Context and concepts

- Context: You’re thinking of outsourcing your manufacturing operations. What are the pros and cons?
- Concepts: vertical integration, separation, specific assets, the holdup problem.

Make or buy?

Firm X & Y produce input and output

“vertical integration”

Firm X produces input

Firm Y produces output

“vertical separation”

Sony Corporation of America

- Sony Electronics (TVs, VCRs, stereos, etc)
- Sony Computer Entertainment (Playstation)
- Sony Pictures Entertainment (movies and TV shows)
- Sony Music Entertainment (Columbia, Epic, Sony Classical)
- Sony/Loews Cineplex (theaters, in ch 11)

Other examples

- JP Morgan: challenges of outsourcing IT
- AT&T Broadband: add content?
- Citibank: securitized credit card debt allows (partial) separation of credit card processing from lending
- Zara: benefits of integration?
- Disney: movies, stores, parks, products
- Merck MedCo: distribution subsidiary
- Apple: benefits of having its own stores?
### Advantages of buying

- Production efficiency
  - Economies of scale and scope
  - Expertise, core competence
- Competition among suppliers
  - “High-powered incentives” of the market

### Advantages of making

- Avoid holdup problem: incomplete contracts and specific assets
- Control over supply chain
- Information
- Strategic leverage (esp access to supplies)

### Takeaways

- Vertical separation (“buy”) has the potential advantage of low cost, which might be the result of scale economies, expertise, and/or market incentives.
- Vertical integration (“make”) has potential advantages of: incentives to invest in specific assets, greater control over supply chain, access to market information, and strategic leverage (eg, access to supply).
- More complex arrangements are possible, too (next class).