EXECUTIVE INSIGHTS

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When to Vertically Integrate

While vertical integration is a common strategy to secure distribution channels and boost profitability, it can expose a company to significant risk.

L.E.K. Consulting has reviewed common vertical integration scenarios and the factors that underlie success in each case.

Vertical integration—whether upstream or downstream—is a well-understood and accepted strategy to capture value. Motivations are varied. Companies may desire to better secure critical supplies or exert greater control over a dysfunctional downstream channel. Specific circumstances must exist in order for these motives to ultimately translate into value creation.

Despite its widespread acceptance, vertical integration is also one of the riskiest strategies in business because it often involves entering into activities with success factors and economics that are quite different from the core business. Downstream integration raises the prospect of customer conflicts of interest (i.e. customers perceive you as a competitor on their turf). Upstream integration can result in the captive supplier losing sales that it had previously been making to your competitors and it can also limit your sourcing flexibility.

L.E.K. Consulting has helped many clients think through the merits of vertical integration and we offer the following case-based guidance as you weigh the risk/return of upstream and downstream acquisitions.

Valid Reasons to Vertically Integrate

While there are many reasons to vertically integrate, three are most common:

- Fixing a value-chain weakness
- Leveraging a value-chain segment strength
- Increasing market power or reducing cycle risk

Fixing a Value-Chain Weakness

At times a key element of the value chain simply is not working. PepsiCo initiated a strategy to acquire bottlers in part because bottlers were focusing on high-volume, high-profit carbonated soft drinks rather than new products. PepsiCo, recognizing the declining popularity of carbonated soft drinks, needed its bottling channel to focus on smaller but growing segments. One building products business has recently embarked on a strategy of acquiring distributors because they believe that their independent distributors are not aggressively developing their markets.

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In other instances, upstream manufacturers are forced to forward integrate out of necessity. Last year, Armstrong World Industries announced the sale of an owned flooring distributor. The CEO of Armstrong's Flooring Division said, "If you recall, we got into the distribution business….out of necessity when our major distributor...went out of business." The Armstrong World Industries CEO added, "We are not in the distribution business. [Manufacturing and distribution] are two very, very different business models. My experience is you can do one of those well, so you are either really good at the distribution business or you are a really strong manufacturer."[1]

In yet other instances, companies have limited access to attractive independent channels and so forward integrate to achieve this access. Goodman, a manufacturer of HVAC equipment, realized that attractive distributors were already tied up in exclusive relationships with larger competitors. So Goodman embarked on a strategy of buying and building its own captive HVAC distribution channel to gain greater market access. Goodman's evolution from a subscale player to a market leader in residential HVAC equipment is largely (but not solely) the result of this strategy.

The problem can also lie upstream. For example, a company may acquire a supplier to reduce uncertainties in supply, or because the cost of supply failure is unacceptable. Boeing purchased key component suppliers for the Dreamliner in order to address delivery problems. Nucor, a steel manufacturer, purchased a scrap-metal broker to secure a vital supply source.

When using vertical integration to fix a value chain failure, four conditions must exist:

1. Transactions between the previously independent parties must be frequent, of high value or strategically important.

2. The transactions must be sub-optimal in terms of cost, time, reliability, quality, etc. prior to integration.

3. Integration promises to reduce time or cost, or promises to improve effectiveness.

4. Channel conflict (i.e. competing with existing customers) must be minimal or manageable.

Leveraging a Value-Chain Segment Strength

In addition to addressing supply-chain weaknesses or risks, vertical integration can also apply a key strength. Years ago, when Sherwin Williams was solely a paint manufacturer, the company embarked on a strategy of building or acquiring retail paint stores. The company now owns more than 3,000 stores across North America, an extremely strong position in a retail channel that used to be highly fragmented. Sherwin William's strategy succeeded because of its strong brand position with DIY and contractor customers. Apple Inc.'s retail strategy represents another example of leveraging brand strength downstream.

A company can also apply strengths in areas other than brand position. For example, firms may compete on the basis of product breadth. Companies with the broadest product range may find an independent distributor's value proposition weaker in contrast. Take the example of Dal-Tile, a leading manufacturer of tile products. They offer an extremely broad product line and, while they also sell through independent dealers/retailers, they maintain more than 250 company-owned outlets. These include Dal-Tile dealers, design centers and stone showrooms.

To ensure that this strategic path makes sense, companies should look for the following conditions:

1. An asset or capability that you control is unique and competitively differentiated.

2. This asset can be applied to either an upstream or downstream portion of the value chain.

3. The value of applying this asset to another segment of the value chain significantly outweighs traditional risks of vertical integration (learning a new business, customer conflict, etc.).

[1] Sources: Central Pennsylvania Business Journal, September 6, 2012 and Armstrong World Industries Earnings Conference Call, October 31, 2012

Increasing Market Power or Reducing Cycle Risk

Vertical integration can also be used to improve industry structure or correct exposure to cyclicality. Companies that pursue integration in this scenario usually have some combination of the following characteristics:

1. Highly cyclical demand markets.
2. Capital-intensive and high fixed-cost upstream assets; capacity utilization is a key driver.
3. Highly specific assets that cannot serve diverse markets.
4. Upstream activities are significantly more profitable than downstream activities. (Need to defend higher upstream profits by exerting greater downstream control).
5. Highly concentrated upstream or downstream supply channels. (This means that vertical integration steps will capture a reasonable portion of the upstream or downstream market).

Downstream vertical integration can materially improve market power. To understand why, consider an industry with four suppliers and four customers. Each customer can negotiate across four suppliers to secure the best deal; however, if two suppliers acquire two customers, the number of remaining suppliers is critically low. In this case, half of the customers are captive to two suppliers and the remaining customers have only two independent sources remaining which would in turn likely cause the other suppliers to believe they have more pricing power – which in turn increases the pricing power of the vertically integrated players.

Vertical integration can also help companies better ride the waves of business cycles. In markets where supply is tight and prices are rising, the integrated player can fully participate in more of the downstream profit pool. When markets are soft and prices are lower, the integrated player can subsidize downstream business to gain share while maintaining upstream (i.e. more profitable) volumes. This strategy, in our experience, works well across most parts of an economic cycle – other than the recent construction cycle when industry utilization dropped to unprecedented levels of economic activity. In that environment, both the upstream and downstream failed to earn back cost of capital and the strategy accelerated shareholder-value destruction. Clearly, this strategy requires a conservative balance sheet and is not for the faint of heart.

In situations where there are larger players in a more consolidated upstream portion of the value chain, there may also be opportunities to improve efficiency and profitability in a fragmented downstream environment by consolidating downstream assets. In heavy materials businesses where freight and distribution costs can be high, having local downstream scale can improve operational efficiency and provide advantages over smaller-scale independent players.

Companies pursuing vertical integration in an attempt to increase market power or reduce cycle risk can be seen across many heavy material and commodity categories. For example, the major cement companies (e.g. Holcim, Cemex, etc.) have successfully vertically integrated into downstream redi-mix cement operations in many markets. Another sector where downstream vertical integration is evident is corrugated packaging. Corrugated material players like Smurfit Kappa, Boise and others are pursuing a strategy of acquiring downstream players in order to better manage efficiencies and stability across the value chain.

Conclusion

Channel partners and suppliers can be vital allies in a manufacturer's quest to create value. However, these relationships are rarely perfect and it can be tempting to address imperfections in downstream or upstream relationships through acquisition.

As your company considers this path, L.E.K. Consulting suggests that you consider three key points:

- **Examine Non-Integrated Benefits Carefully:** While you focus on integration benefits, make sure you also focus on potential losses. Will your new captive supplier lose sales previously made to competitors? How will your step to acquire a customer be viewed by your other customers?

- **Consider New Key Success Factors:** Much of the risk involved in vertical integration arises as the acquirer enters a new business that requires very different expertise. For example, a manufacturer that purchases distributors must learn the critical importance of working capital management and the need to vigorously defend and expand its distributor value proposition.

- **Think Alliance First:** Many of the benefits of vertical integration can be achieved through an alliance. In the process, you may require much less capital and be exposed to much less risk. So if supply stability is the objective, consider a long term supply agreement or even a joint venture around a specific supply source before pursuing an acquisition of the entire supplier.

The vast majority of strategic guidance preaches the virtues of focus. Experts suggest that you focus on "core competencies" or "strategic market segments." The strategic logic behind vertical integration can run counter to this advice by leading you to apply core competencies to downstream activities or expand your focus to upstream or downstream businesses. In doing so, be extremely careful to ensure that the benefits of these steps outweigh the risks associated with a potentially diffused strategic focus.

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