Value-adding partnerships as alternatives to vertical integration: An exploratory discussion by reference to some Northern Ireland examples

Boyle, Emily . Boyle, Emily.

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ABSTRACT

In the present economic circumstances, vertical integration can no longer act as a buffer against the vagaries of the environment. It is implied that there are only 2 ways for firms to operate to ensure the fulfillment of the value-added chain - either through competing in the marketplace or through vertical integration. Value-added partnerships (VAP) have been identified as an interim structure between these 2 extremes. In VAPs, individual companies cooperate with each other; they appreciate that they have a stake in their partners' success, and that the financial soundness of their trading partners is of paramount importance to their own performance. Handy (1989) has implied that the contractual fringe is often made up of ex-employees who have been laid off by the core organization and then contracted by it to carry out work for it. The Northern Ireland dairy industry and Moy Park Ltd. are 2 examples of the implementation of VAPs.

FULL TEXT

INTRODUCTION

Until recently organisation theorists believed that organisational growth was natural. (Robbins 1987: 384). Various models of continuous growth and development were propounded (Greiner 1972; Weinshall and Raveh 1983). It was assumed that large businesses were superior to small ones, that the advantages of economies of scale and of the power and influence gained from size made large businesses not just desirable but inevitable. (Galbraith 1967; Peters 1987). In the late 1960s Drucker asserted that 'the large organisation is the environment of man in modern society', (1968: 173) and as late as 1980 Alfred Chandler contended 'The large business firm and its managerial hierarchy are essential for organising modern industrial activity'. (1980: 1). One way in which firms achieved their size was through the process of vertical integration. However by 1980 some theorists were also beginning to question these assumptions--to suggest that rather than experiencing infinite growth, organisations might have a 'life cycle' and that they would at some stage inevitably go through a period of prolonged decline and shrinkage (Kimberly, Miles et al. 1980; Whetten 1980).

The poor performance of many of the giant multi-national corporations in recent years adds weight to this view. It also suggests that the advantages claimed for large organisations may have been greatly overstated in the past and that small businesses have several significant advantages over large ones, particularly as far as flexibility and adaptation to a changing environment are concerned. (Peters 1987; Handy 1989). Because of the problems that the giant corporations have recently encountered many have turned to organisational restructuring, retrenching and downsizing in an attempt to alleviate their position.

One way that this can be achieved is through what Peters refers to as 'vertical deintegration' (1987: 8). However downsizing and deintegrating can leave firms weak and vulnerable to take-overs. In order to prevent this from happening some firms have begun to build up different types of inter-firm relationships, based on trust and cooperation rather than competition. Value Adding Partnerships (VAPs) are an example of this type of relationship. One way of creating a VAP is for a firm to lay off its full-time employees and contract out the work to them as self-employed business people.

This paper provides an introductory discussion of this process. It examines the theory behind vertical integration and the reasons given as to why it is not an effective structure for businesses in the present economic conditions before going on to consider the way in which some firms in Northern Ireland have used the process of deintegration to form VAPs with ex-employees. Other methods of forming VAPs, as well as factors that inhibit their creation, are also discussed. The evidence for the paper has been derived entirely from newspapers and other secondary sources.

REASONS FOR VERTICAL INTEGRATION

The reasons suggested by academics for vertical integration being adopted are many and varied. Economists have concentrated on listing the specific factors that are likely to encourage firms to integrate vertically. For example, Alexis Jacquemin summarised the reasons for firms vertically integrating in the following way:

Industries that are characterised by a close technological interdependence between successive stages of production and, moreover, that require a large volume of specific intermediate products or services are...designated for operations of vertical integration. Because of the necessity for recurrent transactions with specialised suppliers (benefiting from accumulated experience). strict quality control, delivery according a precise frequency, and utilisation of complex information under uncertainty and more generally because of close co-operation between users and suppliers, market mechanisms become rather inefficient(1987: 145).

In other words, where the conditions listed above exist, the administrative costs of having the various processes within the boundaries of the same firm are assumed to be less than the transaction costs involved if the processes are carried out by single sector firms, and the products bought and sold on the open market. Oliver Williamson (1975) has argued that the transaction costs are pushed up firstly by the bounded rationality of the firm's management, caused by uncertainty in the environment, and secondly by opportunism on the part of the firm's potential trading partners, when for some reason only a small number of possible trading partners exist. The existence of these two sets of characteristics will encourage 'information impactedness', i.e. communication distortion, which will make the risks of relying on transactions in the market too costly and so lead to vertical integration as the alternative.

In contrast to the approach adopted by economists, organisation theorists have emphasised the control that vertical integration gives an organisation over its environment. For example, Khandwalla has argued that it is a means by which management 'try to insulate the organisation from the external turbulence' of its environment (1977: 334), and Mintzberg has contended that it is used as a means for businesses

...to bring some of the forces of supply and demand within their own planning processes and thereby regulate them...thus the firm can extend its control into its environment, seeking to regulate whatever out there can disturb its routine operations (1979: 327).

REASONS FOR DEINTEGRATION

In the present economic circumstances, however, vertical integration can no longer act as a buffer against the vagaries of the environment. As Peters points out as far as industry is concerned, 'Nothing is predictable...Predictability is a thing of the past' (1987: 9). Changing technologies, changing tastes especially for customised alternatives, and rapidly increasing competition all reduce the ability of vertically integrated firms to control their environments. Thus the predominant advantage of vertical integration in the eyes of organisation theorists no longer exists.

In fact, Peters has argued that in the past the advantages of vertical integration have always been overstated and the disadvantages ignored (1987: 16-17). One such disadvantage is the question of focus. As Johnston and Lawrence (1988) point out most vertically integrated firm started out in one specific process--their area of 'distinctive competences' (1988: 98). When the firm becomes integrated this can become a liability because 'the strong culture that supports that focus makes it hard to perform tasks that require distinctly different orientations and values' (Johnston and Lawrence 1988: 99). Another disadvantage of vertical integration is that the administrative costs rise steeply--due to the increase in the size of the firm. As organisations grow larger so the opportunities for problems of communication distortion and information impactedness to affect their performance adversely increase. In order to reduce the risk of this occurring and to ensure that the work of the firm gets done satisfactorily--'to ensure the machine like consistency that leads to efficient production', and 'to ensure fairness to clients' (Mintzberg 1979: 83) without requiring constant communication between management and workers - various 'coordinating mechanisms' are developed. These include such features as direct supervision, the standardisation of work process through the creation of formalised rules and procedures, and the standardisation of output whereby the anticipated level of performance of each employee in terms of output, revenues, costs, material usage and so on is pre-ordained (Mintzberg 1979). These coordinating mechanisms require the employment of a considerable number of supervisory and technical employees--work study people, training officers, cost and works accountants and so on--and their staffs (collectively termed the 'technostructure' by Mintzberg) both to install and maintain. All of this pushes the firm's administrative costs upwards. Added to this are the costs of providing for the indirect services needed to maintain the goodwill of the workforce, usually in the form of a greatly expanded personnel function. There are also the costs of the dysfunctions caused by operating in this way, particularly as far as flexibility, motivation and employee/client relations are concerned. Finally vertical integration does not provide any opportunities for synergy--in the way that horizontal diversification does--to compensate for the high administrative costs. (Ansoff 1965: 80 and Galbraith 1989: 310).

Whilst the administrative costs of vertical integration have always been high, transaction costs between firms have recently been falling, thanks largely to the rapid diffusion and falling costs of information technology. This can increase the number of potential trading partners available to any firm by providing them with the expertise and knowledge to work closely with each other; it can ensure that rigorous standards of quality are adhered to; and it can enable firms to respond rapidly to each other when required. This technological development has spawned a considerable increase in the numbers of single sector companies, which in turn reduces the chances of any firm in the value-added chain, either supplier or user, behaving purely opportunistically towards any other firm.

Thus, in terms of the relative financial penalties incurred, the administrative costs of vertical integration have increased as compared to the costs of operating through the marketplace. This seems to make deintegration increasingly attractive. However, whilst the return to the traditional method of single sector firms operating through the market might seem logical, it also has its drawbacks. The traditional concept of competing in the market place for suppliers and customers breeds a selfishness in firms. Their main concern is that of maximising their own profits as far as possible. Therefore, instead of treating their trading partners as allies they view them as rivals, and concentrate on trimming their own costs at the expense of their partners. As Johnston and Lawrence point out:

If a company perceives a trading partner as an adversary, it may ship shoddy materials, squeeze margins, delay payments, pirate employees, steal ideas, start price wars, or corner a critical resource--all practices that reveal a lack of concern for the supplier's or customer's wellbeing (1988: 98).

These arguments imply that there are only two ways for firms to operate to ensure the fulfilment of the value-added chain: either through competing in the market place or through vertical integration. However, as Jacquemin points out, it is more realistic to consider these as the two extremes of a continuum and that a variety of inter-firm and intra-firm structures exist in between. (1987: 147).

VALUE ADDING PARTNERSHIPS

VAPs have been identified as one such interfirm structure. According to Johnston and Lawrence, a VAP may be seen as

...a set of independent companies that work closely together to manage the flow of goods and services along the entire value-added chain. It is an organisational form much like the putting-out system of the early industrial revolution, whereby manufacturing was done in cottages and coordinated by a merchant-manufacturer who supplied the raw materials and sold the finished product (1988: 94).

In VAPs individual companies co-operate with each other: they appreciate that they have a stake in their partners' success, and that the financial soundness of their trading partners is of paramount importance to their own performance. They realise that they share common goals. They provide information for each other. They operate therefore through a system of close co-ordination for the benefit of all the members of the VAP. To a large extent successful VAPs rely on 'the attitudes and practices of the participating managers', who appreciate the importance of 'the relationships along the entire value-added chain and the need for each link in the chain to be as strong as possible' (Johnston and Lawrence 1988: 94 and 96).

Furthermore, since VAP members are usually single sector firms they can bring their own distinctive competences and focus, so often lost in vertically integrated concerns, to bear in their operations. Overall it can be argued that VAPs combine many of the advantages of vertical integration--for example facilitating a certain degree of planning, research and development, sharing information, and economies of scale--with those of smallness including fewer administrative costs, greater flexibility and adaptability, closer personal relations, less problems of motivation, easier control and improved focus.

The concept of VAPs (if not the name) is by no means new. Writing in 1967 J.K.. Galbraith commented on the mutual advantages for firms of establishing long term contracts with each other (1969: 40) A year later Drucker noted that Increasingly major organisations farm out to each other the very performance of their own functions. Increasingly each organisation is using the others as agents for the accomplishment of its own tasks (1967: 166).

In 1976 Herbst talked of organisational networks of which the basic characteristic is 'the maintenance of long term directive correlations, mutually facilitating the achievement of a jointly recognised aim' (1976: 33). More recently Morgan has identified an organisational structure called the 'loosely coupled network', which

...has a small core of staff who set a strategic direction and provide the operational suppon to sustain the network, but it contracts other individuals and organisations to perform key operational activities (1989: 67).

Handy describes a similar organisation structure which he classifies as a 'shamrock organisation' which consists of a small full-time organisational core, the contractual fringe and an abundance of part-time and temporary employees (1989: 72-81). The core and the contractual fringe are in fact value-adding partners. The advantages cited for this system over the traditional organisation structure include the fact that the threat from a slump is dissipated by spreading the risk over several firms (what Handy (1989: 74) refers to as 'exporting the uncertainty'), and that the core organisation only pays the contractual fringe 'for results, not for time.' (1989: 77).

EXAMPLES OF DEINTEGRATION AND THE FORMATION OF VAPS

Handy implies that the contractual fringe is often made up of ex-employees who have been laid off by the core organisation and then contracted by it to carry out work for it (1989: 77-78). In Northern Ireland the dairy industry provides an example of this very process. Until recently the dairies bought their milk from farmers at prices set by the Milk Marketing Board. They then processed it mainly into liquid milk. For example in 1964 Northern Dairies had nine plants all producing liquid milk (Business Telegraph, 16.4.1991). The milk was then delivered to the customer, usually the final consumer at prices set by the Milk Marketing Board. In the days before mass refrigeration was common, the dairies employed full-time roundsmen to ensure rapid delivery of the milk to the consumers' doorstep. This method of operating remained the norm until 1984/5, despite considerable changes in the industry. Firstly, demand for liquid milk began to fall, largely as a result of an increase in demand for soft drinks. (Sales of milk have been declining for the last ten years, although in 1989 there was a slight rise on the previous year [Business Telegraph, 5.3.1991). The dairies therefore diversified into other products--yoghurt, cheese, butter, ice cream, lollies, pre-packed salads and now even 'fromage frais' (Business Telegraph 16.4.1991 and 26.3.1991). Thus in 1989 only 14 percent of the milk bought by the dairies was used for liquid milk (Belfast Telegraph 9.8.1989). A further change has been the rapid increase in refrigerated space in shops and supermarkets, facilitating the sale of milk through these outlets. Indeed, in 1989 a quarter of the province's liquid milk was sold through supermarkets (Belfast Telegraph, 9.8.1989). Finally, qualified drivers are no longer as scarce as they used to be. Thus the dairies are no longer constrained by the 'smallness of numbers' of potential milkmen qualified to drive as they were in the past.

Under these circumstances in 1984/5 the dairies decided to lay off their roundsmen and enfranchise them as self employed milkmen, thus in effect creating a number of VAPs. The VAPs consist of the farmers who provide the milk , the dairies who buy it and process it and sell it to the roundsmen, the Milk Marketing Board which still sets the price of unprocessed milk and now recommends the price to be charged to the final customer, and the Dairy Council for Northern Ireland which 'represents the processors and producers of milk' and is responsible for its marketing (Business Telegraph, 5.3.1991). This body has recently embarked on a major advertising campaign 'supporting doorstep delivery of the pinta'.

The creation of these VAPs has provided benefits for both the dairies and the milkmen. The dairies have benefited from reduced costs in several areas. With fewer employees there is less administration to be done, and less labour welfare costs to pay. Control of the milkmen is now through the price recommendationary mechanism rather than by supervision or by specifying the customers for each roundsperson. At the same time demand for milk delivered to the door has in no way been diminished by the change. As for the milkmen, they have gained from greater freedom and flexibility as well as financially. Such matters as when to deliver the milk and to collect the money and how many assistants to have are now their own personal decision. Yet they can still rely on the dairies to provide the milk, on the Milk Marketing Board to recommend prices, and on the Dairy Council to promote their product and their role.

Another very similar set of VAPs was created by Moy Park Ltd, one of the largest poultry producers in the United Kingdom, which sells processed poultry products to such supermarket chains as Tescos, Asda and Waitrose in Britain and to Stewarts in Northern Ireland. Its headquarters are situated in Craigavon; and it has two modern hatcheries in Northern Ireland and one in Yorkshire; two processing factories in Northern Ireland and one in Southport; a factory in France; and its sales and marketing 'nerve centre' in Crewe. The number of people employed directly by the firm has risen from 1500 in 1985 to 2000 in 1990, 1100 of whom are in Northern Ireland (Business Telegraph, 10.12.85 and 4.12.90). It also provides work for 800 others indirectly (Belfast Telegraph, 19.4.88). Its turnover has increased from L60 million in 1987 to L60 million in 1990 (Belfast Telegraph, 19.4.88 and Business Telegraph, 4.12.90).

Until 1984 Moy Park had been part of the Courtaulds Group and was losing money heavily. In that year Courtaulds decided to divest and sold it to the then management team. A five year plan of restructuring the organisation was then introduced. The firm claims to be an 'integrated food production' concern 'beginning with the elite breeding stock, which leads to parent stock, then to broiler chickens' (Business Telegraph 4.12.90). However this is not completely accurate. One aspect of the restructuring was the laying-off of the farmers who had previously been employed to tend the broilers. As Anne Ferguson points out:

One quality that distinguishes Moy Park from its peers is that instead of owning broiler houses it contracts farmers within a twenty mile radius to grow for it (1988: 79).

The farmers are sold day-old chicks which have been specially bred to Moy Park's specifications--originating as hatching eggs from Ross breeders, which become the grandparents of the broilers that the farmers buy. These are very pure in strain, disease free, and with the large flat breast structure and white meat that consumers demand. Moy Park also provides the feed for the birds (Ferguson 1988: 79). According to the production director, Eric Reid the system works as follows:

We pay a base Grade A price plus a bonus for good farming. They (the farmers) don't get anything for birds below that grade. This stops all the bad farming and monkeying about...Over my dead body would I go back to managed houses. This way there's no guaranteed wage of any description--they are totally self-motivated and have total ownership (Cited in Ferguson 1988: 79).

There are clearly similarities between the milk roundspeoples' and the broiler farmers' situations. Both have changed from being full-time employees to being self-employed small businesses, with a very close relationship with their former employers. Both know precisely what results are expected of them by their VAP partners. Both have been trained in the way to do the job during their years as employees of their respective companies. Neither have any worries about the quality of their inputs--this being guaranteed by their VAP partners. Finally, both have made available to them the means of providing themselves with the required capital to carry out their tasks satisfactorily. The milk roundspeople can either hire their lorries from the dairies or buy them outright; while Moy Park provides small grants and 'puts in a good word for a grower with his bank' if he/she needs money either to maintain a broiler house or to build a new one (Ferguson 1988: 79).

Where conditions such as these do not exist, however, the creation of VAPs is less probable. For example, television is an industry in which the core organisations have increasingly become single sector firms. Ten years ago the majority of programmes shown on British television were produced by the television companies themselves. Now, however, a large number of them are made by independent producers. At present more than ten independent programme making concerns are operating in Northern Ireland. Some of these, like Brian Waddell Productions, have been formed by ex-employees of the local television companies, yet there has still been no discernible evidence of VAPs developing between them and the television companies. Indeed, the independent producers spend a great deal of time and energy trying to get partners, both to help pay for their proposed projects and to screen them (Business Telegraph, 7.4.91). Suggested reasons for the lack of development of VAPs in this area include the non-routine nature of the work of the producers, and the problems for the television companies of trying to ensure the quality of the inputs and in specifying the desired end results.

OTHER METHODS OF CREATING VAPS

The VAPs identified here have been created by vertically integrated firms laying off employees in one specific part of the process, and contracting them individually to do the work that they were previously employed to do. However, it is equally possible for a firm to divest of a process as a unit and then to become a value adding partner to that unit. Management buy-outs are one way of achieving this. This method of VAP creation is particularly useful when the capital requirements for doing the job are beyond the means of an individual. Indeed, VAPs need not be derived from vertically integrated firms at all. They can just as easily occur from the coming together of a number of single sector concerns who realise the benefits of operating in this way. For example since the early 1950s Desmond's, the major Northern Ireland clothing manufacturer has built up a very effective VAP with Marks and Spencer (Business Telegraph, 19.11.85). Similarly, Henderson's, the grocery wholesaler has recently become sole provider for all the Spar and VG stores in Northern Ireland. (Belfast Telegraph, 12.4.91). Again, Shorts, the plane maker which was sold to Canadian multi-national Bombardier in 1989 has established a very close relationship with Maydown Precision Engineering investing L4.5 million in it in March 1991. Maydown provides 'quality machined parts' for Shorts (Belfast Telegraph, 21.3.91).

As already noted, the use of VAPs in business is not new. Where vertical integration is illegal then such an inter-firm relationship is commonplace. For example, in the property business prior to the passage of the Building Societies Act in 1987, most estate agencies were partners in a VAP with a building society or insurance company. With the passage of the Act restrictions on building societies and insurance companies owning estate agencies were lifted, and many estate agencies were swallowed up by their financial partner. In Northern Ireland the most successful example was the takeover of Brian Morton's by the Halifax Building Society. However, other take-overs were less successful. The buy-out of Ulster Property Sales by the Nationwide Anglia Building Society was the first to take place in Northern Ireland after the Act came into operation, but it was an unmitigated disaster or the building society; within two years the estate agency had been sold back to its management team. (Business Telegraph, 26.2.1991) Moreover, the relationship that existed between the two companies prior to the take-over had been destroyed and could never be rebuilt. In 1991, therefore, Ulster Property Sales was appointed Northern Ireland representative for Hambro Guardian Assurance--thus creating the potential, however, for the creation of a new VAP.

CONCLUSION

The concept of VAPs--as an inter-firm relationship which combines many of the advantages of vertical integration with the benefits of small firm size--might seem very appealing to managers struggling to cope with the problems facing large organisations today. However, both Johnston and Lawrence (1988: 100) and Handy (1989:91) agree that this type of working relationship can be very difficult to maintain. If it is not handled satisfactorily, suggest Johnston and Lawrence (1988: 100) it can easily either degenerate into anarchy or revert to vertical integration. How this can be prevented bears examination in its own right.

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Emily Boyle, lecturer in the Department of Marketing and Business Organisation, University of Ulster at Jordanstown.

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