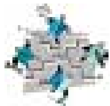


Virtual integration

Managing value chain in the digital economy

Vadim Kotelnikov

What Is Virtual Integration?

Virtual integration is a new form of value chain management. Under such a system, the links of the value chain are brought together by informal arrangements among suppliers and customers. Shipments of the components that your firm needs can be easily arranged through the Internet or a networked computer system. The same type of arrangement allows you to fully serve your customers in ordering, services, or any other needs.

Virtual *versus* vertical integration

In the past, organizations attempted to extend their control by 'hard wiring' key suppliers into vertically integrated supply chains. Using the full capability of e-business, there is now the potential to revolutionize the way supply chains are configured and managed. The new paradigm is one of 'virtual' supply chains, made up of loose affiliations of companies, organized as a supply network, where physical assets are replaced by information. However, to make the new paradigm work, information must flow seamlessly within and across the organizations that make up the virtual supply chain. Even with the phenomenal growth in e-business, there remain barriers, both internal and external, to implementing these information flows.

Vertical integration is history, the future will be about virtual organizations operating within virtual supply chains. In all sectors e-business is increasing the pressure for supply chain responsiveness. Many of the pressures that organizations currently face can be grouped into a general category of 'increased demands and more of them:

- Ever more demanding customer requirements - not only concerned with reduced costs and shorter lead times, but also increasingly focused on requirements for product and service offerings, tailored to an individual customer's requirements.
- Ever increasing competition - not only because of easier market entry, enabling new entrants to steal significant market share at the expense of unresponsive existing suppliers, but also because e-business now gives opportunities for customers and suppliers to bypass traditional supply chain structures.
- Ever increasing volumes and velocity of information - the requirement to gather, process and act on massively increasing volumes of information in a rapid and intelligent manner.[2]

Virtual integration, as opposed to traditional vertical "contractor-subcontractor" integration, represents the decomposition of the traditional company. Virtual integration is characterized by culturally different value-added relationships between manufacturers and suppliers. In the new world of virtual integration, no matter who signs the check, all the people are working together for a common cause. Vertical integration performs, virtual integration innovates.

Vertical *versus* virtual integration

- Vertical integration **performs; and**
- Virtual integration **innovates.**

Case in point: Dell Computer Corporation

When Dell Inc. first began using the Internet to expand their business, the company had three basic objectives:

- To make it easier to do business with Dell;
- To reduce the cost of doing business with Dell; and
- To enhance customer relationships.

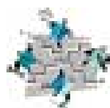
Starting in 1996, by 1999 Dell was selling more than $ 35 million per day over the Internet. "But, for Dell, online commerce was only the beginning," writes Michael Dell[1], the Founder & CEO of Dell Computer Corporation. "Because we viewed the Internet as a central part of our IT strategy, we started to view the ownership of information differently, too. Rather than closely guarding our information databases, which took us years to develop, we used Internet browsers to essentially give that same information to our customers and suppliers - bringing them literally ***inside*** our business. This became the key to what I call a **virtually integrated organization** - an organization linked not by physical assets, but by information. By using the Internet to speed information between companies, essentially eliminating inter-company boundaries, it would be possible to achieve precision and speed-to-market for products and services in ways not dreamt possible before. It would be **the ultimate business system** for a digital economy."[1]

Virtual integration: Action areas

- **Integrate into customers' operations:** To increase customer value addition and differentiate yourself from your competitors, integrate yourself into your customers' operations. The more of your customers' work you undertake, the harder it is to find the line that separates you from them.
- **Use the Internet to transform the processes** that link you with your customers, suppliers and other alliances, and **work intimately** with them to reduce distinctions from them.
- **Converge your core competences and outsourcing**. With virtual integration, flawless coordination of outsourced processes, such as product design or coaching, can be achieved, so that operations of different companies are intertwined and cannot exist independently.

Bibliography

1. "Direct from Dell", Michael Dell with Catherine Fredman, 1999.
2. "From vertical integration to virtual integration", Jeremy Hammant, 2002. ❐



Come together

Key issues in strategic alliances

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Strategic alliances have become a favoured tool for corporate growth in the global economy. It is estimated that more than 10,000 strategic alliances were formed among businesses worldwide in 2000, and that the number of such alliances in the USA has grown by 25 per cent each year since 1987.

A strategic alliance among two or more parties - creating either a separate joint venture entity or a contractual arrangement providing for product development, research, distribution, marketing, investment, or intellectual property licensing can be a quick and effective means to increase market penetration, reduce costs and gain access to new business capabilities. However, strategic alliances are hardly foolproof: approximately half of all alliances fail, mainly because the parties involved did not clearly agree on goals, objectives, level of commitment, or provide flexibility in dealing with future contingencies. A clear understanding of the key negotiating issues involved in the creation of the most common alliance types can do much to ensure that the parties' goals are met.

In most business transactions, the role of the lawyer is to button down every contingency that might arise. In the light of how rapidly market conditions can change, this focus is short-sighted. In the context of a strategic alliance, both the lawyers and the business people should focus on creating an alliance relationship within an elastic framework that allows the alliance parties to have a long-term relationship that is adaptable to changing market conditions.

Key issues common to most alliances

Some strategic alliances include an equity investment by one alliance partner in the other. A strategic investor typically has different investment objectives from a venture capital investor, and may focus more on operational than financial issues, such as negotiating a low valuation for the venture or securing a return on its investment. Typical concerns of strategic investors will include access to the technology, observation rights or advisory status on the venture's board of directors, or a right of first refusal on any future acquisition of the company, its technology or issuances of stock. While all these concerns may be valid for the investor, the other participants in the venture may well object to them. The key to resolving these disputes is to weigh the size and attractiveness of the investment against what rights can reasonably be granted.

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Licence arrangements

Strategic investors are often interested in a licence of technology as part of the strategic alliance. Licence agreements should be viewed in the context of the various competitive and financial issues raised previously, but they also raise a host of very specific concerns, such as:

- Exclusivity
- Scope of use
- Duration of the licence granted
- Ownership of derivative technology
- Infringement claims
- Timing of royalty payments; and
- Training and warranty issues in the use of the technology licensed.

Conclusion

A well-conceived strategic alliance gives the partners a flexible framework to pursue business opportunities in a way that is mutually beneficial to each partner. Given that half of all alliances fail to achieve their goals, proper planning from the outset can help ensure that the alliance partners meet their goals and take full advantage of all the strengths that a focused strategic alliance can offer. ❐

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