A vertical integration strategy and a corporate diversification strategy

Chapter 6: Vertical Integration A vertical integration strategy is one way of increasing the value created by the firm by bringing within the firm's boundaries several stages of an industry's value chain. Integration may be forward if the firm becomes closer to its customers, e. g., the firm establishes its own dealerships to sell products, or backward if the firm gets closer to its raw material sources, e. g. by having its own mining company to supply steel materials. Integration may also vary in degree depending on the number of stages in the value chain over which it decides to exercise greater control.

Vertical integration is about controlling parts of the value chain so that costs can be minimized and/or profits maximized in any of three ways. First, it can reduce opportunistic threats from the firm's buyers and suppliers by making transaction-specific value-adding investments, e. g., by capitalizing on economies of scale (opportunism-based). Second, the firm can exploit any of its valuable, rare, and costly-to-imitate resources and capabilities, e. g., as part of the processes used to make its end-products (capabilities-based). Third, the firm can take advantage of stable or volatile business conditions to squeeze profits by reducing its costs as much as possible (flexibility-based). The value of adopting any of these three strategies would depend on how rare and costly to imitate these strategies are, whether the firm does something its competitors do not, the degree to which it exercises control, and the variety of uncertainties that it faces.

Implementing vertical integration requires a high degree of control, so a functional or U-form organization structure is the most commonly used (aside from a good CEO), a necessity when adopting cost leadership and product differentiation strategies. The expected conflicts that arise from this

structure can be resolved with the use of closely-managed budgets and management oversight committees. The three ways by which a firm implements a vertical integration strategy affects the manner by which it rewards its people: individual, group, or corporate. Lastly, a firm operating internationally can choose the extent to which it adopts a vertical integration strategy.

Chapter 7: Corporate Diversification

A corporate diversification strategy is adopted by a firm that wishes to maximize profits by reducing costs or increasing revenues, or do both, by widening the firm's scope of business, which can be accomplished in many ways. It can diversify in a limited manner or in a related or unrelated business. What is important is that the firm realizes that by coming up with the investment that allows it to diversify, it is certain that it does a better job than others in doing this.

Diversification has the potential to create economic value for the firm. It can do so because it can exploit operational economies of scope such as shared activities and core competencies. It can also exploit financial economies of scope such as its ability to allocate capital, reduce risk, or avail of tax breaks. It can also exploit anticompetitive economies of scope such as multipoint competition and market power advantages. Lastly, there are also employee incentives to diversify that result in management getting higher salaries by managing a bigger business. Research has shown that related diversified firms outperform unrelated diversified firms.

How well a firm's diversification strategy creates sustained competitive advantage depends on the value, rarity, and imitability of the strategy. If very few competing firms exploit the same economies of scope through

diversification; if the degree of imitation through direct duplication or substitutes is low; and, a firm's core competencies, capital and market structures and power are costly to duplicate, then the firm has a better chance of sustaining an advantage over its competitors.

Firms that do business in the global marketplace are implementing both a geographic and a product-market diversification strategy. A firm that pursues a diversification strategy in the domestic market can exploit the same economies of scope and pursue an international diversification strategy, with the difference that outside a firm's home market, there are financial and political risks that would give rise to a new set of challenges. If the firm learns to manage these risks, it can improve the way it exploits these markets and sustain a strategy of maximizing value creation.

Works Cited

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