


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.



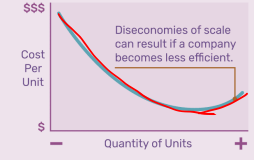
Manufacturing costs can fall 70% to 90% every time the business doubles its output.



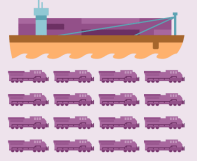
Internal
The sheer size of the company allowing bulk purchases.



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.

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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
 - Technical:** large-scale machines or production processes that increase productivity
 - Purchasing:** discounts on cost due to purchasing in bulk
 - 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
 - Risk-Bearing:** spreading risks out across multiple investors
 - Financial:** higher creditworthiness, which increases access to capital and more favorable interest rates
 - 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 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 . *market barter.*

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.

Transaction Cost Economics (TCE)

Structure
TCE → transportation bargain

Competitive . *Reduction Cost*

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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

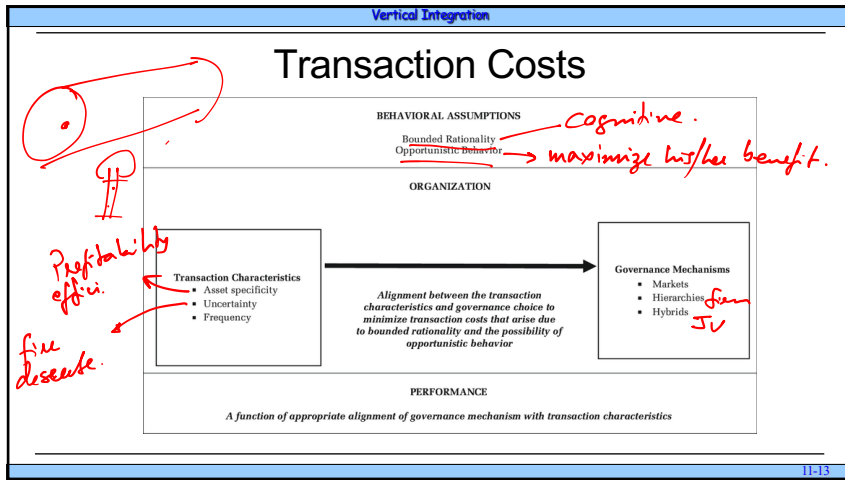
Transaction costs are directly linked to:

- Search & Information Cost (*find supplier*)
- Bargaining Cost (*Purchase*)
- Enforcement (*monitor*)

Internalise
employment contract

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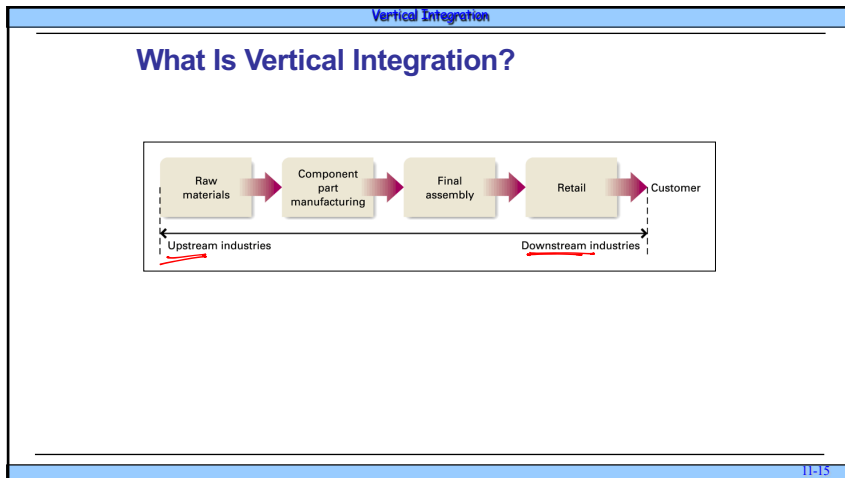
Vertical Integration

What Is Vertical Integration?

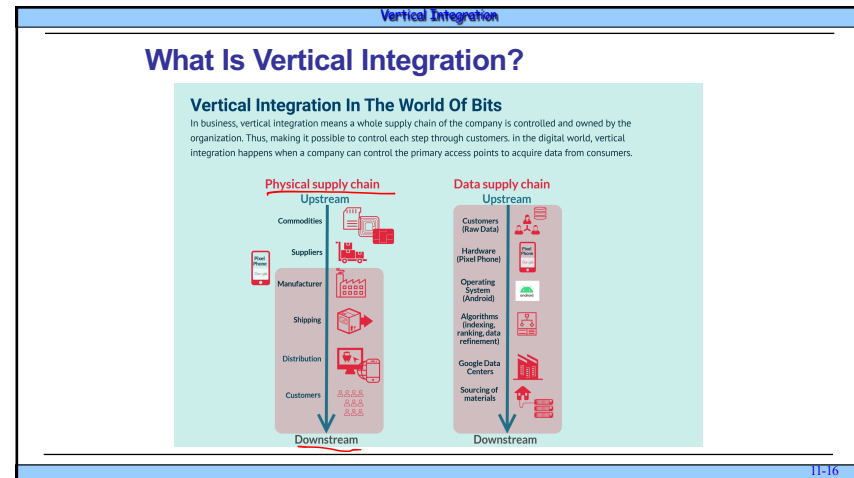
- Vertical integration is a special exponent of unrelated diversification
 - A firm is engaged in several stages of a given industry's value chain
- Existence – why do firms emerge?
- Boundaries – why is the boundary between firms and the market located exactly there as to size and output variety?

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Vertical Integration

What Is Vertical Integration?

Horizontal vs. Vertical Integration In A Nutshell

Horizontal integration refers to the process of increasing market shares or expanding by integrating at the same level of the supply chain, and within the same industry. Vertical integration happens when a company takes control of more parts of the supply chain, thus covering more parts of it.

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Vertical Integration

What Is Vertical Integration?

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Vertical Integration

When to Vertically Integrate?

Value Chain Economics
Asset Specificity

Transaction Characteristics
(Importance of asset in value chain)

Governance Mechanisms
(Difficulty in writing contracts)

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Vertical Integration

Value Chain Economies

The Logic of Value Chain Economies

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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

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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 <u>quality</u> • 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

J.V. Hybrid.

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? <i>Supplier.</i>	→ The fewer the companies the more attractive is VI ✓
Is transaction-specific investment needed? <i>asset specificity</i>	→ If yes, VI more attractive ✓
Does limited information permit cheating? <i>monitoring ↑</i>	→ VI can limit opportunism ✓
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? <i>output₁ → input₁ → output₂ → input₂</i>	→ Greater the similarity, the more attractive is VI ✓
Are the two stages strategically similar? <i>related.</i>	→ Greater the strategic similarity ---the more attractive is VI ✓
How great the need for entrepreneurship & continual upgrading of capabilities <i>capex ↑</i>	→ Greater the need, the greater the disadvantages of VI ✓
How uncertain is market demand? <i>cyclicity</i>	→ Greater the unpredictability ---the more costly is VI ✓
Are risks compounded by linkages between vertical stages <i>uncertainty</i>	→ VI increases risk. ✓

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Vertical Integration

Summary

T.C. → Frequency, Uncertainty, Specificity Asset.

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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