Vertical Integration Redux: Challenging the Wisdom of Manufacturing Outsourcing

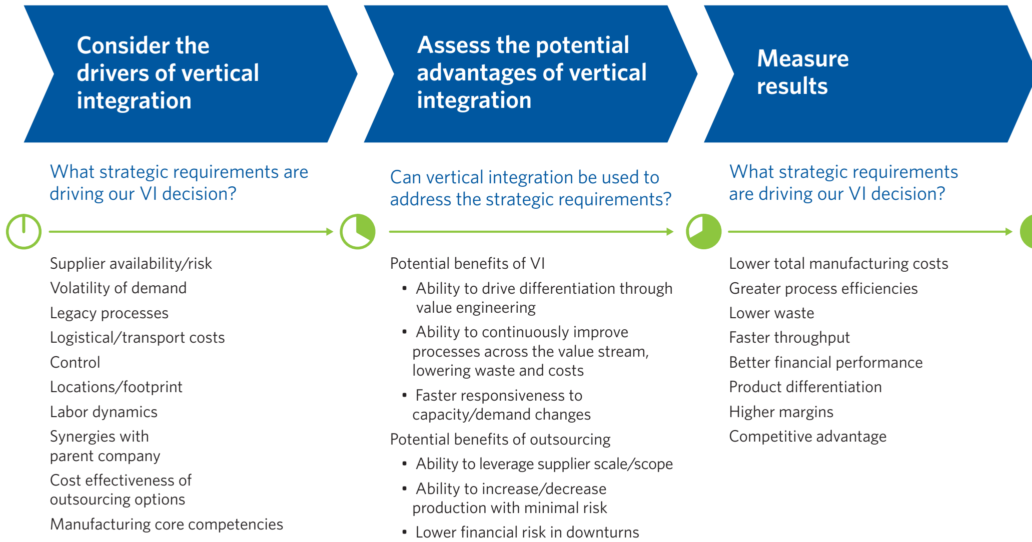
Evaluating the strategic, operational, and financial opportunities (and risks) created through a vertically integrated business model

IDEA IN BRIEF

- It is time to revisit vertical integration as gains from manufacturing outsourcing diminish or underwhelm relative to expectations, and increased control of the value stream presents an even greater opportunity to drive competitive advantage in the longer-term
- Vertical integration can be beneficial when: supply and distribution channels are unstable, suppliers fail to provide greater economies of scale or scope, insourcing could create proprietary access to superior scare resources, and significant operational efficiency gains are available from supply chain coordination
- However, companies must be selective and careful in determining what and how to vertically integrate and at what level of capacity as the decisions have much longer-term consequences and higher sensitivity to business fluctuations

A major heavy equipment OEM steadily increased outsourcing of its production activities as demand grew rapidly following the mid-90s and the company needed to quickly scale up its capacity and take advantage of the promise of greater outsourcing. As a result of the 2008 economic downturn and the significant reduction that the company had to make to its orders, the company's supplier base unfortunately weakened—resulting in more costly, less responsive and less reliable material inputs. As demand since recovered and is on track to grow beyond pre-2008 levels, the company was faced with a set of decisions to either plan its capacity expansion using the same heavily supplier-leveraged model (balance sheet attractive) or alternatively (and in sharp contrast) develop a more vertically integrated model and grow capacity through internal capital investment. In short, contemplating moving from what was perceived to be an efficient and highly leveraged model, to one that offers more control and *possibly* lower cost, but with greater balance sheet burden.

Kaiser was asked to evaluate the potential cost saving and strategic and operational benefits that could accrue from a vertical integration strategy relative to the key risks associated with increasing its fixed cost/asset base and reduction of business model flexibility. Kaiser brought insights on best practices and lessons learned from comparative benchmarks and conducted economic value analyses to assess the financial risks/rewards and sensitivity to key operational factors. Moreover, Kaiser introduced a decision framework for the company to use as a basis to drive effective vertical integration tradeoff decisions at the component level.



Kaiser's analysis revealed that the company was significantly disadvantaged in its manufacturing cost structure relative to industry peers that were heavily vertically integrated.

The key points of differences were threefold:

- By having greater control, vertically integrated companies were able to more significantly employ lean principles to identify manufacturing process improvements, component-level technical cost reduction, and reduce variances across the entire value stream
- Analysis of our client's strategy revealed that significant portions of manufacturing outsourcing were going to small, captive suppliers that were not cost competitive due to their limited economies of scale and offered little to no advantages in product quality as compared to what could be built in-house
- By planning internal capacity closer to average demand as opposed to peak periods and using suppliers to serve surge capacity, Kaiser determined that the company could have much higher levels of asset utilization and financial efficiency

By moving to a more vertically integrated manufacturing model, the company is now able to take advantage of significant new opportunities in both cost reduction and value innovation that were previously unavailable under its prior heavily outsourced strategy.

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