Opportunities for Action

Taking Care of Brands Through Vertical Integration

Esprit, H&M, Zara, and other vertically integrated brands have captured significant market share over the past few years, growing more rapidly than traditional manufacturers and retailers. By controlling the whole value chain, from manufacturing to retail—and thereby blending product and retail identity—vertical brands can offer attractive economics. With traditional retail channels on the decline, many manufacturers—especially those in textiles, furniture, leather goods, sporting goods, and luxury goods—are choosing vertical integration as a way to better manage their brands.

There are, however, many approaches to vertical integration. To get a closer look at the risks, benefits, and best practices of the various approaches, The Boston Consulting Group conducted a detailed survey among a number of leading brands. This article presents highlights from that study.

Why Vertical Integration Now?

In a traditional business system, the producer controls product design and development, manufacturing, selling and distribution to retailers, product service, and advertising, whereas the retailer is responsible for store concept and design, store management, product assortment, visual merchandising, and selling to consumers. But traditional retailers, especially department stores, are facing formidable challenges these days. Caught between two types of competitors—specialty boutiques on one side and discounters on the other—their brands are hard-pressed to give the products they carry the attention they need or deserve. All too often, consumers find overflowing shelves, messy salesrooms, out-of-stock merchandise, thin assortments, illogical floor arrangements, and a lack of service at the point of sale. Brand identity—a manufacturer’s most precious asset—is severely compromised or completely lost in such an environment.

What’s more, manufacturers complain that despite the prevalence of electronic data interchange, retailers typically fail to provide them with useful information about inventory turnover, price realization, and sales by product group. Given these frustrations, the solution for an increasing number of producers is to seek more control over the fate of their brands by moving into the retailing side of the value chain. After talking with senior managers at companies that have chosen this option, we compiled a comprehensive set of criteria that other manufacturers might use to assess their opportunities for vertical integration. (See the exhibit “Success Factors for Vertically Integrated Brands.”)

But retail, as the industry saying goes, is detail. Even if you decide that vertical integration is right for your company, getting all the parts in place is incredibly challenging. That’s why manufacturers should look at the whole range of approaches to vertical integration and assess the opportunities and risks in light of their own strengths and weaknesses.

Advantages of Vertical Integration

In a traditional store, a consumer is unlikely to pick two products of the same brand off a rack displaying several brands unless the labels are prominent. But at a Benetton, Ikea, or Geox store, for example, choosing the brand of a single manufacturer is unavoidable because store brand and product brand are one and the same.

Vertical brands also have a promotional advantage. One advertisement can serve both the product and the store, and vertical brands can
attract consumers with prime store locations, pleasing store designs, and the free publicity such stores often provide. And because the brand’s owner controls the entire value chain, it can avoid delays and friction costs between production and sales. As a result, vertical brands can respond very rapidly to changes in demand, which gives them an especially strong advantage in fashion goods and fresh foods.

Finally, vertical brands are unique in their ability to offer a harmonious brand gestalt and consistent product positioning. Owners of vertical brands can ensure that their products are sold in the right environment, with the right visual merchandising—specifically, with consistent colors, lighting, and other design elements in all their stores and consistent packaging for all their products. And they can provide coherent, comprehensive product offerings with no redundancy. But whether a manufacturer chooses to set up shop in a store of its own or in a corner of another retailer’s store—or to do some of both—is a decision that requires careful consideration.

### Vertical Integration with a Retail Partner

Vertical integration doesn’t necessarily involve opening one’s own store. Shop-in-shops (SiS) and concessions are two formats that allow manufacturers to continue to benefit from the retailer’s traffic while capitalizing on the advantages of vertical brands. The SiS approach—in which a portion of a retailer’s store is dedicated to a particular brand—has become much more common over the past five years. It gives the manufacturer greater control over the presentation of its brand, but the traditional division of responsibilities between retailer and manufacturer remains unchanged. Retailers still purchase the merchandise and bear the inventory risk. Manufacturers are still at one remove from consumers. Instead of gathering insights for innovation or merchandising directly from consumers, they must depend on the retailer to provide such information, which often is not forthcoming.

Consequently, more and more SiS manufacturers are moving to the concession format. Under this model, too, some of a retailer’s store is dedicated to a specific brand, but the manufacturer bears the full risks of inventory. Manufacturers
can also employ their own personnel, use their own data systems, and enjoy many of the benefits of vertical integration.

Many companies view the SiS and concession formats as win-win opportunities for manufacturers and retailers alike, offering advantages in sales productivity and selling competence for both parties. Indeed, some brand producers that migrated first to directly operated stores have since streamlined their outlet portfolios and are now focusing on SiS and concessions instead.

Vertical Integration with Directly Operated Stores

A number of manufacturers have found success by establishing their own directly operated stores. These run the gamut from factory outlets on the discount side to standard stores to flagships on the high end. Of the three types, flagship stores seem to be what every CEO dreams of. Whether it’s Calvin Klein in Paris, Jil Sander in New York City, Dolce & Gabbana in Los Angeles, or Versace in Miami, these showy palaces—which display the brand as a work of art—create a lot of buzz in the shopping world. And because flagship stores can deliver the full brand experience through spectacular visual merchandising, extraordinary customer service, and breadth of product assortment, they attract other retailers that may want to carry the brand.

Although some manufacturers worry that integrating into retail may create a conflict of interest with other retailers they supply, in fact it often proves an advantage because it creates a brand platform that increases sales everywhere. A strong concept can keep consumers coming back and provide an opportunity for deeper market research. Because contact is direct and immediate, manufacturers can acquire valuable consumer insights to improve their products.

But flagship stores are expensive, and many of them are not profitable. Their pricey interiors mean high depreciation, their prime locations mean high rents, and their attentive service means high personnel costs. They can have nearly three times the selling space of a standard store, with only double the sales. Not that these stores can’t be worth the investment: successful flagships contribute enormously to a brand’s image and therefore indirectly to sales. But from a financial perspective, they ought to appear in the marketing and communications budget rather than in the profit-and-loss statement.

Success Factors for a Directly Operated Retail Store

Directly operated stores often realize gross margins higher than those of either traditional retailers or other vertically integrated formats because they control the selling process through their own staff. But before a manufacturer opens such stores, it must decide on the degree of centralized management that it wants to establish. The advantages of centralized decision making include uniformity in visual merchandising, product assortment, service level, and personnel training. The manufacturer can determine which products will have priority in which of its stores, forecast sales demand with greater ease, and benefit from economies of scale.

But too much centralization can shortchange regional preferences, undermine the motivation of local managers, and increase the cost of monitoring. In general, we have found that both high-end and discount stores fare better with centralized management of merchandising, product assortment, and sales planning. Midrange stores often do better with more freedom at the regional level.

Because they control both production and retail, managers of successful directly operated stores can take advantage of a pull-driven system in
which they can quickly follow up on consumers’ responses to their products. By segmenting their product assortment into established products that are continually replenished, seasonal products, and new products whose appeal is being tested, they can ensure that they are providing consumers with the products they want, at the right time and price, with no out-of-stocks.

Directly operated stores can also be a platform for diversification into other categories. Montblanc, for example, opened its own retail stores in 1990 to sell writing instruments (its core product category), then launched a line of leather goods in 1995, jewelry for men in 1996, watches in 1997, fragrances in 2001, and jewelry for women in 2005. Starting with one store over a decade ago, Montblanc has developed into a retail network of more than 250 directly operated stores around the world—one of the largest networks in the luxury industry.

Because vertical brands have both a retail and a product identity, the quality of interaction with customers can be a key source of competitive advantage—but it also has the potential to cause problems. The store environment, the skills of the salespeople, and any printed materials that are distributed can all affect the brand’s identity. Managers must have the ability, in particular, to attract and manage a talented sales staff. That requires an incentive plan that stresses both the development of skills and the monitoring of individual goals.

Franchising can be a smart move for established vertical brands. In a franchise, two legally independent partners agree to cooperate. The franchisee pays for the use of the brand, for sourcing, and for both the product and retail concept. The franchise fee depends on product turnover. The franchise owner provides the concept and training as well as support and advertising. Franchising generally permits more rapid growth than a directly operated store, but it can compromise the brand image if it isn’t managed carefully. That was the experience of Benetton, for example, which entered the United States with franchises and has since moved increasingly to directly operated stores. But many others have found success with franchises, including Accor, Esprit, Levi Strauss, Marc O’Polo, McDonald’s, Starbucks, Tom Tailor, and Yves Rocher.

Many manufacturers are coming to realize that their brands are too valuable to be left for others to manage at the point of sale. Vertical integration offers many options, with varying levels of risk and opportunity, for manufacturers to explore. Companies should use a formal framework to evaluate their prospects for success with this strategy. The goal is to produce a detailed picture of the gains and pains they will face in moving to retail operations. Manufacturers that make an effort to carefully weigh the different approaches to vertical integration will find it well worth their time.

Berndt Hauptkorn
Joe Manget
Stefan Rasch

Berndt Hauptkorn is a manager in the Munich office of The Boston Consulting Group. Joe Manget is a vice president and director in the firm’s Toronto office. Stefan Rasch is a vice president and director in BCG’s Munich office.

You may contact the authors by e-mail at:

hauptkorn.berndt@bcg.com
manget.joe@bcg.com
rasch.stefan@bcg.com

To receive future publications in electronic form about this topic or others, please visit our subscription Web site at www.bcg.com/subscribe.

© The Boston Consulting Group, Inc. 2005. All rights reserved. 11/05