THEME 9: GROWTH STRATEGIES

1st Part: Vertical integration and Scope of the Firm

2nd Part: Internal and external growth
1st Part:

Vertical Integration and The Scope of the Firm
Vertical Integration and The Scope of the Firm

OUTLINE

• Transactions Costs and the Scope of the Firm.
• The Costs and Benefits of Vertical Integration.
• Designing Vertical Relationships.
From Business Strategy to Corporate Strategy: The Scope of the Firm

- **Business Strategy** is concerned with *how* a firm competes within a particular market.
- **Corporate Strategy** is concerned with *where* a firm competes, i.e. the *scope* of its activities.
- The dimensions of scope are:
  - geographical scope;
  - product scope;
  - vertical scope.
Market Economy: Two Economic Organizations

- **Market Mechanism:** Individuals and firms make independent decisions that are influenced by market prices.

- **Administrative Mechanism:** Firm decisions concerning production, supply and purchased inputs are made by managers and enforced through the system of hierarchy.
In situation [A] the business units are integrated within a single firm. In situation [B] the business units are independent firms linked by markets. Are the administrative costs of the integrated firm less than the transaction costs of markets?
Cure Ham Industry

- V1: raising pigs.
- V2: slaughtering pigs.
- V3: curing hams.

**Key issue**: transaction costs in the market vs administrative costs of a firm.
Transactions Costs and The Existence of the Firm

- Transaction cost theory explains not just the **boundaries of firms**, also the **existence of firms** (see note).
- In 18th century English woollen industry, no firms-independent spinners and weavers linked by merchants.
- Residential remodeling industry -- mainly independent self-employed builders, plumbers, electricians, painters.
- **Where market transaction costs are high, firm is a more efficient means of organization.**

**Note:**
- Firm understood as an organization consisting of a group of individuals who are interconnected by contracts with a central contracting authority (**contractual approach of the firm**).
- Transaction costs comprise costs of search and contract negotiating and enforcement.
Determinants of Changes in Corporate Scope

1800-1980: Expanding scale and scope of industrial corporations due to declining administrative costs of firms:
• Advances in transportation, information and communication technologies.
• Advances in management: accounting systems, decision sciences, financial techniques, organizational innovations, scientific management.

- Increasingly turbulent external environment
- Increased no. of managerial decisions. Need for fast responses to external change
- Admin. costs of firms rise relative to transaction costs of markets

1995 onwards: Rapid increase in global concentration (steel, aluminium, oil, beer, banking, cement).
Key drivers: quest for market power and scale economies.
Also, large corporations better at reconciling size with agility.
Depends on a firm’s ownership of vertically related activities.

When a firm owns and controls numerous stages of the value chain of its product, then there is a high degree of vertical integration.
• **Backward integration**, when a firm owns and controls the production of its products components and inputs.

• **Forward integration**, when a firm owns and controls activities that were previously done by its customers, such as distribution.

• **Partial vertical integration**, when the internal production is not self-sufficient and the purchase of a little amount of supplies is necessary to support further production.

• **Full vertical integration** between two stages of production, when during transference between the two no sales or purchases are realized from third parties.
Note: Some companies will manufacture components or semi-finished items. In those cases there will be additional integration opportunities into assembly or finished product manufacture.
The Costs and Benefits of Vertical Integration: BENEFITS

- Technical economies from integrating processes, e.g. iron and steel production.
  - but doesn’t necessarily require common ownership.
- Superior coordination.
- Avoids transactions costs of market contracts, specially in situations where there are:
  - small numbers of firms;
  - transaction-specific investments;
  - opportunism and strategic misrepresentation;
  - taxes and regulations on market transactions.
The Costs and Benefits of Vertical Integration: COSTS

- **Administrative costs** of internalization.
- **Differences in optimal scale of operations** between different stages prevents balanced Vertical Integration (VI).
- **Strategic differences** between different vertical stages creates management difficulties.
- Inhibits development and exploitation of **core competencies**.
- **Limits flexibility**: -in responding to demand cycles;
  -in responding to changes in technology, customer preferences, etc.

  But where *system-wide flexibility* is required, VI allows speed and coordination in achieving simultaneous adjustment throughout the vertical chain (see “Making VI Work: Zara”).

- **Compounding of risk**: any problem in one stage can threaten all other stages.
Assessing the Pros and Cons

- Within the same industry, different companies can be successful with very different degrees of vertical integration.

- 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.

- Key criteria in the next slide.
<table>
<thead>
<tr>
<th>Question</th>
<th>Advantage</th>
</tr>
</thead>
<tbody>
<tr>
<td>How many firms are available to undertake the activities?</td>
<td>The fewer the companies the more attractive is VI.</td>
</tr>
<tr>
<td>Is transaction-specific investment needed?</td>
<td>If yes, VI more attractive.</td>
</tr>
<tr>
<td>Does limited information permit cheating?</td>
<td>VI can limit opportunism.</td>
</tr>
<tr>
<td>Are taxes or regulation imposed on transactions?</td>
<td>VI can avoid them.</td>
</tr>
<tr>
<td>Do the different stages have similar optimal scales of operation?</td>
<td>Greater the similarity, the more attractive is VI.</td>
</tr>
<tr>
<td>Are the two stages strategically similar?</td>
<td>Greater the strategic similarity, the more attractive is VI.</td>
</tr>
<tr>
<td>How great the need for entrepreneurship &amp; continual upgrading of capabilities?</td>
<td>Greater the need, the greater the disadvantages of VI.</td>
</tr>
<tr>
<td>How uncertain is market demand?</td>
<td>Greater the unpredictability, the more costly is VI.</td>
</tr>
<tr>
<td>Are risks compounded by linkages between vertical stages?</td>
<td>VI increases risk.</td>
</tr>
</tbody>
</table>
The value chain for steel cans

What factors explain why some stages are vertically integrated, while others are linked by market transactions?
Different Types of Vertical Relationships

- **Spot sales/purchases**
- **Long-term contracts**
- **Agency agreements**
- **Franchises**
- **Joint ventures**
- **Informal supplier/customer relationships**
- **Supplier/customer partnerships**
- **Vertical integration**

**Degree of Commitment**: Low - High

**Formalization**: Low - High
Intermediate between spot transactions and vertical integration are several types of vertical relationships: such relationships may combine benefits of both market transactions and internalization.

Key issues in designing vertical relationships:
- How is risk allocated between the parties? Uncertainties over the course of the contract. For example: franchise agreements → franchisee bears more risk.
- Are the incentives appropriate, to minimize transaction cost? Very often, the most effective incentive is the promise of future business.
Recent Trends in Vertical Relationships

- From *competitive contracting to supplier partnerships*, e.g. in autos.
- From vertical integration to outsourcing (not just components, also IT, distribution, and administrative services).
- Diffusion of franchising.
- Technology partnerships (e.g. IBM-Apple; Canon-HP).
- Inter-firm networks.

*General conclusion*: boundaries between firms and markets becoming increasingly blurred.
CASE STUDY
2nd Part:

Internal and External Growth
Internal and External Growth

OUTLINE

• Internal Development.
• Mergers and Acquisitions.
• Strategic Alliances.
INTERNAL DEVELOPMENT (ID): CONCEPT

• ID is where strategies are developed by building on and developing an organisation’s own capabilities.
INTERNAL DEVELOPMENT (ID): MOTIVES

• Strategic capabilities:
  – Highly technical new products.
  – Direct involvement in new markets.
  – Spread of costs over time.

• Environment:
  – No other choice or no suitable target.

• Expectations:
  – Avoiding a traumatic integration.
 Acquisition is where strategies are developed by taking over ownership of another organization.

Merger: Voluntary amalgamation of two (or more) firms into one new legal entity. Mergers are effected by exchange of the pre-merger stock (shares) for the stock of the new firm. Owners of each pre-merger firm continue as owners, and the resources of the merging entities are pooled for the benefit of the new entity (http://www.businessdictionary.com/).
MERGER AND ACQUISITIONS (M&A): MOTIVES

• Environment:
  – Speed.
  – Competitive situation (avoiding excess capacity).
  – Deregulation and financial motives.

• Strategic capabilities:
  – Exploiting core competences or addressing a lack of resources or/and capabilities.
  – Cost efficiency.
  – Learning.

• Expectations:
  – Continuing growth expected by shareholders.
  – Senior managers’ ambitions.
  – Speculative motives rather than strategic ones.
MERGER AND ACQUISITIONS (M&A): MAIN DIFFICULTIES

• Adding any value to the purchases.
• The integration of the new company.
• Organisational learning through the transfer of knowledge.
• Cultural fit (‘clash of cultures’).
• As a result, in the majority of cases it leads to a poor financial performance.
EXERCISE

“GENERAL ELECTRIC FOCUSES ON EUROPE”
STRATEGIC ALLIANCES: CONCEPT

• Two or more organisations share resources and activities to pursue a strategy.
STRATEGIC ALLIANCES: MOTIVES

- The need for critical mass.
- Co-specialisation.
- Learning from partners.
- Also important in the public sector: PPP.
STRATEGIC ALLIANCES:
TYPES

At one extreme, **loose formulas**:

- **Networks**: arrangements whereby two or more organisations work in collaboration without formal relationships (the airline industry).
- **Opportunistic alliances**: around particular ventures or projects.
STRATEGIC ALLIANCES: TYPES

At the other extreme, involving ownership:

• **Joint Ventures**: arrangements where organisations remain independent but set up a newly created organisation jointly owned by the parents.

• **Consortia**: a particular kind of joint venture arrangement typically focused on a particular project (such as the European Airbus).
Intermediate arrangements (contractual in nature, but unlikely to involve ownership),

- **Franchising**: the franchise holder undertakes specific activities such as manufacturing, distribution or selling, whilst the franchiser is responsible for the brand name, marketing and usually training (e.g. McDonald’s).

- **Licensing**: Commonly when the right to manufacture a patented product is granted for a fee (e.g. science-based industries).

- **Subcontracting**: when a company chooses to outsource particular services or part of a process (e.g. IT services).
### Exhibit 7.3: Types of strategic alliance

<table>
<thead>
<tr>
<th>INFLUENCING FACTORS</th>
<th>FORM OF RELATIONSHIP</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>The Market</strong></td>
<td><strong>Loose (Market)</strong></td>
</tr>
<tr>
<td>Speed of market change</td>
<td>Networks</td>
</tr>
<tr>
<td></td>
<td>Opportunistic alliances</td>
</tr>
<tr>
<td></td>
<td>Managed separately by each partner</td>
</tr>
<tr>
<td></td>
<td>Draws on ‘parent’s’ assets</td>
</tr>
<tr>
<td><strong>Resources</strong></td>
<td><strong>Contractual</strong></td>
</tr>
<tr>
<td>Asset management</td>
<td>Licensing</td>
</tr>
<tr>
<td>Partner’s assets</td>
<td>Franchising</td>
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<tr>
<td></td>
<td>Subcontracting</td>
</tr>
<tr>
<td></td>
<td>Managed together</td>
</tr>
<tr>
<td></td>
<td>Dedicated assets for alliance</td>
</tr>
<tr>
<td><strong>Risk of losing assets to partner</strong></td>
<td><strong>Ownership</strong></td>
</tr>
<tr>
<td></td>
<td>Consortia</td>
</tr>
<tr>
<td></td>
<td>Joint ventures</td>
</tr>
<tr>
<td></td>
<td>Slow change</td>
</tr>
<tr>
<td></td>
<td>Managed together</td>
</tr>
<tr>
<td></td>
<td>Dilutes risk</td>
</tr>
<tr>
<td></td>
<td>Favourable climate</td>
</tr>
<tr>
<td><strong>Expectations</strong></td>
<td><strong>Low risk</strong></td>
</tr>
<tr>
<td>Spreading financial risk</td>
<td>Maintains risk</td>
</tr>
<tr>
<td>Political climate</td>
<td>Unfavourable climate</td>
</tr>
<tr>
<td></td>
<td>Favourable climate</td>
</tr>
</tbody>
</table>
STRATEGIC ALLIANCES: SUCCESS

- A clear strategic purpose and senior management support.
- Compatibility at the operational level.
- Defining and meeting performance expectations.
- TRUST: competence based and character based.
APPLICATION

CO-OPS
KEYS FOR SUCCESS

MEMBERS
- Needs.
- Commitment.
- Autonomy and Independence.
- Credibility of / Trust on the Board of Directors.

PROFESSIONAL MANAGERS
- To be aware of and tuned with the idiosyncrasy of the cooperative formula.
  Management based on:
  - Quality/Innovation.
  - Training.
  - Planning.

RELATIONSHIP BETWEEN MEMBERS & MANAGERS
- Social discipline (rules by consensus).
- Personal contact, proximity to members.
- Information, transparency.
- Communication & mutual trust.