Moving on up

Is the recession heralding a return to Henry Ford's model?

The early part of the 20th century was not an easy time for the Ford Motor Company. Economic downturns were frequent and deep. Shortages of raw materials on the back of the first world war stalled assembly lines. And the motor industry's supplier network was too small to keep pace with demand, making it hard to ensure that all of a car's parts were ready for assembly at the right time.

Henry Ford tried stockpiling parts and materials, but found that the inventory costs were too high. The answer, he decided, was total control: owning the whole supply chain. By the 1920s his company ran coal and iron ore mines, timberlands, rubber plantations, a railroad, freighters, sawmills, blast furnaces, a glassworks, and more. Capping it all was a giant factory at River Rouge, Michigan, which built the parts and assembled the cars.

Ford's "vertical integration" solution was wildly successful. But the top-heaviness, complacency and stifling of competition that came to typify vertically integrated models eventually pushed them out of fashion. Today, supply chains have become global and complex. Yet the current recession has shown that they too are dangerously vulnerable to economic downturns.

Mark Gottfredson of Bain & Company, a consultancy, argues that many company chiefs have overestimated the ability of their supply chains to cope. Those that have chosen partners on cost basis alone are suffering especially—in the past year, thousands of low-cost Chinese manufacturers have folded. Some big Western suppliers have failed, too, such as Smurfit-Stone Container, a cardboard producer, which filed for Chapter 11 bankruptcy protection in January.

So, as companies battle to survive, has the time come to revisit Ford's solution? Some firms are already moving in a vertical direction. General Motors, a company in trouble if there ever was one, is seeking to buy back operations run by Delphi, a bankrupt car-parts supplier it spun off in 1999. Chinese steel-makers, having endured soaring commodity prices, are buying up Australian mining companies. And investment bankers in Asia report discussions with clients seeking to purchase struggling suppliers.

But vertical integration's fans have a struggle ahead to overcome its poor image. Almost any MBA graduate (some of them are still worth listening to) will declare that companies should do best when they focus on the part of the business where they have an advantage, rather than expending money and time on the dozens of steps required to deliver the final product.

However, managers who want a greater degree of control may find vertical integration has its advantages. Some are unsavoury—as the early steel and oil barons discovered, owning raw-material sources can be a useful way of squeezing competitors. Yet expanding upstream or downstream can boost profits. In the apparel business, for instance, the owners of brands reap higher returns than those that produce the outfits. And in digital photography, it is not the camera-makers that have the widest profit margins, but companies like SanDisk, which makes camera memory cards.

When a company expands down the chain closer to the ultimate customer, it also reaps learning benefits, says Tom Osegowitsch, a lecturer in management at the University of Melbourne. For instance, Zara, a Spanish clothing company, finds that owning shops gives it insights into what its customers really want, helping make its manufacturing operations more nimble.

Still, the trend of the last few decades to focus on “core competencies” is no mere fad. Although reliance on supply chains has risks, owning parts of the chain can be riskier—for example, few clothing-makers want to own textile factories, with their pollution risks and slim profits. Big, complicated businesses are hardly agile, and when new technology emerges, the owners of factories bear the costs of upgrading. And the lack of competition in vertical operations can cause a certain bureaucratic stiffness to set in among company divisions.

For managers, vertical integration carries the uninviting prospect of forcing them to operate outside their comfort zones. Mr Gottfredson points to research by Bain arguing that when a company moves two or more steps away from its main business, it fails two-thirds of the time. (For example, a shoemaker that decides to sell directly to end customers will not only have to distribute its wares but operate shops, too—and running a factory doesn’t prepare a manager to do either one.) “There is a lot working against you,” says Mr Gottfredson. “You will be competing with your customers and selling to a new customer base through a distribution channel you don’t understand.”

Looking sideways

There may be a third way. A company can gain some of the benefits of vertical integration without full ownership. Consider Toyota, a motor company that has been a byword for decent management in a way that General Motors has not been. Toyota rigorously screens its suppliers for quality and financial health, and then spends time and money to ensure their efficiency and survival, sometimes taking minority stakes.

In the 1980s, when Toyota chose Johnson Controls to supply seats, it blocked the supplier from expanding its facility, fearing that the additional cost would harm Johnson's profits and effectiveness. Instead, Toyota’s engineers worked with Johnson to streamline production, rearrange the factory floor, and cut inventories, ultimately showing that expansion wasn’t needed after all.

To follow Toyota's example, argues Joel Sutherland, now of Lehigh University and once head of operations at one of Toyota's suppliers, is to create a supply chain with the stability and efficiency of vertical integration but with some of the flexibility of looser networks of suppliers. The approach is also far cheaper than the traditional vertical method of owning suppliers outright, a virtue at a time when cash and credit are rare.

Like the duration of the downturn itself, how well supply chains will endure is anyone's guess. But the return of deep economic cycles may cause many managers to discover that there’s comfort in keeping suppliers close. Recalling the days when Henry Ford ruled, vertical integration—in adapted form at least—may emerge from disgrace as an innovative solution in an era when innovation is sorely required.

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