

# The terminal decline of vertical integration economics essay



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The traditional theory of the firm suggests that profit maximisation is the sole objective of a firm. Increasing profits requires either the reduction of costs, which can be achieved by reaching the minimum efficient scale (MES), and exploiting economies of scale, or increasing revenue by increasing market share or obtaining a dominant position in the market. Both of these may occur as a result of a firm's growth. Growth may occur in any one of the two ways - internal and external.

Internal or organic growth is growth that comes from a firm's existing businesses, through the use of profits or loans to finance expansion over a period of time by increasing the number of both fixed and variable factors within the firm. " There is consensus in the academic literature that innovation and creativity, which increase the customer base, are central to organic growth (Lawrence & Stoddard, 2009). Internal growth can occur through two main ways, either by expanding an organisation's geographic reach, and expanding into new products in order to increase the size of its available market. Organic growth is often a fairly slow process as the market is likely to be highly saturated or the strength of the competition may mean that the firm is unable to raise or even maintain prices. Lack of profit may also hinder organic growth. By contrast, external growth which is growth by acquisition can be a more rapid way for a firm to expand or grow through mergers and takeovers; hence this is why most of the growth in the size of organisations has occurred through external growth (Britton & Worthington, 2009). A takeover (or acquisition) is where one company makes an offer to the shareholders of another. Where the management of the target firm resists the advances of the buyer but is eventually forced to accept a deal by

its current owners, is called a hostile takeover. A merger is the amicable involvement of two companies with the agreement of the management of both companies, the result of which is the creation of a new legal identity. A striking aspect of mergers and acquisitions is that they occur in bursts interspersed with relative inactivity. This trend is called the wave pattern of mergers and has been observed in the US with perhaps the longest history of mergers for over 100 years, in the UK from the early 1960s and, more recently, in continental Europe. Several countries have experienced phenomenal levels of takeover activity followed by a slump over the past decades (Sudarsanam, 2010). Arguably, the United States of America (USA) has experienced the longest history of substantial takeover activity going back to the late 1890s, as illustrated in Figure 1 below.

mergerss. jpg

Figure : The three merger waves in the US, 1890-1978

In order to understand fully the motivation for mergers and takeovers, it is important to recognise that there are four main types of mergers; horizontal integration, vertical integration (vertical backward integration and vertical forward integration), conglomerate merger and lateral merger. Horizontal integration (or expansion), occurs when two firms at the same stage of production in the same industry combine their business operations; for example, between two car manufacturers or between two brewers. A recent and highly controversial example of a horizontal expansion is the £12. 2bn merger of Lloyds TSB and Halifax Bank of Scotland (HBOS) that took place in the global financial crisis of 2007-present. As a result of the merger, the

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newly formed bank has nearly 33% of the retail banking market (BBC, 2008). Vertical integration (or expansion) is the process of merging with a company at a different stage in the production process in the same industry; for example a merger between a car manufacturer and a metal-pressing company. One of the most prolific vertical expansions of the 19th century according to the standard account was the vertical merger between General Motors and Fisher Body in 1926. (Casadesus-Masanell, Ramon Spulber, Daniel F, 2010). There are varieties of vertical integration. Vertical integration can take place `backwards` towards the beginning of the production process or `forwards` towards the end of it. Vertical backward integration is where a firm combines with a firm in the previous process, for example, a brewery integrating with hop growers. A renowned example of vertical backward integration is when Ford sought to acquire Autolite to produce the sparkplugs for its automobiles (U. S. v. Ford Motor Co., 405 U. S. 562, 1972). Vertical forward integration is combining with the next process in order to expand the scope of the firm's activities to both produce and distribute the final good, for example, a brewery taking over public houses. Another well-recognised example of vertical forward integration is when, shoe manufacturer Brown Shoe Company acquired shoe retailer Kinney (U. S. v. Brown Shoe Co., 370 U. S. 294, 1962). Figure 2 below illustrates horizontal and vertical integration (forward and backward).

Figure : Vertical Integration with contrast to Horizontal

Integration <http://wapedia>.

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Conglomerate mergers are neither vertical nor horizontal but involve a merger between firms involved in producing different goods (Senior Nello, 2009). Perhaps the most notable conglomerate merger was between the Walt Disney Company and the American Broadcasting Company in 1996 (New World Encyclopaedia, 2007). Although firms have no obvious relationship, for instance like the example above, they may still decide to merge in order to increase their market share to satisfy managerial ambitions or to diversify and reduce their risk exposure. And finally, a lateral merger is a type of horizontal integration in which there are some similarities between the businesses. For example, a brewery may merge with a restaurant chain to increase the market for its product. Mergers were very common during the late 1980's, as shown in Figure 3 below, with many companies merging with competitors and other businesses (related and unrelated). Yet towards the end of the 1990's most companies concluded that bigger companies with multiple businesses, could be detrimental and inevitably lead to un-competitiveness due to diseconomies of scale. As a result, this led to a large fall in the number of acquisitions and mergers in the United Kingdom (UK), again this is illustrated below in Figure 3.

Figure [http://www.revisionguru.co.](http://www.revisionguru.co.uk/graphics/diagrams/economics/unit4/growth1.gif)

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Vertical integration is an enduring topic for economics and more precisely for corporate strategy. Vertical integration is often one of the first diversification strategies a firm considers (Harrigan, 1984), regardless of the fact that the financial outcomes of vertical integration remains a contemporary issue, particularly in the drug, entertainment and health-care industries. George <https://assignbuster.com/the-terminal-decline-of-vertical-integration-economics-essay/>

Stigler has also given weight to the view that firms tend to integrate vertically in the early stages of their development in order to exploit the technical economies of scale that are available at that stage. Nineteenth century steel tycoon Andrew Carnegie was first to introduce and champion the idea of vertical integration. This led other businesspeople to use the system to promote better financial growth and efficiency in their companies and businesses. One of the earliest and most well known examples of vertical integration was the Carnegie Steel company located in Pittsburgh, Pennsylvania. The company controlled not only the mills where the steel was manufactured but also the mines where the iron ore was extracted, as well as the coal mines that supplied the coal too. The efficiencies of controlling all parts of the process - from mining the steel to making the final product - proved gripping. " The ultimate success of vertical integration will be dependent on the ability of top managers to accurately assess its net benefits and costs" (Golden et al, 2002). Firms have always been very keen to integrate since it allows them to take advantage of linked technical processes that will enable them to reduce their costs (Clinton et al, 2008). Securing supplies is one of many compelling benefits that vertical integration brings. Even if there is no price advantage from using in-house suppliers, control will assure uninterrupted deliveries during shortages or even when demand exceeds capacity. A good illustration of this benefit are oil companies, they have possibly grasped vertical integration the most tightly, owning the oil wells, refineries, pipelines and tankers, plus the gas stations that fill motorists' tanks (Armitage, 2010). Another common argument for vertical integration is the belief that " synergies" exist, allowing two companies or organisations to work more efficiently together than either

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would separately. Such synergies may result in the ability for the organisations to exploit economies of scale, eliminate duplicated functions, share managerial expertise, and raise larger amounts of capital (Ravenscraft and Scherer 1987). For example; Carlton and Granada hope to save £55 million annually by combining their operations (Goodway, 2010).

Despite the advantages of vertical integration, the late 20th century saw a change in the business structure: vertical integration was replaced by a horizontal pattern in which specialist retailers bought from the garment makers - and spread sideways into selling shoes or jewellery made by other manufacturers who no longer wanted to run shops. Soon this horizontal expansion was seen as so virtuous, companies acquired completely unrelated businesses and conglomerate mergers were born. Such acquisitions offered diversification, unlike vertically-integrated operations that, despite the variety of processes and skills employed, still had all its eggs in one basket. Even though diversification is the riskiest of the four mergers presented, and requires the most careful investigation, since it means going into an unknown market with an unfamiliar product offering, it was still deemed more desirable due to its ability to allow the company to exploit new markets and spread its risks (Brietzke, 1999). For example; AOL's merger with media giant Time Warner in the year 2000, saved it from being affected quite so disastrously as many of AOL's Internet competitors by the 'dot com crash' (Henry, 2002). Horizontal mergers may also be motivated by a desire for greater market power or share. When firms come together there will inevitably be a reduction in the number of competitors in the market, hence resulting in the firm to have a much larger market share

than before. However, horizontal mergers may spark competition issues, that is, monopolistic activity. In such circumstances, authorities such as Britain's Competition Commission have the duty to obstruct any tie-up that could create a monopoly capable of abusing its power. For example, the British competition commission intervened in preventing the largest supermarket chains from buying the retailer Safeway (Hollingsworth, 2008).

Nonetheless, the circle has now turned 360 degrees: Vertical integration is back in favour. Australia's Macarthur Coal, which supplies a third of the coal used by the world steel industry, has been bought by milling companies eager to secure their own fuel source (Armitage, 2010). ArcelorMittal, the world's largest steel maker, has restructured into a vertical company, buying iron ore mines from Liberia to Mexico (Armitage, 2010). Anglian Building Products, one of the UK's largest double-glazing companies, has adopted vertical integration as its business model too, operating glass furnaces, blending its own PVC to extrude into sections, and employing its own van fleet and installation staff. Director Melanie Russell says: "One of the main competitive advantages is that we operate a vertically-integrated service enabling total control of all processes, from initial design, survey, manufacture, fabrication and glazing to final installation and after sales support." (Armitage, 2010) The resurgence of vertical integration is largely due to the reason that, when vertical integration was in "decline" or "out of fashion", many companies outsourced their customer services to call-centers, often overseas. However, they lost control of their vital functions which proved unsatisfactory for many companies performances and so companies such as the mobile groups Orange and AT&T Inc, as well



as Abbey National bank, now Santander, are among many firms bringing vertical integration back into the limelight.(Armitage, 2010) The resurgence of vertical integration has not been restricted to the UK only, India who has arguably acquired the biggest gain from the outsourcing of customer service has the most to lose due to the return of vertical integration. However, India has also embraced vertical integration. One of its organization, Reliance Industries, stretches from oil production through textiles, to retailing, and Chairman Mukesh Ambani says: “ Backward vertical integration has been the cornerstone of the evolution and growth of Resolution.” (Reliance Industries Limited). Another well know Indian organization “ Tata” has also recently adopted the same policy, following its purchase of Britain’s Corus steel company by buying vehicle makers Jaguar and Land Rover (BBC, 2008)

Despite the resurgence of vertical integration, the main brake on this trend may be the fear of governments, that vertical integration is non-competitive. The European Union (EU) blocked General Electric’s \$44 billion bid for Honeywell’s (Bloomberg, 2001) since it believed that a combined group would control too much of the jet engines market, while British regulators stepped in to deter Sky television from owning Manchester United Football Club and in 2009 blocked a ticket agency from buying a concert organizer (Armitage, 2010). But while trends in organizational structure keep changing, the current wish to control supplies and outlets is making vertical integration popular again.