeing has had to make substantial investments in specialized assets in order to serve Northrop's needs. Thus the companies are mutually dependent. Boeing would be unlikely to renege on any pricing agreements with Northrop, for it knows that Northrop could respond in kind. Each company holds a hostage than can be used as insurance against the other company unilaterally reneging on prior pricing agreements.
- ***Credible Commitments:*** A credible commitment is a believable commitment to support the development of a long-term relationship between companies.

Strategic Alliances

- ***Maintaining Market Discipline:*** Building cooperative relationships with trading partners is good, but unless the company has some sanction that it can apply to that partner if it fails to live up to its side of the bargain, the result can be that the company becomes too dependent on an inefficient partner. One way of maintaining market discipline is to periodically renegotiate the agreements (every 4 or 5 years). Thus a partner knows that if it fails to live up to its side of the agreement the company may refuse to renew the agreement after a period of time.

Diversification

- ***Types of Diversification:***
  - ***Related Diversification:*** this refers to diversification into a new activity that is linked to a company's existing activity by a commonality between one or more components of each activity's value chain.
  - ***Unrelated Diversification:*** this refers to diversification into a new activity that has no obvious commonalities with any of the company's existing activities.
- ***Creating Value through Diversification:*** The diversified company can create value in three ways: acquiring and restructuring poorly run enterprises; by transferring competencies among businesses; and by realizing economies of scope.

Diversification

- ***Acquiring and Restructuring:*** A restructuring strategy is based on the premise that an efficiently managed company can create value by acquiring inefficient and poorly managed enterprises and improving the efficiency of those enterprises. Such improvements can come from a number of sources:
  - the acquiring company will typically replace the top management team of the acquired company with a more aggressive team.
  - the new team typically sells off any unproductive assets.
  - the new teams encouraged to intervene in the running of the acquired business.
  - to create incentives for the new top management team and other employees of the acquired unit.
  - the top managers of the acquired unit will also be made aware that failure to deliver performance improvements consistent with these goals within a given amount of time will probably result in their losing their jobs.

Diversification

- ***Transferring Competencies:*** Companies that base their diversification strategy on transferring competencies seek out new businesses related to their existing business by one or more value-creation functions. If successful, competency transfers can lower the costs of value creation in one or more of a company's diversified businesses or enable one or more of a company's diversified businesses to undertake their value-creation functions in a way that leads to differentiation and a premium price.
- ***Economies of Scope:*** Arise when two or more business units share resources such as manufacturing facilities, distribution channels, advertising campaigns, R&D costs, and so on. Each business unit that shares resources has to invest less in the shared functions.

Diversification

- ***Bureaucratic Costs and the Limits to Diversification:*** A large number of studies have come to the conclusion that extensive diversification tends to depress rather than improve company profitability. This research raises the question: why does diversification fail so often?
  - ***Bureaucratic Costs:*** these are a function of the number of businesses in a company's portfolio and the extent of coordination required between the different businesses of the company.
  - ***Number of Businesses:*** The greater the number of businesses in a company's portfolio, the more difficult it is for corporate managers to remain informed about the complexities of each business.
  - ***Coordination Among Businesses:*** These costs can arise from an inability to identify the unique profit contribution of a business unit that is sharing resources with another unit.

Diversification

- ***Limits to Diversification:*** Even though diversification can create value for a company, it also involve bureaucratic costs. Bureaucratic costs place a limit on the amount of diversification that can be profitably pursued.
  - ***Diversification That Dissipates Value:*** Another reason diversification fails is that many companies diversify for the wrong reasons. Consequently, they end up dissipating value rather than creating it.
  - ***Diversification to Pool Risks:*** The benefits of risk pooling are said to come from merging imperfectly correlated income streams to create a more stable income stream. This ignores that stockholders can do their own risk elimination. Studies have shown that corporate diversification is not a very effective way to pool risks.

Diversification

- ***Diversification to Achieve Greater Growth:*** Growth should be the byproduct, not the objective of a diversification strategy. However, empire-building top executives sometimes have a tendency to pursue growth for its own sake.
- ***Related or Unrelated Diversification:*** One issue that a company must resolve is whether to diversify into businesses related to its existing business by value chain commonalities or into unrelated businesses. Related companies can create value by sharing resources and by transferring competencies between businesses. Unrelated diversifiers can create value only by acquiring and restructuring poorly managed companies.

Strategic Alliances

Strategic Alliances as an Alternative to Diversification:

- The bureaucratic costs associated with implementing the strategy can make diversification unprofitable.
- Strategic alliances seem to be a particularly viable option when a company wishes to create value from transferring competencies or sharing resources between diversified businesses.
- The downside to alliances is that profit have to be split with a partner.
- There is risk of giving away critical know-how to its alliance partner.

Vertical Integration, Diversification, and Strategic Alliances

- ***Objectives to discuss:***
  - 1. Discuss the range of corporate-level strategies open to a company.
  - 2. Identify how vertical integration can create value for a company.
  - 3. Identify the fundamental bureaucratic limits to the profitable pursuit of vertical integration.
  - 4. Discuss how diversification can create value for a company.
  - 5. Identify the fundamental bureaucratic limits to the profitable pursuit of diversification.
  - 6. Explain why so much corporate diversification ends up dissipating value, rather than creating it.
  - 7. Show why long-term contracting and strategic alliances are often viable alternatives to vertical integration and diversification.