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Module: 12, Integration Strategy

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**QUADRANT - I**

**Module 12 : Integration Strategy**

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3. What is Integration Strategy?
4. Types of Integration Strategy
5. Vertical Integration
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1. **Learning Outcomes**

After studying this module, you shall be able to

- Understand the concepts of Integration Strategy.
- Know about various types of Integration Strategy.
- Understand about Vertical Integration, its types and relative advantages and disadvantages.
- Differentiate between Vertical Integration and Horizontal Integration.
- Know about the Horizontal Integration Strategy with relative merits and demerits.

2. **Introduction**

The top management at any organization is constantly striving to make strategic decisions that affect the entire organization with an objective to achieve sustainable growth in the long run. The primary objective of a corporate level strategy is to create value across different businesses and explore options as to how additional value can be created over and above what the business is actually doing. Corporate-level strategies are basically about decision related to (a) allocating resources among the different business of a firm (b) transferring resources from one set of businesses to other and (c) managing and nurturing a portfolio of businesses. The strategic thinkers have various options available to them as corporate level strategies. These include growth strategies, stability strategies, end game strategies, defensive strategies and so on. As growth is perceived to be equivalent to success, strategic leaders prefer growth strategies through variety of strategic alternatives. These are concentration strategies, integration strategies, diversification strategies, cooperation strategies, internationalization and digitalization strategies. In this module, we shall discuss in detail the integration strategies.

3. **What is Integration Strategy?**

Among the various strategic options for growth, a firm implements integration strategy when it intends to expand the business by widening its scope by committing itself to the adjacent business, by combining activities related to present activity of a firm. Integration means when two businesses are brought together to add value to the overall organization. It is a strategy of “aggregation” or “expansion” under which growth is achieved by expanding the scale of operations. This strategy is also known as management control strategy which allows the firms gain control over distributors, competitors and/or suppliers to supplement or complement its existing scope of operations.

In the integration strategy, a firm may combine activities related to the present activity of the firm through value chain. As we know that a value chain, is a set of interrelated activity performed by any organization right from procuring the raw material to creating the finished products and serving the customers.

4. **Types of Integration Strategy**
Integration Strategies can be of broadly two types which are further classified under different categories. These are as follows:

I. **Vertical Integration**
   a. Forward Integration
   b. Backward Integration
II. **Horizontal Integration**
   a. Acquisition
   b. Mergers
   c. Takeovers

5. **Vertical Integration**

Vertical Integration strategy is a growth strategy, as it allows an organization to create value by producing its own inputs (raw material) or by distributing its own products. Through the vertical integration strategy, company gains control over their industry’s value chain. There are various advantages of vertical integration strategy which includes:

- Create high entry barriers for new competitors by limiting access to raw material or access to the distribution network.
- Allows for positive differentiation as the access to resources and markets can be leveraged.
- Protect product / service quality through higher control of input / customers
- Facilitates better internal scheduling and creates flexibility in terms of responding to the changing demand.
- Helps to leverage product innovation, as the firms having control over value chain can constantly innovate to offer higher value to the customers.
- Brings in stability of the ecosystem production.
- Better utilization of resources by deploying assets which can help a firm to enhance the efficiency of operations.
- Reduces the business risk of uncertainty in the availability of raw material or access to right markets.
- Reduces the overall costs as the procurement procedures gets simplified
- Provides access to new business opportunities.
- Protects proprietary technology
- Increases the competitive advantage by improving marketing or technological intelligence.

In addition the benefits there are certain disadvantages and risks associated with the vertical integration strategy. These are:

- There is a loss of flexibility resulting from large investments due to being “locked up” in a particular business.
- Problems associated with unbalanced capacities along the value chain.
- Additional administrative and bureaucratic costs because of creation of new set of complex activities.
• Costs and expenses associated with increased overhead and capital expenditures.
• Higher business risk due to additional capital deployment in other businesses.
• Lower acceptance of technological advances or better methods of production / distribution.
• There is a loss of operating flexibility through higher dependence on internally produced inputs.
• Requirement of new skills and capabilities or else there can be compromise on competencies.
• Demand uncertainty creates problems.

5.1 Forms of Vertical Integration

Vertical Integration can be of two types' backward and forward integration. When the organization chooses to reduce its input costs by producing its own inputs it is known as backward integration.

The conditions under which a firm can choose to adopt the backward integration strategy include:
• When the supplier are unreliable and the firm is not sure about the consistent supplies. Further in case the quality of input is also not reliable, the firm can choose to move backward and create its own capacities.
• Whenever the suppliers become more powerful and their bargaining power of supplier is higher. In this case, such suppliers tend to increase the prices at their own will thereby disrupting the cost structure of any firm.
• Whenever the supplies are constrained or are inconsistent in terms of delivery.
• Whenever the profit margins of the supplier are substantial and the firm intends to leverage higher profitability by moving backward.

For example a yarn manufacturer starts manufacturing its own raw material i.e. acrylic fiber, then it is known as backward integration. On the other hand, if the yarn manufacturer enters into the fabric manufacturing business, then it is known as forward integration. Both these strategies were adopted by a leading textile manufacturing company i.e. Vatdhman. For example, PepsiCo India Holdings is forayed into contract farming of citrus fruits like oranges and Keanu to ensure that high quality fruits only go in their Tropicana brand of juices. NTPC also explored the possibility of venturing into coal mining business. Similarly pipe manufacturer Jindal Saw Ltd. entered into backward integration by entering into a lease agreement with Rajasthan for iron ore mines in the state. Another example of backward integration is Sona Koyo Steering Systems Ltd, country’s largest manufacturer of steering systems for passenger cars and utility vehicles, which invested in an aluminum die-casting facility in Dharuhera. Globally firms like Starbucks purchased coffee farms in China to ensure that they have access to quality beans throughout the year.

Backward integration as a strategic alternative makes more sense where there is a dependence on critical skills and there are fewer alternatives to supply or deliver the results. This strategy results in
cost savings if the volume is big. Further in case the raw material is one of the prime determinants in creating differentiation in the end product, then it is wise enough for any firm to move backward as it can result in better competitive advantage. Further the backward integration strategy results in reduced dependencies on the suppliers. This strategy also has its own demerits as backward integration calls for higher capital investment, results in reduced flexibility and increases the cost of managing the supplies.

When the firm performs the functions of its own customers, for example, distribute its own products to lower distribution costs or ensure better service quality to its customers it is known as forward integration. The conditions under which a firm can choose to adopt the forward integration strategy include

- When the distribution network is not efficient and badly affects the service quality of the service provider or the manufacturer.
- When the industry is growing and the firm intends to leverage the overall benefits of capturing the higher market share. Being close to the customers, the firm can have access to better information
- When the firm has surplus capital and have under-utilized human resources.
- When there are high margins in the distribution network and the firms want to ensure the higher benefits actually flow to the firm.
- When the production is stable and the firm can ensure that there is access to markets which can be exploited.

Source: http://www.comindwork.com/weekly/2017-04-10/productivity/supply-chain-vertical-integration-types
Forward integration gives better access to consumers and has higher market visibility. Another benefit of forward integration is lower distribution costs. As the firms set up its own distribution network, it saves on passing on the commission to external stakeholders. In the long run, the competitive cost advantages get accrued to the firm thereby resulting in higher profitability. However there are certain disadvantages of the forward integration strategy. First of all there is threat to current competencies as the firm has to moved beyond its existing business operations. Further there is a higher risk, in case the firm is unable to manage the distribution effectively the overall costs will increase also resulting in reduced flexibility. When the firm enters into its own distribution network, there is a risk of reduced competitor intelligence. Some of the examples of forward integration include – Reliance Petrochemical Limited holds license to set up 5000 fuel retail outlets. Similarly Arvind Mills opened its own independent brand stores under the name of Arrow, Flying Machine etc. Globally Disney operates its own retail stores that sell the merchandise based on Disney’s characters.

Further the vertical integration continuum choices can be viewed as

- **Full Integration** – This is a scenario where a firm participates in all stages of the vertical activity chain. In other words, the firm takes 100% control over its supplies and distributors.
- **Partial Integration** – This is a scenario where a firm builds positions only in selected stages of the vertical chain.
- **Tapered Integration** – This strategy is a mix of mixture of vertical integration and market exchange. A firm internally produces less than a half of its own requirements and buys the rest from outside suppliers. The benefit of this strategy is that it expands input and output channels without substantial capital outlay. On the other hand a firm has to sacrifice economies of scale and makes coordination and monitoring more difficult.
- **Quasi Integration** – In this scenario, the company does make any of its key suppliers but purchases most of its requirements from outside suppliers that are under its partial ownership or control.
- **Long Term Contracts** – The company signs an agreement or contract with another firm providing agreed upon goods and services for a specified period of time.
6. Horizontal Integration

Horizontal Integration is one of the popular growth strategies for expansion. In this case the firm adds other business activities at the same level of value chain and seeks ownership of or increased control over a firm’s competitors. Horizontal integration: is a strategy where a company acquires, mergers or takes over another company in the same industry value chain. In addition to the external expansion mode, the firm can also do an internal expansion through the reinvestment of operating profits. This strategy is also known as lateral integration. Some of the popular examples of horizontal integration include the acquisition of Compaq by HP; acquisition of Whatsapp by Facebook; Motorola by Google; Ola Cabs acquired TaxiforSure; takeover of Satyam by Mahindra.

6.1 Advantages of Horizontal Integration

The underlying motivation to adopt the Horizontal Integration strategy is to increase profits through this strategy. Some of the benefits that accrue to the firm through Horizontal Integration are:

- Achieve economies of scale – By achieving economies of scale the firm is able to lower its cost structure and thereby increase the overall profitability in the long run.
- Block Competition – Through this strategy the firm is able to reduce industry rivalry by eliminating excess capacity in an industry. This strategy increases market share and pricing power.
- Product Differentiation – Through product bundling and cross selling, the firm is able to build product differentiation which provides competitive edge to the firm.
- Economies of Scope – The firm can offer diversified products thereby increasing the economies of scope.
- Increased bargaining power over suppliers and buyers
6.2 Disadvantages of Horizontal Integration

The implementation of Horizontal Integration strategy also comes with certain disadvantages. These are:

- **Creation of Monopoly** – Whenever a firm engages in a horizontal integration strategy, there is a risk of creation of monopoly which could result in reduced competition and therefore detrimental to the customers. In situation of a monopoly, the firm can compromise on quality of products and services.
- **Increased Work Load** – When the firm engages in horizontal integration strategy and either merges or acquires a competing firm, the overall workload of the top management increases resulting in reduced efficiency and effectiveness.
- **Anti-trust issues** – With the acquisition of a competitor, the market share of a firm can increase, which can result in increased industry concentration and they may attract the anti-trust issues.
- **Mergers and Acquisitions** often fail to produce the anticipated gain and do not create value, which may attract criticism from the shareholders for poor utilization of organizational resources.

7. Forms of Horizontal Integration

Horizontal Integration can take in form of mergers, acquisitions and takeovers. In this section, we look into brief about each of these strategies to expand and grow.

7.1 Horizontal Mergers

A horizontal merger involves two firms operating and competing in the same kind of business activity. For example the merger of Exxon and Mobil is a classic example of horizontal merger. Similarly when Lipton India merged with Brooke Bond; Bank of Rajasthan with ICICI Bank; or merger of associate banks with State Bank of India. Some of the benefits of horizontal merger include (a) economies of scale by reducing the overall costs of the business (b) enables the new entities to offer a wide range of products and services to their customers in the most efficient way (c) bring in efficiencies by bringing down the overall cost of operations (d) reduced competition and therefore leveraging market benefits. On the other hand, there are few disadvantages of horizontal merger as well. These include (a) compromise on customer interests because of the creation of monopolies. (b) difficulty in integrating the culture and employee behaviour of two companies which are merged. (c) Increased business risk due to reduced diversification as the company is investing all its wealth or cash into one business.

7.2 Acquisition

Acquisition is often made part of organization growth strategy whereby it is more beneficial to take over an existing firm’s operations rather than creating its own. An acquisition occurs when the buying company obtains more than 50 percent ownership of the target company. Such strategy can
be achieved by either paying in cash or in acquiring company’s stock or a combination of both. Some of the acquisition examples include – freecharge acquired by snapdeal in 2015; babyoye by Mahindra Retail; Myntra acquired Jabong; Zomato acquired Urban Spoon. The strategy has its own unique advantages and disadvantages. Some of the benefits include (a) decreased time to access and penetrate the target market (b) prevents an increase in the number of competitors (c) overcome entry barriers. The major disadvantages of this strategy include (a) increased financial and market risk (b) target too small or large (c) overestimation of market potential (d) incompatible corporate culture (e) inadequate due diligence

7.3 Takeover

A takeover is virtually the same as an acquisition. Takeover is a special type of acquisition when the target firm did not solicit the acquiring firm’s bid for outright ownership. Takeovers are either friendly or negotiated takeover or are hostile takeover. The former takeover happens when there is a proper negotiation between the existing promoters and prospective investor. Both the parties have common interest and objective and therefore they decide to come together. On the contrary, in case of a hostile takeover the board rejects the offer, but the bidder continues the pursuit. In 1998, India Cements was able to do hostile takeover of Raasi Cements.

8.0 Summary

In this module, we have discussed in detail Integration as one of the popular growth strategy adopted by various firms across the world. Integration strategy is broadly classified as vertical integration and horizontal integration strategy. Vertical Integration is further classified as forward integration and backward integration. Some of the key advantages of vertical integration strategy include reduced business risk, increasing competitive advantage, higher control of suppliers and customers. Further the degree of vertical integration can be full integration, partial integration, quasi integration or tapered integration. Another strategy to integrate is to move across the value chain, but either merging, acquiring or takeover of the competitors. This strategy is known as Horizontal Integration and has its own respective advantages and disadvantages.