

External Suppliers And Vertical Integration

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Introduction

Companies often decide whether to purchase an input or activity from an external supplier or perform it within the firm. This is the classic “make-or-buy” question. Vertical integration occurs when a firm controls more than one stage of its supply chain, such as raw materials, component production, distribution, retail, or after-sales service. Outsourcing relies on independent suppliers through contracts and relationships.

The original essay lists flexibility and market access as general advantages of suppliers and assumes that vertical integration always creates economies of scale and direct customer control. Those claims are too broad. A supplier may offer scale that the buyer cannot achieve internally, while integration may create coordination economies, quality control, or strategic security. The correct choice depends on transaction cost, capabilities, asset specificity, uncertainty, scale, technology, competition, capital, and risk.

Clarifying the Decision

The decision is rarely all-or-nothing. A company can own a critical process while buying standard components, use multiple suppliers, form a joint venture, license technology, reserve capacity, or dual-source. It can integrate upstream toward inputs or downstream toward customers.

Managers should define the activity precisely. “Manufacturing” may contain design, tooling, assembly, testing, logistics, and maintenance, each with a different optimal boundary.

Transaction-Cost Economics

Transaction-cost economics asks whether an activity is governed more efficiently through the market or hierarchy. Markets use prices and contracts. Hierarchies use authority, internal planning, and employment relationships.

External sourcing has costs beyond price: searching, negotiating, monitoring, enforcing, adapting, and resolving disputes. Internal production has bureaucracy, capital, management, and incentive costs. The preferred form minimizes total cost while supporting strategy.

Asset Specificity

An investment is asset specific when it has much less value outside one relationship. A supplier may build dedicated tooling, locate near a plant, or develop specialized knowledge. Once the investment is made, either party may gain bargaining power.

High asset specificity can favor integration or long-term contracts because repeated renegotiation creates hold-up risk. However, ownership does not remove conflict; it changes the governance mechanism.

Advantages of External Suppliers

Specialist suppliers can aggregate demand from many customers and achieve scale, learning, and technical depth. They may spread fixed cost across a larger volume and update equipment more frequently than one buyer could.

Suppliers also provide flexibility. A buyer can change volume or technology without owning every asset, although contracts may limit flexibility. External sourcing preserves capital for activities where the firm has greater advantage.

Access to Innovation

Suppliers often serve several industries and observe new materials, processes, and tools. A collaborative supplier can contribute design ideas and reduce time to market. Innovation is strongest when incentives, intellectual-property rules, and information sharing are clear.

Overdependence on one supplier can narrow learning. The buyer should maintain technical competence to evaluate proposals and avoid becoming unable to specify what it needs.

Market Discipline

Competitive bidding can create price and performance discipline. External providers know that poor performance may lead to lost business. Internal units can become protected from comparison.

Price competition can also encourage unrealistic bids, quality reduction, or labor abuse. Procurement should evaluate total cost, capability, risk, and ethics rather than selecting the lowest quoted price.

Risks of External Sourcing

Supplier failure, geopolitical disruption, transport delay, cyberattack, natural disaster, labor conflict, or financial distress can interrupt operations. Long global chains may reduce visibility.

The buyer may also lose control of quality, intellectual property, data, and customer experience. Switching can be slow if components require qualification or regulatory approval.

Information Asymmetry

A supplier knows more about its process and cost than the buyer. The buyer knows more about demand and product strategy. Misaligned information can cause overordering, underinvestment, opportunism, and blame.

Shared forecasts, audits, traceability, and joint planning help, but sensitive information needs access controls. Trust should be supported by verification and incentives.

Advantages of Vertical Integration

Integration can improve coordination among design, production, inventory, and distribution. It may reduce delays caused by negotiation and align investment with product strategy. Ownership can protect proprietary technology or assure supply.

Integration can also capture margins at another stage, though a transferred internal margin is not automatically new economic value. (Williamson, 1985) The firm creates value only if the combined operation performs better than market alternatives after capital and management costs. (Chopra & Meindl, 2019)

Quality and Traceability

Owning a process can provide direct control over specifications, training, data, and corrective action. This can be important in food, aerospace, medicine, semiconductors, and other safety-critical sectors.

Ownership does not guarantee quality. An internal plant can hide defects or resist change. Independent certification, measurement, and accountability remain necessary.

Supply Security

Integration may secure a scarce input or capacity. It can reduce exposure to supplier bargaining or export restrictions. During disruption, internal control may support prioritization.

Yet a single owned facility creates concentration risk. A diversified supplier network may be more resilient. Security depends on redundancy, inventory, geographic diversity, and recovery capability, not ownership alone.

Disadvantages of Vertical Integration

Integration requires capital and management attention. The firm assumes fixed costs, labor obligations, compliance, maintenance, and technology risk. If demand falls, external purchases may be reduced more easily than an owned facility.

The company may become locked into an obsolete process. Internal transfer pricing can hide true cost, and business units may be forced to use an inferior internal supplier.

Capabilities and Core Competence

A firm should ask whether the activity contributes to differentiation and whether it can perform it competitively. A strategically important activity is not necessarily one the firm should own; partnership may provide better capability.

Conversely, outsourcing a capability central to learning can hollow out the organization. Managers should preserve enough expertise to innovate, govern suppliers, and recover from failure.

Economies of Scale and Scope

The original essay attributes economies of scale to vertical integration. Scale depends on volume, not ownership. A specialist supplier serving many customers may have greater scale than an integrated buyer.

Integration may create economies of scope through shared data, facilities, brand, or distribution. It may also eliminate double marginalization when separate firms each add a markup. These benefits must be measured rather than assumed.

Customer Relationship

Downstream integration into retail or digital channels can provide direct customer data, service control, and faster feedback. It may also create channel conflict with independent distributors.

External suppliers do not automatically expand the buyer's customer market; upstream suppliers typically provide inputs, not sales outlets. The original claim confuses suppliers with distributors. Each stage should be identified accurately.

Contracts as an Alternative

Long-term agreements, service-level terms, price adjustment, capacity reservations, quality clauses, audit rights, intellectual-property protections, and termination rules can address many risks without ownership.

Contracts remain incomplete because future conditions cannot all be predicted. Governance should include escalation, joint review, and relationship management.

Dual Sourcing

Dual sourcing balances competition and resilience. One supplier may provide the majority of volume while another maintains qualified capacity. The approach reduces single-point dependence but sacrifices some scale and increases coordination.

Allocation rules should avoid starving the backup supplier of enough work to remain capable. Critical components may justify the extra cost.

Supplier Development

When performance is weak but the relationship is valuable, the buyer can support process improvement, forecasting, training, or investment. Supplier development is more constructive than repeatedly changing vendors without diagnosing causes.

Support should not become domination. Purchasing practices such as last-minute changes or delayed payment may create the very quality problems the buyer criticizes.

Risk Assessment

A make-or-buy analysis should map operational, financial, geopolitical, cyber, legal, environmental, and human-rights risks. Scenario analysis can test demand change, supplier failure, tariff shifts, and technology transition.

Risk should be valued, not merely listed. The cheapest option in a normal year may be the most expensive under disruption.

Sustainability and Labor

Outsourcing does not outsource responsibility. Firms can face legal, reputational, and moral consequences for unsafe labor, forced labor, pollution, or deceptive claims in the supply chain. (Federal Trade Commission, n.d.)

Integration can improve visibility but also brings direct liability. Standards, worker voice, traceability, and remediation are required under either model.

Competition and Antitrust

Vertical relationships are generally lawful and can improve efficiency. The FTC notes that vertical arrangements may raise concerns when they reduce competition or block entry. An integrated firm controlling a critical input could limit rivals' access or raise their costs.

Large acquisitions require legal review. Efficiency claims do not automatically outweigh competitive harm, and contracts short of ownership may achieve similar benefits.

Financial Evaluation

Managers should compare net present value, not only unit price. Internal cost includes capital, depreciation, overhead, ramp-up, working capital, downtime, and exit cost. Supplier cost includes price, transport, inventory, quality, monitoring, and risk premiums.

Sensitivity analysis should test volume, exchange rates, yield, lead time, and residual value. Strategic options and learning may be included qualitatively or through scenarios.

Decision Matrix

A structured decision can score strategic importance, capability, scale, asset specificity, supply risk, quality, innovation, capital, flexibility, legal concerns, and reversibility. Scores should support discussion, not create false mathematical certainty.

The recommendation should state assumptions and trigger points. A firm might continue external sourcing now but integrate if volume reaches a threshold or if a supplier market consolidates.

Recommendation for a Troubled Supplier Relationship

The original essay recommends staying with suppliers because integration is difficult. Difficulty alone is not a decision rule. Management should diagnose whether problems arise from one supplier, poor specifications, unstable forecasts, unrealistic pricing, or a structurally weak market.

A staged response could include corrective action, alternative qualification, dual sourcing, redesigned contracts, and internal capability development. Full integration should be considered only if strategic benefit exceeds cost and the firm can operate the activity well.

Conclusion

External sourcing and vertical integration are alternative governance structures, not universally good or bad strategies. Suppliers can provide scale, innovation, flexibility, and capital efficiency. Integration can improve coordination, control, learning, and supply security. Each can also create dependency, rigidity, cost, and competitive risk.

The best decision defines the activity precisely, evaluates total cost and risk, protects critical capabilities, and considers hybrid options. Managers should not integrate simply to “control everything,” nor outsource simply because ownership is difficult. The objective is a supply architecture that creates value, remains adaptable, and performs under both ordinary and disrupted conditions.

References

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