

30 July 2004

Vertical Integration and its Implications

Vertical Integration (VI) is the process through which a company integrates different aspects of the business, namely the upstream and downstream activities. In other words, VI takes place when a company merges or takes over another company in the same supply chain. Suppose Company A, a tire manufacturer, takes over company B, which is involved in the processing of rubber and is the primary supplier to A – this is VI.

However, why does a company need to vertically integrate? VI helps a company focus on its core competencies, and at the same time, it offers the merged entities a competitive edge against their major rivals.

Components of vertical integration

Vertical integration primarily seeks to integrate forward and backward integration. **Forward Integration** can be defined as a strategy for growth in which a company develops by seeking ownership or control over its distribution systems. For instance, if Company A realizes that it can earn greater profit margins by reducing the number of its existing distributors and goes on to open its own exclusive outlets, then Company A would be resorting to forward integration. Forward integration helps the company gain ownership and increases its control over distributors, while helping it to ensure the effective and reliable delivery of its products and reducing costs. **Backward integration**, on the other hand, is a strategy for growth in which a company seeks ownership or control over its suppliers. The example cited earlier in this article is a perfect case in point of backward integration. A proper balance of these components enables effective management of the company.

Essentials of developing a sound VI plan

Before a company undertakes VI, the plan for integration should cover issues such as product lifecycle, sources of funds, branding, retail distribution and vendor sourcing. A company that plans its VI and works accordingly can create value by:

- Creating barriers to competitive entries
- Focusing on its core competencies
- Protecting the quality of its products

VI may not always be feasible for a company. Due to constant technological changes, demand uncertainties, and cost disadvantages, VI may not always work out in favor of the company. In such situations, the company can:

- Go for short-term contracts with its suppliers
- Create strategic alliances
- Carry out periodic renegotiations
- Opt for long-term cooperative relationships and outsourcing



TenStep Supplemental Paper

In a nutshell, despite several drawbacks, a successful VI project will help the company counter bottlenecks that may crop up with raw material suppliers, provide opportunities for diversification, and offer resistance against heightened competition.