

Contemporary Management Issues

Chapter 3

Where should a company
compete (vertical integration
and diversification)?



Agenda

- Introduction
- Chap 1 – What is behind the term « company »?
- Chap 2 – Why does a company need to grow?
- Chap 3 – Where should a company compete (vertical integration and diversification)?
- Chap 4 - Where should a company compete (geographical scope)?
- Chap 5 – Why and How innovation?
- Chap 6 – Why and How does a company pursue its CSR?
- Chap 7 - Why and How a platform strategy?
- Chap 8 – Why and how deal with the ethical issues?
- Conclusion

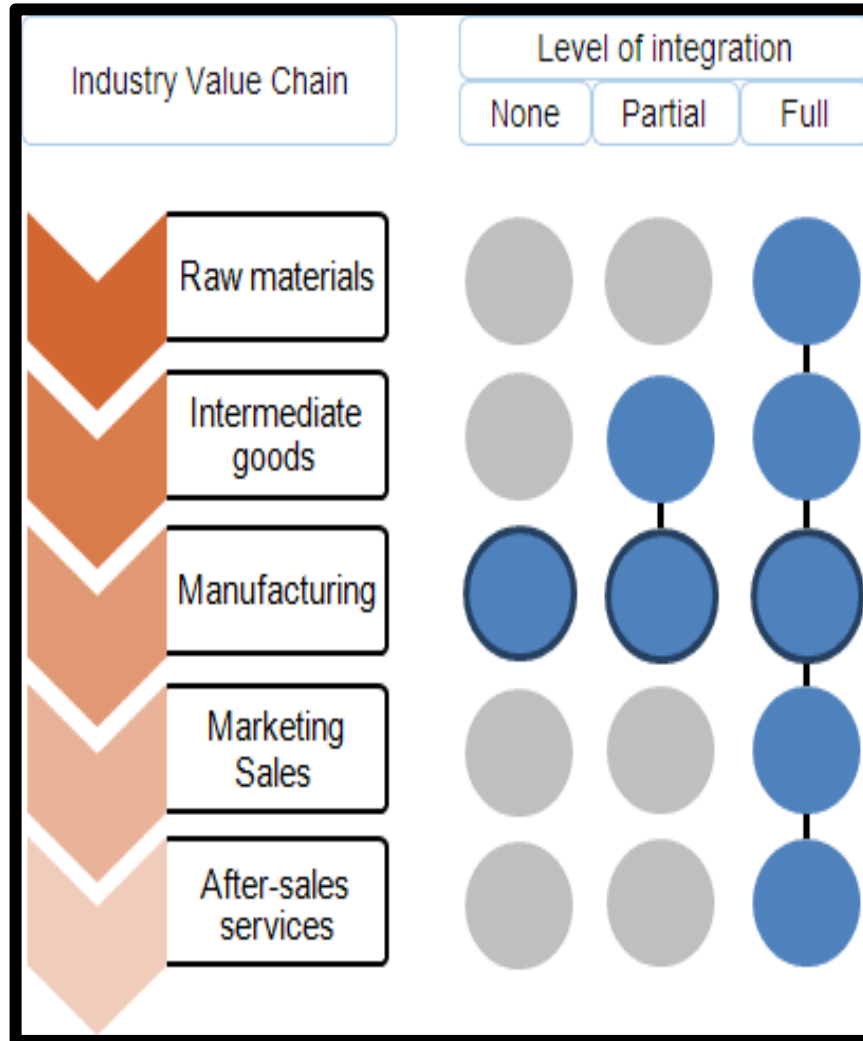
PLAN du cours

Chap 3 – Where should a company compete (vertical integration and diversification)?

Introduction

1. The choice of « making » or « buying/sub-contracting »
2. Pivotal company with a third alternative of “making with”
3. Product diversification : what variety of products to offer?

Introduction



Last class :

Different growth choices

(one focus : vertical, horizontal and diversification)

A real strategic challenge: Where to compete?

- Where on the value chain?
- On which product?

Introduction



Introduction



« If 2020 has been a one-of-a-kind year for the film industry, 2021 should easily endorse the new hegemony of streaming. Netflix has once again proved its lead in the competition by proudly announcing a rather crazy strategy: to release one "original" film (or exclusive buyout) per week on the platform, and this over the whole year. »



Introduction

First strategic challenge: what activities to integrate?
What products/services? (horizontal, vertical,
diversification)

Then : make or buy?

Introduction



Investment in
2010



Shutdown a few
years later



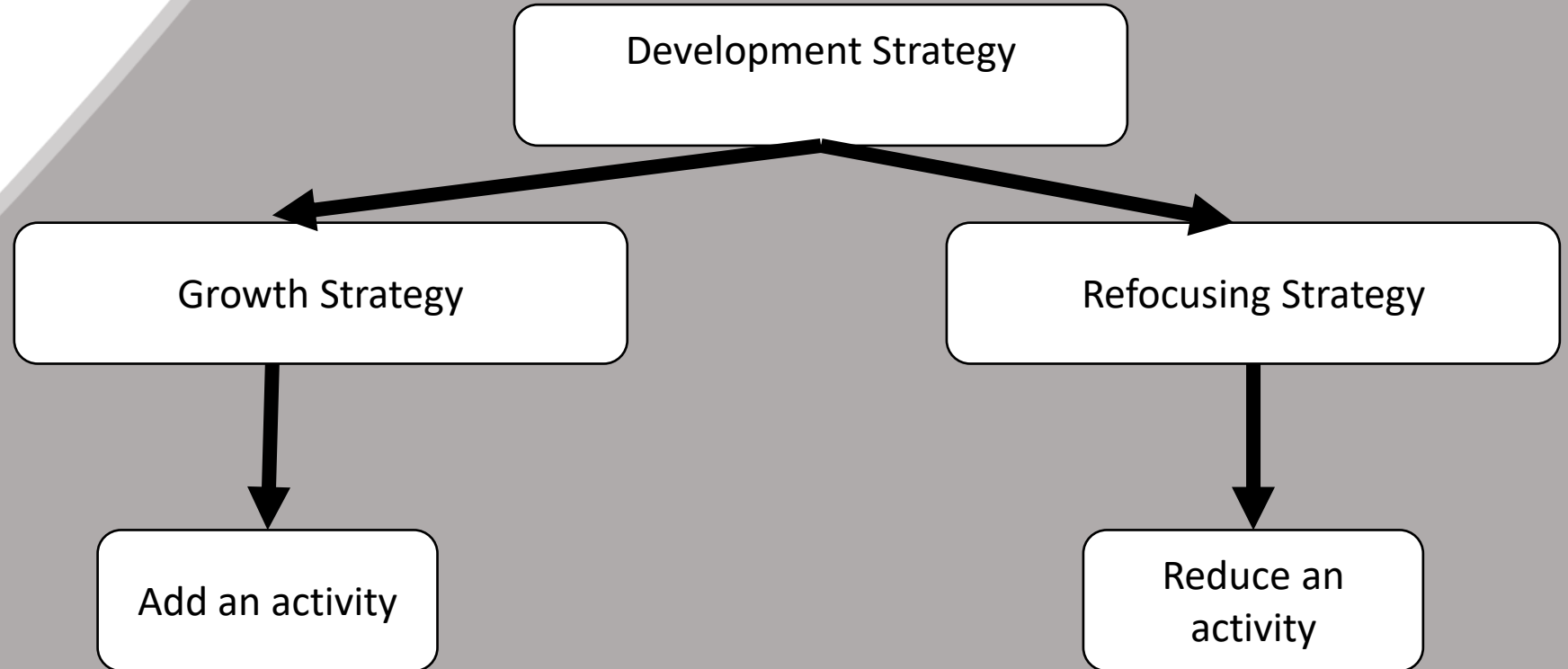
- Choices can evolve through time and when a company can decide to stop an activity
- When they stop an activity, it is a refocus strategy
- The refocus strategy can be horizontal or vertical

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Coca-Cola is killing Coke Zero and replacing it with a new drink

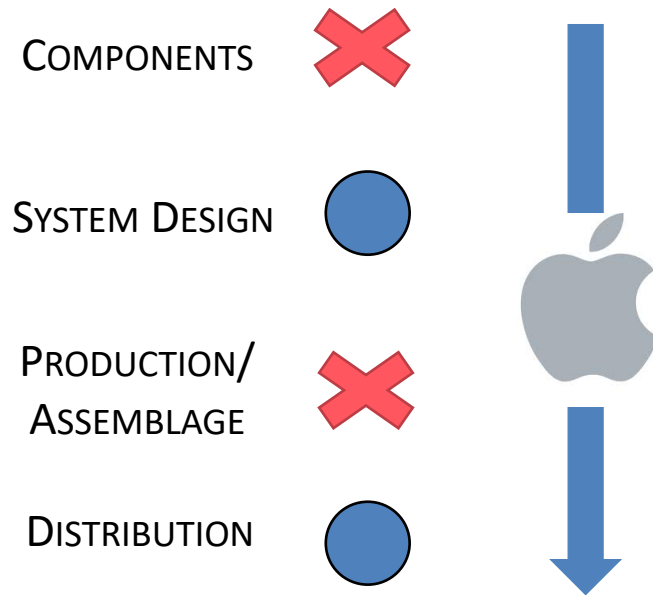
Kate Taylor Jul 26, 2017, 4:35 PM UTC+2





The choice are dynamic they evolve through time

Introduction



✓ Interesting the company decides to refocus on certain activities

Introduction

Why refocus and not merge ?

- 50 to 70% of mergers end in value destruction five years after the announcement
- 75% of buyout operations that exceed 30% of the acquirer's turnover are a failure

✓ Growth can be counter-productive

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Why choice to “make”?



Explanation 1: Transaction cost theory

1. Vertical integration

Explanation 1 – Transaction costs

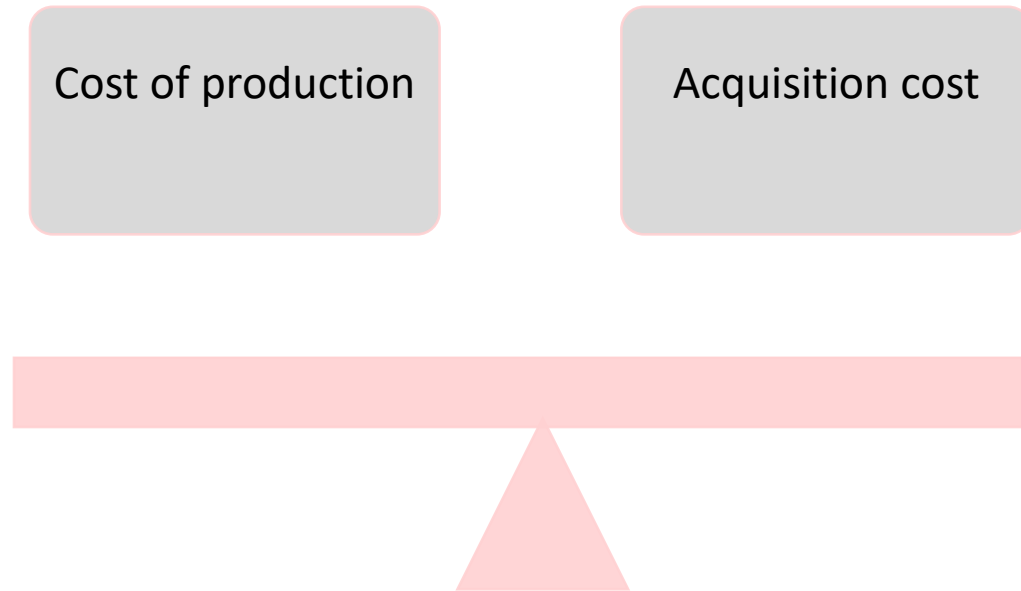
Based on a transaction cost approach

- The question becomes : Is it cost-effective to extend the boundaries of the enterprise ("to grow")?
- The market is not so "optimal"=> There are costs to trade called “transaction cost”
(Nobel Prize Ronald Coase)

In other words, what determines the boundaries of the company are the costs.

1. Vertical integration

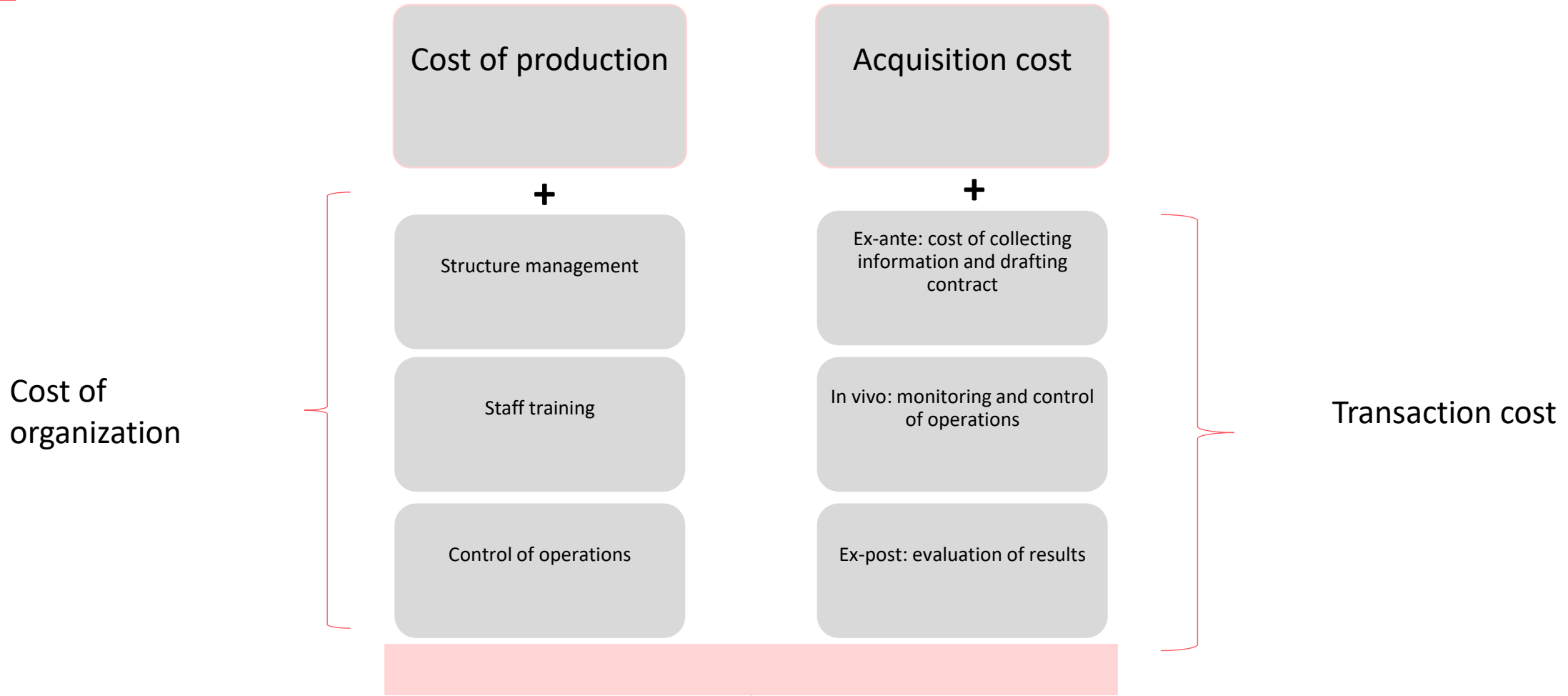
Explanation 1 – Transaction costs



Error!

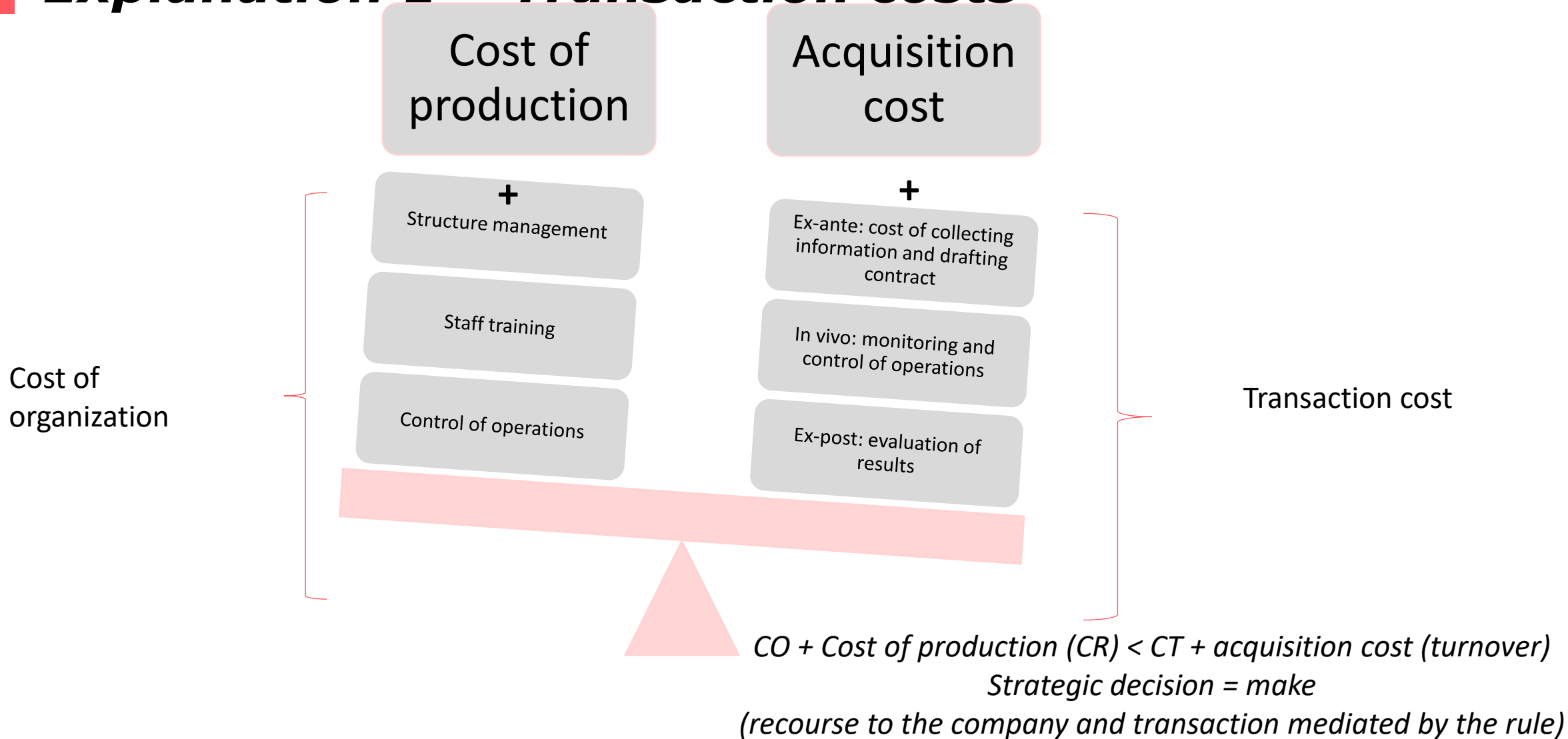
1. Vertical integration

Explanation 1 – Transaction costs



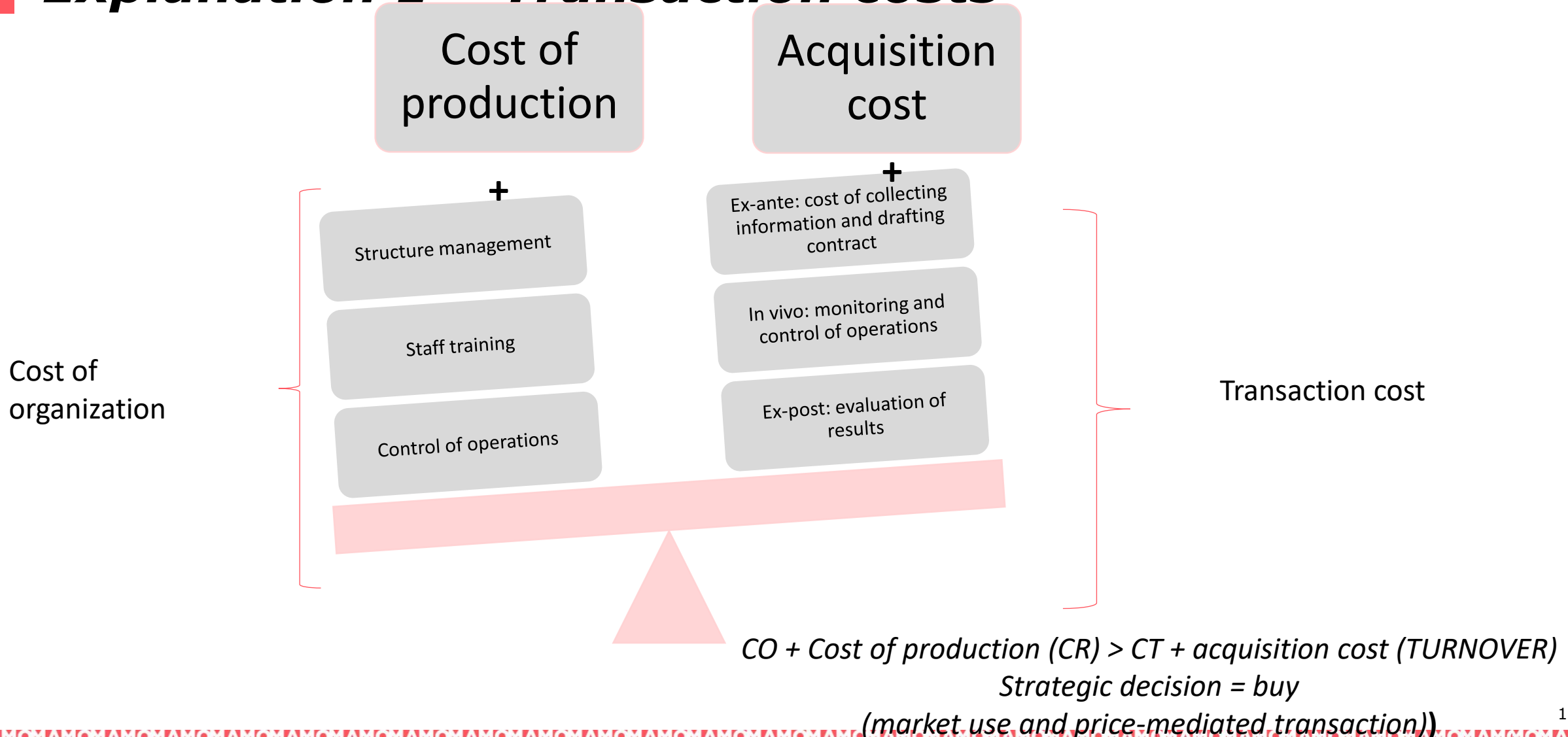
1. Vertical integration

Explanation 1 – Transaction costs



1. Vertical integration

Explanation 1 – Transaction costs



1. Vertical integration

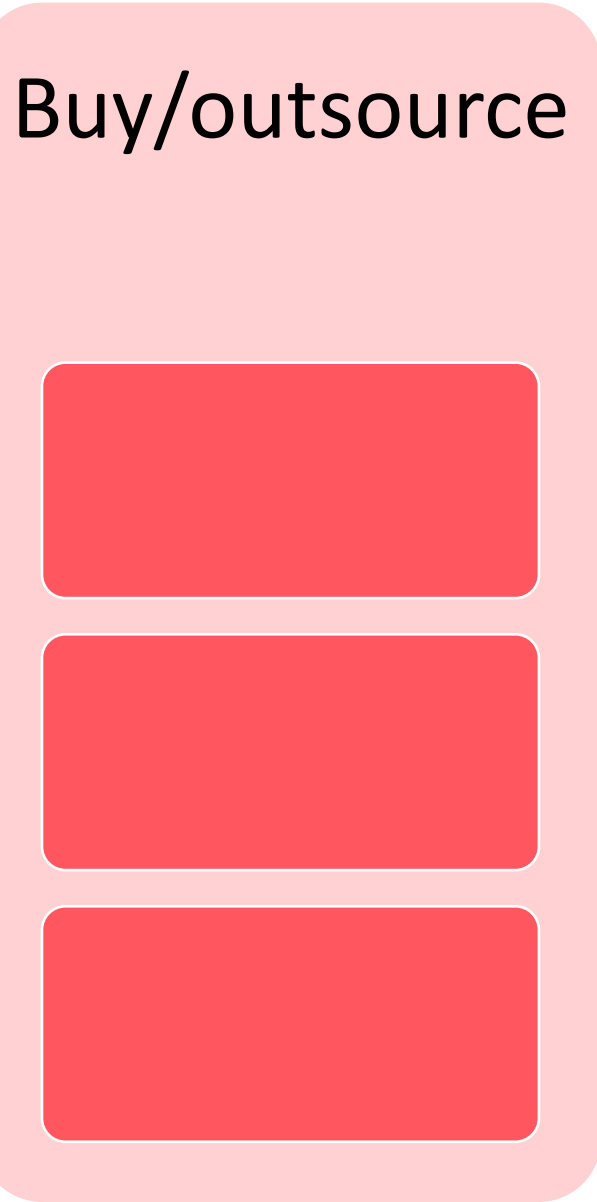
Explanation 1 – Transaction cost

The advantages in terms of the cost of buy

- *Economies of scale and experience of the service provider (lower cost of production)*
- *fixed cost becomes variable (flexibility)*
- *Better allocation of resources (main activity)*

But, the advantages come with disadvantages:

- *Standardized product or standardized service (little exchange is required)*
- *Risk of opportunism of the claimant (if dependent on an SSP)*
- *Risk of default of the service provider (may endanger the company)*

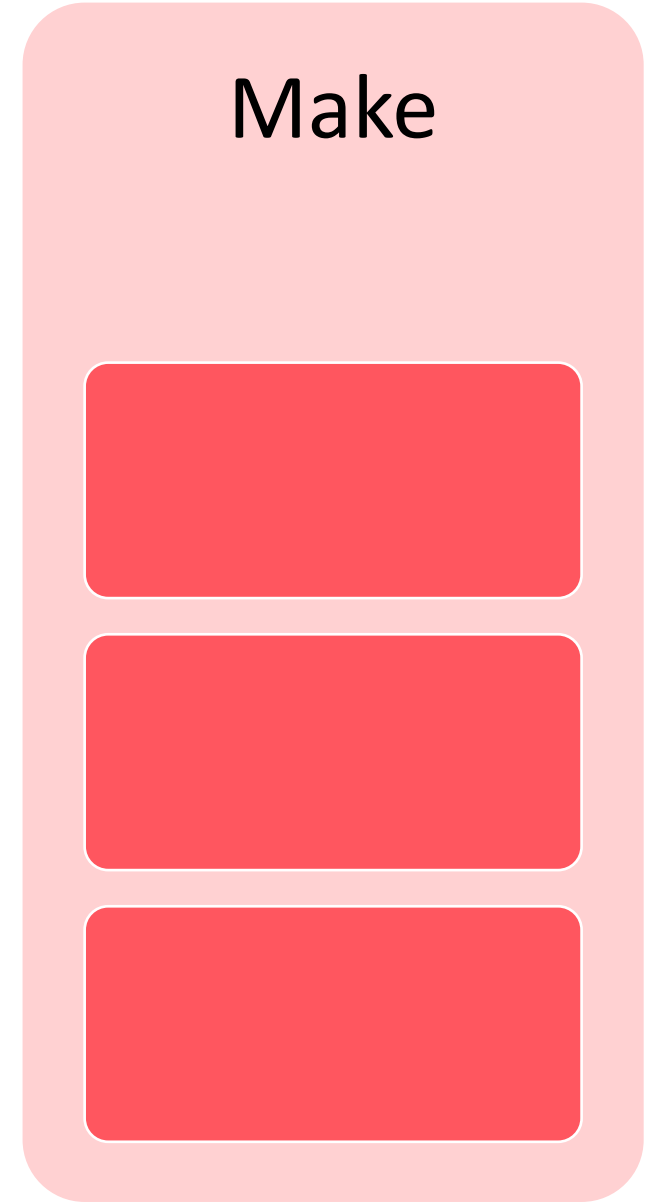


Low transaction cost

Can Provider do better?
Proximity core competencies

Product is standardized?
Uncertainty and complexity

Risk of supplier hold-up?
Number of suppliers



High transaction cost





Buy

Task is far from the core competencies

Low uncertainty and complexity

Numerous

Low transaction cost

Can Provider do better?
Proximity core competencies

Product is standardized?
Uncertainty and complexity

Risk of supplier hold-up?
Number of suppliers

Make

Tasks are related to the company's core core competencies

High uncertainty and complexity

Few

High transaction cost



Explanation 2: core competence theory

1. Vertical integration

Explanation 2 – The core competencies

According to the company's "Resource based view" approach:

- The company can be considered as a set of knowledge and core competence
- The core competence or distinctive competence of a company is what it does better than its competitors, which allows it to differentiate itself, which creates value for the consumer (e.g. tincture for Benetton; recommendation algorithm for Amazon)
- The choices to integrate should be based on what she knows how to do best.
- **In other words, what determines the boundaries of the company are the more or less strong link with the skills of the company. .**

1. Vertical integration

Explanation 2 – The core competencies

The benefits of keeping what it does best:

- Continues to develop the skills source of differentiation
- Protection of know-how
- Specific investment
- Process control and result

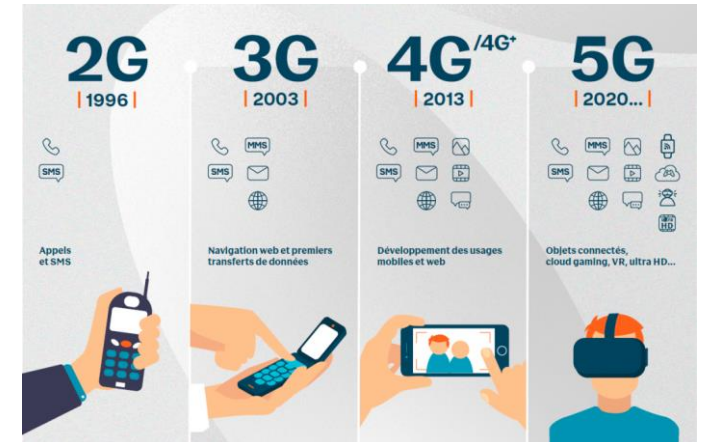
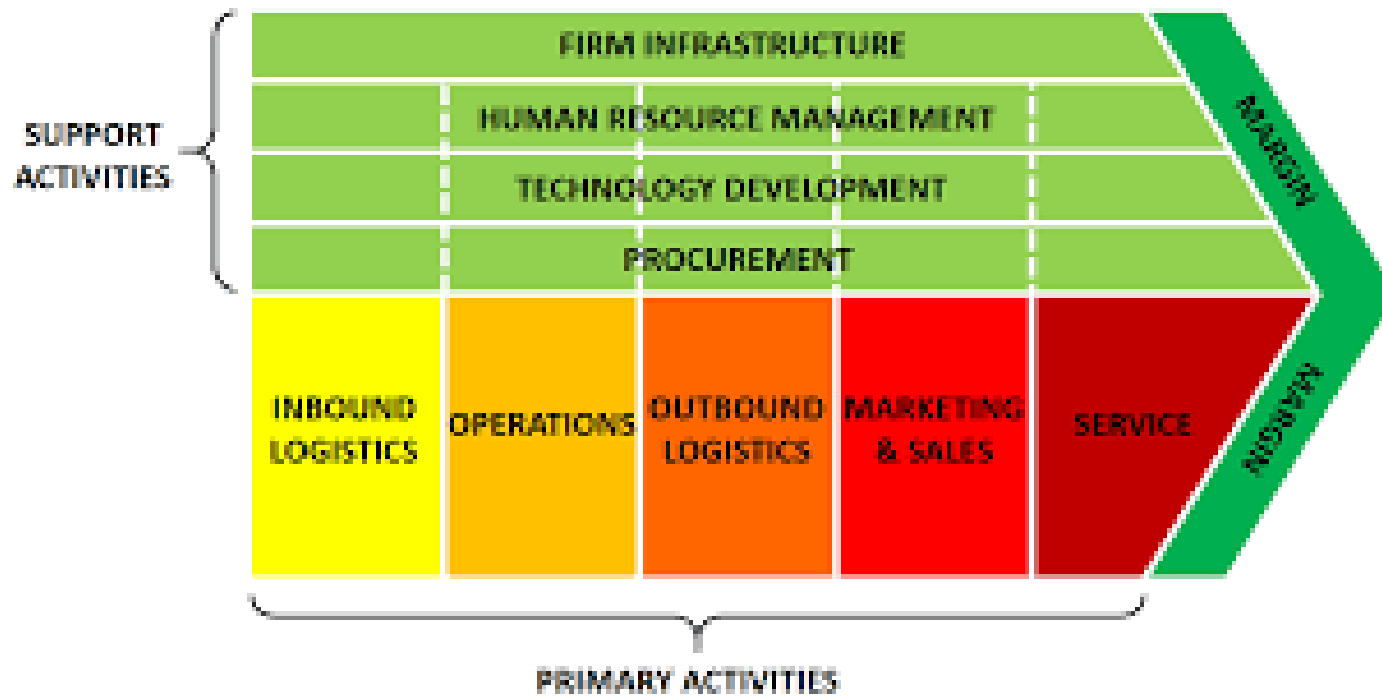


Explanation 3: Value chain theory

3. Vertical integration

Explanation 3 – The value chain

- Based on a Porter value chain approach:
- Business boundaries according to high value-added activities



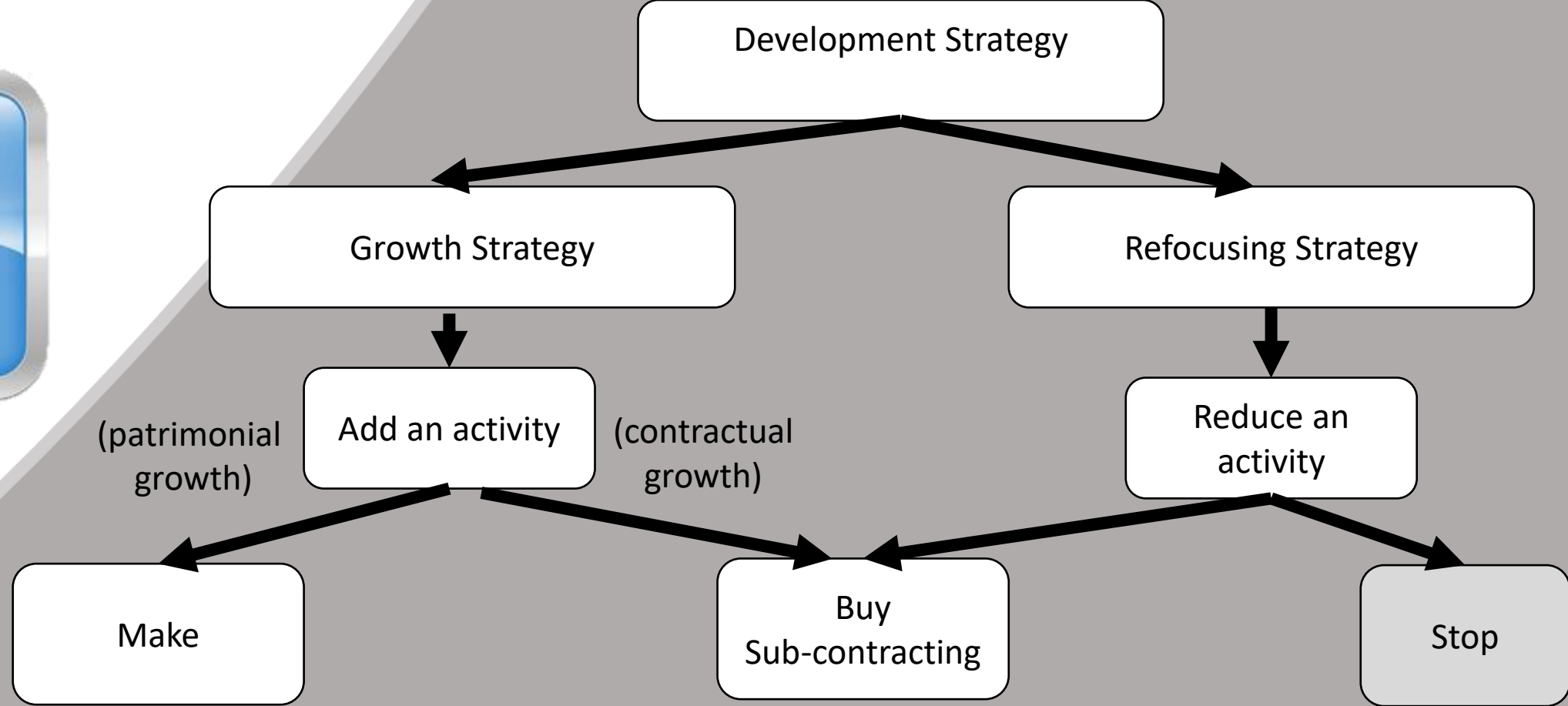


Explanation 4: control theory

1. Vertical integration ***To go further***

- Control the Process, not only the result







Recap

Hierarchy (make)

. Advantages

- *Close control of operations (quality of the process and result)*
- *Specific investment*
- *Develops skills to differentiate oneself*
- *Protection of know-how*
- *Capture the value added*

. Inconvénients

- *Cost of organizing the hierarchy (/market)*
- *Dilution of resources*

Market (buy)

Advantages

- *Economies of scale and experience (of the provider)*
- *Variable fixed loads (flexibility)*
- *Better allocation of resources (main activity)*

-. Inconvénients

- *Transaction cost*
- *Opportunism of the service provider (hold up)*
- *Uncertainty about the result*
- *Standardization of services*
- *Loss of know-how*
-

PLAN du cours

Chap 3 – Where should a company compete (vertical integration and diversification)?

Introduction

1. Make choice

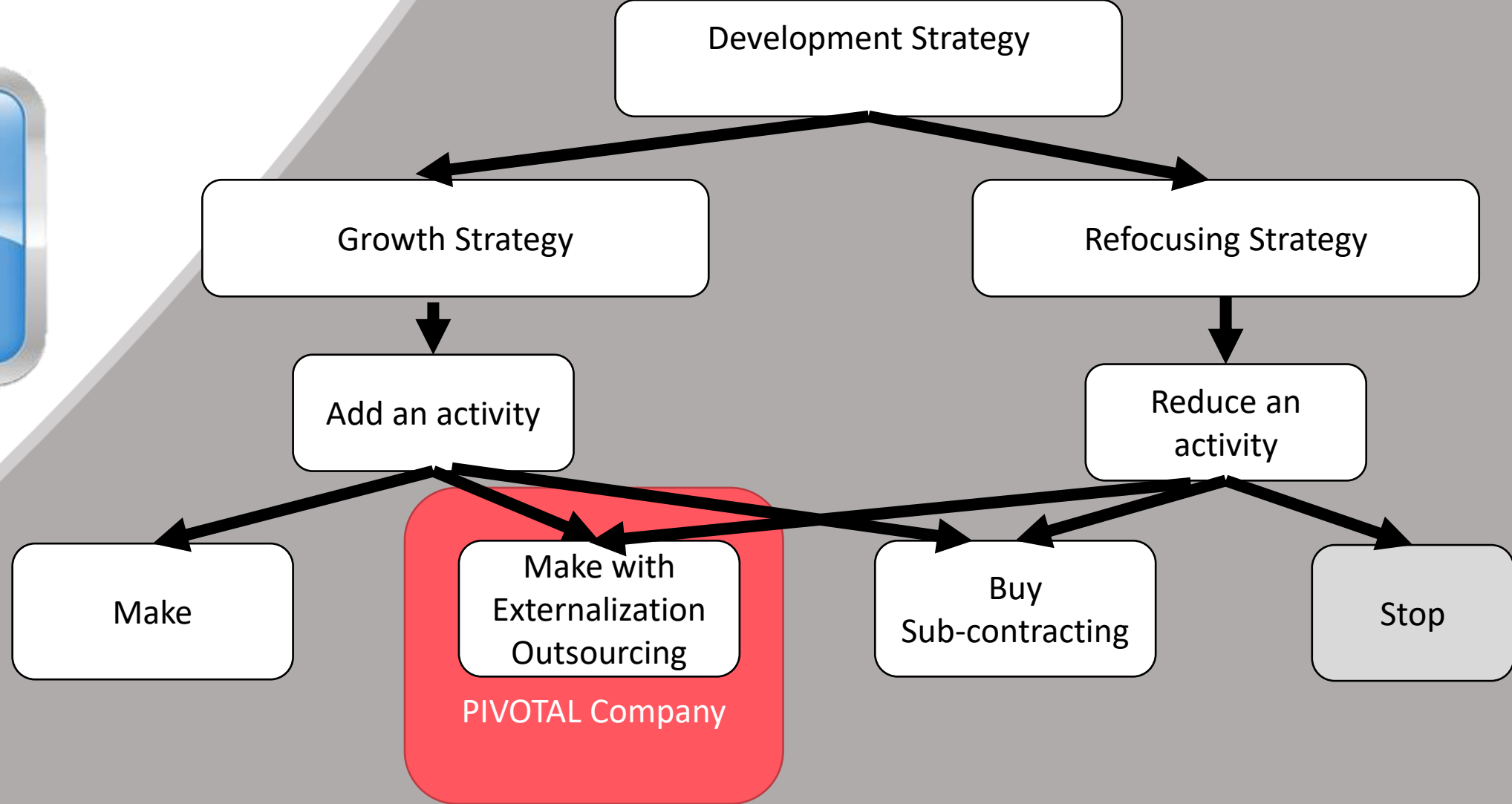
(which link in the industry value chain? Should we do or do it)

2. Pivotal company/Networked organization

(what third alternative between make and outsource?)

3. Product diversification

(what variety of products to offer?)



2. Pivotal company / networked organization

The third choice

“make with” (i.e. externalization ; out-sourcing) is not buy (i.e. sub-sourcing)

“Make with” /externalization/Out-sourcing
where tasks done in-house are **now being completed** by individuals or businesses **outside** of the firm and not affiliated with it.

- Reflection on key competences
(Long term result)
- Accountability (let the other be in charge)
- *Abandon*
- *Transfer of skills*

Remark **strategic outsourcing** : goal reduce cost and consist most of the time in abandon of none core activities of the value chain (takes times)
Versus **operational outsourcing** : goal to reduce cost and consist most of the time in abandon of support functions (see all instananeously the results)

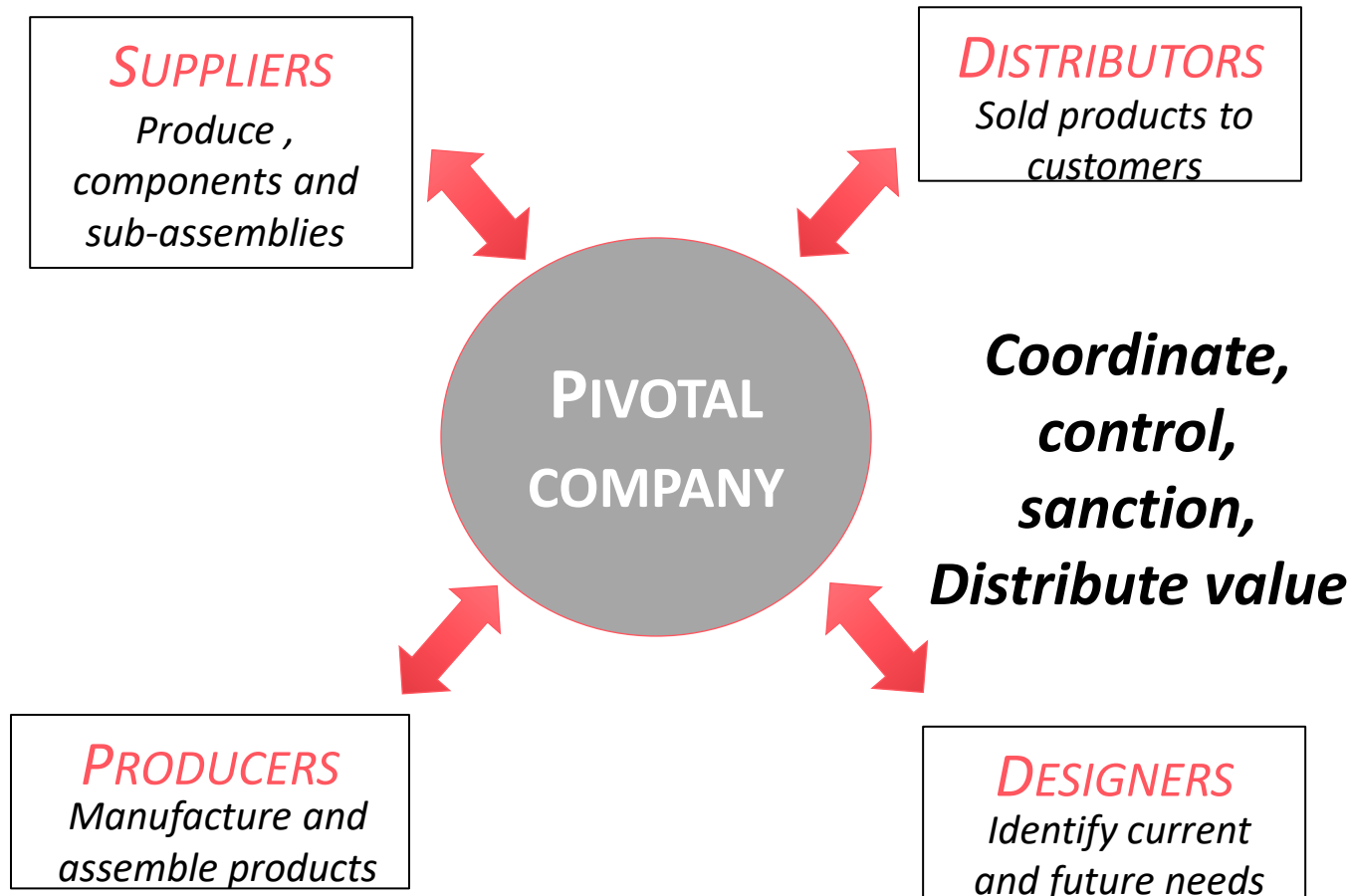
Sub-contracting

when a company **hires** another individual or company to complete a specialized task that typically cannot be done internally.
Subcontracting does not involve permanently allocating out entire jobs or departments within a firm and the job is agreed upon on a contract basis

- Cost reduction
Short-term result
- Execution
- *Punctual*
- *Purchase Sale*

2. Pivotal company / networked organization

The third choice



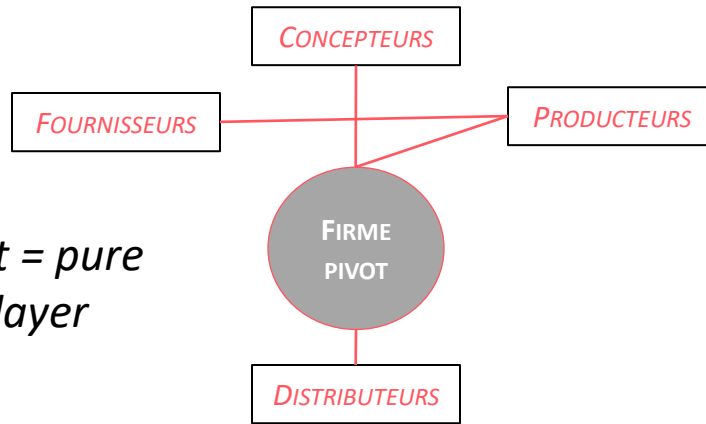
- Pivotal company : Mobilize specific skills around the firm to benefit from resources without resorting to a growth strategy

2. Pivotal company/ networked organization

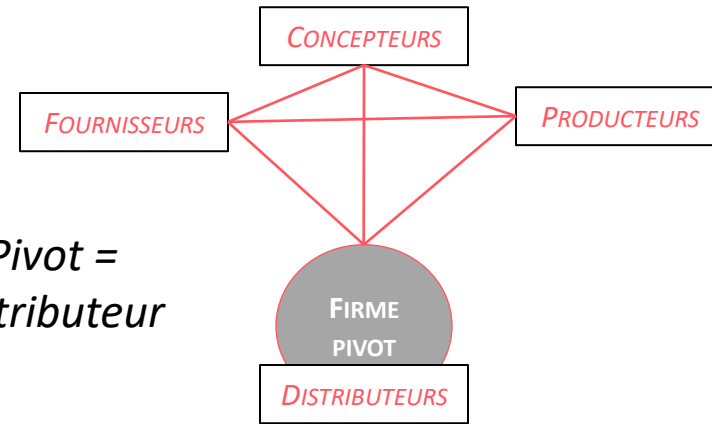
The third choice



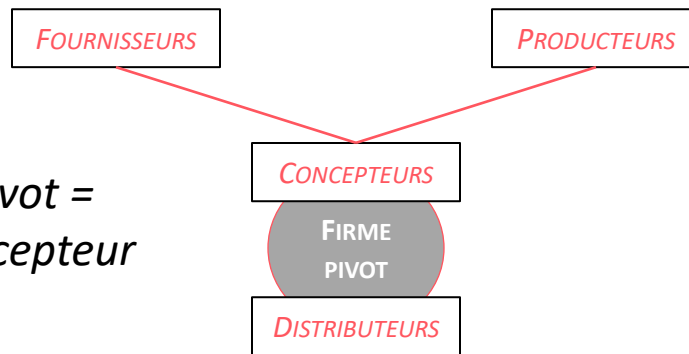
Pivot = pure player



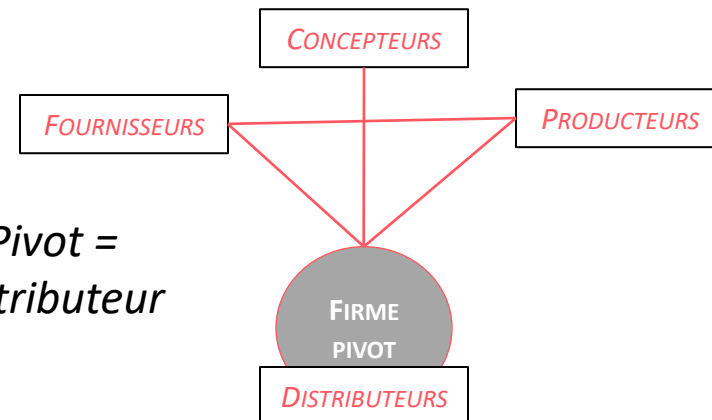
Pivot = distributeur



Pivot = concepteur



Pivot = distributeur



2. Pivotal company/ networked organization

The third choice

Pivotal Enterprise / Networked Enterprise

1. Thinking about key competencies: identifying organization-specific knowledge that gives it a competitive advantage
2. Refocusing approach: abandonment of one or more fields of activity or certain games
3. Externalized process: abandonment of the realization of a step of the production process to entrust it to an external service provider

2. Pivotal company/ networked organization

The third choice

Refocusing on key competences= >

What is a key skill? VRIN framework

A skill that contributes to the **creation of value**

→ *Ex: the logistics service for Chronopost, it is only an accessory for Renault*

A **rare**, distinctive skill

→ *Ex: after-sales service for Darty*

A skill that is **difficult to imitate**

→ *Ex: location for a tourist organization (hotel, seaside center)*

A **non-substitutable** skill

→ *Ex: alicaments for Danone*

2. Pivotal company / networked organization

The third choice

3rd choice: "Doing with": network management

- There is no typical network configuration
- The pivotal role can be embodied by different actors
- A trend towards value migration toward distribution and conception (to whom knows and access the customers)



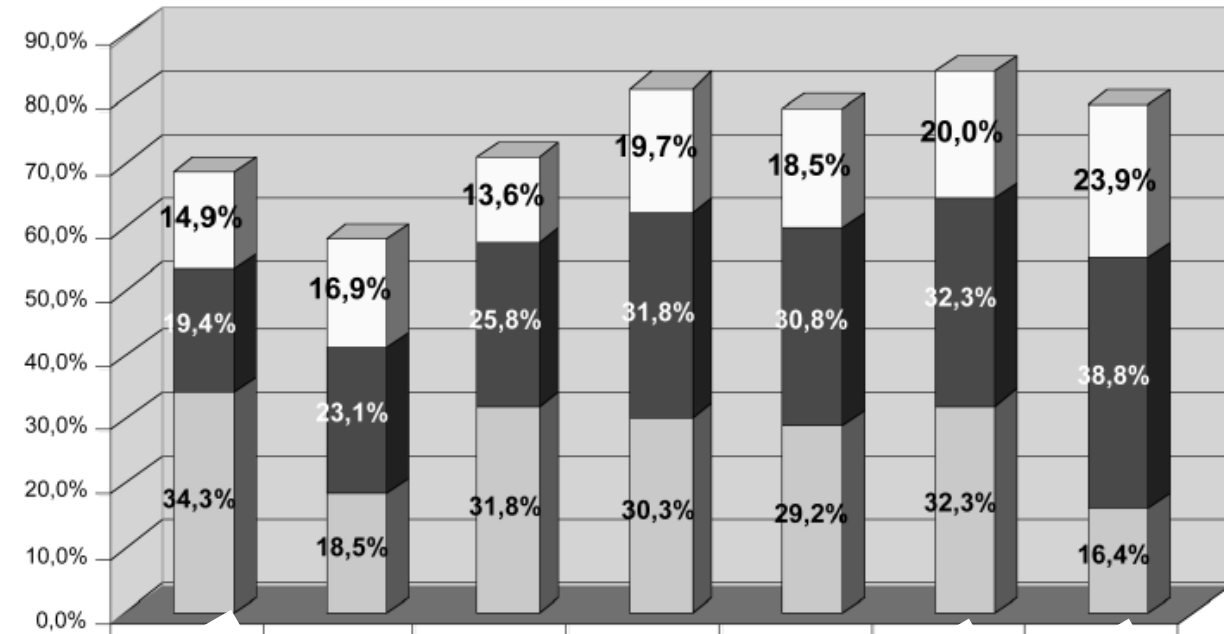
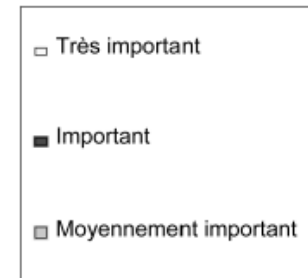


What are the downsides of externalization?

2. Pivotal company / networked organization

The third choice

- Barrier or slowdown to decision for externalization



Security problem and brand image
Technology change
Social risk
Lost of control
Group culture
Lost of competences
Perceived dependences

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Chap 3 – Where should a company compete (vertical integration and diversification)?

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1. Make choice

(which link in the industry value chain? Should we do or do it)

2. Pivotal company/Networked organization

(what third alternative between make and outsource?)

3. Product diversification

(what variety of products to offer?)

3. Product diversification

Strategic choice from where to compete / what products?

- Competing products : horizontal growth or refocusing
- Vertical chain : vertical growth or refocusing
- Different products : conglomerate (or concentric) diversification or refocusing

3. Product diversification

- GE: Established in 1892 with the acquisition of Edison General Electric Company and other electrical companies



Jeffrey Robert Immelt en 2015 de se détacher GE Capital (spin-out)



50% de profit

1/3 des revenus du conglomérat

Diversification discount

3. Product diversification

- *Why or when diversify?*

"When the new entity created or acquired has more value by being own by an other company than alone"

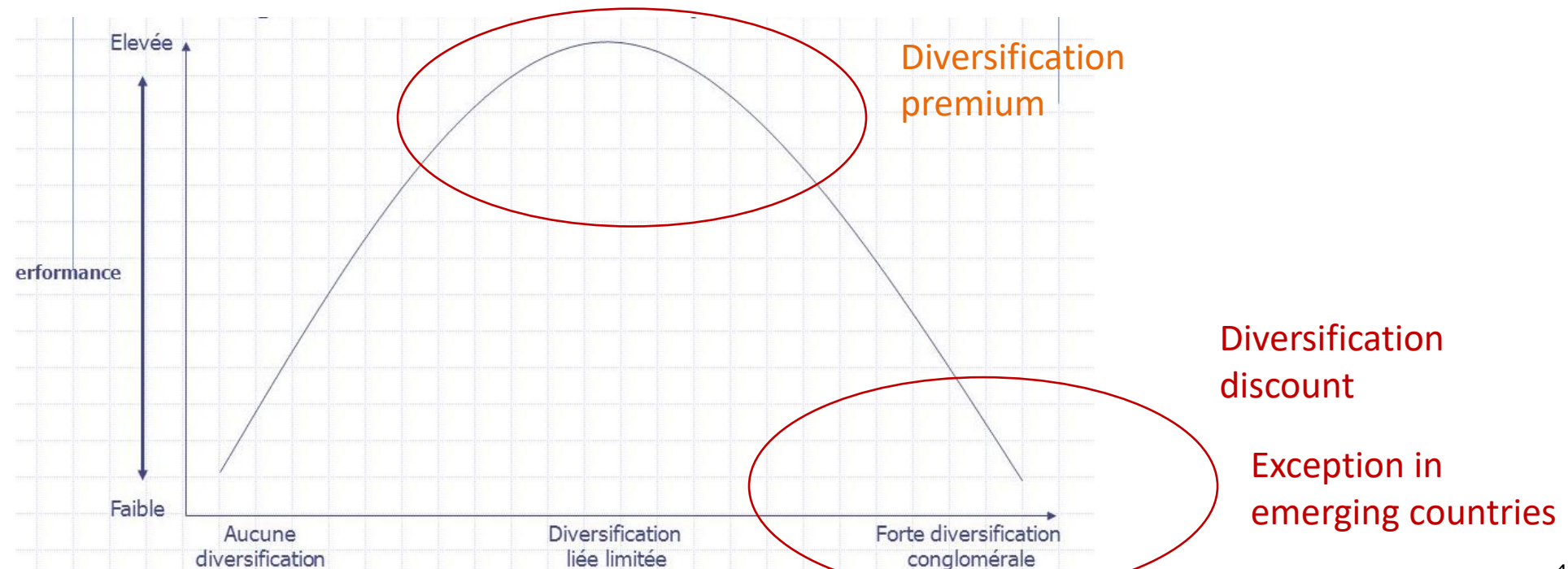
- *Why or when to refocus?*

"When the new entity created or acquired has more value alone"

3. Product diversification

- *When to diversify?*

If separate activities have more value under the management of the same company than if they are managed separately



3. Product diversification

- *When to diversify (concentric growth)?*

Field savings: By expanding its products/markets with a "red thread" between products, the company increases its notoriety, achieves **synergies** and better spreads its indirect fixed costs

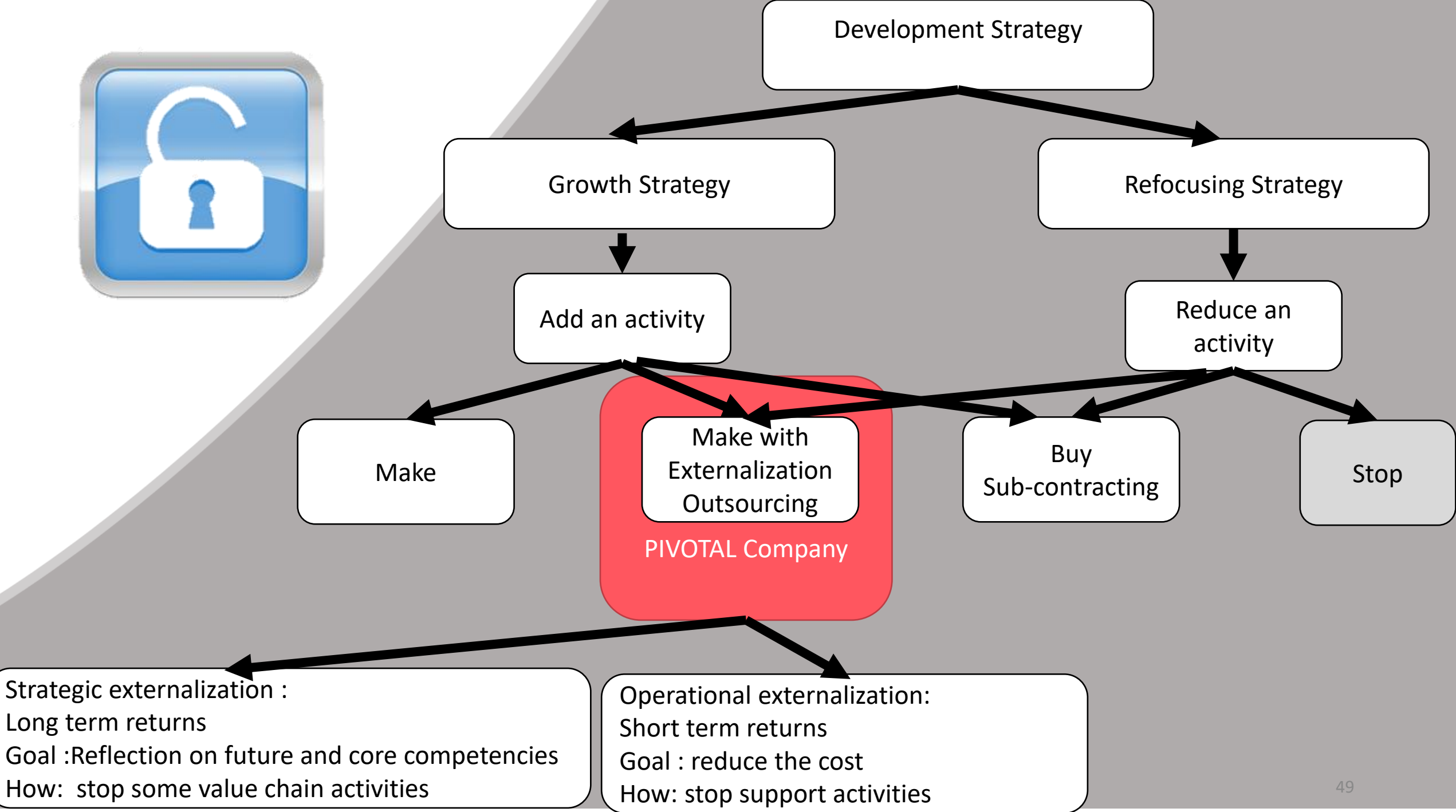
Avantages	Limits
<ul style="list-style-type: none">• Concentric- Redeploy skills- Pooling productions- Effect of synergies (economy of scale, experience etc.)-	<ul style="list-style-type: none">• Concentric- Significant investments- Organizational difficulty- Interdependence of brands- Interdependence of technologies

3. Product diversification

- *When to diversify (conglomerate growth)?*

Economies of scope: By expanding its products/markets without red wire and therefore without synergies, but reduces risks.

Avantages	Limits
<ul style="list-style-type: none">. Conglomérale<i>Amortize risk</i><i>Manage and finance the product lifecycle</i>	<ul style="list-style-type: none">.. Conglomérale- Significant investments- Organizational difficulty- No field effect (resource dispersion)- Mastery of new professions-





Takeaways

- ❑ What are the growth strategies ? 4 decisions
- ❑ Difference between growth and refocusing strategy
- ❑ Consequences of a merge
- ❑ The different theories that explain making or buying
- ❑ What a transaction cost
- ❑ Control of result versus process
- ❑ What a pivotal firm
- ❑ The link between diversification and performance
- ❑ Premium and discount diversification
- ❑ VRIN framework

Introduction



What strategic choice of Benetton?
Why did you make that choice?

✓ Increase the size is not the only solution

[https://www.xerficanal.com/strategie-management/emission/Philippe-Gattet-Comprendre-la-strategie-d-externalisation-\(outsourcing\)_3745103.html](https://www.xerficanal.com/strategie-management/emission/Philippe-Gattet-Comprendre-la-strategie-d-externalisation-(outsourcing)_3745103.html)

(minute 3:10)

Quiz

Artus

This Friday, July 8 2022, the project of a new site for the aeronautical equipment manufacturer Meggitt Artus, located in Avrillé, near Angers (Maine-et-Loire), was anchored in the concrete... Xavier Monange, Vice-President of Strategic Projects and Director of Institutional Relations confirmed the construction of a new plant, located in the same municipality but on a different site. [...] The plant currently employs 320 people on permanent contracts and is called Meggitt Artus, after being acquired by the British group Meggitt in 2011. Today, the company specializes in aeronautical equipment and works for big names in civil or military aviation such as Airbus, Boeing, Dassault, Safran or Thales.

Why change the location? Simply because the current factory, of 9,000 m², is as “full as an egg”. Inside, there are still original equipment and machinery. All this works, but the tool becomes obsolete and is no longer too suitable to support the growth of the equipment manufacturer. The new equipment will make it possible to produce more and thus at a lower cost. Who says bigger factory, says "increase in the quantities produced", says "speed of production" and also says jobs... How much more, in the long run? In full growth, Meggitt Artus plans to recruit, within 10 years, 180 people, increasing the workforce from 320 to 500. Profiles sought? "All types," says Marc Guiborel. From research to production, through support functions, purchasing... »

10) Question: What is Meggitt's growth strategy when it acquires Artus?

- a) Internal growth strategy
- b) External growth strategy
- c) Contractual growth strategy
- d) None of the three answers

Quiz

Artus

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11) Question: How to qualify the growth of Meggitt Artus when the company decides to recruit 180 people?

- a) Diversification
- b) Contractual growth
- c) Patrimonial growth
- d) None of the three answers

Quiz

Artus

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12) Question: Why does Arthus want to increase its production volume?

- a) To benefit from resource allocation logic
- b) To benefit from a network effect
- c) To benefit from economies of scale
- d) None of the three answers