

Vertical Integration

Economies of Scale

- Economies of scale are cost advantages companies experience when production becomes efficient, as costs can be spread over a larger amount of goods.

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Vertical Integration

Economies of Scale

An economics term that describes a competitive advantage that large entities have over smaller entities.

Manufacturing costs can fall 70% to 90% every time the business doubles its output.

Internal: The sheer size of the company allowing bulk purchases.

External: Receiving preferential treatment from government or other external sources.

Diseconomies of scale can result if a company becomes less efficient.

Large shipping companies can use ships that carry as many goods as 16 freight trains.

Banks Govt.

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Vertical Integration

Economies of Scale

- Internal economies of scale happen when a company cuts costs internally, so they're unique to that particular firm
 - 1 - **Technical:** large-scale machines or production processes that increase productivity
 - 2 - **Purchasing:** discounts on cost due to purchasing in bulk
 - 3 - **Managerial:** employing specialists to oversee and improve different parts of the production process

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Vertical Integration

Economies of Scale

- Internal economies of scale happen when a company cuts costs internally, so they're unique to that particular firm
 - 1 - **Risk-Bearing:** spreading risks out across multiple investors
 - 2 - **Financial:** higher creditworthiness, which increases access to capital and more favorable interest rates
 - 3 - **Marketing:** more advertising power spread out across a larger market, as well as a position in the market to negotiate

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Vertical Integration

Economies of Scale

- External economies of scale are achieved because of external factors, or factors that affect an entire industry.
 - These occur when there is a highly-skilled labor pool, subsidies and/or tax reductions, and partnerships and joint ventures—anything that can cut down on costs to many companies in a specific industry.

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Vertical Integration

Economies of Scope

- Economies of scope describe situations where producing two or more goods together results in a lower marginal cost than producing them separately.
 - Economies of scope can result from goods that are co-products or complements in production, goods that have complementary production processes, or goods that share inputs to production.

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Vertical Integration

Economies of Scope

Four Types

<p><u>Operational</u></p> <p>Financial</p> <p>Anticompetitive</p> <p>Managerialism</p>	<p><u>Economies of scale</u> relate to cost economies from increasing output of a single product.</p> <p><u>Economies of scope</u> relate to cost economies from increasing the output of multiple products.</p>
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Vertical Integration

Economies of Sequence

- The “**economies of sequence**” is defined as building segments in an efficient sequence. Prerequisite conditions on segments comprise those segments that contribute to a reduction in transport costs.

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Vertical Integration

Economies of Sequence

- Cost of the Value Chain in one firm is lower than that it multiple firms.
 - Lower transportation cost
 - Lower energy cost
 - Better labor utilization
 - Lower inventory

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Vertical Integration

Why do firms exist?

Ronald Coase Contracts. *David Williamson.*

- According to Ronald Coase's essay "The Nature of the Firm", people begin to organise their production in firms when the **transaction cost** of coordinating production through the market exchange, given imperfect information, is greater than within the firm.

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Vertical Integration

Transaction Costs

- Williamson defines transaction costs as the costs of running an economic system of companies, and unlike production costs, decision-makers determine strategies of companies by measuring transaction costs and production costs. Transaction costs are the total costs of making a transaction, including the cost of planning, deciding, changing plans, resolving disputes, and after-sales.

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Vertical Integration

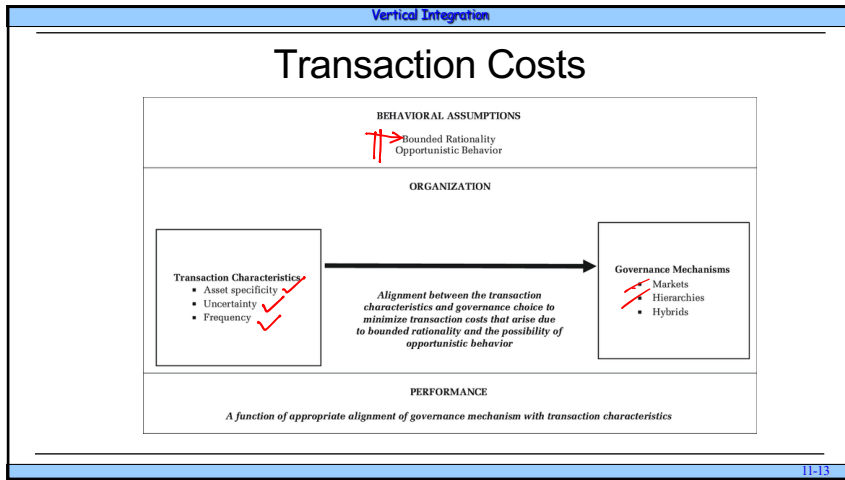
Transaction Costs

Transaction costs are directly linked to:

- Search & Information Cost (*find supplier*)
- Bargaining Cost (*Purchase*)
 - frequency.
 - uncertainty.
 - specificity.
- Enforcement (*monitoring*)
 - holdup cost.

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Vertical Integration

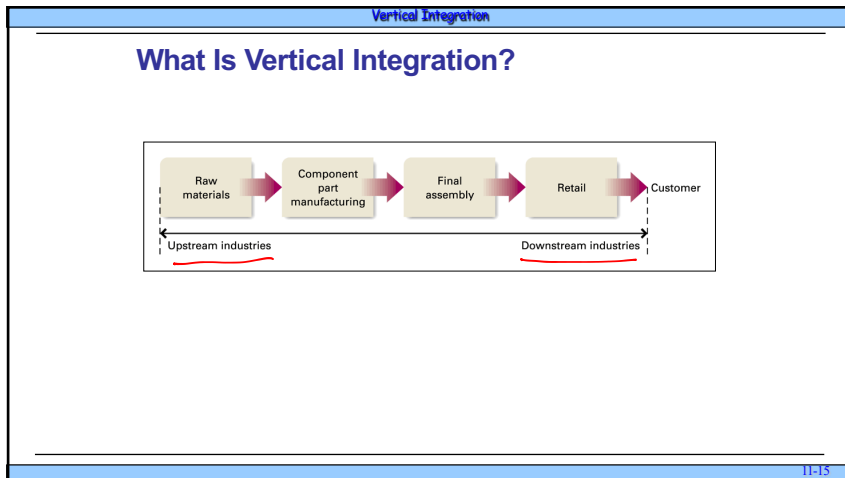
What Is Vertical Integration?

Upstream
 Ref ← Petrochem ← Thread ← fabric

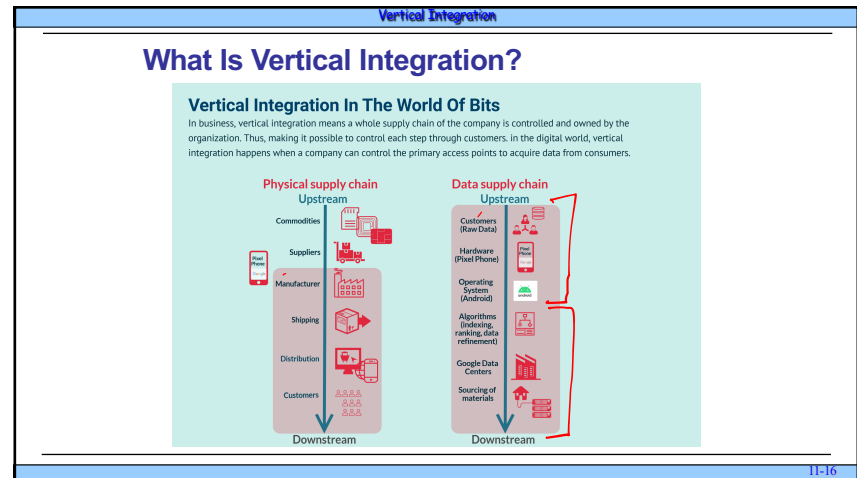
- Vertical integration is a special exponent of unrelated diversification
 - A firm is engaged in several stages of a given industry's value chain
- Existence – why do firms emerge?
- Boundaries – why is the boundary between firms and the market located exactly there as to size and output variety?

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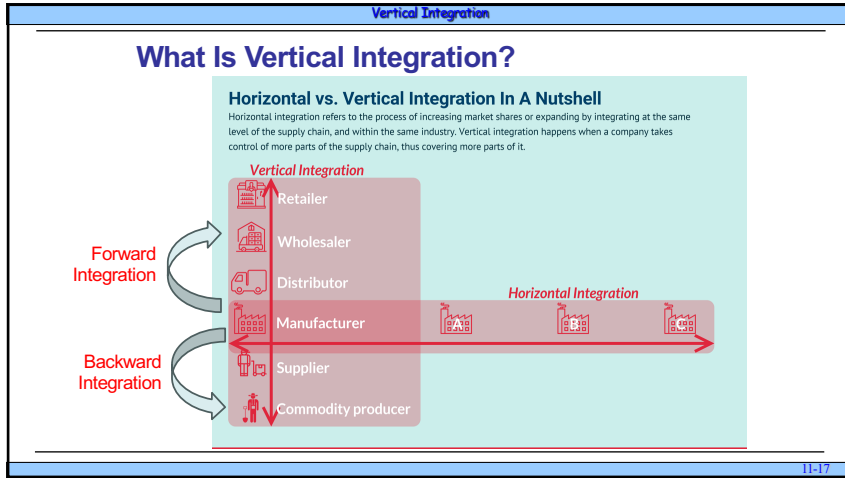
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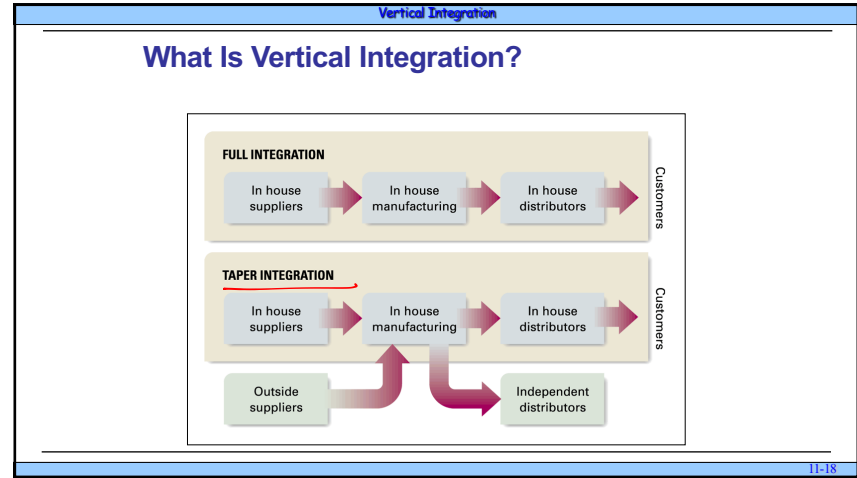
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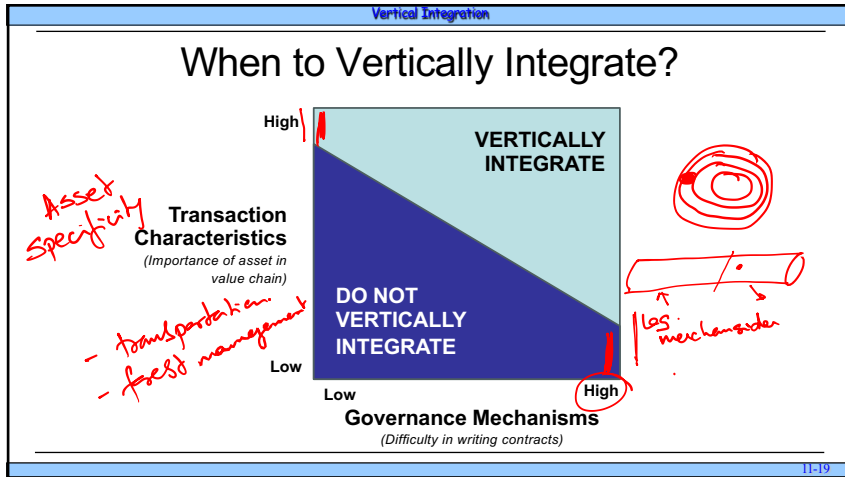
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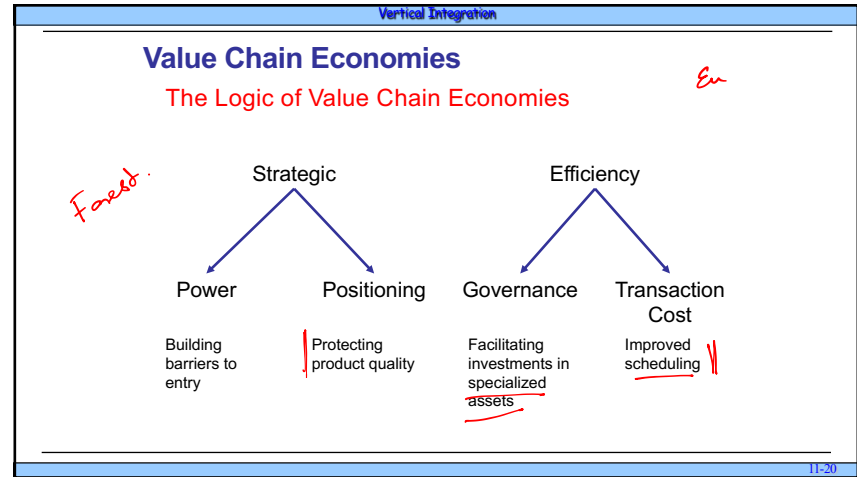
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Vertical Integration

Value Chain Economies

The Logic of Value Chain Economies

Environmental Uncertainty	→	Bounded Rationality
Opportunism	→	Small Numbers
Risk	→	Specific Assets

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Vertical Integration

Value Chain Economies

The Logic of Value Chain Economies

- Value migration ✓✓
- Differentiation ✓✓
- Customers demand integrated solutions
- Synergies
- Emerging industries
 - Credibility
 - Compatibility/standards

Ola
↓
bakey

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Vertical Integration

Arguments Against Vertical Integration

- Cost disadvantages
 - Company-owned suppliers that have higher costs than external suppliers
- Rapid technological change
 - Tying a company to an obsolescent technology
- Demand unpredictability
 - Difficulty of achieving close coordination among vertically integrated activities
- Bureaucratic costs

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Vertical Integration

Link to Firm Performance

Theory on TCE and the RBV

<p>advantages of vertical integration</p> <ul style="list-style-type: none"> • higher product quality • protection of proprietary products and technologies • higher customer satisfaction • lower transaction costs due to less dependency on external suppliers 	<p>disadvantages of vertical integration</p> <ul style="list-style-type: none"> • higher production, agency and coordination costs • reduced flexibility and market exit barriers • focus on non-core competencies
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Vertical Integration

Alternatives to Vertical Integration

- Short-term contracts and competitive bidding
- Strategic alliances and long-term contracting
- Building long-term cooperative relationships

COMPANY BOUNDARY BEFORE OUTSOURCING

COMPANY BOUNDARY AFTER OUTSOURCING

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Vertical Integration

When is Vertical Integration More Attractive than Outsourcing?

How many firms are available to undertake the activities?	→ The fewer the companies the more attractive is VI
Is transaction-specific investment needed?	→ If yes, VI more attractive
Does limited information permit cheating?	→ VI can limit <u>opportunism</u>
Are taxes or regulation imposed on transactions?	→ VI can avoid them

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Vertical Integration

When is Vertical Integration More Attractive than Outsourcing?

Do the different stages have similar optimal scales of operation?	→ Greater the similarity, the more attractive is VI
Are the two stages strategically similar?	→ Greater the strategic similarity ---the more attractive is VI
How great the need for entrepreneurship & continual upgrading of capabilities	→ Greater the need, the greater the disadvantages of VI
How uncertain is market demand?	→ Greater the unpredictability ----the more costly is VI
Are risks compounded by linkages between vertical stages	→ VI increases risk.

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Vertical Integration

Summary

Vertical Integration...

- makes sense when value chain economies can be created and captured
- may allow a firm to leverage capabilities
- may be a response to the threat of opportunism and uncertainty
- as a form of exchange *per se*, is not rare nor costly to imitate

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