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BY KEN FAVARO

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"Owning the value chain" was a favorite strategy in the early part of last century. Companies sought advantage by moving "upstream" to control the means of production that supplied their main business or "downstream" to ensure their path to market. For example, 100 years ago Ford owned rubber plantations, coal and iron ore mines, and even railways.

But vertical integration largely fell out of favor when conglomeration became fashionable during the late 1960s and early '70s. In fact, many industries underwent vertical dis-integration. Today, for example, almost three-quarters of the parts going into American cars are sourced from outside the United States. Whereas computer companies once made the memory and processing chips and wrote the operating and applications software for the computers they manufactured and sold, specialists in chip making, software development, and hardware assembly now dominate the industry. And although some energy companies still find oil in the deep sea, process it in their refineries, and sell it to Jane Doe at her corner gas station, the oil industry now has "pure play" companies in each stage of its value chain.

Is vertical integration a thing of the past? On the contrary, it seems to be making a comeback, particularly in Silicon Valley, where it's been given a new label (just to remind us that everything that emanates from there is innovative!): the "full stack" business model. Some companies are migrating upstream: Take Netflix and Amazon getting into the original programming business and Harry's (a U.S. startup that sells men's razors and shaving cream by monthly subscription) acquiring a factory in Germany to make its own razor blades. Others are integrating downstream. Consider Apple owning and operating a retail chain to sell its own products and Google launching a wireless telecom network in the United States. Some companies are even doing both. Tesla, for instance, is bypassing traditional dealerships to sell its cars directly to the consumer while also building the world's largest battery plant.

Many non-tech companies are also pursuing vertical integration. Ferrero, the chocolate company, made its first-ever acquisition in 2014 — buying a Turkish company that processes hazelnuts, the precious ingredient in Nutella, its world-famous chocolate spread. Howard Schultz calls Starbucks's business model "vertical integration to the extreme," because the company buys and roasts all its own coffee and sells it through entirely company-owned stores. Back in 2012, Delta Air Lines bought a refinery to have its very own source of aviation fuel. There's even a growing trend of pension funds bypassing private equity funds by setting up their own internal shops to do private equity investments on their own.

Are all these modern forms of vertical integration

Ken Favaro
ken.favaro@strategyand.pwc.com
is a senior partner with Strategy& based in New York. He leads the firm's work in enterprise strategy and finance.

good strategies? Yes, if two special conditions are met. The first is a "market failure" that is hurting your business; the most common are supply risk, demand risk, and profit gouging. The second is that you have the power or capabilities to fix and even exploit that market failure. Without market failure, vertical integration is just plain ole diversification. And without the power or capabilities to exploit a market failure, it's a very risky strategy.

Netflix, for example, is backward-integrating into programming because it says that the cost per hours viewed is reduced significantly by producing a series such as *House of Cards* instead of licensing all its content. In effect, Netflix is saying that the content providers are profit-gouging. Similarly, the pension funds setting up their own private equity offices are forward-integrating to avoid what they consider to be excessive fees from third-party firms. In each case, the companies are entering a new business in direct competition with those for whom that business is their focus. If their moves show sustained success, we will know that there really was price-gouging going on; if they fail, they will learn that companies have to pay up for things that are not so easy to replicate on their own.

Starbucks and Ferrero are attempting to mitigate supply risk. Starbucks buys and roasts its own coffee because it does not trust industry suppliers to provide the quality its main business requires. When it bought a hazelnut processor, Ferrero broke its long-standing refusal of M&A because it feared a disruption in its supply of the essential ingredient in its most important product. Both companies are now among the biggest buyers of coffee and hazelnuts, respectively, in the world. Thus, they both have the firepower to be their own suppliers of the core commodities they need to feed their main businesses. If they are right about their supply risk, their vertical integration will indeed be a critical ingredient to their continued success. But it'll prove to be just an unnecessary complication if they are wrong.

The Google and Apple examples are good illustrations of vertical integration to manage demand risk. Frustrated with the lack of innovation at incumbent telecom companies, Google set up its own mobile network. The company is hoping to demonstrate that better Internet service is possible — so customers will demand more from established operators, which will in turn drive more Internet traffic and thus greater demand for its search business. Apple has its own stores to ensure that its products are displayed, sold, and supported on the shop floor in a manner that is consistent with its brand values. It doesn't trust other retailers to do that. Because Google's and Apple's main businesses are so dominant, they can afford to forward-integrate into different businesses that are not all that profitable for the incumbents. But these strategies will become dangerously expensive if their main businesses ever lose their stronghold.

In the end, vertical integration is a strategy driven by lack of trust that upstream and downstream players will come through for your business, and not overcharge you. If that lack of trust is well founded, there's a failure in the market. And if you have the market power or essential capabilities to enter your suppliers' or customers' business, vertical integration makes sense for your strategy. But those are two very big ifs. +

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