Vertical Integration in Luxury Companies: Objectives and Effects

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Abstract

This paper analyses the causes and the consequences of the deep movement of vertical integration that occurred during the last thirty years in luxury fashion companies. Starting from ten case studies, we show that luxury fashion firms are more and more involved in the fields of production (mostly for finished products, but also in raw materials) and distribution. We discuss the explanations provided by the companies to explain their choices of integration and refer to the economic theory to highlight other arguments that can explain this evolution. We then examine the consequences of vertical integration on market structure and strategy in the luxury fashion sector.

Keywords: Luxury, Vertical integration, Upstream control, Retail, Corporate strategy, France, Italy.

Introduction

The luxury market has experienced an impressive development during the last three decades. The figures provided by Bain & Company show that sales of luxury products passed from 72 billion euros in 1994 to 168 billion euros in 2010[i], that is to say an average annual growth rate of 5 %. Luxury fashion products (ready-to-wear, shoes and leather goods) still have a considerable share since they represent half of this amount. In addition to its economic weight, the sector of luxury fashion deserves to hold the attention of researchers because of the evolution of its structures (number, size and organization of the companies) in recent years. More than jewelry companies, watchmakers or perfume producers, the companies whose core business is fashion have experienced very major changes in their organization and strategies. The major players of the market tend to increase their international presence, to be more diversified, as well as to be more vertically integrated than during previous decades. It is this last strategic trend which is the object of this paper. Our objective is to show through a series of case studies the causes of this process – which can come from the evolution of the basic conditions of the market or from a deliberate strategy of the actors to evolve their business model - and its effects on the operation of the luxury sector.

A company is said to be vertically integrated when it is present at several successive stages of the production process of a product. Nevertheless, many works have specified the various methods of integration, which are much more complex than the simple possession of 100% of two successive phases of production. Harrigan (1984) describes the various levels of integration implemented by the companies, from complete control to total disintegration via intermediate levels where only selected stages of the production process are integrated, or the alternative forms of control to the property (quasi-integration, restrictions vertical…). This grid of analysis better corresponds to the diversity of practices observed.

Schematically, in the case of luxury fashion, one can define four phases in the realization of a product:

1. Creation, design,
2. Raw materials production (fabric, leather…),
3. Final product manufacturing (apparel, handbags, shoes),
4. Distribution, through wholesale and retail.

We are conscious that this important simplification leads us to set aside multiple essential divisions of the company (such as quality control, communication…) to concentrate only on the activities obviously necessary to the manufacturing of the product. If creation is the main activity and goal of all luxury fashion companies, we will highlight that most of them have from now on an increasing involvement in the production sphere, in a direct or indirect way, and in distribution. Certain firms among the most well-known are in addition already involved in the raw material supply, primarily in leather tanning. In the rest of this paper, we will call “upstream control” the involvement in raw material or finished products production and “downstream control” the involvement in retail distribution.

The basis for this paper is a monographic analysis of French and Italian luxury companies undertaken for our current PhD thesis at Paris-Dauphine University as well as a series of studies carried out by the expertise division of the Institut Français de la Mode (French Institute of Fashion). The choice of this approach is explained by the fact that the luxury sector is not like others since it includes part of other sectors (clothing, accessories…) and does not have true existence as an aggregate. The nomenclatures, which define the contents of the statistical data being used for the scientific validations of the economic theories, ignore this, which complicates any statistical work on luxury. We have to mention that the availability of data in a sector where the culture of secrecy is important makes it even more complicated. The primary sources of these monographs are the literature available on companies (works, annual reports, case studies, press) supplemented by semi-directed interviews for certain companies that agreed to answer our questions.

An originality of the luxury industry

Many authors mention an increasing disintegration of the companies during recent years concurrent with a series of evolutions at individual and global levels. While being based on the example of data processing, Quelin (1997) raises five factors that have incited the companies to massively outsource part of their activities to third party companies.

1. Centering on the strategic activities. Only the functions contributing significantly to the competitive advantage of companies will remain in house.
2. Economies of scale and of costs. Quelin notes that "in certain cases, the economies of scale are reached much more easily by the service provider than by the user". A subcontractor agglomerating the orders of several clients would be thus able to produce more efficiently than if each client had its own manufacturing units.
3. Policies of reorganization. The companies tended overall to be centered on their core business and to yield the activities having little to do with it.
4. Technological mutations. In periods marked by quick technological changes, companies can privilege outsourcing in order not to support the risk of an investment in a technology whose future is not assured.
5. The globalization of markets. It involves a redistribution of roles between firms, since they now have to face a more aggressive competition. Moreover, there is a strong link

between economic globalization and foreign subcontracting, as it has been showed by McLaren (2000).

These strategies were developed in a context where the macroeconomic environment was in full upheaval. In the fashion sector, except luxury, the increasing integration of the economies has considerably changed the organization of value chains. Nowadays, most companies preserve in-house only the essential activities for creation of value and its perception by the customer (design, distribution) and outsource the phases of manufacturing to subcontractors located in countries with low costs of labor (in the Mediterranean zone or Asia).

The fact is that the luxury sector was in counter-current to this movement. Indeed, the companies tend towards an increasing integration on several levels of the production process.

Our thesis work focuses on twenty case studies of companies. In this paper, we present ten of them that seem to us significant of this change. These companies have different countries of origin, founding dates, specializations and sizes.

Table 1 – Upstream control by the luxury companies: expressions and motives

Enterprise	**Group**	**Raw materials sourcing policy**	**Manufacturing control**	**Explanations provided by the company**
Louis Vuitton	LVMH	The monogram canvas is outsourced. The company recently set up les Tanneries de la Comète, a tannery in Belgium. Fabric is outsourced	12 production plants in France for trunks, handbags, small leather goods, 3 plants in Spain for small leather goods, 2 plants in the USA, 4 workshops in Italy for shoes. Apparel manufacturing is outsourced	The necessity to serve a fast-growing demand and to maintain quality
Christian Dior Couture	Christian Dior	Mostly outsourced. The company pre-orders its leathers long before their use (from six months to one year) to reserve the best quality	5 production plants for handbags and shoes located in Italy and exploited with local partners. The company bought back its licensee for childwear (Baby Dior) and own production plants in France and Thailand. The couture workshop still exists but ready-to-wear is outsourced, such as shoes	Concerning Baby Dior, the company argues that this activity has a strong potential in terms of image and turnover
Hermès	Hermès International	The company owns 6 production plants for textiles and four tanneries. It also has minority participation in the silk fabric maker Perrin	The company also controls 11 production plants for leather goods. Ready-to-wear is outsourced	The guarantee of the best quality, the necessity to train craftsmen for years before they can work for the company

Enterprise	Group	Raw materials sourcing policy	Manufacturing control	Explanations provided by the company
Yves Saint Laurent	PPR (Gucci Group)	Outsourced	Gucci group bought back Mendès in 2000. Mendès was the exclusive licensee for the production of YSL ready-to-wear and owned 25 directly operated stores	Control of the whole process of product development and of the distribution
Armani	Armani	Outsourced	The company owns production plants for apparel, shoes, handbags, knit, denim and children collection	Quality control and know-how
Gucci	PPR (Gucci Group)	Outsourced. Gucci has around 200 main suppliers for handbags components, 267 suppliers for shoes components	The company has three workshops (Casellina for leather goods, Baccio for shoes and Novara for womenswear) but its employee focus on product development and finish control. Production is realized by many subcontractors: 500 for handbags, 26 shoes factories of which 4 are controlled by Gucci	Direct control of quality, cost, timing, shipping, inventory
Bottega Veneta	PPR (Gucci Group)	Outsourced	The company owns production plants for accessories and partially shoes and ready-to-wear	Quality, know-how, knowledge protection
Tod's	Della Valle Group	Outsourced	The company produces a large majority of its products (shoes, leather goods) in its own plants. Casual clothes, jewelry and sunglasses are outsourced	Quality control, efficiency, brand prestige
Salvatore Ferragamo	Ferragamo	Outsourced (more than 450 suppliers)	For shoes, bags and ready-to-wear, the company relies on a network of small workshops, all located in Italy. It focuses on product development and quality control	Flexibility, efficiency
Prada	Prada	Mostly outsourced	9 in-house divisions producing knitwear, ready-to-wear, belts, men's and women's shoes, leather ready-to-wear, and handbags. Some are shared with Miu Miu, another brand of the Prada group	Control of production know-how, production costs, flexibility and quality

Sources: annual reports, press, interviews

Starting with upstream control (manufacturing of the models and even in certain cases production of semi-finished products such as textiles and leather), it appears that many companies of the luxury sector now have a clear involvement, sometimes indirectly, in the production sphere. We also can notice that this control is tighter for leather goods producers (handbags or shoes), the manufacturing of clothing remaining largely outsourced.

This higher upstream control took two main forms: traditional vertical integration for certain activities and the end of the license-based exploitation of the brands. In this latter case, companies which were not creating their products any more internalized design, product development, production planning, quality control.

Let us specify that these practices of integration are recent, the majority were implemented during the 1990s and the 2000s. Understanding that its historical workshop of Asnières was no longer able to satisfy the demand for its products, the Louis Vuitton company inaugurated a second workshop in 1977 and has continued to open new production units. Hermès massively invested in its production site of Pantin, which employs dozens of craftsmen, and bought back some French companies such as the Manufacture de Haute Maroquinerie (MHM) or the Gordon-Choisy tannery. Christian Dior put an end to many manufacturing licenses in the second part of the Nineties and set up its handbag division at this time. In the same manner, Gucci and Yves Saint Laurent followed this strategy of total control of the production process and canceled dozens of license agreements.

The arguments used by the companies to justify the integration of certain activities lead nevertheless to some questions. The need to obtain production of high and constant quality or the existence of a specific know-how which cannot be practiced out of the company are true specificities of the luxury sector; yet the examples of integration concern in most cases only a part of the production process and only some segments of products (in general leather goods and accessories). Are the products produced by subcontractors of less quality? The answer is probably negative. In the same way, if integration went hand in hand only with specific know-how, what can we say of Christian Dior who produces its bags but subcontracts its ready-to-wear? According to this reasoning, the leader of Parisian fashion would thus not have specific know-how in clothing except for its activity in haute couture, which is obviously false. We will thus explore in this paper, using the economic theory, the reasons which lead luxury companies to be integrated for one activity rather than another, and to what extent. We will show that economic arguments are clearly a part of the explanation for these choices, as is the environment in which the firms evolve, marked by a weakening of the production sectors in Western Europe.

Table 2 – Downstream control by the luxury companies

Enterprise	Group	Number of directly operated stores (2003)	Number of directly operated stores (2010)	Share of the retail sales in turnover (%, 2010)
Louis Vuitton	LVMH	317	459	>95
Christian Dior Couture	Christian Dior	159	237	81
Hermès	Hermès International	125	193	84
Yves Saint Laurent	PPR (Gucci Group)	58	78	55
Armani	Armani	119	130	68
Gucci	PPR (Gucci Group)	198	317	73
Bottega Veneta	PPR	59	148	85
Tod's	Della Valle Group	95	159	49
Salvatore Ferragamo	Ferragamo	u	312	70
Prada	Prada	u	319	70 (group)

Sources: annual reports, press, interviews

u: Unreported

The situation is even more obvious in the development of the activities of distribution. A large majority of the companies studied carried out a thorough integration of this function during the last years. The share of retail sales largely exceeds that of the external customers (shops, department stores…).

We can add to these forms of direct control all the strategies aiming to secure for the company the good execution of the manufacturing or the distribution of its products by third-party companies (distributors, subcontractors…). One speaks in these cases of "vertical quasi-integration", a situation where market power makes it unnecessary to take over the third party company, as shown by Blois (1972) taking the example of the luxury car sector.

The objectives declared by the companies as being at the origin of this increasing downstream orientation are most frequently the need to have a consistent image and offer, at a global level at a time of massive openness of borders, the guarantee of the best service during and after the sale and a better knowledge of customers. Once again, these explanations do not seem complete to us and we will provide other reasons that push the companies to control their distribution. Also, we will turn to the theory of integration to analyze the causes and consequences of this movement.

Theoretical justifications of vertical integration

The economic theory of vertical integration describes three main arguments which make it desirable for companies: the increase in market power it provides (1), the savings in costs or gains of efficiency it allows (2), the reduction of uncertainty to which it leads (3).

Harrigan (1984) states that the benefits of vertical integration are often studied at the microeconomic level, while being based on the behavior of a single firm, frequently in a situation of monopoly. However, vertical integration also occurs in competition, as a means of differentiation. It consequently also has a strategic dimension in the sense that it guarantees under certain conditions to the companies which implement it an important competitive advantage. This is for example the case of companies which practice double marginalization (or double mark-up). The most studied theoretical case is that of two successive monopolies, a single manufacturer who sells to only one customer. Both apply their margin, maximize their monopoly profit and limit the quantities sold. The existence of only one company, present on the two stages of manufacturing and distribution, will improve well-being in the economy, making it possible for a greater number of individuals to consume at minor prices and the company to have a more important surplus (Tirole, 1988). Firms can also be incited to be integrated downward in order to provide a sufficient promotional effort for their products. Visibility, advice to the consumers, a qualitative environment, and after-sales service have a positive effect on the manufacturer's sales. This can explain why the producer wants to replace an external distributor which will be less sensitive to this objective. Many researchers have given statistical proofs of the positive link between manufacturers' efforts and vertical integration (see for example Lafontaine and Show – 2005).

An upstream integration making it possible to substitute an input coming from a firm in monopoly is also justified in order to avoid dependence on this supplier. Vertical integration is also a means of closing market access while preventing, by the purchase of a supplier, other companies from producing their goods. Salop and Sheffman (1987) analyze the case where a dominant company manages by integration to increase costs for its competitors. We also have to mention all kinds of entry barriers which established firms can set up to prevent or slow down the arrival of new competitors. Integration towards distribution plays a significant role here, as we will see it in the case of the luxury industry.

Concerning economies and efficiency due to integration, several topics have been explored. Bain (1956), who was one of the first authors to show the importance that the processes of vertical integration in the economy presented, focused on the conditions of emergence of companies integrated for technological reasons. He evokes cases of companies led by the interdependence of two technologies to jointly carry out two phases of the same production process. The most frequently used example is the production of steel where the heat released by the upstream activities makes it unnecessary to heat steel for the production of steel sheets. This benefit of vertical integration was the least developed in the economic literature.

On the contrary, the exploration of the multiple economies resulting from integration and the greater effectiveness that it allows led to important efforts of the researchers. One of the most emblematic sources of these works is the transaction costs theory, defined by Williamson starting from Coase's famous article. This theory proposes to compare the associated costs with in-house production by an actor to those linked to the establishment of contracts with companies which can become providers for this good or service. These costs of contracting cover at the same time the traditional costs (land, work, capital, materials…) plus the costs coming from the monitoring of the relation between the two companies (costs of acquiring and processing information, legal costs, organizational costs, costs associated with inefficient behaviors … See Joskow - 1985). Several factors influence these transaction costs which the companies must bear: uncertainty of the behavior of the partner, complexity of the action to be undertaken, importance of the specific investments to make and the possible sunk costs, the frequency of the transactions…

Many theoretical and empirical works tested all of these dimensions (for a complete survey, see Lafontaine and Slade - 2007). The results of these tests, based on different methods and samples, point overall in the same direction. Downstream integration will be more important if the effort of the company to emphasize its products is high; and symmetrically it will be less strong since the distributor shows significant efforts. Vertical integration in most empirical tests is positively correlated with the development of specific know-how by the third-part company (human capital specificity) or of any specific requirement by the client (see in particular Mahoney, 1992). According to the Williamsonian theory, this integration aims to reduce the risk of "holdup" by subcontractors that have become impossible to circumvent. This theory was criticized by Coase and Simon (see Gabrié, 2001). The complexity of the production process is also one of the recognized causes of vertical integration. As for uncertainty, it has a driving role in integration, but only upstream.

Apart from the classical integration, which can appear expensive and not very flexible, the vertical restrictions set up by the companies also enable them to forge advantageous relations with their subcontractors. Because of a greater market power, they can impose their views on a great number of issues (detention of stock by the subcontractor, delivery period, free access to the production site, specifications on the product, marketing policy of the subcontractor…).

Why are luxury fashion companies more and more integrated?

The practices of integration by the luxury fashion companies as they appear in the monographs and the interviews we carried out validate most of these economic theories:

- *Productive efficiency and appropriation of manufacturing margins*. The savings made thanks to backward integration (search for efficiency, integration of the manufacturing margins) have been confirmed[ii]. However, this argument is valid only for the activities where the manufacturers have a positive profit margin, which is only the case for leather goods activity in France. Indeed, as shown by the studies of INSEE (the French statistical agency) dedicated to apparel manufacturers, the latter have posted a negative operating margin for many years (their rate of margin was - 3.3 % in 2007). This may explain besides other elements why the luxury companies do not wish to proceed to repurchases of their subcontractors for apparel. We can also add that the strongest increase of the accessories market (shoes and leather goods) compared to ready-to-wear could reassure the companies on the weak risk to have unused production capacities for these items.
- *Supply assurance of an input*. Still concerning the upstream control, in accordance with the economic theory of the supply assurance, the rarefaction of the manufacturing of leather in Europe could involve the repurchase of tanneries by certain luxury companies in order to ensure their supply. Adelman (1955) had already shown that in a market in strong growth, a firm can be incited to be integrated upstream by fear that the suppliers of intermediate goods are not able to fulfill all its demand.
- *Risk aversion and integration for survival reasons*. A more specific case in luxury and one which can be close to a form of risk aversion lies in integrations carried out to avoid the effective direction ("direction de fait" in French legal terms) of a sub-contracting company. If a customer concentrates a very high share of the turnover of a supplier or if he is deeply involved in management through the directives he gives, the supplier can be turned against him in the event of financial problems. To avoid this

behavior, the customer can be incited to carry out the integration of the company. As confirmed even by certain interviewed professionals, the cases where luxury companies count for more than a half of the turnover of one their subcontractors are not rare, and the rates are sometimes even higher. This is why the risk is far from negligible. Moreover, the many vertical restrictions and the phenomena of quasi-integration are another cause of the risk, since they can prove an involvement of the luxury companies in the management of their partners.

- *Production networks and integration*. Following Chandler (1966) and Arrow (1975), Bolton and Whinston point to the need to consider the overall network of production and distribution to understand the presence of a firm at the levels of production and/or distribution. From this intuition, we detailed the different cases in the luxury industry. Indeed, the clothing, leather goods and shoe sectors all have quite specific characteristics. In France, the clothing sector still has a network of manufacturers, primarily specialized in women's ready-to-wear, on which the clients can rely. This spares them from having to carry out integration. They have an important market power insofar as, after the vast movements of delocalization of the 1980s-1990s, luxury companies are the least likely to make or buy garments made in France. On the other hand, the French leather sector is weakened. All the know-how necessary to produce handbags still exist, which made it possible for the companies to be integrated, in France for most of them. In Italy also, locally available know-how made it possible for companies to create their own production units. However, the shoe sector has almost disappeared in France, even for the luxury items, and the most emblematic brands have consequently created their production plants in Italy, or work with subcontractors in this country.

Table 3 – Production networks and integration choices by the French brands

	Apparel	**Leather goods**	**Shoes**
Direct control by the French brands	Weak	Strong	Strong
Existing suppliers in France	Many (mostly for womenswear)	Some	Very few

Source : IFM, Etude sur la répartition de la Valeur Ajoutée

- *Advantages of the integration through retail*. Concerning integration towards retail, facts are in conformity with the economic theory which says that integration is important for companies whose brand value is strong (Lafontaine and Slade, p.632). It is clear that this basic movement, followed by all of the luxury companies, answers to the need for providing a significant effort of promotion for the products of the company as much as it ensures its economic viability through a doubled margin. Richardson (1996) also highlighted the role of a distribution network in the capacity to respond quickly to market evolutions. The fact is that luxury companies are more and more directed following the downstream feedback since information on customers' choices is one of the keys to ensure success. The domination of retail sales in the companies' turnover also requires a nimbler organization. Indeed, contrary to the wholesale scheme, where only the sold items will be produced, the company which sells through retail must stick closer to the market evolutions to avoid too substantial and expensive stocks.

- *Quasi-integration*. Lastly, in terms of vertical restrictions, those existing in the universe of luxury are various and numerous. It should moreover be noted that even when luxury companies are in a wholesale model of sales (department stores, multi-brand shops), they manage to sell at their conditions when their market power is sufficient. A desirable brand will be able to impose a certain number of conditions on the retailers so that it ensures the suitable diffusion of its products. The testimony of Hata (2004) on the development of Louis Vuitton in Japan is, for this reason, exemplary. Conditions of several types are frequently evoked by the companies: the definition of the purchasable minimum quantities, the predefinition of the purchasable set so that the identity of the collection is respected whatever the store…

Consequences of vertical integration on the luxury sector

As we saw, this higher vertical integration deals partly with strategic considerations: to guarantee its supplies and if required to obstruct those of the competitors, to prevent or slow down the arrival of new competitors.

In the case of luxury companies, the entry barriers are already high: the company must have a recognized brand, a reputation established for quality products … However, this point is not always the most difficult to surmount. Recent revivals of companies (Balenciaga, Vionnet…) show that it is possible to build on the legacy of a disappeared brand to enter the competition.

For now on, new economic constraints are added which makes us wonder about the possibility for a newcomer to compete with established actors.

The latter have as we saw taken the dominant position on the sector of production, either by a direct control, or by the favorable market conditions obtained thanks to their important power to negotiate (reservations of leathers of better quality, fixing of the best delivery periods…).

With regard to distribution, the increasingly marked orientation towards the downstream of the established firms and their thorough internationalization give them the “entry ticket” to the ever more important market. If luxury companies are in the majority of the cases tenants of commercial surfaces which they exploit, their old presence means that they profit from a physical location that is more advantageous than a new actor. Moreover, the fact that some belong to multibrand groups gives them a higher power to negotiate, since it gathers the totality of the brands held by the group.

The process of vertical integration thus plays the part of what is called strategic commitment in game theory (Antomarchi, 1998). The established firm informs potential entering companies that it is present on the market in a very important and irreversible way. The latter understand that the cost of entry will be too high and decide not to enter in competition.

This increase in the entry barriers explains the increasing concentration of the structures of the luxury industry and the reasons for which in spite of the strong growth of this market few companies have emerged during the last twenty years.

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[i] The sectors covered by these data are clothing, leather goods, shoes, perfumes and cosmetics, watches, jewelry and arts of the table.
ii See in particular Louis Vuitton, l'industriel, L'Usine Nouvelle n° 3247, July 7th, 2011.