CIPS Procurement Topic

CIPS KNOWLEDGE

Forward Integration

Forward integration is an aspect of strategic development relating to securing inputs and acquisition … most often used to refer to an organisation's attempt to expand downstream into industries that distribute the organisation's products (Lysons and Farrington, 2006).

CPD 1 HOURS

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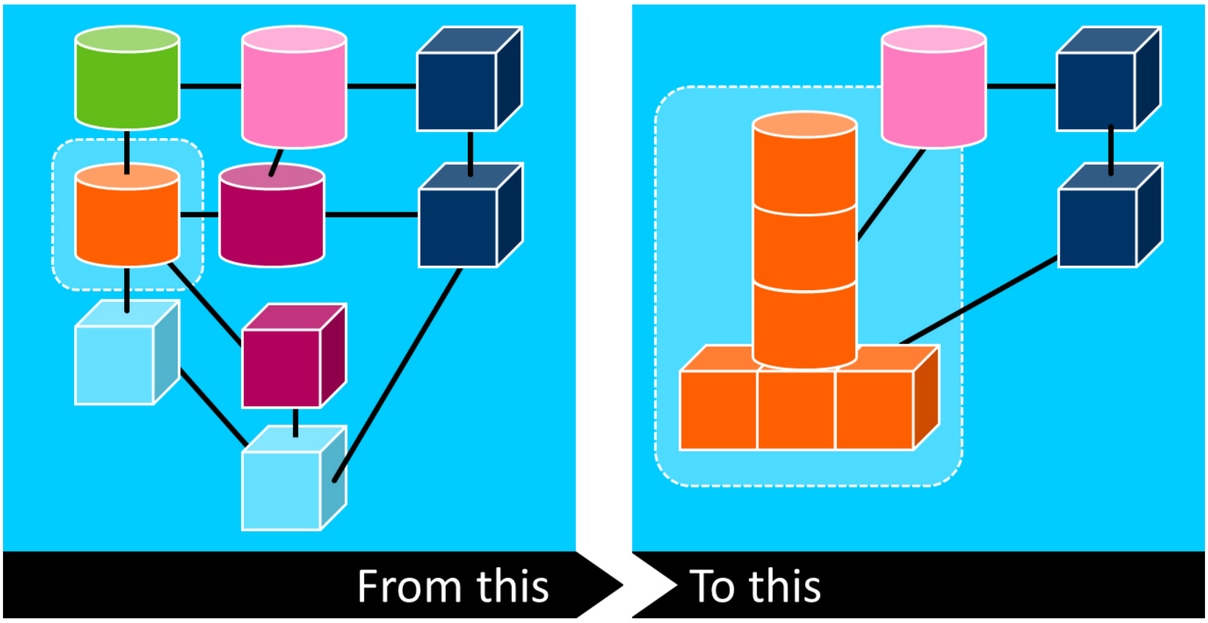
Introduction

Forward integration is an aspect of strategic development relating to securing inputs and acquisition. The term is most often used to refer to organisational attempts to expand downstream into industries that distribute its products, for instance, that of a vehicle manufacturer acquiring a car distribution chain (Lysons and Farrington, 2006). Backward integration strategies (vertical integration), on the other hand, adopt the opposite approach: vertical integration refers to an organisation's attempt to expand upstream into industries that provide inputs, for instance, a vehicle manufacturer acquiring a steel rolling plant (Lysons and Farrington, 2006). Forward (and backward) integration is an important concept in terms of the value chain. During each stage in the chain, value is intended to be added to the product. The company at a particular stage in the value chain takes the product produced during the previous stage and transforms it in such a way that it is worth more to the organisation and customer at the next stage in the value chain (Hill and Jones, 2010).

When considering forward integration it is important to remember that each distinct stage of the value chain is a separate industry/industries, where many different organisations are competing. Furthermore, within each of these industries, each company has a value chain comprising many different value-creating activities, such as R&D, production, marketing, or customer service (CIPS: Procurement's Role in the Generation and Capture of Value in Supply Chains; Hill and Jones, 2010). To illustrate forward value chain integration, the value chain in the PC industry might look like the following: raw materials (Dow Chemicals, Union Carbide, Kyocera), component parts manufacturing (Intel, AMD, NVIDIA), final assembly (Dell, Hewlett-Packard, Apple), retail (Apple, Dell, PC World), customer. In this example, both Dell and Apple have forward-integrated from being the point of final assembly to establishing retail channels and operations to add value for their customers (Hill and Jones, 2010).

Definition

Forward integration is the set of activities related to securing outputs, such as acquisition of distribution channels or transport undertakings. It is the opposite of backward integration which concerns securing inputs, such as raw materials by acquisition of supplies (Hill and Jones, 2010; Lysons and Farrington, 2006).



Adapted from: *Honeywell*

Successful Application

Vertical integration strategies can be difficult for companies to implement successfully. Considerable risks can be involved in such integration, it can be expensive and such strategic decisions can be hard to reverse (Hindle, 2008). Organisations should ultimately assess whether they can cope financially with downstream setup costs and whether existing competencies are adequate to outperform current arrangement in the long-run (Hindle, 2008).

Steps to Successful Application

- Establish the justification for forward integration to be able to build a strategy: is it to create or exploit market power by raising barriers to entry, to allow price discrimination across customer segments, or to expand?
- Conduct an analysis of the firm's core competencies: consider how these might transfer forward to add value in the chain.
- Analyse setup costs involved and other feasibility issues.
- Establish a timeframe and plan for executing the integration strategy: when should the company inform distributors or other supply chain entities? What are the implications surrounding contractual obligations with existing distributors?

Stuckey and White (1993)

Hints and Tips

- Although forward integration may deliver cost savings, it ultimately results in terminating relationships or agreements with distributors or other supply chain entities. It is important to carefully consider what the repercussions of these actions might be (Lynch, 2006).

- It is important to recognise that forward vertical integration requires heavy setup costs (Stuckey and White, 1993).
- It is important to remember that value chains run across industries and within these there are value chains of organisations (Hill and Jones, 2010).

Potential Advantages

- A significant benefit of forward integration is that it can remove dependence on distributors who have no particular allegiance to a specific brand or product (Lysons and Farrington, 2006).
- Downstream integration helps to ensure that production is stable and continuous, and with predictable demand requirements (Lysons and Farrington, 2006; Monczka et al., 2009).
- There are substantial cost savings to be gained by eliminating intermediaries and distributors in the value chain (Lysons and Farrington, 2006).

Potential Disadvantages

- There is always a risk carried with forward integration because companies attempt to add value in an area where they may have little competence (Lynch, 2006).
- Forward integration will potentially mean breaking off relationships with other entities (e.g. retailers) in the supply chain (Lynch, 2006).
- Because values are implied, companies, suppliers and customers can differ in their perceptions which makes managing value in the supply chain challenging (CIPS: Procurement's Role in the Generation and Capture of Value in Supply Chains).

Performance Monitoring

- Cost/benefit analysis of forward integrating in the value chain (CIPS: Procurement's Role in the Generation and Capture of Value in Supply Chains).
- Porter's industry analysis method and develop: will moving downstream provide a sustainable competitive advantage? (Porter, 2008).
- Benchmarking: to position the company against competitors (Porter, 2008).
- Lead time: the time between an event/action starting and its completion (also called cycle time, completion time, and turnaround time). How has efficiency increased as a result of moving downstream? (Reijersa and van der Aalst, 2005).

Case Studies

- In 2001 Apple forward-integrated when it entered the retail industry. The company opted to establish retail stores to sell its computers and music players (other major companies such as Sony and Dell have followed this lead). In 2010 alone, Apple reported a massive US$9bln in retail sales and US$2.4bln in retail profit (Hill and Jones, 2010).

- The Body Shop is a good example of vertical forward integration: the company produces many of its natural cosmetics products and then sells them in its own stores. As a result, the company has greater control over its special product range and can respond quickly to market trends without having to negotiate with other retailers to stock (Lynch, 2006).
- In the early 2000s BMW predicted that reallocating material supplies and modifying the approach to distributing finished cars in the global market would save costs and add value to the supply chain. In fact, investments and costs for materials, production and distribution reduced by 5-7% (Fleischmann et al., 2006).

Further Reading/Reference

CIPS Source Downloads

- CIPS: Procurement's role in the generation and capture of value in supply chains

Web Resources

- The Economist on vertical integration http://www.economist.com/node/13396061
- Introduction on when to vertically integrate http://sloanreview.mit.edu/article/when-and-when-not-to-vertically-integrate/
- News article on the return of 'vertical integration' http://www.scdigest.com/assets/NewsViews/06-08-17-1.cfm
- How Apple Inc. benefits from forward vertical integration http://www.supplymanagement.com/news/2010/apples-supply-chain-judged-best-in-world-again/?locale=en
- How vertical integration is Samsung's greatest strength http://www.businessweek.com/magazine/content/10_39/b4196042898121.htm

Books

- OM, Collier/Evans, ISBN 978-0538745567
- Global Logistics and Supply Chain Management, John Mangan, Chandra Lalwani, Tim Butcher & Roya Javadpour, ISBN 978-1119998846
- Managing Global Supply Chain Relationships: Operations Strategies and Practices, Barbara Flynn, Michiya Morita & Jose Machuca, ISBN 978-1616928629
- Principals of Supply Chain Management: A Balanced Approach, Joel D. Wisner, Keah-Choon Tan & G. Keong Leong ISBN 978-0324657913
- A Practical Application of Supply Chain Management Principals, Thomas I. Schoenfeldt, ISBN 978-0873897365

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- Porter, M.E. (2008) The Five Competitive Forces That Shape Strategy. Harvard Business Review, January.
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Video

Strategic links: why firms own production chains
https://www.youtube.com/watch?v=gbi5ogf4HHk&feature=player_embedded

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