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BUSINESS | LOGISTICS REPORT

Guest Voices: New Supplier Strategies Revive Important Corporate Questions

MIT's Alexis Bateman writes that vertical integration is gaining favor as companies address quality and sustainability, but it also demands a close look at business priorities



Taylor Guitars used a partnership to bring the manufacturer greater oversight and control of the ebony that goes into the company's guitars. PHOTO: BLOOMBERG NEWS

By **ALEXIS BATEMAN**

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Companies have been vertically integrating operations for many years to gain more control over the supply of key materials. Henry Ford's ownership of rubber

plantations and iron ore mines that provided raw materials for automobiles is a classic example.

The strategy waned in popularity for a time as outsourcing gained favor in business circles, but it is regaining attention as regulatory pressures and the greater focus on materials that go into finished goods put corporate reputations at rising risk. Vertical integration gives companies more control over critical elements of their supply chains, but it also places new demands on corporate leaders as they address questions of how far their companies can go in overseeing all stages of production.

Although much of the recent focus on sourcing has been on issues of sustainability, questions over product quality are also a prominent consideration as companies look at vertical integration.

In 2006, medical device manufacturer Boston Scientific Corp. set up a battery manufacturing operation. The company was so concerned about keeping tabs on the quality of these items, it ceased sourcing them externally.

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The batteries power devices that are implanted in human bodies, and provide lifesaving protection for the heart or soothe debilitating, chronic pain. Safety and regulatory pressures pertaining to product quality prompted Boston Scientific's action. The strategy also led to the development of industry-leading battery longevity.

Sometimes vertical integration is a response to increasing demand from regulators and consumers to make supply chains more transparent. Companies can pay a high price for failing to detect and deal with a growing list of transgressions such as the use of slave labor, food contamination, and environmental malpractice.

Taylor Guitars crafts its popular instruments from materials such as ebony and other exotic woods that are stressed and/or endangered owing to illegal and unsustainable logging practices. In 2011 the company struck a partnership with an international distributor of guitars to purchase Cameroon's largest ebony mill. The move has given Taylor greater control over the harvesting and processing of ebony, as well as continuity of supply and more transparent

production processes. Also, the guitar maker is better able to promote proper working conditions and fair wages, and has bolstered its market reputation.

Palm oil is another material that attracts controversy. Critics accuse producers of causing damaging deforestation and promulgating harsh working conditions. Most companies that buy the material—which is used in a wide range of products—have been largely unaware of the challenges faced by producers, leaving them at risk of being implicated in related supply chain scandals.

Dr. Bronner's, a personal care products company that is adamant about sustainability, uses palm oil in its soaps. The company found that securing a sustainable supply of palm oil is extremely difficult because of the complexity and opacity of the supply chain.

In 2007, the enterprise launched a sister company in Ghana called Serendipalm. The facility employs over 200 people and sources organic palm oil from some 500 small organic farms. The farmers are paid fair prices and price premiums that improve quality of life in farming communities. "There wasn't fair trade palm oil, and so that's why we have a mill in Ghana. It's all small holders and it's all completely transparent," said Michael Milan, chief operating officer of Dr. Bronner's.

The investment paid off in other ways. After the launch of the sustainable palm oil venture, demand for the product climbed. Dr. Bronner's now supplies progressive European brands with the material.

'Vertical integration can carry significant capital costs and the production may not always be aligned with the company's own demands.'

Of course, vertical integration is no panacea for solving supply chain transparency problems, and there are lots of pros and cons to consider.

One benefit is that the strategy can reduce transaction costs that come from dealing with multiple external actors, and it can improve the availability of data as well as communications along the supply chain.

On the negative side, vertical integration can carry significant capital costs and

the production may not always be aligned with the company's own demands. That means a company with a supplier within its own business may still have to use external suppliers or find manufacturing capacity to fill gaps.

Also, the strategy often allows less flexibility and makes it more difficult to switch to new suppliers in response to innovation or other market changes.

Still, managing reputation risk is increasingly important to companies, and regulatory requirements are becoming more stringent, especially concerning social and environmental issues.

So it's likely that more companies will decide that for certain key supply chain operations, it's better to do it yourself if you want it done right.

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