

AEM 2601: Home Work 03 – Best Answers

1. **For its Zara brand, Inditex manufactures the majority of the garments it sells and undertakes all of its own distribution from manufacturing plants to its directly managed retail outlets. Benetton outsources most of its production, and most of its retail outlets are owned and operated by franchisees. Which is the superior system?**
 - According to Grant, when a company chooses the optimal vertical relationships, it needs to take into account different factors: resources, capabilities and strategy; allocation of risk; incentive structures. Hence, there is not a perfect solution because the companies must choose between vertical integration and outsourcing basing on their own characteristics and those of the industry. In this case, Zara's high level of vertical integration compared to other fashion companies such as Benetton reflects its strategy based upon fast cycle new product development. Indeed, as we have seen in previous readings, Zara has based its competitive vantage on the concept of fast fashion so that tight integration between its retail stores, designers and manufacturers is essential. Indetex policy state that production shall be adapted to customer demand. Hence, speed of response to customers' demands is much more important than finding low cost way of production. Benetton does its own design, but its manufacturing is undertaken by contractors. The advantages of this system are: it avoids the problem of managing manufacturing plants far away from the retailers' corporate head offices; retailing and manufacturing are strategically dissimilar (different capabilities and optimal scale); it offers flexibility to both sides in adapting to uncertainty. Zara has succeeded by creating a vertically integrated system where the disadvantages of vertical integration (higher costs of manufacturing in Europe, lack of flexibility in shifting plant locations, etc.) are offset by the quick response to market demand and design flexibility that its tightly coordinated system permits. Thus, Zara's highly compressed product development cycle would be impossible for companies like Benetton or any other retailer relying on contract manufacturers. On the other hand, for Benetton vertical integration would not work most likely.
 - Vertical integration is neither good nor bad. Zara, as a firm that is integrated across design, manufacturing, and retailing, is an unusual company in the fashion clothing. Most fashion clothing retailers do not manufacture, while most manufacturing companies do not retail their own products. This is because manufacturing and retailing are strategically different. For example, Benetton designs its clothes, but it contracts out manufacturing and franchises retailing outlets. Through this system, Benetton does not have to worry about managing different business activities, especially since it has no experience in manufacturing and retailing. This allows the company to concentrate on the activities where they possess superior capabilities. Benetton and its business partners can also have more flexibility to adapt to uncertainty. Benetton can change suppliers according to costs and product quality; manufacturers can spread risk by supplying different brands and retailers. Zara has succeeded with a vertically integrated system because, despite disadvantages of vertical integration (such as high labor costs of manufacturing in Europe, difficulty in managing strategically different business activities, etc.), it has created value through flexible, fast-cycle product development and tight integration between its retail stores, designers, and manufacturers. Thus, there

- is no superior system; each company should choose a degree of vertical integration that best fits with the company's other capabilities.
- There is not necessarily a superior system in this case. Vertical integration is the optimal strategy for some firms, but not all. One simplification Grant made in Ch. 11 is that if the transaction cost of an activity outweighs the administrative cost of performing that activity internally, then the activity should take place within the firm. There is a lot more analysis that must go into the decision to vertically integrate, however. One of the largest benefits of vertical integration is the ability to capture technical economies from the physical integration of processes. For example, there is a lot of benefit to linking oil refining with petrochemical production. Another huge benefit to vertical integration is avoiding transaction costs in vertical exchanges. Transaction costs can add up to be extremely impactful, especially if a firm's buyers and suppliers have substantial bargaining power. One disadvantage to vertical integration is that there are differences in the optimal scale between different stages of production. For example, just because UPS uses trucks doesn't mean they use enough trucks to justify opening a factory to produce trucks. Vertical integration requires a company to develop distinctive capabilities and manage strategically different businesses, which can be costly. Additionally, vertical integration can cause incentive problems within the company, inflexibility, investment in unattractive businesses, and additional risk. There are several criteria to consider when making the decision to vertically integrate: certainty of market demand, similarity between the vertical stages, distribution of information between the stages, and the number of firms in the vertically adjacent activity. It is not a simple cost/benefit analysis, but a company's industry outlook must be taken into consideration as well. It is entirely possible that both Zara's and Benetton's differing strategies are optimal within their individual spaces.
 - Firms can excel at vertical integration in Zara's case or in outsourcing in Benetton's case. Both systems can be very beneficial to a firm and provide distinct competitive advantages. Which system a firm chooses depends on its strategy, objectives and resources. However, I believe Zara has the superior system as its vertical integration efforts have led Zara to become a renowned retail store with much success. By vertically integrating, Zara has developed superior coordination capabilities that has allowed them to have a quick turnaround in bringing runway styles to their stores at low costs. Zara is able to have this quick turnaround since it controls everything from design, manufacturing, and retailing. Zara is also able to avoid transaction costs associated with forming contract in intermediate markets. Zara's excellent inventory control, customer response time, and brand image have arisen from Zara's vertical integration system. On the other hand, Benetton outsources its production which can provide cost advantages by preventing the company from taking on roles where it lacks distinctive capabilities and problems with managing strategically different businesses. However, Benetton will not be able to ensure its suppliers are on track to deliver products or that its products adhere to legal standards.

2. What are the costs and benefits of outsourcing manufacturing from IKEA's perspective?

- One cost of outsourcing manufacturing is the lack of control over the environmental effects of IKEA products' manufacturing. This is illustrated by the formaldehyde problems in the 1980s and 1990s. Even with IKEA's stringent requirements about formaldehyde emission after the 1980s incident, suppliers failed to meet the standards. The problem was that most of IKEA's suppliers bought from sub-suppliers, who in turn purchased the binding materials from glue manufacturers. Eventually, IKEA decided to work directly with glue-manufacturing chemical companies. These incidents arise because IKEA cannot monitor each production stage of each of the thousands of manufacturers. Similarly, when IKEA set wood standards for its products, it had to appoint forest managers to monitor compliance, adding to the company's costs. Another cost is that IKEA cannot fully control the labor practices of its manufacturers. When the news came out about IKEA's Indian rug producers' child labor problems, IKEA was unaware of the practice. After the incident, IKEA had to commit extra costs in hiring an external agency to monitor child labor practices at its suppliers' factories. In the late 1950s, Sweden's large furniture retailers felt so threatened by IKEA that they pressured manufacturers not to sell to IKEA. One benefit of outsourcing from IKEA's perspective is that it could expand supply to meet the growing demand. Manufacturers in Poland also provided high-quality products at much lower costs, another advantage for IKEA and allowed the company to lower prices further. Another benefit of outsourcing is that IKEA can partner with suppliers from different countries and capitalize on the different expertise. For example, Indian carpet manufacturers have more knowledge and access to skilled personnel than IKEA to produce Indian rugs.
- The benefits associated with outsourcing from IKEA's perspective is that outsourcing allows IKEA to offer customers a variety of products, obtain products low costs and therefore sell at low costs, and prevent the company from manufacturing products where it does not have distinctive capabilities. IKEA specifically seeks out manufacturers with spare off season capacity to supply it with furniture. This allows them to keep prices low and offer a range of products to its consumers to match different consumer tastes and changing consumer demand. However, there are also costs associated with outsourcing. In IKEA's case, many of its supplier were not adhering to chemical legal standards or child labor laws. IKEA was not aware which of its suppliers were violating these laws until the suppliers were exposed by news outlets. This in turn tarnished IKEA's brand image and reputation as it positioned itself as a sustainable and ethical company. By outsourcing IKEA is not able to always ensure that its suppliers are adhering to its ethical standards and therefore the company suffers large losses when unethical suppliers are exposed.
- There are both costs and benefits to IKEA's initiative of outsourcing manufacturing. First of all, IKEA would not have grown to the furniture giant it is today without outsourcing. Eventually, IKEA had expanded its outsourcing to 2,300 suppliers in approximately 70 countries. Aside from sheer size and market share, I will further discuss the costs and benefits of outsourcing. One benefit of this plan for IKEA is that they were able to avoid the Swedish furniture manufacturing "cartel" that Ingvar Kamprad, founder of IKEA, despised and distrusted. Also, IKEA was able to find cheaper manufacturing options abroad, first in Poland and then all over the world. This

cheaper manufacturing allowed IKEA to further lower its prices on its affordable furniture, thus capturing an extraordinary market share. Since their furniture is fairly simple, and for the most part is made-for-assembly, manufacturing did not have to necessarily be in-house since it was not overly complicated. The costs of outsourcing were not immediately clear to IKEA. It all started with a formaldehyde scandal, where the glue used in their furniture manufacturing emitted illegal levels of formaldehyde. This alone lost IKEA 20% of its market in Denmark. The formaldehyde issue was on and off for about a decade. Later, IKEA was exposed for outsourcing labor to factories that employ child labor. These two issues are directly related to their decision to outsource manufacturing, because IKEA was unable to closely monitor the conditions and operations at 2,300 external manufacturing plants. IKEA subsequently had to spend millions of dollars in addition to substantial time and effort in attempt to resolve these issues. Aside from monetary costs, these scandals have an enormous impact on IKEA's brand image and consumer loyalty. Though IKEA claims to have not known of the use of child labor on its products, the media and the public would not see it that way. Was outsourcing a good idea for IKEA? Probably, yes. However, when you have 2,300 manufacturing suppliers, mostly in developing countries, it is very difficult to manage the quality and morality of operations.