

A Business Primer on Vertical Integration

How to think strategically as value moves upstream and 'clustering' replaces acquisition as the path to innovation and collaboration

By Mona Pearl & Marco Galante

The continually evolving economy of the last couple of years has prompted companies around the world to seek a competitive edge, while lowering operational costs and focusing on efficiency and effectiveness. The search for feasible growth models that provide the right strategic moves opens the dialogue for companies to more closely examine the strategy of vertical integration.

The objective of vertical integration is the creation or enhancement—either upstream or downstream—of market positioning, targeting particular markets for the development and extension of a supply chain. This strategy ideally creates or enhances both cost effectiveness and market positioning within the vertical chain, at one or multiple levels within that chain. Such a business organization would substantially put all stages of goods production—from the acquisition of raw materials to the retailing of the final product—under the control of one company or a group of companies.

As major manufacturing sectors experience commoditization, increased competition from emerging markets, and the resulting need to improve profit margins, companies should explore vertical integration and examine its compatibility with their operations.

Opportunities in Nutrition

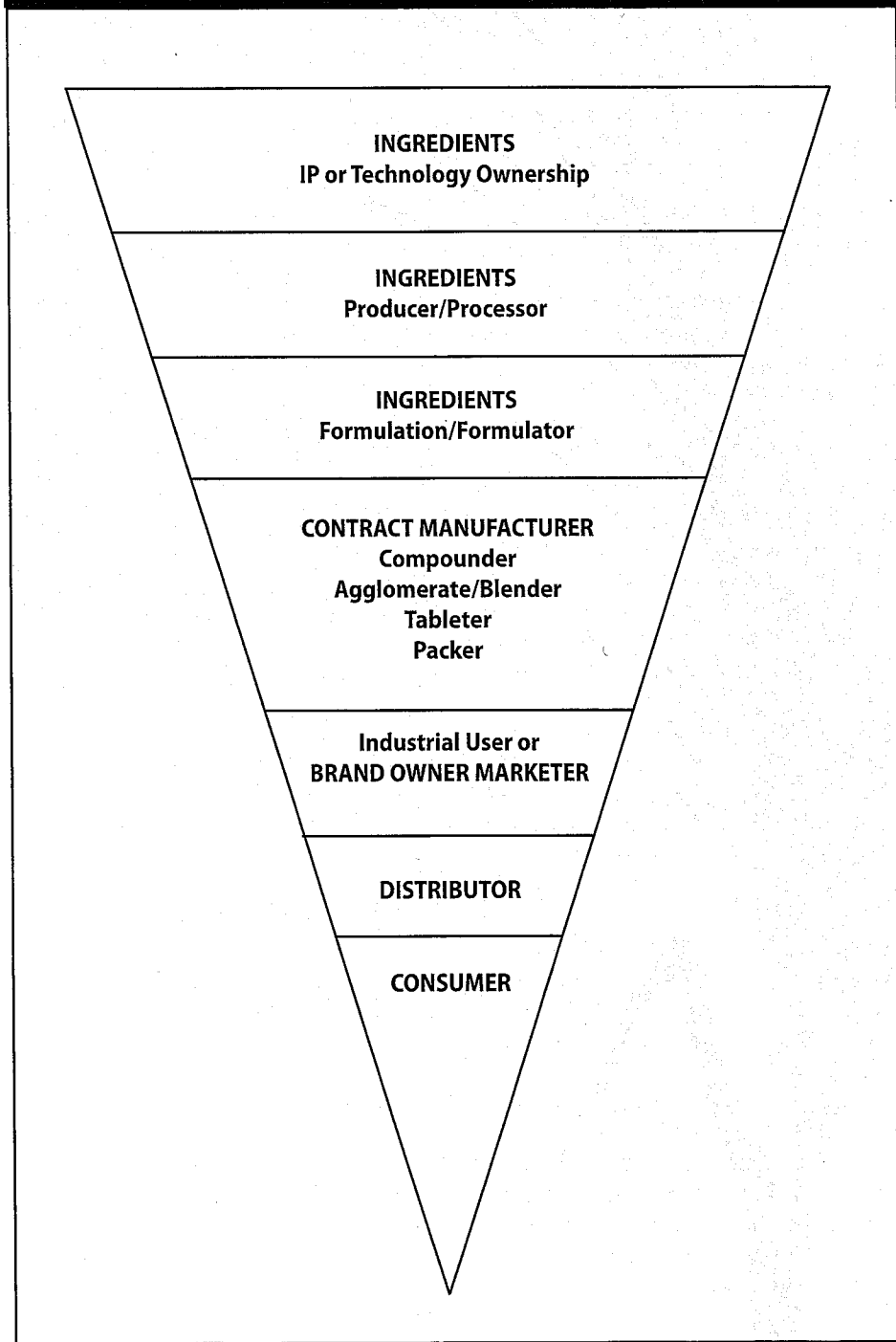
Within the functional food, beverage and supplement sectors, the final “use cost” of effective, health-specific ingredients is increased by the multiple margins required at each point of the vertical chain,

as illustrated by the steps in the accompanying diagram. Selective vertical integration eliminates some or the majority of these “intervening” steps and, via the reduction of multiple margins, can ultimately create savings. This strategy should allow for more cost-effective ingredients, particularly regarding their end use within the functional food, beverage or supplement categories.

Vertical integration is an opportunity for the potential elimination or reduction of incremental margins endemic to a fragmented supply chain, as seen in particular within the healthy food and dietary supplement sectors.

Motivation for vertical integration comes from a desire to exercise greater supply chain control, as well as create value in order to decrease costs or increase rev-

Multiple Margins along Vertical Chain Increase Use Costs for Nutrition Companies



venues, or both. In addition, a vertical integration strategy can augment operational flexibility, leverage the company's capabilities, provide a more defensible market position, reduce the potential threat of opportunism, and ultimately enhance selling advantages.

A large number of empirical studies indicate that cost is the most statistically and economically important factor in the decision to vertically integrate. Consequently, a company makes this decision by comparing the benefits of the strategy with the cost and the capital investments required, of both human and hard assets. The decision to vertically integrate should be based on whether the benefits of control and profits exceed the risks and the investments.

Integration makes strategic sense when all or a large part of the company's chain captures more value than any market "exchange" is providing.

Types of Vertical Integration

There are three basic types:

- **Backward or "upstream" vertical integration** occurs when a company controls subsidiaries that produce some of the inputs used in the production of its products.
- **Forward or "downstream" vertical integration** occurs when a company controls distribution centers and retailers in the sale of its products.
- **Balanced vertical integration** is used when a firm controls all or most components, from raw materials to final delivery.

The three types noted are only general concepts, as firms use a wide variety of subtle variations. For example, suppliers are often contractors, not legally owned subsidiaries. Still, a client may effectively control a supplier if their contract assures the supplier's revenue stream and profitability. Distribution and retail partnerships exhibit similarly wide ranges of complexity and interdependence.

Examples from the Food Sector

Poultry Processor (B2B and B2C)

While breeding and growing operations are not necessarily owned by the processor, stringent, contractual control is exercised over the breed and feeding in collaboration with the farmer. Slaughter, portioning, further processing, cooking, marketing and sales, and distribution are functions owned and all undertaken by the processor.

Fast Food Service (B2B)

While fast food companies may license or franchise their restaurants, very large chains exercise substantial control over exclusive suppliers of various food and non-food items, as well as over exclusive distributors. In this form of vertical integration, the chains may not have actual ownership of the assets of their downstream supply chain.

Value Moves Upstream

A company should vertically integrate into those business activities in which it possesses valuable, unique, and costly-to-imitate resources and capabilities.

Likewise, a company interested in vertical integration would likely be looking to enhance market positioning and better control costs, as well as to harvest a portion of the multiple margins. One's capacity for cost improvement depends on the cost of the outsourced side supply versus the investment in and the cost of administering the same activities internally.

Vertical integration may intensify competition upstream and/or downstream, which, in turn, affects the distribution of margins and profits along the chain and, ultimately, end-user prices.

When a company vertically integrates and self-supplies some input, potential suppliers are often precluded from providing those inputs and thus operate at a competitive disadvantage. However, suppliers may choose to be acquired or partially controlled by that company.

In many industries, particularly on the manufacturing side, products have become commoditized (e.g., meat: beef, pork and poultry). As a result, a considerable portion of added value has moved upstream, and companies have put an emphasis on customizing products that

meet consumer requirements. Evolving market trends reinforce this shift, including trends in economics, consumer demographics, tastes, and lifestyle changes.

The portion of value-added services from traditional production activities that include core product design and manufacturing has declined substantially with the rise of new global economies, as have margins. In many mature industries, products have reached levels of performance that already satisfy the requirements of the majority of customers.

Further refinements of the technical/functional performance of mature products tend to confront severely diminishing returns. Companies are looking for ways to differentiate their products and justify the pricing to the customer or end-user.

A company should not vertically integrate into activities where it does not have the resources or knowhow to achieve competitive, cost-effective advantages. It must have sufficient financial resources, organizational structure and management controls to successfully implement a vertical integration strategy.

Vertical integration strategies typically require that one business be integrated with an existing business (in the case of acquisition), thus resulting in challenges in and around management integration.

Vertical Integration SWOT Analysis

<p>Strengths</p> <ul style="list-style-type: none"> • Lower transaction costs, which can lead to increased margins/profitability • Improved supply chain coordination: ability to synchronize supply and demand along the chain of products in a more effective and efficient manner, while customizing the process and adapting it to changing needs • Less uncertainty and more sustainability through higher investment • Important strategic similarity among the vertically-related activities • Economies of scale with sufficiently large production • Increased barriers to entry for potential competitors 	<p>Weaknesses</p> <ul style="list-style-type: none"> • Core competencies between activities may be different • Diminished ability to increase product variety if significant in-house development is required and costs of materials are higher • Higher investment, monetary and organizational costs
<p>Opportunities</p> <ul style="list-style-type: none"> • Capture and own upstream suppliers and/or downstream buyers as well as resulting profit margins • Create access to distribution channels • Expand and develop core competencies either within the company, by driving change and innovation, or through acquisitions • Differentiate and create a competitive edge and improved market positioning 	<p>Threats</p> <ul style="list-style-type: none"> • Developing new core competencies may jeopardize existing competencies • The perception/possibility of a company monopolizing the market/sector may lead to collaboration among competitors if the vertical integration is viewed as too serious a threat • Potential for increased administrative and marketing expenses

Vertical integration could potentially diminish a company's flexibility, as the integrated organization expands its oversight to include multiple activities, changes to structure and control systems, and compensation practices reflecting its larger organization.

It is important to be flexible when facing an uncertain future, but alternatives to vertical integration—particularly strategic alliances—should also be considered. Also of note, the advent of strategic partnerships has led to advances in collaboration and business clusters.

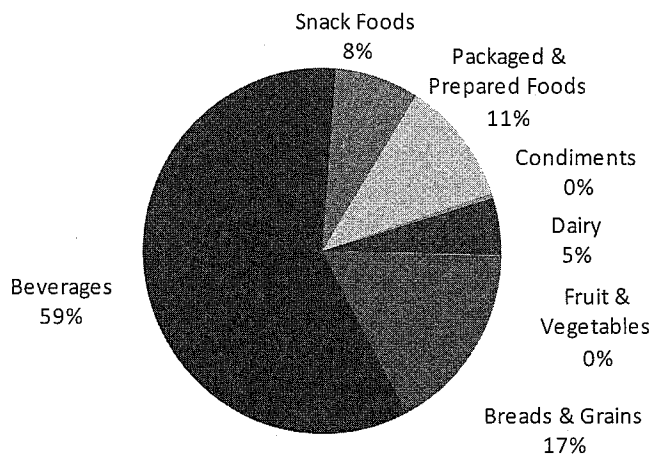
Organic Expansion

Corporate organic growth—through the development of specific processes, strategic alliances, or strategic clusters—also requires an investment in the company and the initiation of changes in its operations. This process may be similar to a start-up process, which may require less initial capital, but is much slower and less certain.

Vertical expansion through the acquisition of companies that either produce intermediate goods needed by a business, or market and distribute its product, is strategically desirable when planning for growth because it more quickly secures the supplies needed to produce and sell the product. Appropriate due diligence and actionable execution should result in a more efficient business, with lower costs and more profits.

Vertical expansion through acquisition increases company size, which can help to reduce cost and gain market share

\$39.1 Billion U.S. Functional Food Sales by Product in 2010



Source: Nutrition Business Journal estimates (consumer sales)

with more market dominance. Acquisitions can help meet a number of objectives if approached and executed as part of a long-term strategy:

- Enter an adjacent market space
- Expand into a new geography or obtain a physical footprint in a new location
- Access new customers
- Complete or add a product or service line
- Capture market share
- Prevent a competitor from gaining these advantages
- Accelerate revenue growth
- Reduce costs
- Access technology
- Strengthen pool of talent and capabilities

Clusters Are the Future

Winemakers know that the best wine starts with grapevines planted just close enough together to compete for nutrients, causing the plants to put more energy into reproduction, thus improving both quality and quantity. Businesses located together in clusters also demonstrate the best results.

Clusters have been shown to increase productivity, innovation and the entrepreneurial spirit, leading to new business creation. They may provide greater access to human capital, informational resources, cross-industry relationships, and financial incentives.

Clusters also provide greater collaboration in sharing infrastructure and transportation hubs, a more economical supply chain, access to information about competition, and a reduced corporate footprint on the environment. Opportunities to reduce operating costs may come as a result.

It's Time to Integrate

In response to a rapidly changing global marketplace, companies must craft flexible business models that are capable of responding to those changing dynamics, suitable, of course, to their unique capabilities. Vertical integration by strategic acquisition, appropriately assessed,

planned, carefully executed and subsequently nurtured, is the road to success. Through this paradigm shift in mindset and strategy, businesses will create and foster a sustainable competitive edge.

Being established is never equivalent to being relevant. There is danger in losing market relevance by delivering less value and neglecting the competitive edge.

References

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Businessweek, "How To Take Advantage of Business Clusters," Richard Mammone, December 8, 2009

Bios

Marco Galante, principal of investment banking firm **J. H. Chapman Group**, is a global food industry veteran with a 25-year pedigree, having held senior management positions at such companies as **Prima Foods**, **Viskase**, **Freddy Hirsch Group** and **Debs Vogue**.

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NBJ Bottom Line

In a vacuum, vertical integration certainly sounds like a bed of roses, but does the strategy have a proven track record in the nutrition industry? In truth, the pendulum swings both ways, but many companies have made successful forays up and down the chain in recent years.

On the sour end, much of the industry's vertical flops come from suppliers drifting downstream into brand ownership. Feature **Kemin** and **Cognis** both developing branded finished products for sale on the consumer market—Kemin with *FloraGlo* and Cognis with *Tonalin*—but pulling back after the required marketing spend loomed too large. And because of a lack of marketer interest, **DSM** recently assembled a small, retail-focused team to bring its *i-flex* and *i-cool* ingredients all the way downstream, though the jury is still out on the level of consumer interest.

To Galante and Pearl's point, organic expansion in a vertical direction can be a slow and uncertain undertaking, especially for raw material and ingredient suppliers, as they often lack the experience, expertise and extra cash required to successfully market products at the consumer level.

Acquisition strategies, however, have proven successful for several suppliers, with finished product companies acting as exclusive funnels for their ingredients. **Glanbia**, a world leader in whey protein, recently gobbled two of the biggest U.S. sports nutrition companies, **Optimum Nutrition** and **BSN**, both of which are heavyweights in the protein powder market. DSM has also taken the acquisition route downstream, having purchased **Martek** earlier this year, which itself acquired **Amerifit Brands** in early 2010. **GLG LifeTech** is another supplier that has found a modicum of success in vertical integration, controlling all the means of its stevia production while, through a joint venture, simultaneously selling RTD stevia-sweetened teas in the Chinese market.

On the brand-owner side of the spectrum, heavy hitters like **NBTY** and **Atrium Innovations** continue to integrate by swallowing up contract manufacturers and assuming control of individual proprietary ingredients. A few MLMs have also made headway with vertical strategies. **Herbalife** owns a substantial amount of its manufacturing, and **Univera**, under its parent company **ECONET**, is the last link in a full chain from supply to consumer.

The list is fairly short thus far, but—especially considering the acquisitions from Glanbia and DSM, as well as increased interest from pharma and traditional CPGs—nutrition industry interest in vertical integration appears to be a growing trend.