

# Vertical Integration and Outsourcing

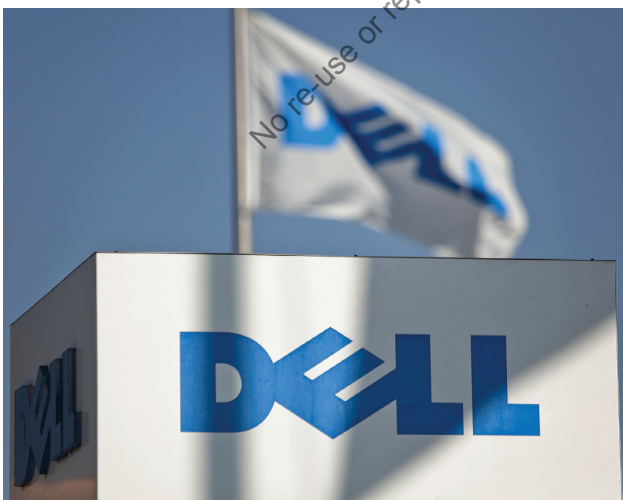
## LEARNING OBJECTIVES

Studying this chapter should provide you with the knowledge to:

1. Define vertical integration, forward vertical integration, and backward integration.
2. Describe the three Cs that represent the primary reasons that firms choose to vertically integrate (make) and perform an activity internally versus outsource (buy) the activity to (from) a supplier.
3. Describe the two Fs, which examine the potential dangers of vertical integration.
4. Explain the advantages of outsourcing and the conditions under which it might be advantageous to outsource an activity to an external supplier.
5. Discuss the actions a manager could take to prevent a subcontractor from becoming a competitor.

## Dell and ASUS: A Tale of Two Companies

Ed Lallo/Bloomberg via Getty Images



Dell began in 1984 with a simple idea in mind: create and deliver custom personal computers (PCs) directly to customers within 48 hours. What started in Michael Dell's dorm room at the University of Texas, Austin, grew to a Fortune 500 company in less than

a decade.<sup>1</sup> Moving inventory quickly without the costs of store-fronts or distributors made these computers affordable, and also provided customers with the latest technology within days. The company became a powerful player in the PC market in just a few years.

From the early 1990s until 2006, Dell was a darling of stock analysts. In fact, Dell's market value (market cap) jumped from \$2.5 billion in 1995 to \$100 billion in 2005.<sup>2</sup> Dell was rewarded by Wall Street with a higher stock price for its growth and ability to generate high profits with relatively few assets. The company's ability to generate high profits with only a few assets was possible because it outsourced most of the components and operations associated with making its PCs to outside suppliers. This allowed it to focus on computer design, final assembly, sales and distribution, and service. Over time, Dell streamlined its business model by outsourcing more and more of its low-value manufacturing operations, eliminating expensive equipment and competencies. For example, by outsourcing motherboards and the final assembly of its computers, Dell cut the cost of those activities by roughly 20 percent.<sup>3</sup>

Outsourcing low-value-added manufacturing tasks reduced assets on Dell's balance sheet and allowed the organization the

freedom to focus on higher-profit-margin products and services. Both Dell and Wall Street loved the change. As Dell moved upmarket selling more powerful PCs and servers, it continued to outsource more of its lower-value components and processes, mostly to suppliers in China. Eventually, Dell outsourced the management of much of its supply chain, and more of the final assembly of the entire computer.<sup>4</sup> It got to the point where some Dell computers were almost completely designed and manufactured by other companies.

Although Dell outsourced to increase efficiency and improve its performance, other companies in the industry chose the opposite approach. ASUS, a Chinese company that was the recipient of much of Dell's outsourcing, began making circuits and motherboards for Dell (and other PC manufacturers) cheaper than Dell could. ASUS had a cost advantage from manufacturing circuits

and motherboards in China and soon became the world's largest manufacturer of PC motherboards.<sup>5</sup>

As ASUS produced more and more of Dell's components, it increased both sales and profits. Over time, ASUS continued to build new manufacturing knowledge and capabilities, moving upmarket behind Dell, from circuits and motherboards to supply chain management, computer assembly, and computer design. Eventually, in 2007 ASUS launched its own inexpensive Eee PC in Taiwan at a price tag of \$340, and the computer quickly sold out. ASUS stock increased by 4.9 percent the day it launched.<sup>6</sup> This led to a worldwide launch of the Eee PC, which is now sold through BestBuy and Amazon.com.<sup>7</sup> Analysts appreciated ASUS's vertical integration strategy (bringing more activities inside the firm), just as they appreciated Dell's outsourcing strategy (sending more activities to suppliers).

Dell and ASUS prospered with opposite strategies: one outsourcing, the other integrating. Dell improved its profit returns on net assets (RONA) by outsourcing manufacturing processes and their associated physical assets while focusing on higher-value-added activities such as design, marketing, and service.<sup>8</sup> ASUS increased revenues and profits by moving upmarket behind Dell, gradually developing more sophisticated manufacturing capabilities and eventually launching its own PC. Dell and ASUS's successes raise the following questions: How can two companies in the same industry each find success with opposite vertical integration strategies? Are both strategies appropriate, or did analysts overlook weaknesses in one or both of these strategies? Finally, did Dell or ASUS management set up their respective companies for greater future success or failure?

## What is Vertical Integration?

Dell and ASUS made different decisions about the extent to which they wanted to perform activities related to developing, designing, manufacturing, selling, and servicing their computers. Dell decided to outsource some of the activities that it had previously conducted internally to ASUS and other suppliers. **Outsourcing** refers to a firm contracting out a business process or activity to an external supplier.

Dell's leaders made this decision because they believed that other firms could perform these activities more efficiently than Dell could. So they outsourced what they perceived as lower value-added activities—or those activities on which they made lower profit margins. At the same time, ASUS decided to enter into an increasing number of activities related to making a computer—from making components and motherboards to fully designing and manufacturing its own Eee personal computer. This is referred to as **vertical integration (or insourcing)**—bringing business processes or activities previously conducted by outside companies in-house. ASUS developed the capabilities to perform these additional functions efficiently and improved the company's overall performance. Moreover, by adding activities, ASUS's leaders believed that they could build additional manufacturing capabilities for the company that would be useful in the future.

This case illustrates the classic “make” (ASUS) versus “buy” (Dell) choice that leaders face as they try to offer unique value to the market. Two firms can look at the same activity and one might decide that it makes sense to make it, or conduct the function internally within the firm, while another firm might decide to outsource it. As shown in the Dell–ASUS case, this choice can have real impact on a firm's ability to succeed. Consequently, it is important to understand when to make and when to buy.

**outsourcing** The process where a firm contracts out a business process or activity to an external supplier.

**vertical integration (or insourcing)** Bringing business processes or activities previously conducted by outside companies in-house.

This chapter will cover why companies choose to conduct an activity within the firm; the benefits of outsourcing, and the conditions when it might be advantageous; and the dangers of outsourcing as well as the risks of vertical integration. In the Strategy Tool at the end of the chapter, we provide a tool, the “Make vs. Buy Assessment,” that can be used to decide whether to make versus buy.

## The Value Chain

The different aspects of the *value chain* have been covered in earlier chapters, but they warrant a more in-depth discussion here as a clear understanding of the value chain is critical to the “make versus buy” decision. The **value chain** for an industry is the sequence of activities that transforms raw materials into finished products. Each key activity “adds value” to the prior activity—hence the term *value chain*.<sup>9</sup>

To illustrate, let’s walk through the industry value chain for gasoline. To get gasoline to the consumer, we first need to explore for crude oil, then drill, then ship, then refine the crude into gasoline, then ship again, then finally sell gasoline to the end consumer, as outlined in Figure 7.1.

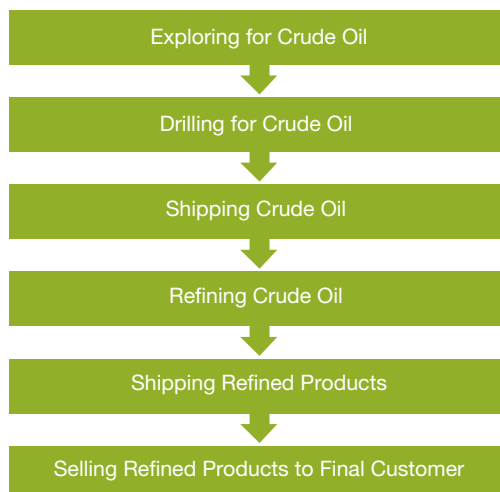
Companies have their own value chains that are usually distinct from an industry value chain. Companies that participate in many or all stages of the industry value chain from exploration to final sale are highly *vertically integrated*.<sup>10</sup> Companies that participate in only one activity (such as shipping crude oil) are *vertically specialized*.<sup>11</sup> Activities closer to the beginning of the industry value chain, or the raw materials used to create a product, are referred to as *upstream activities* and those toward the end, or final products that consumers purchase, are *downstream activities*.<sup>12</sup>

**value chain** The sequence of all activities that are performed by a firm to turn raw materials into the finished product that is sold to a buyer.

## Forward Integration and Backward Integration

If a company wants to grow by moving forward in the value chain—that is, downstream—we say that company engages in *forward integration*.<sup>13</sup> This might be an oil-refining company that wants to open its own gas stations to sell gas. Or it might be an oil-exploration company that decides to refine the crude oil that it finds. In contrast, if a company wants to grow by moving backward in the value chain—that is, upstream—we say that company is *backward integrating*.<sup>14</sup> This might be a drilling or refining company that wants to do its own exploration.

For any given activity in the value chain, an organization’s leaders must answer this key question: Do we make it or do we buy it? In other words, do we do it ourselves, or do we have some other company do it? The answer to this question hinges on whether the firm can build a



**FIGURE 7.1** The Oil Industry Value Chain

capability that will allow it to do a better job of offering unique value by conducting the activity itself rather than having another company do it.

In some cases, a firm's leaders will decide that being vertically integrated into more activities will allow it to better deliver either a low-cost or differentiated product to the customer. In other cases, a firm might think it is better off by being vertically specialized.

To illustrate, Walt Disney is vertically integrated into many vertically linked activities in the value chain. It produces its own movies and TV shows with its own studio and its wholly owned subsidiary Pixar. Disney also distributes its TV shows and movies through its own TV networks (ABC and Disney Channel) and to movie theaters through a worldwide distribution network. Disney doesn't own movie theaters, but many years ago most of the movie studios such as Paramount and Fox did own their own theaters.<sup>15</sup>

In contrast, Nike is much more vertically specialized than Disney. Nike designs and markets its athletic footwear, equipment, and apparel, but outsources many other activities in its value chain.<sup>16</sup> It does not manufacture its shoes, equipment, or apparel, and for the most part, it sells its products through stores owned by other companies, such as Foot Locker. When Nike started selling its shoes and apparel through its own Niketown stores, it *forward integrated* by conducting activities within the firm that are downstream and closer to the end customer. Likewise, ASUS engaged in forward integration as it continued to take on more activities for Dell in the final assembly of a computer. If Nike were to start to manufacture its own shoes or apparel, it would be engaging in *backward integration* by incorporating more activities that combine materials and components into a final product. When Netflix started to create its own originally produced shows—such as political drama *House of Cards* and comedy *Arrested Development*—this was a form of backward integration designed to allow it to differentiate its service from competitors.

The success of firms such as Nike, Disney, Netflix, and ASUS has been strongly influenced by the choices of organizational leaders regarding which activities along the value chain should be conducted within the firm and developed as core competencies, and which activities should be outsourced to other companies. This choice of whether to “make” or “buy” hinges on a variety of factors that we address in the next section.

Copyright © 2018 John Wiley & Sons, Inc. All rights reserved.  
No re-use or republication without publisher's express written permission.