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THE UPS AND DOWNS OF VERTICAL INTEGRATION

By Gregory Wank

In the brutally competitive food industry, vertical integration can be a powerful business strategy. By taking control of the key components of your product cycle, you can eliminate uncertainty, reduce costs, enhance quality, and gain an edge over the competition. But this strategy can also increase your risks and strain your resources, so careful planning is critical.

What is Vertical Integration?

Vertical integration means obtaining ownership or control of different stages of the production process. A manufacturer, for example, might integrate its business with an "upstream" business, such as a raw materials supplier, or a "downstream business," such as a distributor or retailer.

Vertical integration generally is achieved in one of three ways:

- Expanding an existing business to include an upstream or downstream process,

- Merging with or acquiring another company in the production chain, or
- Forming a strategic partnership or joint venture with another company in the chain.

What are the Benefits?

The food industry is particularly well-suited to vertical integration because the production process contains many layers, from sourcing raw materials to processing/manufacturing to packaging, storing, shipping, and marketing. Each stage adds cost and uncertainty for other members of the chain. If a grower's crops are damaged by a late frost, for example, the impact is felt throughout the chain, from the distributor whose costs go through the roof to the manufacturer that can no longer secure the raw materials it needs, and so on.

By gaining control over upstream or downstream processes, you can eliminate some of this uncertainty and

reduce your dependence on third parties. A meat processor that integrates livestock supply into its business, for example, can stabilize its costs and insulate its business against shortages. Other examples of vertical integration in the food industry include:

- Manufacturers that ship directly to retailers by integrating warehousing and distribution
- Livestock suppliers that integrate feed companies
- Manufacturers or processors that integrate fruit and vegetable growers
- Growers that integrate fertilizer companies
- Distributors that integrate merchandising by securing contract manufacturing or a private label supply

In addition to reducing costs and securing a steady supply, vertical integration helps you ensure prompt service along the chain, exercise greater control over the quality of products and services you provide

to your customers and, ultimately, improve your profitability.

What are the Risks?

The biggest disadvantage to vertical integration is that it requires you to get involved with a new line of business. This can be a big drain on your time and resources and can cause you to lose focus on your core business.

Integration also increases your risk by eliminating third parties that previously absorbed part of the risk. Suppose a manufacturer of baked goods buys fresh fruit from a company that imports fruit from South America. The importer absorbs some of the risk of price volatility by guaranteeing its prices to the manufacturer for three months. The manufacturer can potentially reduce its costs and secure a steady supply by acquiring the importer or bypassing it and purchasing directly from the growers. But the manufacturer would also assume all of the risk associated with fluctuating prices.

Another potential downside is that price pressure from customers can have a "trickle-down" effect. Say a distributor has one major customer. If the customer pressures the distributor to cut its prices, then in a vertically integrated chain it's

likely that all of the members will share the burden of the price cut.

A final danger of vertical integration is that by focusing your attention on the vertical structure you may lose sight of less costly alternatives outside the chain.

Evaluating your opportunities

Determining whether vertical integration is right for your business involves weighing the risks against the potential rewards. Suppose you use eggs in 80% of your products and buy your entire supply from one supplier. And suppose the supplier sells 75% of the eggs it produces to your company. By integrating the egg supplier into your business, you can secure your source of eggs and reduce your costs. And even though you're entering a new line of business, your risk is relatively low because 75% of the egg supplier's sales are virtually guaranteed.

If, on the other hand, you use eggs in only 20% of your products and your company accounts for only 10% of the supplier's sales, your risk/reward analysis may have a different outcome. The rewards are less significant because the cost savings are limited to 20% of your products. And the risk is greater because in order for the egg

business to succeed, you'll have to sell eggs to a lot of other customers.

The method of integration is also a critical important factor. A strategic partnership or joint venture provides less control than a merger, acquisition, or expansion, but it's also less risky. In a strategic partnership, for example, you might provide capital to one of your suppliers in exchange for a guaranteed supply. You enjoy many of the benefits of vertical integration while minimizing the risks associated with entering a new business.

Achieving Certainty in Uncertain Times

Food companies seeking certainty and stability in a volatile industry should explore opportunities for upstream and downstream integration. If the circumstances are right and you understand the risks, vertical integration can provide you with a competitive edge.



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