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Business 2

Fourth Edition

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The chapter begins by identifying the reasons why businesses grow or retrench. The difference between organic growth and external growth is then explained. The chapter goes on to discuss how to manage and overcome the problems of growth and retrenchment. In relation to this, the following issues with growth are considered: economies of scale (including technical, purchasing and managerial) and diseconomies of scale; economies of scope; the experience curve; synergy; and overtrading. This section includes an explanation of Greiner's model of growth. The impact of growth or retrenchment on the functional areas of business is then discussed. The chapter ends with an assessment of methods and types of growth. Methods of growth considered include mergers, takeovers, ventures and franchising; types of growth considered include vertical (including backward and forward), horizontal and conglomerate integration.

The reasons why businesses grow or retrench

For most businesses, growth is an important objective, and is sometimes the only way to ensure that a firm survives in the long term. Growth is usually seen as a natural development for a business, providing benefits and opportunities for the business and for its stakeholders. At a basic level, growth enables a company to reach breakeven and make profit. It provides more opportunities for a company to take advantage of economies of scale (which were explained in Chapter 13 of the AQA A-level Business Book 1 and are reviewed again later in this chapter), and a growing and dynamic company is more likely to remain competitive. Growth by diversification allows a company to spread risks, and a large company with plenty of assets and diversified activities will find it easier to cope with recession and fluctuations in the business cycle.

Growth may be due to increased demand for a business's products following the successful exploitation of a competitive advantage. A strong economy where living standards are rising is likely to lead to increased demand for goods and services and thus provide opportunities for businesses to expand to meet demand. The identification of new markets for existing products or new products in existing markets can also lead to business growth.

Conversely, poor performance or poor economic conditions may cause a business to decline in size (or **retrench**). For example, weak demand due to recession might cause a business to concentrate production on

Key term

Retrenchment The cutting back of an organisation's scale of operations.

a narrower range of products or in fewer locations. Strong competition from rival businesses may mean a business loses market share and has to close down production facilities. Sometimes a business that has diversified too much may retrench because it decides to refocus on a narrower range of activity so that it can reap the benefits of greater specialisation. General Electric (GE) is an example of this and is included in a Fact file towards the end of this chapter in the discussion about conglomerates.

The difference between organic and external growth

Growth can be achieved either internally (known as organic growth) or externally. The choice of which type of growth is best suited to a particular organisation depends on a trade-off between the costs involved, the level of risk and the speed of each method of development.

Key terms

Organic (internal) growth When a firm expands its existing capacity or range of activities by extending its premises or building new factories from its own resources, rather than by integration with another firm.

External growth When a firm expands by integrating with another firm as a result of either a merger or a takeover (also known as an acquisition).

Integration The coming together of two or more businesses via a merger or takeover.

Merger Where two or more firms agree to come together under one board of directors.

Takeover (acquisition) Where one firm buys a majority shareholding in another firm and therefore assumes full management control.

▲ Mergers happen when two or more firms come together

Organic (internal) growth

Organic growth is usually pursued because a firm wishes to grow in a steady and closely managed way. This is likely to be the case where:

- a firm's product is in the early stage of its life cycle and is not yet fully established in the marketplace
- a firm's product is highly technical and the firm needs to gain experience of dealing with it, ensuring that any problems can be ironed out
- the costs of growth need to be spread over time.

For some firms, organic growth is the best option because there are no suitable opportunities for external growth available.

Finance for investment and expansion accompanying organic growth usually comes from the retained profit resulting from existing activities, from borrowing or by attracting new investors. As a result, this process of growth tends to be relatively slow, but less risky than external growth.

External growth

External growth tends to be via the **integration** of two or more companies and can occur by **merger** or **takeover** (acquisition). Mergers occur when two businesses believe and jointly agree that they can increase their combined profit, or achieve other objectives, by merging their businesses. Takeovers (acquisitions) are accomplished by the acquiring firm offering cash or shares (or both) to the shareholders (i.e. the owners) of the firm that is being taken over. External growth is usually the fastest way to achieve growth, but given the problems of integrating two separate organisations, it can be risky.

External growth, whether by merger or takeover, can be classified into three broad types of integration – vertical, horizontal and conglomerate. Mergers and takeovers and the different forms of integration are discussed in the final section of this chapter.

Fact file

WPP

WPP began life as a maker of wire shopping baskets. Today it is the world's largest advertising and marketing agency and a world leader in 'communications, experience, commerce and technology'. Its development is an example of external growth.

In 1985, Sir Martin Sorrell bought a controlling stake in a small UK manufacturer of wire baskets called Wire and Plastic Products. This was used as the foundation on which to build an international advertising and marketing services group. The company was renamed 'WPP' and established as a marketing services group in 1986, with Sir Martin as its Chief Executive. (Sir Martin retired from the company in 2018).

WPP has grown rapidly since then, initially through large acquisitions and later through organic growth and a range of smaller-scale acquisitions.

WPP's business expertise and the services it offers include the following:

- communications – advertising, content, media investment, public relations and public affairs
- experience – branding and design
- commerce – commercial solutions, both online and offline, including direct-to-consumer platforms and helping clients navigate marketplaces such as Amazon and Alibaba
- technology – data management, marketing technology consulting and systems integration services.

How to manage and overcome the problems of growth and retrenchment

Managing and overcoming the problems of growth

Topics covered later in this section explain a range of growth-related issues that highlight some of the problems of growth and how these can be overcome. For example:

- Economies and diseconomies of scale. As the scale of its production increases, a business benefits from falling average costs as its takes advantage of economies of scale. However, it must ensure that close attention is given to appropriate organisational structures and communication systems to ensure that diseconomies of scale do not emerge.
- Economies of scope. A firm can gain cost advantages as it grows by diversifying its product range. This is because it can benefit by using the same facilities, equipment, labour and technology. This depends significantly on how diversified the product range becomes. For example, in the case of conglomerates, which usually have very different products in their portfolio, this is less possible.
- The experience curve. This indicates that the more experienced a business gets at making a product, measured by the cumulative volume of production since it began producing, the better, faster and cheaper it is likely to be at producing the product. If a firm does accrue benefits due to the experience curve effect, the fact that it is growing and therefore increasing its cumulative volume of production should bring benefits.
- Where growth is via external means, the integration of two businesses can produce synergy because the new integrated business produces, for example, better profits and revenues than the sum of profits and revenues of the two individual firms. However, there is extensive evidence to suggest that to be successful, in relation to mergers and takeovers, the two firms need to plan effectively for the process of merging different cultures and to have realistic expectations of what they can achieve.
- Overtrading. Overtrading is a common reason for business failure. To avoid it, businesses need to plan carefully to manage growth, for example, in terms of increased orders, by ensuring sufficient working capital.

- Greiner's model of growth. The model provides a clear picture of the phases of growth, the problems that are likely to emerge and how these can be dealt with in order to allow a business to move to the next stage.

Without strong and effective management, growth can result in a loss of direction and control. The demands placed on leaders or managers in relation to managing and motivating a large team require very different skills from those needed to manage and motivate a relatively small team. Introducing an appropriate organisational structure, having an effective management team and carrying out detailed financial and operational planning and forecasting are vital.

Additional organisational issues to consider when a business grows include:

▲ Management structures will have to change as a business grows

- Management structures and hierarchies will need to change so that the business is better positioned to achieve its objectives. A medium-sized business may replace its simple and clear functional structure with a complex matrix structure or, depending on the nature of the business, a product-based or region-based structure. Spans of control are likely to increase and new layers of authority and departments will need to be created. The whole process of management becomes more complex. In most instances, the expertise to build and manage that structure will come from outside the business. A bigger company needs managers to take control of departments and a hierarchy that has the expertise and the time to drive it forward. The Fact file on James Cropper plc (below) and the Case study of Friends Reunited at the end of this chapter provide examples of how growing businesses can benefit from outside expertise.
- There will be more delegation. The original owners are likely to lose much of the direct contact they had with customers, suppliers and staff, and will take on more of a managing and leading role. Professionals in finance, marketing and personnel will need to be recruited to take on growing specialist responsibilities, and an effective management team will need to be created.

Fact file

James Cropper plc

James Cropper plc makes distinctive and technically advanced paper products, including the red paper for the Royal Legion's famous poppies. The company was founded in 1845, employs 570 staff in the UK and the USA, and has an annual turnover of approximately £100 million. It exports half of its products.

In 2012, the company was finding it difficult to compete and to expand overseas. In addition, it lacked someone with the international experience and specialist knowledge in the materials it dealt with among its board of directors. Its problems were solved with the appointment of a non-executive director (NED) with the necessary experience and expertise.

The new NED identified that low profitability was because the business hadn't been able to identify how to grow. He helped the business to recruit appropriately experienced and skilled new talent, including a new CEO. He was also instrumental in developing a department focused on new technology and innovation and in identifying a new business opportunity involving the use of paper rather than plastics packaging.

The chairman of the business, Mark Cropper, said of the NED, 'With his background and authority he was a catalyst for change.'

By 2018, the business was achieving steady growth in profits and in its share price. This illustrates the value that a new and independent voice with substantial business experience can bring to a business that is looking to grow but needs to change its structures and strategies in order to do so.

Source: adapted from 'The value that outside expertise can bring to business growth', by Alison Coleman, *Forbes*, 20 February 2018

- Staff responsibilities will need to change. As the business and workload grows, employees will need to focus on what they do best; jobs will become more clearly defined, with job descriptions, training and development plans, and appraisal systems being introduced.
- Staff motivation may decline, at least in the short term, as the changes that result from growth begin to have an impact. This may in turn affect customer service. For example, in the past employees may have been used to dealing directly with the owner/boss of a business, and the additional layers of management that will be introduced as the business grows may be resented. Managing and motivating a larger team successfully is likely to require a democratic leadership and management style, which may be very different to the previous style.

What do you think?

Michael Dell, of Dell Computers, once said: 'If you limit a company by its structure or by the people in the company, you will, by definition, limit the full potential of that business.'

Do you agree?

Author advice

Most of the issues discussed above were explored in various chapters in Book 1. For example, leadership styles were covered in Chapter 4 and organisational structure, span of control, levels of hierarchy, job descriptions, training, appraisal and motivation were covered in Chapters 22 and 23. Ensure that you are familiar with these areas before proceeding further with this chapter.

Fact file

From private to public limited company

For many firms, problems arise when growth involves changing from private to public limited company status. Going from a private limited company to a public limited company usually means floating shares on the stock market. Companies join the stock market all the time, and the more optimistic the economic climate, the more new issues of shares there are. The value of a stock market listing is that a company has a higher profile and access to a large pool of capital. This can provide a more balanced capital structure, especially for highly geared firms.

A drawback of flotation is that public companies are answerable to their shareholders, and investment analysts will scrutinise the company prospectus closely. Once the company is floated on the stock market, shareholders may simply be interested in generating quick profits at the cost of longer-term success. The shareholders of a private company tend to be 'in it for the long run', for example, happy to agree to high levels of research spending and accepting relatively low dividend payouts. However, once the shareholder base is widened, the firm comes under severe pressure to generate record levels of profit year by year, even if the 'right' thing to do is to spend heavily on research in the hope of generating future success.

Managing and overcoming the problems of retrenchment

Just as a business must manage and overcome the problems associated with growth, it must do the same when retrenchment takes place, that is when it reduces the scale of its operations.

The main problems that are likely to occur when any form of retrenchment takes place include:

- damage to employee morale due to job losses
- damage to the relationships with customers and suppliers if they are affected by reductions in products available for sale or by reductions in the purchase of supplies
- general reputation among stakeholders who may be adversely affected
- loss of corporate knowledge when experienced employees leave.

Retrenchment can be managed in a number of different ways, each of which is likely to have both positive and negative effects on a business and on its various stakeholder groups. These include:

- Reducing the workforce gradually by freezing recruitment or offering early retirement or voluntary redundancy. Using this strategy might lessen the feelings of job insecurity among existing employees because any changes to their employment status would be voluntary. On the other hand, staff who choose to retire early or take voluntary redundancy may be key people in the organisation and, if they leave, their skills and experience disappear. Cutting back in this way may provide less opportunity for the organisation to introduce change and to restructure.
- Delayering, which means removing a layer of management from the organisational hierarchy. This has less impact on operations at shop-floor level and hence on production. It may empower or enrich jobs at the lower levels of management because these jobs will now have more responsibility allocated to them. However, the workload of the remaining management team will increase, which can add to stress levels and reduce motivation. Motivation might be further affected due to the loss of promotion prospects when a layer of opportunities vanishes.
- Closing a factory, outlet or division of a business. This will reduce overall fixed costs and hence lower a business's breakeven point. In addition, and depending on the nature of the closure, capacity utilisation may rise in other factories, outlets or divisions. The problem with this strategy is that it is almost impossible to reverse if there is an upturn in the economy. In addition, closure will mean a loss of many staff with valuable skills.
- Making targeted cutbacks and redundancies throughout a business. This strategy should allow a business to reorganise in order to meet objectives – for example, putting more emphasis on e-commerce. It also enables a business to get rid of less productive staff, which might improve the overall performance of all staff. It may, however, create feelings of job insecurity and lack of trust among the remaining staff.

Poor performance may also lead to a change in ownership of the business or changes in its leaders and senior managers. Much will depend on the context of the business. For example, a business that is not performing well and whose share price is falling may be an attractive proposition for another business considering a takeover. It might be that a business is not performing as well as it could be because the original management did not have the necessary skills or experience. In this case, new leaders might be brought in.

Did you know?

Interim managers are employed for a specific task or set period. They can oversee a period of development or the setting up of a new structure, or can come in to run departments until existing members of staff have developed the skills to take over.

Private investors and venture capital firms evaluate management structures and expertise before committing funding, and often insist on recruiting new or interim management. This can be seen as a way of taking control away from the founder, but it is often a means of protecting any investment by ensuring that skills gaps are plugged and that the necessary structures and experience are in place.

Fact file

Management buyouts (MBOs)

A management buyout (MBO) is where the managers of a business buy out the existing shareholders in order to gain ownership and control of the business or part of the business.

Reasons for buyouts

- A large company might sell off a small section to raise cash, refocus the business or get rid of an unprofitable activity – all forms of retrenchment. The management team of the parent company's unwanted section might feel it could be successful with a different approach or more finance.
- Owners of a family business who wish to retire might prefer to sell to the management team in the hope of maintaining employment and continuity in the community.
- A business might be in the hands of the receiver, who must try to keep it going in order to raise money to pay off creditors. One way of doing this is to sell part of it to the management team.

Finance for buyouts

Finance for management buyouts can come from managers' personal funds, bank loans and investment funds obtained by selling shares to employees. However, more often it comes from either venture capitalists or private equity firms. Venture capitalists and private equity firms work by lending the MBO the cash it needs and by taking a stake in the company for a return on their investment over three to five years.

Benefits of buyouts

- Management and employees have more motivation and responsibility.
- Objectives may be clearer because there is no owner–manager conflict.
- There is likely to be less bureaucracy in the form of a head office that might hinder progress.
- Profits will not be diverted to another part of the organisation.
- If successful, the possibility exists of floating the company on the stock market or selling shares in a takeover offer.

Risks of buyouts

- If unsuccessful, personal losses are felt by the new owners or investors.
- The original owners might have been correct in assessing that the business was fundamentally unprofitable.
- There may be little access to capital.
- They often involve considerable rationalisation and job losses, with adverse effects on staff morale.
- Managers have to learn a whole range of new skills immediately, particularly if they have bought out from a large company. Suddenly, they have to do everything that before they took for granted, such as looking after the IT infrastructure, human resources and payroll.

Are buyouts a good thing?

- According to figures from the Centre for Management Buy-Out and Private Equity Research at Imperial College Business School, the value of buyouts in the UK shows a cyclical trend. From £16 billion in 2003 to a peak of £47 billion in 2007, value then fell consistently to 2010. It then began to rise again but fell back following the 2016 Brexit referendum – from £28 billion in 2017 to £21 billion in 2018. Commentators suggest that this is because the largest funds are being focused on deals outside of the UK given the uncertainty around Brexit. The actual number of buyouts reflects the same picture, with 672 recorded in 2007 and 402 in 2018.
- Some institutional investors are critical of such deals, suggesting that if management sees value in a business, it should deliver this value to existing shareholders of the plc and not wait until the division has been hived off in a buyout before exploiting such value. Historically, the main method for management to realise investments in a buyout was to float it on the stock market again.
- Some commentators argue that workers may be more at risk with a management buyout than if the company had been purchased by a large organisation. If the company is not successful, workers and managers share the loss, but if the company is successful, it is really only the managers who benefit. Others argue that managers are the real risk takers and that workers' jobs might have disappeared if there had been no management buyout.

Fact file

From public to private limited company

A number of companies change from public to private limited company status. Sometimes this is due to retrenchment because the company is less successful than previously. However, this is not always the case. Private limited company status has the advantages of more privacy and less pressure on management resulting from share price movements. This allows management to take a longer-term view. Firms go private because, in general, there is less interest in private firms. In such instances, the benefits of being listed are outweighed by the cost of meeting regulatory requirements and by the amount of time that needs to be spent with analysts and fund managers and generally communicating with the market.

Author advice

The different legal structures of business were covered in Chapter 2 of Book 1. Chapter 2 also explained the role of private equity companies in taking over or buying out public limited companies and transforming them into private limited companies in order to turn them around. Ensure that you are familiar with the characteristics and implications of private and public limited companies.

Did you know?

Well-known brands that became private limited companies after a spell as a public limited company include Virgin, Iceland, Caffè Nero and Matalan. Owners regularly point to the short-termism of city investors as a reason for returning their companies to private limited company status. Public limited companies are subject to intense scrutiny by City commentators, who often put quarterly performance figures above long-term performance. Richard Branson has often criticised institutional investors for demanding quick returns instead of investing for the long term. Malcolm Walker, Iceland's founder, has said that a profit warning that would be treated as a blip if a company is privately owned might be seen as a disaster if it is publicly owned. Michael Dell led a $25 billion private equity-backed buyout of his computer company Dell in 2013, saying the company he founded in 1984 needed room to invest in better products and rebuild for the cloud computing age. In 2018, he took the company public again, keeping control of about half the shares compared with 14 per cent before the buyout.

Issues involved with managing growth

Economies of scale and diseconomies of scale

As a business expands, it may experience economies of scale. Economies of scale are the advantages a business gains, usually in terms of reduced average (unit) costs of production, due to an increase in its size. However, if a business grows too large, it may suffer disadvantages that lead to a lowering of efficiency and higher unit costs of production. These are known as diseconomies of scale.

Economies of scale and diseconomies of scale were covered in detail in Chapter 13 of Book 1. The AQA specification for the 'Strategic methods: how to pursue strategies: Assessing a change to scale' part of the course requires students to understand three specific types of economies of scale – technical, purchasing and managerial economies. Each of these, in addition to other economies of scale and diseconomies of scale, were explained in Chapter 13 of Book 1. Ensure that you review that chapter before proceeding further with this chapter. Additional points about the three economies of scale identified in this part of the specification are included below.

Key term

Technical economies of scale
The lower unit costs that arise because larger firms are able to use more efficient techniques of production and to benefit from the law or principle of increased dimensions.

Technical economies of scale

Technical economies of scale focus mainly on capital inputs, workforce specialisation and the law of increased dimensions. The first two are more often seen in very large, mass-production businesses. Capital inputs include capital investments in specialised equipment or machinery that increase productivity, or cutting-edge technology that improves internal control and reduces related costs such as transportation and distribution. Workforce specialisation creates efficiency by breaking down large, complex tasks into small, simple tasks performed in a mass production-line environment – the result is a reduction in average costs. The law or principle of increased dimensions applies mainly to transportation and distribution industries. It means that, for example, doubling the height and width of a warehouse or container leads to a more than proportionate increase in the cubic storage capacity of the warehouse or container. This again results in a reduction in average costs.

Key term

Purchasing economies of scale A reduction in unit costs as a result of buying in large quantities; these are sometimes called buying economies of scale.

Purchasing economies of scale

Firms purchasing supplies on a larger scale should be able to buy them in bulk and thus reduce average costs. They may be able to cut out wholesalers by buying direct from producers, thus reducing costs further. If purchases of supplies are in sufficiently large quantities, this might give the firm more buyer power and enable it to make very specific demands about product quality, specifications, service, and so on, so that supplies exactly match its requirements. **Purchasing** (or buying) **economies of scale** can also refer to the fact that a large firm wishing to borrow a large amount of money may be able to do so at a lower interest rate than firms borrowing smaller amounts.

Fact file

Wal-Mart and Asda

In his book *The Wal-Mart Effect* (2006), Charles Fishman notes how purchasing economies of scale can have a huge impact on costs. Apparently, prior to the takeover of Asda by Wal-Mart, Asda used to pay $14 per metre for 50,000 metres of material to make men's jeans. After the takeover, purchasing rose to 6 million metres per annum and the price fell to $4.77 per metre. Asda also benefited from technical economies when the Wal-Mart takeover took place. Analysts at Deutsche Bank estimated that Asda saved £150 million when it linked into the Wal-Mart IT system.

Key term

Managerial economies of scale
Larger firms have greater scope to benefit from the specialisation of labour at supervisory and manager level in each of the functional areas of the firm.

Managerial economies of scale

Larger firms can afford to employ specialist managers for the different functional areas or to lead specific projects within a business. This means more specialisation and greater knowledge and understanding of these functional areas/projects, which should increase productivity and lower average costs.

Key term

Economies of scope Cost advantages that result from firms providing a variety of products rather than specialising in the production or delivery of a single product.

Economies of scope

Economies of scope enable an organisation to lower its average unit costs by using the same facilities, equipment, labour force and technology to produce or provide a range of different products.

Economies of scope exist if a firm can produce several product lines at a given output level more cheaply than a combination of separate firms each producing a single product at the same output level. Economies of scope differ from economies of scale in that a firm receives a cost advantage by producing a complementary variety of products with a concentration on a core competency. While economies of scope and economies of scale are often positively correlated and interdependent, the benefits from economies of scope have little to do with the actual size of output.

Economies of scope are sometimes termed 'economies of diversification'. This occurs when a firm builds on or extends existing capabilities, resources or areas of expertise for greater competitiveness.

The motivation for mergers and takeovers is sometimes an attempt to create economies of scope. Evidence suggests that mergers and takeovers that extend or enhance a company's product portfolio succeed more often than mergers and takeovers undertaken to increase size. Pharmaceutical companies, for example, frequently combine forces to share research and development costs and bring new products to market.

Examples of the economies of scope include:

- Extending the product range to benefit from the value of existing brands. For example, Amazon expanding into selling toys and sports goods or McDonald's expanding its range of food products to include salads and healthy foods.
- A company like the Kimberley-Clark Corporation, which manufactures a wide range of paper products for a variety of end users, including hospitals and healthcare providers, infants, children, families and women, benefits from economies of scope. Its brands include Kleenex, Huggies, Kotex and Andrex. All of its product lines utilise similar raw material inputs and/or manufacturing processes, as well as distribution and logistics channels.
- A drinks maker, such as Coca-Cola, using its current equipment, facilities, technology, distribution channels and labour to produce a wider range of drinks (Sprite, Fanta, Minute Maid as well as the range of Coca-Cola branded drinks). As a result it is able to diversify and lower costs.
- Fast food outlets have lower average costs producing a wide range of different food products than would separate firms specialising in each individual food product. This is because the provision of multiple food products shares storage, preparation and customer service facilities.
- Banks offering a variety of financial services, such as retail banking and investment services, through a single service infrastructure that is likely to include branches, ATMs and internet sites. The costs of providing each service separately would be much greater than the costs of using a single infrastructure to provide multiple services.
- Flexible manufacturing, where a producer can manufacture multiple products with the same equipment. If the equipment provides the flexibility to change as market demand changes, the manufacturer can add a variety of new products to their current line quickly in response to consumer preferences.

▲ Kimberley-Clark has economies of scope

Key term

The experience curve Indicates that the higher the cumulative volume of production, the lower the direct cost per new unit produced; essentially, the more experienced a firm gets at making a product, the better, faster and cheaper it is likely to be at making it.

- Using a specialist expertise or competency to benefit a range of different products. For example, Proctor & Gamble, which produces hundreds of products from razors to toothpaste, can afford to hire expensive graphic designers and marketing experts who will use their skills across all the product lines. Because costs are spread out, this lowers the average unit cost of production for each product.

Economies of scope (or scope economies) can increase a firm's value and lead to increases in performance and higher returns to shareholders. Building economies of scope can also help a firm to reduce the risks inherent in producing a single product or providing a service to a single industry.

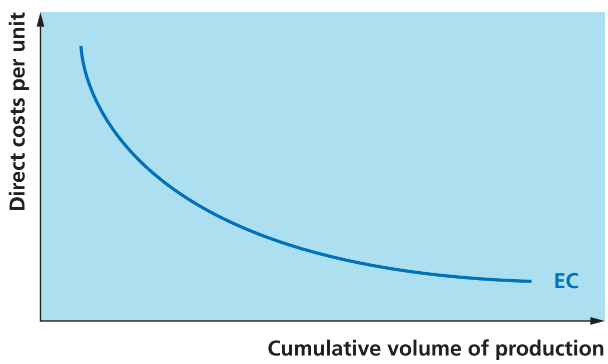


Figure 11.1 The experience curve

The experience curve

The experience curve is based on the idea that the more 'experienced' a firm is at making a product, the better and faster it becomes at making it and therefore the cheaper it is able to make it. As a result, it is able to fulfil demand better than its rivals.

The experience curve is a graphical representation of a phenomenon explained in 1966 by Bruce D. Henderson, founder of the Boston Consulting Group (BCG). It refers to the fact that firms learn from doing and, as a result, the higher the cumulative volume of production, the lower the direct cost per new unit produced. The cumulative volume of production is the quantity produced from the first unit, when the firm began operations, to the last unit, that is, where it is at this point in time. In the 1960s, BCG's work with a wide range of companies suggested a consistent relationship between the cost of production and the cumulative production quantity. Its data revealed that product costs declined by 20–30 per cent for each doubling of cumulative production quantity and that this was a fairly constant and predictable movement.

In Figure 11.1, direct costs per unit are measured on the vertical axis and the cumulative volume of production is measured on the horizontal axis. When the firm begins production, direct costs per unit are high, but as it gains more experience of producing the product and its cumulative production level increases, direct costs per unit fall, as indicated by the experience curve (EC).

The implication for business strategy is that if a firm is able to gain market share leadership over its competitors, it can develop a cost advantage because its cumulative level of production will be greater and therefore its direct unit costs will be lower. Limitations to an experience curve-based strategy include the fact that:

- competitors may also pursue this strategy, which will reduce the returns to all firms because high levels of competition will limit a firm's cumulative production and so limit the cost savings arising from its experience
- competitors that copy the leading firm's manufacturing methods may achieve even lower production costs by not having to recover R&D investments
- technological change may enable even bigger experience curve effects, particularly for later entrants to an industry, for example because they build new plants that take advantage of the latest technologies and offer a cost advantage over the older plant of the leading firm.

Author advice

The experience curve concept differs from economies of scale. Economies of scale involve the idea that average unit costs fall as the scale of production increases because of a variety of reasons, including bulk buying and the fact that fixed costs are spread over greater level of output. The experience curve effect involves the idea that direct costs per unit fall as skills and expertise improve and a firm finds better ways of doing things. In addition, experience curve analysis is based on the number of units produced since the business started (its cumulative production), whereas economies of scale are based on the number of units produced during a production period such as a day/week/month/year.

Did you know?

The experience curve effect is different to the learning curve effect. The learning curve effect usually relates to labour productivity and the idea that by repeating a task again and again, an individual becomes quicker at completing it so that labour hours per unit fall. It assumes that the nature of the job or the technology surrounding it does not change. The experience curve effect is a wider concept that relates to total efficiency and includes not only labour productivity but also experience in relation to technology, distribution, administration, marketing and manufacturing.

The experience curve was a popular and relevant concept in the 1960s and 1970s when the general business environment was relatively stable and technological change and new product developments were relatively infrequent, compared to today.

In 2013, BCG undertook an evaluation of the experience curve concept and suggested that its original idea about the experience curve needed supplementing. It suggested that today most companies need two types of experiences. As consumer tastes and product generation change even more rapidly, experience in *fulfilling demand* (the ultimate outcome of the experience curve concept) alone is no longer sufficient to sustain a competitive advantage. An additional type of experience – experience in *shaping demand* – becomes necessary as well. The latter experience must be acquired through new and different means that can sometimes be in direct conflict with the current means an organisation employs to acquire experience. The Fact file on Netflix illustrates these ideas. The company has focused on excellence in both fulfilling and in shaping demand, which has allowed it to thrive and overtake established competitors – a phenomenon that the traditional experience curve cannot explain.

Fact file

Netflix – shaping, not just fulfilling demand

By providing on-demand content, creating compelling original programmes and letting customers consume content in the way that they prefer, Netflix is a major disrupter of television, forcing traditional TV companies to change the way they do business. The CEO of Netflix once said, 'Flexibility is more important than efficiency over the long term'.

Netflix has radically shaped demand a number of times by improving the convenience of its service. It started in 1997 as a website service, allowing people to rent DVDs online and receive them through the post. While it competed to some extent with TV for people's entertainment time, it was competing more directly with established video rental stores.

Netflix then introduced streaming of videos, even though the offering was obviously going to cannibalise the company's own DVD business. This service was extended and, by 2007, customers could watch a TV show or film on a computer, TV screen, tablet, phone or gaming device. Offering programming on-demand made it superior to physical stores and television because customers were able to watch what they wanted, when they wanted and how they wanted. This innovation helped end the video rental business and made it more important for cable companies and TV networks to begin offering on-demand content of their own.

In 2013, Netflix began competing with TV networks and cable companies directly by producing its own programmes. Its approach has meant that many of the most critically acclaimed and popular series in recent years, including *House of Cards*, *Breaking Bad* and *The Crown*, have come from Netflix rather than the established television networks.

At about the same time, Netflix also started uploading entire seasons of established TV series at once, enabling 'binge-watching' in contrast to broadcast and cable TV's once-a-week programming model. Many TV networks are now offering this model, even if it means sacrificing advertising revenue.

Today, Netflix is essentially a storehouse of content, including films, documentaries and TV series. For a flat monthly fee, subscribers can watch any programme at any time on any device they choose.

Synergy

In a technical context, **synergy** is the fact that the value added by the system as a whole is beyond that contributed independently by the parts (whether the parts are people, hardware, software, facilities or policies) and is a result of the relationship among the parts and how they are interconnected.

In terms of organisational behaviour, synergy can be seen when a team of people working together is able to outperform what even its best individual member can do. Teams that are successful in this way have been observed to engage in productive disagreement in order to arrive at the best solutions that all agree upon. In contrast, less successful teams have been observed to arrive at a common view quickly, focusing on completing tasks and avoiding disagreement. In a business context therefore, synergy means that teamwork can produce an overall better result than if each person within the group were working toward the same goal individually.

Synergy is often claimed as a potential advantage of mergers and takeovers. Two firms join together and the resulting outcome is expected to be much better than the two individual companies working alone. Some of any subsequent improvement is the result of economies of scale and the reduction in costs due to the integration of two previously separate operations – a single head office instead of two, a single board of directors instead of two, a single HR department instead of two, and so on. Some is the effect of corporate synergy, that is that the separate parts fit together so well that the integrated organisation is more productive, exploits opportunities more effectively and is thus more successful and more profitable than the two individual companies working alone. The AB InBev Fact file below provides a good example of synergies resulting from the merger of two firms.

Key term

Synergy The whole is greater than the sum of the parts; synergy is sometimes summarised as '1 + 1 = 3'.

Fact file

AB InBev

AB InBev, the world's largest brewer, was created from the merger in 2008 of Anheuser-Busch and InBev. AB InBev produces some of the best-known beer brands, including Stella Artois, Budweiser and Corona. At the time of the merger, AB InBev announced anticipated synergies that were higher than could be expected from the economies of scale that would result from two large organisations joining together. But these synergies were realised because the two companies entered the merger with a track record of successful previous mergers and a solid plan of action to ensure their predictions would be realised. On average, the integration of two consumer products companies results in an increase in target sales of about 3 per cent but in the case of the AB InBev merger, there was an improvement of almost 17 per cent over a three-year period following the merger. Analysts suggest that its success is based on the fact that there was a clear focus from the start on managing the changes required to fully integrate the two companies. In addition, appropriate targets and standards were set across the organisation based on the best approaches. These included standards and benchmarks for best brewing operations, and standardised sales and delivery routines to increase efficiency.

Results for the first half of 2019 indicate the continuing success of the merged company, with volume sales growing by 2.1 per cent and revenue by 6.2 per cent, including growth of 8 per cent in the combined revenue of its three global brands, Budweiser, Stella Artois and Corona.

Despite the positive impact synergy can have, evidence suggests that synergy is achieved less often than is claimed and that mergers and takeovers often result in what some commentators call 'negative synergy', that is reduced efficiency of operations. Some of the Fact files and Case studies later in this chapter illustrate this point. A survey of international executives by Bain and Company (a global business consulting firm), indicated that overestimating synergies was one of the most common features of unsuccessful mergers and takeovers. This is because companies often set overambitious targets to justify the mergers or takeovers they are about to enter into. In addition, most companies do not have a clear understanding of the level of synergies they can expect through increased scale following a merger or takeover.

Overtrading

Overtrading was explained in Chapter 19 of Book 1. Refer back to this before proceeding with this rest of the chapter.

> **Key term**
>
> **Overtrading** Takes place when a business grows too quickly without organising sufficient long-term funds to support the expansion. This puts a strain on working capital.

Overtrading usually takes place when a business is attempting to grow too quickly. In such situations, a business accepts work and tries to complete it, but finds that to meet its customers' demands requires more working capital (net assets) than is available. The Case study later in this chapter illustrates this situation.

Overtrading often results in the closure of a business but can usually be avoided by the careful management of cash. This means ensuring that the timing of payments for deliveries from suppliers and the timing of payments for orders from customers are negotiated and regulated to ensure that there is always sufficient working capital available in the business.

Greiner's model of growth

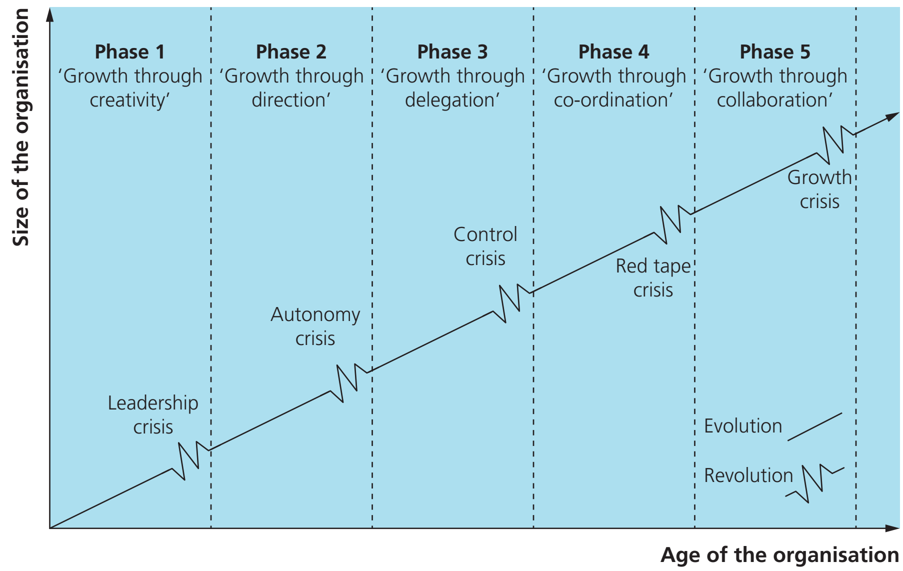
Greiner's model of growth was first published in L.E. Greiner's 1972 article, 'Evolution and Revolution as Organisations Grow' in the *Harvard Business Review* and was reprinted in a revised version in 1998.

> **Key term**
>
> **Greiner's model of growth** A model describing different phases of company growth, each of which includes calm periods of evolutionary development and growth that end with a period of crisis and revolution.

The model includes five key dimensions, as follows.

1. The age of the organisation is measured on the horizontal axis. As an organisation develops over time its organisational practices change.
2. The size of the organisation is measured on the vertical axis. A company's problems and solutions tend to change as its size increases.
3. The stages of evolution. As both age and size increase, evolutionary growth may occur. Greiner used the term 'evolution' to describe prolonged periods of growth where no major upheaval occurred in organisational practice. He suggested that periods of evolutionary growth might last between three and eight years, depending on the nature of the industry.
4. The stages of revolution. Greiner used the term 'revolution' to describe periods of substantial turmoil in organisations, when, for example, serious upheaval of management practices took place.
5. The growth rate of the industry is influenced by the particular market environment. For example, a company in a rapidly expanding market will find that the speed with which it experiences evolution and revolution is different to a more established and slow-growing industry.

Figure 11.2 illustrates these key dimensions.



▲ **Figure 11.2** Greiner's model of growth

Greiner's model of growth identifies five phases of growth, that is, five specific phases of evolution and revolution. Figure 11.2 illustrates that each evolutionary period is characterised by a dominant *management style* used to achieve growth, while each revolutionary period is characterised by a dominant *management problem* or crisis that must be solved before growth can continue. The phases of growth and development are explained below. Table 11.1 summarises the key characteristics of each phase.

Phase 1 – Growth through creativity

- This phase is characterised by: founders who are individualistic, entrepreneurial and focused on the product and the market rather than management activities; communication among employees that is frequent and informal; long hours and modest salaries that reflect the commitment of founders and employees; the business being very responsive to feedback from the marketplace.
- As the business grows, more effective management is required, larger numbers of employees mean more formal structures and communication systems are required. It is at this point that a *leadership crisis* can occur and the onset of the first revolution when a strong business manager is required, who is often not one of the original founders. (See the Fact file on James Cropper plc earlier in this chapter and the Case study on Friends Reunited at the end of this chapter, for examples of this aspect of growth.)

Phase 2 – Growth through direction

- Those companies that survive the first phase by installing a capable business manager usually embark on a period of sustained growth under strong directional leadership that improves the efficiency of operations. Characteristics of this phase include: a centralised and functional organisation structure; systems and procedures such as standards and cost centres; formal communication structures and hierarchies and centralised direction from the top; management rewards that emphasise clear salary structures and increases based on merit.

- Eventually however, the *autonomy crisis* occurs. The strong directive approach ensures employees are more efficient. However, as people's specialist expertise increases, they want more autonomy. At this revolutionary stage, some companies flounder because they stick to centralised methods, mainly because some managers find it difficult to give up being directional and some employees find it difficult to take responsibility. The solution adopted by successful companies is to introduce more delegation.

Phase 3 – Growth through delegation

- Those companies that survive phase 2 do so because they introduce a successful decentralised organisation structure. Its characteristics include: more responsibility being delegated; incentives such as bonuses used to encourage motivation; expansion of the market by mergers and takeovers; communication from the top being infrequent and brief; senior managers exerting control by the regular request for progress reports and the use of profit centres.
- Decentralised systems give managers greater authority and incentives to expand markets, respond to customers more quickly and develop new products. However, this results in the *control crisis* because senior management begins to realise that it is losing control over a highly decentralised structure. The phase 3 revolution sees senior managers trying to regain control by returning to centralised management systems, which often fail because of the huge scale of the operations.

Phase 4 – Growth through co-ordination

- Those companies that survive phase 3 do so because they use special co-ordination techniques. These include consolidating the organisation by merging decentralised units into product groups, each of which is treated as an investment centre, with the return on investment being an important criteria for allocating funds; formal planning procedures; numerous staff hired for the head office to initiate companywide programmes of control and review and to act as watchdogs; stock-options and profit sharing to encourage staff to identify with the firm. Such systems enable the company to achieve growth through the more efficient allocation of its limited resources.
- Managers still have much responsibility, but they have to justify their actions very carefully to head office. This leads to the *red tape crisis*, which is the result of a lack of confidence between staff in the decentralised units and those in head office. Managers in decentralised units resent the heavy direction from staff at head office who know nothing about local conditions. Staff at head office complain about managers and staff in the decentralised units being unco-operative. Both groups criticise the bureaucratic systems and procedures that have evolved and are taking precedent over problem solving, and discouraging innovation. The phase 4 revolution is underway because the company has become too large and complex to be managed through formal programmes and rigid systems.

Phase 5 – Growth through collaboration

- Phase 5 emphasises a more flexible and participative approach to management, with the following characteristics: solving problems through teamwork and a greater emphasis on innovation; teams combined across functions in a matrix structure; previous formal systems being simplified and a control system involving mutual goal setting being introduced; economic rewards being geared more to team performance than to individual achievement.

- Companies realise that there is no internal solution, such as new products, for stimulating further growth. Thus the revolution is triggered by a *growth crisis*.

Author advice

Note that phase 6 was discussed by Greiner in his 1998 update to his original 1972 article but was not incorporated into his diagrammatic or tabulated representations. Hence it is not included in Figure 11.2 or Table 11.1.

Phase 6 – Growth through alliances

- Growth may continue through merger, outsourcing, networks and other solutions involving other companies. The challenge facing companies in this phase is how to access the external support and expertise required for the development of effective alliances and networks.

Table 11.1 Organisational practices in the five phases of growth

Category	Phase 1	Phase 2	Phase 3	Phase 4	Phase 5
Management focus	Make and sell	Efficiency of operation	Expansion of market	Consolidation of organisation	Problem solving and innovation
Organisational structure	Informal	Centralised and functional	Decentralised and geographical	Line-staff and product groups	Matrix of teams
Top management style	Individualistic and entrepreneurial	Directive	Delegative	Watchdog	Participative
Control system	Market results	Standards and cost centres	Reports and profit centres	Plans and investment centres	Mutual goal setting
Management reward emphasis	Ownership	Salary and merit increases	Individual bonus	Profit sharing and stock options	Team bonus

Source: adapted from L.E. Greiner's, 'Evolution and Revolution as Organisations Grow', Harvard Business Review, 1998

It is important to note that each phase is both an effect of the previous phase and a cause of the next phase. For example, the evolutionary management style in phase 3 is delegation. This emerges out of, and becomes the solution to, the demands for greater autonomy in the phase 2 revolution. The style of delegation in phase 3, however, eventually provokes a revolutionary crisis that is characterised by attempts to regain control because of the inconsistency and variety of approaches, resulting from too much delegation.

Greiner's model of growth demonstrates the paradox that success creates its own problems. As a company grows, it faces new crises. Each crisis, in turn, requires management to make adjustments to organisational design.

Key criticisms of Greiner's model include the following:

- It implies there is a logical, sequential development path for company growth; this is not the case in reality because companies may move forwards and backwards along the growth curve.
- It assumes that all growth occurs in discrete phases, when in fact a company may experience two phases simultaneously or miss one phase.
- It has limited value in predicting when transition points, between phases or between evolution and revolution periods, will occur and thus provides no advice for planning ahead.
- It is difficult to understand precisely where a large company is on the growth curve at any one time because different parts of a large organisation may be at different stages.

However, the model does illustrate clearly that not all companies are successful at responding to the various crisis points, with the result that some businesses fail to grow or fail completely.

Author advice

Earlier in this chapter, it was explained that diseconomies of scale would not be considered formally at this point in this book because the topic had been considered in detail in Chapter 13 of Book 1. You may need to refer to pages 234–236 in Chapter 13 of Book 1 in order to answer question 8 in Practice exercise 1 on the next page.

Practice exercise 1

Total: 90 marks

1 Explain two types of retrenchment. *(6 marks)*

2 Identify and explain one reason why a business might grow and one reason why a business might retrench. *(6 marks)*

3 Explain one positive and one negative effect of retrenchment on an organisation or its stakeholders. *(6 marks)*

4 Distinguish between organic growth and external growth. *(6 marks)*

5 Analyse the issues that a business needs to consider in managing and overcoming the problems of growth and retrenchment. *(9 marks)*

6 Explain two problems that may occur for a growing firm that changes from private limited to public limited company status. *(6 marks)*

7 Explain, with an example, each of the following economies of scale – technical, purchasing, managerial. *(9 marks)*

8 Identify and explain three diseconomies of scale. *(9 marks)*

9 Distinguish between economies of scope and economies of scale. *(6 marks)*

10 What does 'the experience curve' illustrate? *(3 marks)*

11 Explain the difference between falling average direct costs due to the experience curve effect and falling average total costs due to the effect of economies of scale. *(6 marks)*

12 Explain the term 'synergy'. *(3 marks)*

13 What does 'overtrading' mean? *(4 marks)*

14 Which one of the following is not a phase of Greiner's model of growth?
- a) Collaboration
- b) Communication
- c) Creativity
- d) Delegation
- e) Direction *(1 mark)*

15 Which of the following is not one of the crisis factors in Greiner's model of growth?
- a) Autonomy
- b) Control
- c) Growth
- d) Leadership
- e) Retrenchment *(1 mark)*

16 Analyse the characteristics of businesses in phase 1 of Greiner's model of growth and how these lead to a crisis of leadership. *(9 marks)*

Essay questions

Total: 25 marks

Answer one of the following questions.

1. Using examples of businesses you are familiar with, assess the implications for a business of organic growth as compared with external growth. *(25 marks)*
2. To what extent does Greiner's model of growth suggest that success at one stage of a company's development is unlikely to last? *(25 marks)*

Case study 1: Overtrading

Josh has a small business that has been in operation for four years. His working capital has been adequate to facilitate the steady growth that has taken place over these four years. His turnover is £250,000 p.a. and his profits are £22,000 p.a. An opportunity to bid for a contract with ABC plc comes up. The contract is to supply products worth £50,000 every two months for two years. Josh thinks this would help his business to grow more quickly – extra turnover of £300,000 p.a. He puts in a bid and is successful, agreeing to payment being made three months after delivery of the goods. Josh agrees an increase in his overdraft with the bank from £30,000 to £40,000. His bank suggests that he might be overstretching himself with such a large contract and will not increase the overdraft to the level Josh requests. Josh thinks he will manage.

He contacts his suppliers and orders sufficient supplies to fulfil the first few orders and asks that delivery is made as soon as possible. The contracts with his suppliers require him to make payment six weeks after delivery.

At the start things go well. ABC plc is pleased with the products they receive. The only problem is that Josh is at the limit of his overdraft because of the additional funding he needs to pay for the supplies he has bought and the wages of employees he has had to employ to meet the orders. He makes sure he can fund his employees' wages, but begins to fall behind with payments to suppliers.

At first he does not worry about the developing situation. As far as he is concerned he has the huge contract to supply ABC plc and that means a lot of additional revenue coming in. ABC plc makes the first payment on time and things ease temporarily. However, the next payment they make is late. Some of Josh's suppliers refuse to supply until they receive payment and some threaten legal action. Josh has gone over his agreed overdraft limit without permission and the bank is now refusing to honour any more payments to suppliers. The bank demands that the overdraft is paid in full within ten days. Josh cannot fulfil any more of the orders for ABC plc or for any of his other customers. The business has to close because he has no money to pay his workers or to buy supplies.

Questions

Total: 15 marks

1 Explain what a cash flow forecast is and how it can assist a business to manage its operations. *(6 marks)*

2 Analyse how Josh could have avoided the problem of overtrading and thus benefited from the growth his business experienced due to the huge order he gained. *(9 marks)*