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STRATEGIC MANAGEMENT

An Integrated Approach

Theory & Cases

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CENGAGE

CHAPTER 9

Corporate-Level Strategy: Horizontal Integration, Vertical Integration, and Strategic Outsourcing

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LEARNING OBJECTIVES (1 of 2)

- Discuss how corporate-level strategy can be used to strengthen a company's business model and business-level strategies
- Define horizontal integration and discuss the primary advantages and disadvantages associated with this corporate-level strategy

LEARNING OBJECTIVES (2 of 2)

- Explain the difference between a company's internal value chain and the industry value chain
- Describe why, and under what conditions, cooperative relationships such as strategic alliances and outsourcing may become a substitute for vertical integration

CORPORATE-LEVEL STRATEGY AND THE MULTIBUSINESS MODEL (1 of 2)

- Corporate-level strategies should be chosen to promote the success of its business-level strategies.
  - This allows a firm to achieve a sustainable competitive advantage, leading to higher profitability.

CORPORATE-LEVEL STRATEGY AND THE MULTIBUSINESS MODEL (2 of 2)

- Levels of business model
  - Business model and strategies for each business unit or division in every industry in which it competes
  - Higher-level multibusiness model that justifies its entry into different businesses and industries

HORIZONTAL INTEGRATION

- **Horizontal integration** - Acquiring or merging with industry competitors to achieve the competitive advantages that arise from a large size and scope of operations.
- **Acquisition** - Company uses its capital resources to purchase another company.
- **Merger** - Agreement between two companies to pool their resources and operations and join together to better compete in a business or industry.

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BENEFITS OF HORIZONTAL INTEGRATION

- Lowers the cost structure
- Increases product differentiation
- Leverages a competitive advantage
- Reduces rivalry within the industry
- Increases bargaining power over suppliers and buyers

PROBLEMS WITH HORIZONTAL INTEGRATION

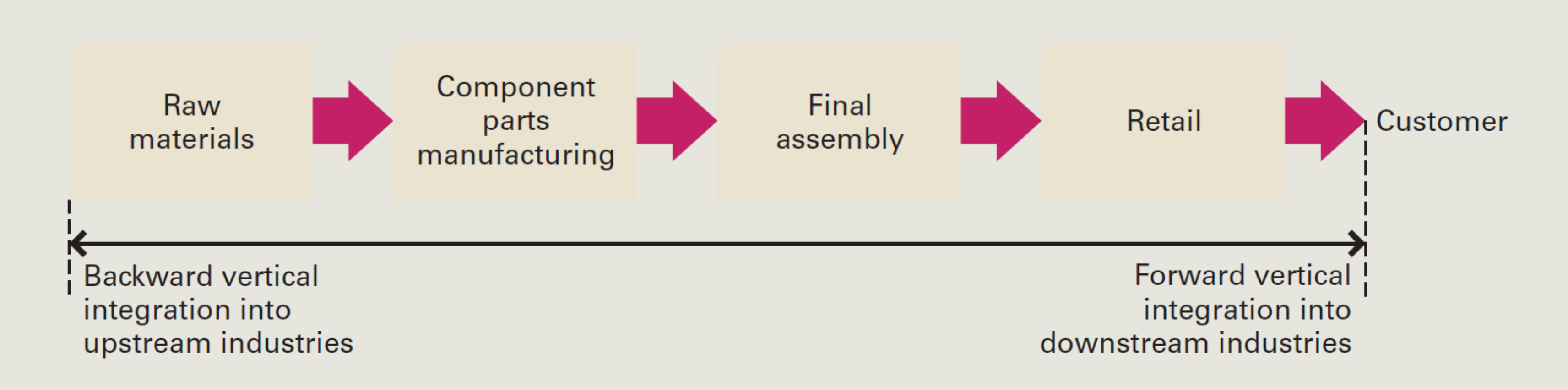
- Difficult to implement
- Conflict with the Federal Trade Commission (FTC)
  - Increase in prices
  - Abuse of market power
  - Crushing potential competitors

VERTICAL INTEGRATION

- **Vertical integration** - When a company expands its operations either backward or forward into an industry.
  - Backward vertical integration - Produces inputs for the company's products.
  - Forward vertical integration - Uses, distributes, or sells the company's products.

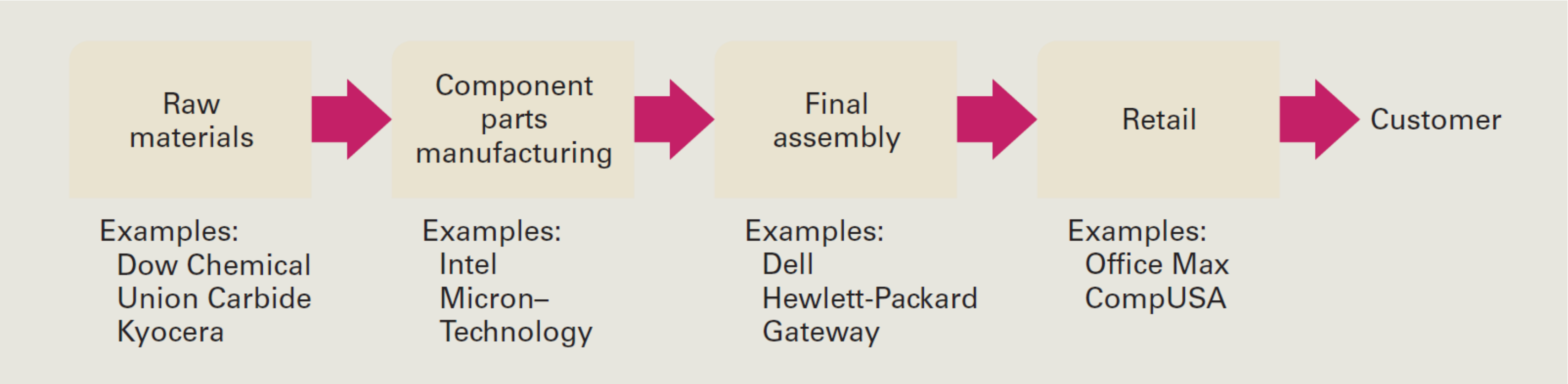
STAGES IN THE VALUE-ADDED CHAIN

Figure 9.1 Stages in the Raw-Materials-to-Customer Value-Added Chain



PC INDUSTRY VALUE-ADDED CHAIN

Figure 9.2 The Raw-Materials-to-Customer Value-Added Chain in the PC Industry



INCREASING PROFITABILITY THROUGH VERTICAL INTEGRATION

- Vertical integration increases product differentiation, lowers costs, and reduces industry competition when it:
  - facilitates investments in efficiency-enhancing specialized assets.
  - protects product quality.
  - results in improved scheduling.

PROBLEMS WITH VERTICAL INTEGRATION

- Increasing cost structure
- Disadvantages that arise when technology is changing fast
- Disadvantages that arise when demand is unpredictable
- **Vertical disintegration** - When a company decides to exit industries either forward or backward in the industry value chain to its core industry to increase profitability.

COOPERATIVE RELATIONSHIPS

- **Quasi integration** - Use of long-term relationships, or investment into some of the activities normally performed by suppliers or buyers.
  - In place of full ownership of operations that are backward or forward in the supply chain

SHORT-TERM CONTRACTS AND COMPETITIVE BIDDING

- Competitive bidding strategy - Independent component suppliers compete to be chosen to supply a particular component.
- Short-term contracts:
  - last for a year or less.
  - do not result in specialized investments.
  - signal a company's lack of long-term commitment to its suppliers.

STRATEGIC ALLIANCES AND LONG-TERM CONTRACTING

- **Strategic alliances** - Long-term agreements between two or more companies to jointly develop new products or processes.
  - Substitute for vertical integration
  - Avoids bureaucratic costs
- Component suppliers benefit because their business and profitability grow as the companies they supply grow.

MODULARITY AND PLATFORM COMPETITION (1 of 2)

- **Modularity** – Degree to which a system's components can be separated and recombined.
- Modular advantages
  - Offers choices in function, design, scale, and features.
  - Allows product variety with economies of substitution.
- Nonmodular (tightly integrated) advantages
  - Components work better together.
  - Better monitoring of quality and reliability.

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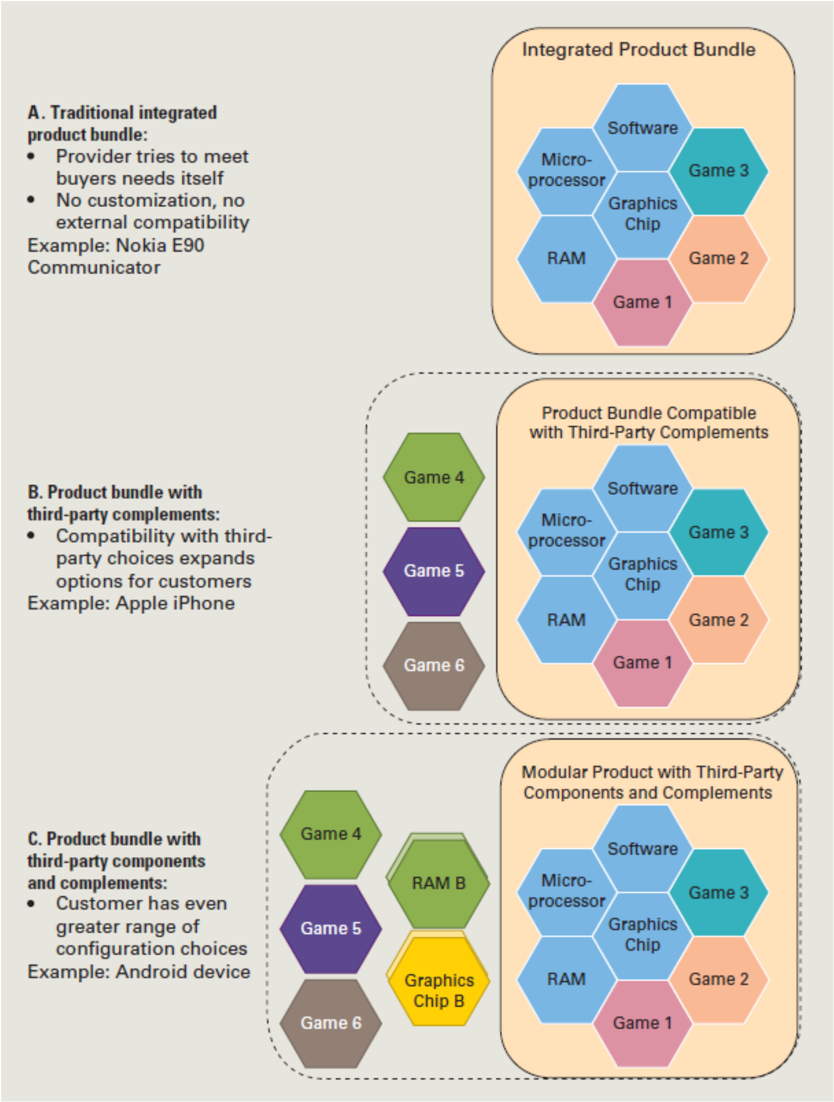
MODULARITY AND PLATFORM COMPETITION (2 of 2)

- **Platform ecosystem** - System of mutually dependent entities mediated by a stable core.
  - More valuable than nonmodular when:
    - customers and third-party options are diverse.
    - compatibility with third-party options is seamless.
    - platform sponsor controls quality and architecture.
  - More valuable than modular when:
    - complements are nonroutine purchases.
    - platform and complement integration increases performance.
    - important components require subsidization.

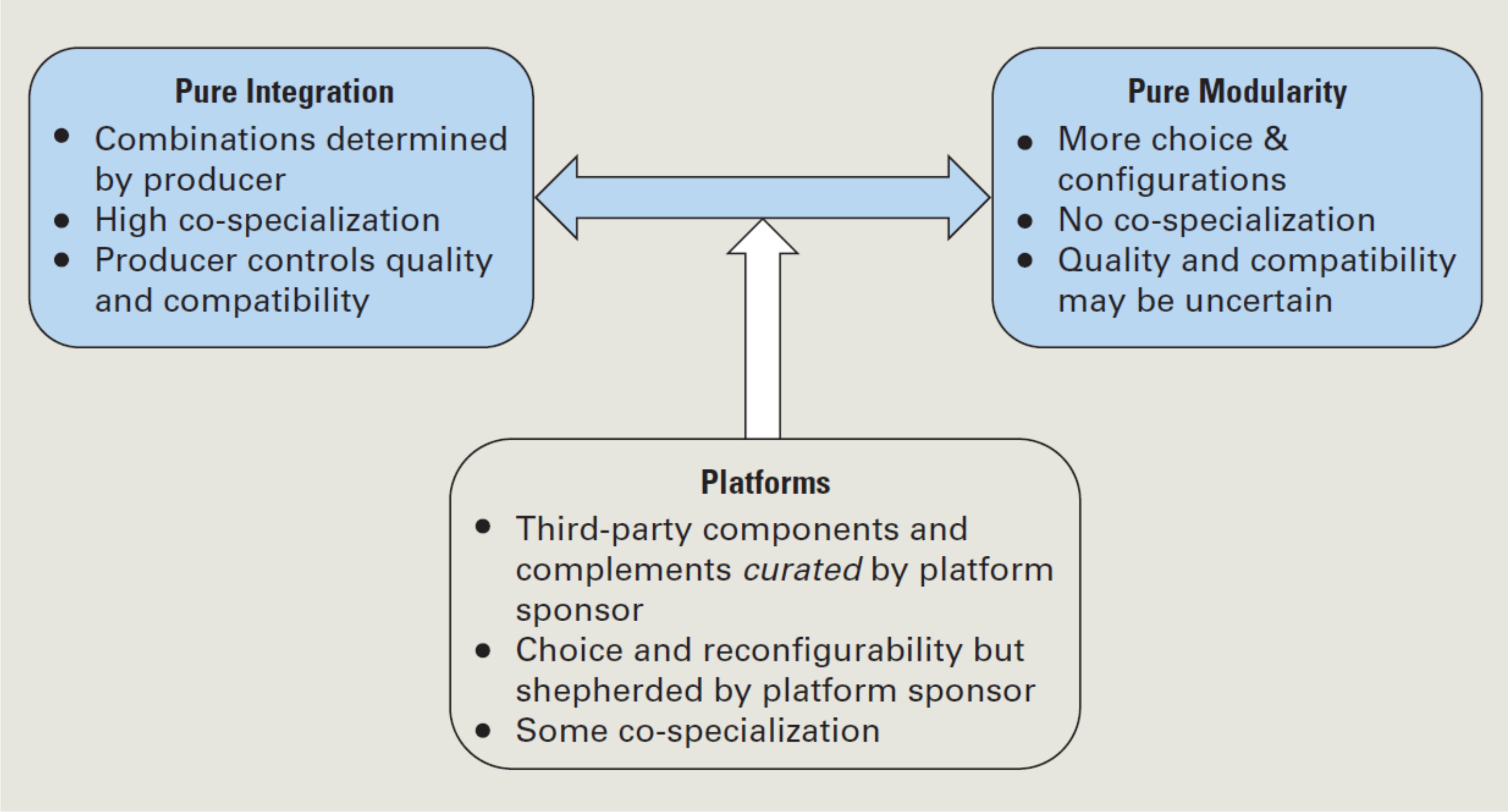
MODULARITY AND PLATFORM ECOSYSTEMS

Figure 9.3 Modularity and Platform Ecosystems



PURE MODULARITY AND PURE INTEGRATION

Figure 9.4 Platforms as a Compromise Between Pure Modularity and Pure Integration



STRATEGIES TO BUILD LONG-TERM COOPERATIVE RELATIONSHIPS

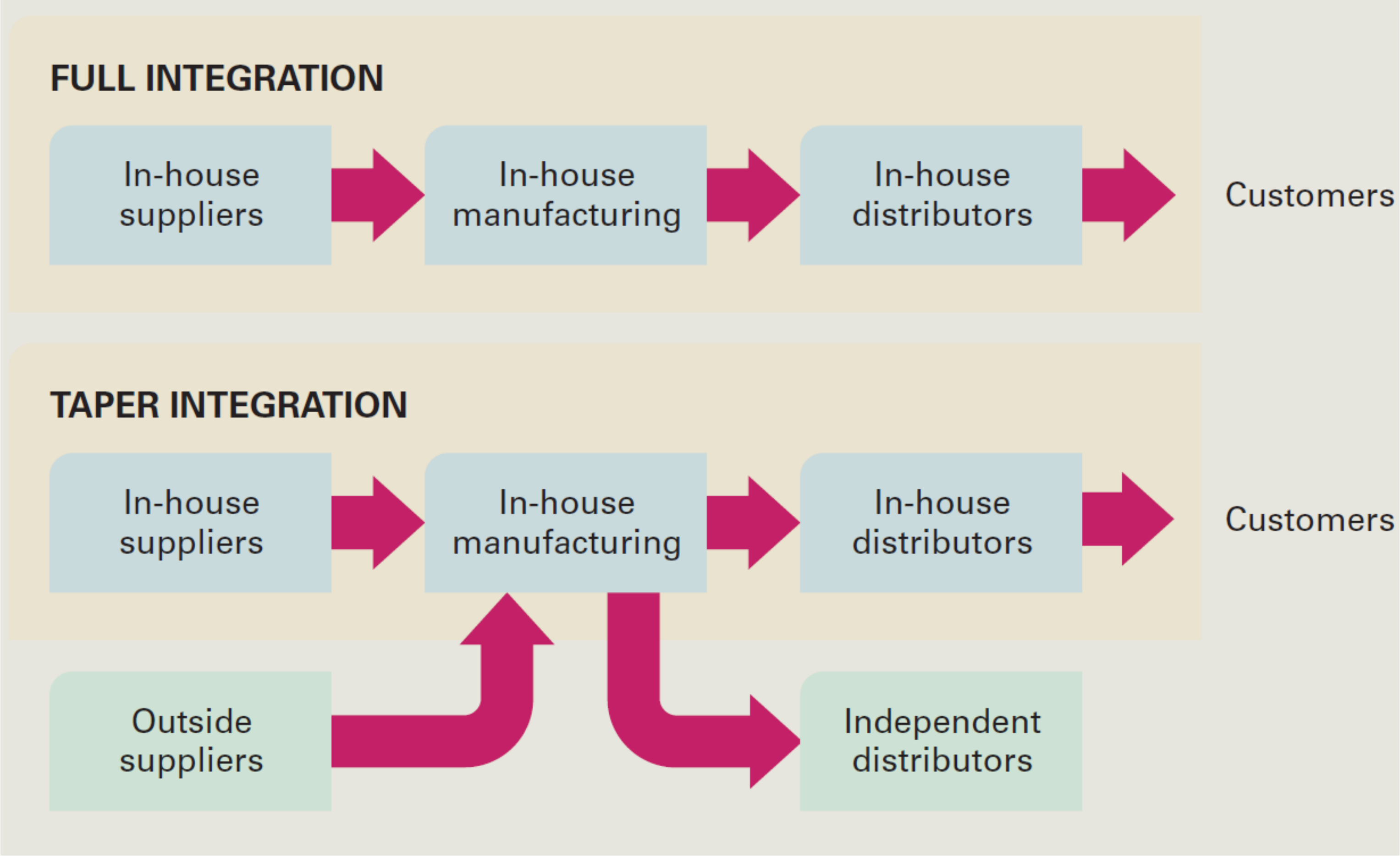
- **Hostage taking** - Means of exchanging valuable resources to guarantee that each partner to an agreement will keep its side of the bargain.
- **Credible commitment** - Believable promise or pledge to support the development of a long-term relationship between companies.
- Each company should possess a kind of power to discipline its partner, if the need arises.
- **Parallel sourcing policy** - A company enters into long-term contracts with suppliers for components to prevent incidents of opportunism.

STRATEGIC OUTSOURCING (1 of 2)

- **Strategic outsourcing** - Decision to allow one or more of a company’s value-chain activities to be performed by independent, specialist companies.
- **Virtual corporation** - Companies that pursue extensive strategic outsourcing to the extent that they only perform the central value creation functions that leads to competitive advantage.

STRATEGIC OUTSOURCING (2 of 2)

Figure 9.5 Strategic Outsourcing of Primary Value Creation Functions



BENEFITS OF OUTSOURCING

Lower cost structure

Enhanced differentiation

Focus on the core business

RISKS OF OUTSOURCING

- Holdup
  - Risk that a company will become too dependent upon the specialist provider of an outsourced activity
- Increased competition
  - Building of an industrywide resource that lowers the barriers to entry in that industry
- Loss of information and forfeited learning opportunities

APPENDIX

NOTE TO INSTRUCTOR: Choose from the following questions (also found in the text at the end of the chapter) to conduct in-class discussions around key chapter concepts.

DISCUSSION:

- Under what conditions might horizontal integration be inconsistent with the goal of maximizing profitability?

DISCUSSION:

- What is the difference between a company’s internal value chain and the industry value chain? What is the relationship between vertical integration and the industry value chain?

DISCUSSION:

- Why was it profitable for GM and Ford to integrate backward into component-parts manufacturing in the past, and why are both companies now buying more of their parts from outside suppliers?

DISCUSSION:

- When will an industry tend to become dominated by platform ecosystems? What will determine which platform ecosystems are more successful in an industry than others?

DISCUSSION:

- What value creation activities should a company outsource to independent suppliers? What are the risks involved in outsourcing these activities?

DISCUSSION:

- What steps would you recommend that a company take to build mutually beneficial, long-term, cooperative relationships with its suppliers?