Vertical Growth

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When a company has already concentrated its market, representing 40-60% of all sales, and market growth slows down, it is time to consider expanding across the entire value chain, including upstream and downstream steps. As opportunities for horizontal expansion become limited, vertical integration can serve as a significant growth driver.

Rationale

There are several reasons to pursue vertical integration:

- *Additional Growth Potential:* In an industry where a company operates within only 20% of the value chain, full integration offers the potential for a fivefold increase in sales and EBITDA. It can provide 10 to 20 years of sustained, profitable growth.

  Over the past 40 years, Ecolab has evolved from a small producer of disinfectant products into a service provider, distributor, and solution designer, increasing its share of the end-client value chain from 10% to 45%. This strategy has driven nearly 50% of its growth, with sales rising from $1 billion in 1980 to $15 billion in 2019.

  Similarly, 40% of Apple's growth over the last decade has come from integrating its distribution channels (both online and offline), which now account for 35% of its sales.

- *Upstream-Downstream Synergies:* Integration at adjacent production stages eliminates costs such as marketing and intermediate storage. It also optimizes production processes, improving predictability, responsiveness, quality, and productivity.

  In highly dynamic markets like luxury goods, fashion, and advanced technology, integrating into direct distribution and marketing to end clients allows companies to anticipate market cycles and client needs more effectively. This approach enables more efficient resource allocation, leading to higher market penetration in both volume and value.

- *Spreading Out Critical Resources*: In fast-moving consumer goods (FMCG) and luxury industries, integrating into distribution allows brand investments to be spread over a larger sales base, ensuring consistency between product positioning and client experience.

  For instance, major luxury brands with strong retail integration allocate around 5-10% of total sales to advertising and promotional costs. For L'Oréal, which does not sell directly to end clients, this figure is around 30% of total sales. Despite similar investment levels, luxury brands achieve better amortization over larger sales volumes.

  Similarly, in industries with high technological content and innovation, vertical integration allows critical R&D investments to be amortized across the entire value chain.

- *Cyclical Resilience*: In cyclical businesses prone to alternating under- and over-capacity, vertical integration ensures reliable supply during periods of high demand and provides stable market access during downturns. This strategy smooths earnings fluctuations and reduces capital costs.

This is why major oil companies are integrated both in exploration-production and refining. In luxury goods, leading brands have moved upstream to secure access to specialized craftsmanship and raw materials which are scarce compared to the growth potential of the market.

- *Competitive Dynamics:* In industries where scale is crucial at all value chain stages, it is important not only to maintain competitiveness at a company's specific value-added stage but also to work with clients (or suppliers) which are themselves competitive and which concentrate the market. If those clients (or suppliers) do not sufficiently invest to concentrate their own step of the value chain, it may be necessary to acquire them. One's concentration dynamics relies on the competitiveness of the entire value chain (own company plus key suppliers and clients).

  Similarly, if a company's clients or suppliers grow their market shares to at least twice that of the company, it may be necessary to integrate defensively to maintain independence.

Constraints

Successful vertical integration – upstream or downstream – requires strong competitive positions in the newly integrated value-added steps. It cannot compensate for weak positions elsewhere.

Beyond this consideration, vertical integration is only possible and attractive provided *three conditions* are met: value to leadership at each step; mapping between the two steps; favorable financial dynamics.

- *Value to Leadership*: A company's competitive presence at multiple value chain stages will reinforce its overall competitiveness, and all the more so that scale effects are strong. It will accelerate the concentration of the industry.

  Conversely, it is not in a large group's interest to integrate into activities and value chain step where there are no competitive barriers, no value to leadership or no room for strong differentiation in the medium- to long-term. Instead, outsourcing or bypassing these steps may be a better option.

  In fashion and small electrical appliances, companies often outsource production steps with no scale effect (textile manufacturing, "simple" assembly…). Similarly, in the optical industry, major players often integrated downstream in laboratories (small local or regional players allowing to adjust lenses and to sell them optical retailers) through partnerships.

- *Mapping between steps:* Leading beer companies do not own hypermarkets (and conversely). There would be too much of an imbalance between their offerings (beer specialists vs. food generalists). Beer companies have not created specialized distribution channels either[1] for a reason. Those would necessitate distribution points, networks or platforms that would be too narrow to be competitive.

  On the contrary, in luxury goods, companies have successfully integrated across multiple product categories (fashion, leather goods, accessories, jewelry…) to create exclusive distribution networks under their own brands, covering all those categories in their stores. This integration transformed the purchasing experience for clients.

[1] Excluding branded brewery chains, which account for a very small share of the market.

One-third of the growth of major luxury goods companies in the past 30 years comes from this successful strategy to develop their own distribution.

A sufficient mapping between the product ranges of the different value-added stages is essential for integration to be effective. Where it does not exist naturally, it can be created by combining activities at one value-added stage before integrating at the next.

In the optical industry, the merger of a leader in prescription lenses with a leader in frames and sunglasses (EssilorLuxottica) created a broad enough product range to enable downstream integration with opticians.

In cases where a complete bijection does not exist (e.g., many components in the final manufacturing of a product), it may nevertheless be necessary to vertically integrate into the production or design of the most critical component to ensure the differentiation, value, and competitiveness of the entire product *(e.g., car engines, computer chips…).*

- *Financial Feasibility:* buying a carmaker when you are a windshield wiper manufacturer is not an obvious move. There is too much of a gap between the value added of each step, their capital employed, their profit pools and the size of the players.

  But this is not the only variable. A fast-growing company concentrating its segment can reach high valuation multiples, enabling it to have sufficient financial power to acquire a slower-growing player upstream or downstream.

Risks

Two major risks are associated with vertical integration strategies:

- *Dilution risk*: Integration should only occur between two highly attractive value steps (strong value to market share, strong levers of differentiation, strong barriers, high potential profitability for a leader…) and with the company reaching strong market share. Otherwise, the strategy merely compounds unsustainably weak positions.
- *Retaliation risk*: Clients or suppliers against whom a company competes with through integration may cease doing business with it, significantly impacting sales. To mitigate this risk, the company conducting the integration strategy must invest quickly and massively to establish as fast as possible a strong and competitive position at the new value chain step.

Conclusion

When market growth slows, industries consolidate both horizontally and vertically. Too often, companies focus solely on horizontal consolidation. But vertical integration and consolidation is just as critical and must be anticipated.

Regardless of a company's starting position within its industry, the key question remains: which value stage must be controlled over the long term to secure market leadership?

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Estin & Co is an international strategy consulting firm, with offices in Paris, London, Zurich, New York and Shanghai. The company assists senior executives of major European, North American and Asian corporations with their growth strategies, and managers of private equity firms with the analysis and valuation of their investments.

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