Edexcel

A Level

Business studies

(Code: WEC13 01)

Unit 03-Section 02

Business growth

5. GROWTH

Growing a business involves increasing revenue, owning more assets, using more resources, and potentially making more profit. It can also increase market share, launch new products, and expand into new markets. Gillam Group, a Canadian construction company, experienced over 29,000% revenue growth since 2011, doubled its revenues in its first three years, and had sales between $50-$100 million last year. Growth can lead to higher revenues, lower unit costs, and a higher profile with larger market share.

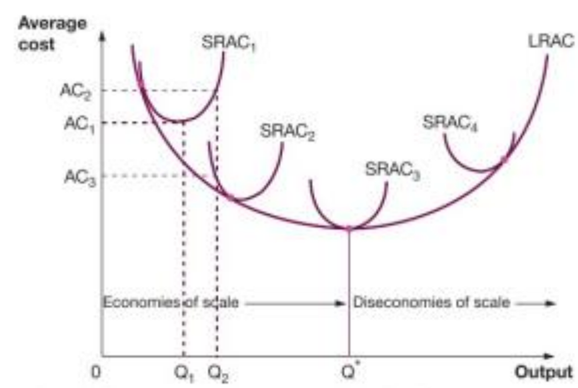
ECONOMIES OF SCALE

The size of a business significantly impacts average costs of production. Larger businesses have a competitive advantage over smaller ones due to economies of scale. In the long run, expanding the scale of operations can lead to more efficient production, resulting in long-run average costs falling due to economies of scale. This process continues until a plant is built that minimizes long-run average costs, as shown in Figure 2.

This is sometimes called the **minimum efficient scale of plant.**

INTERNAL ECONOMIES OF SCALE

What are the different economies of scale a firm can gain? Internal economies of scale are the benefits of growth that arise within the firm. They occur for a number of reasons.



▲ Figure 2 The long-run average cost curve and the effect of economies of scale

Purchasing and marketing economies: Large firms often receive better rates when buying raw materials and components in bulk, and administration costs do not increase with order size. Marketing economies exist, such as buying own vehicles and reducing sales force costs. Administration costs do not increase with sale size.

Technical economies: Technical economies arise because larger plants are often more efficient. The capital costs and the running costs of plants do not rise in proportion to their size.

Specialisation and managerial economies: A firm can afford to employ specialist managers as it grows. In a small business, one general manager may be responsible for finance, marketing, production and human resources. The manager may find the role demanding. Efficiency may improve and average costs fall if a business employs specialists in these fields.

Financial economies: Large firms have advantages when they try to raise finance. They will have a wider variety of sources from which to choose.

Risk-bearing economies: As a firm grows it may well diversify (i.e. develop a wider range of products) to reduce risk.

EXTERNAL ECONOMIES OF SCALE

External economies of scale are the reductions in costs that any business within an industry might benefit from as the industry grows. External economies are more likely to arise if the industry is concentrated (i.e. if there are a large number of firms) in a particular geographic region.

Labour: The concentration of firms may lead to the build- up of a labour force with the skills required by the industry. Training costs may be reduced if workers have gained skills at another firm in the same industry. Local schools and colleges, or even local government, may offer training courses which are aimed at the needs of the local industry.

Ancillary and commercial services: An established industry tends to attract smaller firms that are trying to serve the particular industry's needs. A wide range of commercial and support services can be offered. Some examples include specialist banking, insurance, marketing, waste disposal, maintenance, cleaning, components and distribution services.

Co-operation: Firms in the same industry are more likely to co-operate if they are concentrated in the same region. They might work together to fund a research and development centre for the industry. An industry journal (i.e. magazine) might be published so that information can be shared.

Disintegration: Disintegration occurs when production is broken up so that more specialisation can take place. When an industry is concentrated in an area, firms might specialise in the production of one component. Then, they would transport it to a main assembly plant (i.e. the place where it is put together).

INCREASED MARKET POWER

As businesses get bigger they become more dominant (i.e. more powerful). As a result, rivals are left with a smaller market share and some weaker businesses may be forced to close down. If a business is large enough, it may be able to dominate two particular stakeholders.

- Customers: A dominant business may be able to charge higher prices if competition in the market is limited. Customers are forced to pay higher prices when there is less choice. Also, there is less need to develop new products if there is a lack of competition in the market.

- Suppliers: Sometimes a business can dominate its suppliers.

INCREASED MARKET SHARE AND BRAND RECOGNITION

As businesses grow, their share of the market is also likely to grow. This will give them more power and they may be able to benefit from the advantages previously outlined. However, they will also benefit from having a greater brand recognition (i.e. people remembering and identifying with the brand). As the brand becomes stronger, a business may be able to:

- charge higher prices
- make the product distinct from those of rivals
- create customer loyalty
- achieve greater product recognition
- develop an image
- launch new products more easily.

INCREASED PROFITABILITY

Growth is crucial for businesses to make more profits, with larger companies often making larger profits. For instance, Arca Continental, the second-largest Coca-Cola distributor in South America, experienced a 17.8%

increase in revenues between 2015 and 2016, benefiting shareholders by increasing dividend payments and boosting share prices. This growth also allows for more profit for investment and innovation, enabling the development of new products and acquisitions.

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SUBJECT VOCABULARY

diseconomies of scale rising long-run average costs as a business expands beyond its minimum efficient scale
economies of scale the reductions in average costs experienced by a business as output increases
external economies of scale the cost reductions available to all businesses as the industry grows
indivisibility the physical inability, or economic inappropriateness, of running a machine or some other piece of equipment at below its optimal operational capacity
inorganic growth a business growth strategy that involves two (or more) businesses joining together to form one much larger one
internal economies of scale the cost reductions experienced by a single business as it grows
minimum efficient scale the output that minimises long-run average costs
organic growth a business growth strategy that involves a business growing gradually using its own resources
sole trader or sole proprietor a business organisation which has a single owner
venture capitalist provider of funds for small- or medium-sized companies that may be considered too risky for other investors

THE DISTINCTION BETWEEN INORGANIC AND ORGANIC GROWTH

Businesses can utilize external growth or inorganic growth through mergers and takeovers, such as Doctoralia's 2016 merger with DocPlanner. This strategy allows businesses to double in size overnight, compared to Doctoralia's 9 million monthly users.

In contrast, internal growth or **organic growth** occurs when a business grows naturally by selling more of its output using its own resources.

6. Organic growth

METHODS OF GROWING ORGANICALLY

Organic growth usually involves a business growing by building on its strengths to increase sales. However, there are several different approaches to growing organically.

New customers: Perhaps the easiest approach is to rely on driving sales from existing activities.

New products: Some businesses grow by developing new products. They may be very innovative (i.e. good at introducing new ideas) and committed to research and development.

New markets: Some businesses grow organically by finding new markets for their products.

New business model: It is possible to grow organically by using a new business model. Developments in technology or social change may lead to this growth.

Franchising: A business might set up a franchising operation to increase the speed of organic growth. This approach allows other entrepreneurs to trade under the name of the original business.

ADVANTAGES OF ORGANIC GROWTH

There are many benefits of organic growth. Entrepreneurs should know their business and grow their company by exploiting its own strengths and expertise. For example, they can move quickly by adapting to changes in the market.

- Less risky. Organic growth might be less risky than other growth strategies. Growth can be achieved by extending practices that are well known and understood. This can prevent errors because the culture, norms and practices of the business are already established and effective.

● Relatively cheaper. Growing organically might be cheaper than using other methods. Organic growth can be financed from retained profit. This is likely to be the cheapest of all sources of finance. There will be an opportunity cost, but the financial cost can be zero.

● Keep control. A business will keep more control when growing organically. Owners, or the senior management team, will have complete control of the growth process. This is because there are no outsiders with any controlling interest.

● Better protection. The financial position of a business might be better protected with organic growth. Since growth is gradual, there is less strain on financial resources. As a result, cash flow is stronger and the business will keep more liquidity.

● Avoid diseconomies of scale. A business that grows organically is less likely to experience diseconomies of scale. Sharp increases in unit costs are not likely to occur if growth is steady and measured. It may be easier for a business growing organically to see any possible difficulties resulting from scale increases.

DISADVANTAGES OF ORGANIC GROWTH

Although there are advantages of organic growth, there i the argument that it prevents a business from reaching its full potential. It may miss out on rewarding opportunities and get left behind in the market. Some specific disadvantages are outlined below.

- Slow pace of growth. The pace of organic growth may be too slow for some stakeholders
- Lack of access to resources. Organic growth may prevent the business from using the resources owned by other businesses. As a result, it might miss out on some profitable developments.
- Unable to be competitive. A business that grows slowly may be left behind in the market. The business may end up feeling small if competitors are growing through mergers and acquisitions.
- Unable to fully exploit economies of scale. A business may be able to exploit economies of scale as it grows. However, if a business is growing organically it may take some time before such economies are fully exploited. This could mean that a business is having to operate with higher costs for longer periods of time.
- May be inappropriate. Organic growth may not be appropriate if a market is growing rapidly.

SUBJECT VOCABULARY

franchising a business model where a business owner (the franchisor) allows another person (the franchisee) to trade under their name
retained profit profit after tax that is 'ploughed back' into the business
stake a financial interest in a business which entitles the investor to part-ownership

7. Inorganic growth

REASONS FOR MERGERS AND TAKEOVERS

The distinction between organic and inorganic growth was made in Chapter 5. Inorganic growth means that businesses get bigger by joining together. For example, mergers and takeovers take place when firms join together and operate as one organisation. Why do some businesses act in this way?

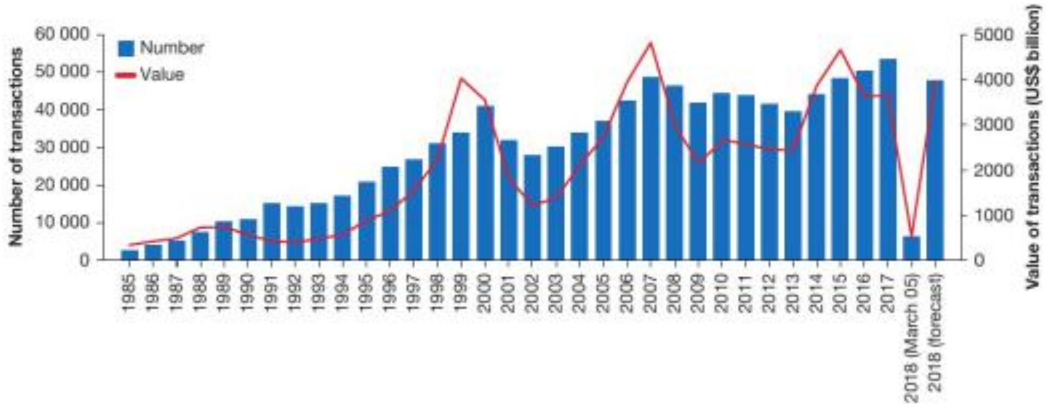
- One of the main motives for integration (i.e. joining) is to exploit the synergies that might exist following a merger or takeover. This means that two businesses joined together form an organisation that is more powerful and efficient than the two companies operating on their own.
- It is a quick and easy way to expand the business.
- Buying another business is often cheaper than growing internally.
- Some businesses have cash available which they want to use. Buying another business is one way of doing this.
- Mergers take place for defensive reasons. One business might buy another to consolidate its position (i.e. make its position more powerful) in the market. Also, if a firm can increase its size through merging, it may avoid a takeover itself.
- Businesses respond to economic changes.
- Merging with a business in a different country is one way in which a business can gain entry into foreign markets. It may also avoid restrictions that prevent it from locating in a country or avoid paying tariffs on goods sold in that country.
- The globalisation of markets has encouraged mergers between foreign businesses. This could allow a company to operate and sell worldwide, rather than in particular countries or regions.
- A business may want to gain economies of scale. Firms can often lower their costs by joining with another firm.
- Some firms are asset strippers. They buy a company, sell off profitable parts, close down unprofitable sections and perhaps integrate other activities into the existing business. Some private equity companies have been accused of asset stripping in recent years.
- Management may want to increase the size of the company. This is because the growth of the business is their main objective. It may also be because the financial rewards to managers is often linked to growth and the size of the company.

DISTINCTION BETWEEN MERGERS AND TAKEOVERS

Both mergers and takeovers are corporate strategies that aim to improve the performance of a business. However, there is a clear distinction between the two.

Merger: A merger is where two (or more) businesses join together and operate as one. Mergers are usually conducted with the agreement of both businesses. They are generally 'friendly. The name of the new business is often formed out of the names of the two original businesses.

Takeover: A takeover occurs when one business buys another, often by buying 51% of the shares. Public limited companies can be acquired by buying 51% of the shares, either on the stock market or directly from existing shareholders. Private limited companies cannot be taken over unless majority shareholders invite others to buy their shares. Companies can take control of another company by buying less than 51%, and must declare this to the stock market.



▲ Figure 1 The number and value of global mergers and takeovers 1985–2018
Based on M&A Statistics, https://imaa-institute.org/mergers-and-acquisitions-statistics/, Institute for Mergers, Acquisitions and Alliances

HORIZONTAL AND VERTICAL INTEGRATION

Integration is when businesses join together to form one. It can be classified in a number of ways, although not all mergers and acquisitions fit neatly into these categories.

The benefits of mergers between such firms include:

● a common knowledge of the markets in which they operate

● less likelihood of failure than merging two different areas of business similar skills of employees less disruption.

Vertical integration occurs when firms in different stages of production join together. **Forward vertical integration** is where a business joins with another that is in the next stage of production. **Backward vertical integration** is where a business joins with another in the previous stage of production.

CONGLOMERATES

A conglomerate is a large business organization that owns multiple businesses, each with its own board of directors, acquired through mergers and takeovers. An example is Tata, which has over $100 billion in revenue in 2017. Conglomerates have a wide range of interests, spreading risk and exploiting economies of scale. However, diversification can lead to difficulties, as the original management team may not fully appreciate the forces driving success in new acquisitions. Over time, a conglomerate may become confusing and slow to eliminate failing companies due to fear of losing diversification levels.

FINANCIAL RISKS AND REWARDS

Financial rewards: The main reason why firms join together is to improve the financial strength of a business and make more money. A number of specific financial rewards are identified below.

- Stakeholder benefits. Shareholders in the 'target' company often get an immediate premium when taken over. This is because the share price often rises sharply during the process of a bid.
- Stronger balance sheet. A takeover or merger results in a larger single organisation. As a result, the strength of the balance sheet improves. The company will have more assets which are also likely to be more diverse. It is possible that the cash flow of the company will also improve since greater revenues will be generated by the larger organisation.

- Lower costs. One of the main motives for mergers and takeovers is to lower costs. Following acquisitions, corporations will be larger. As a result they will be able to exploit economies of scale and lower their costs.
- Lower taxes. It is possible for a company to lower its tax liabilities following a takeover. This is likely to occur if a business acquires another which is located in a 'low-tax' country. Tax liabilities can be reduced by registering all the activities of the business in the country where tax rates are lower. **Risks**: Mergers and takeovers are common corporate strategies. Some of the key financial risks are outlined below.
- **Integration costs**. After a merger or takeover has been agreed, the next step is to physically integrate the two organisations. This can be a very complex, expensive and time-consuming process, the effects of which may be felt for many years.
- Overpayment. T Overpayment is a common reason for merger and acquisition failures, with studies suggesting a failure rate of 70-90%. This can be due to overestimating financial benefits or acquisition costs, leading to inflated prices. For instance, Yahoo! paid $1 billion for social network site Tumblr, despite having only $353 million assets and $114 million liabilities.
- Bidding wars. In some cases, it is possible that one business attracts more than one potential buyer. If this happens the price of the acquisition will start to rise, as it would do in an auction. This makes the takeover more expensive.

THE ADVANTAGES OF INORGANIC GROWTH

Some companies may be under pressure to grow quickly. Shareholders often favour quick growth because it usually stimulates a rise in the share price. Inorganic growth can deliver rapid growth but there are other specific benefits which are outlined below.

- Speedy growth. Businesses can grow far more quickly through mergers and takeovers than growing organically. This means that the benefits of growth, such as larger market share, lower costs resulting from economies of scale, more market power and higher profitability, can be enjoyed more immediately. This might benefit a range of stakeholders.
- Strategic benefits. Acquisitions and mergers can help businesses to improve their strategic position. Firms often join together because their activities may complement each other.
- Economies of scale. An important advantage of inorganic growth is that a company may benefit from economies of scale almost overnight. For example, when two companies join, the new organisation will only need one head office.
- Eliminate competition. Inorganic growth can help to reduce competition in the market. Clearly, if a company takes over a rival, there will be fewer operators in the market. If the process of acquisitions continues in the same market, competition will decrease. This may lead to one firm (or just a few firms) dominating the market, which might allow the remaining companies to raise prices, restricting consumer choice.

THE DISADVANTAGES OF INORGANIC GROWTH

Inorganic growth strategies can be risky, as some mergers and takeovers may fail due to unsatisfactory outcomes. For example, Australian conglomerate Wesfarmers bought UK DIY chain Homebase for £340 million in 2016, but admitted in 2018 that the takeover had failed, leading to a £584 million write-down and a loss of £97 million in half-year.

In some cases, if growth is too rapid, serious problems may occur. Some examples are outlined below.

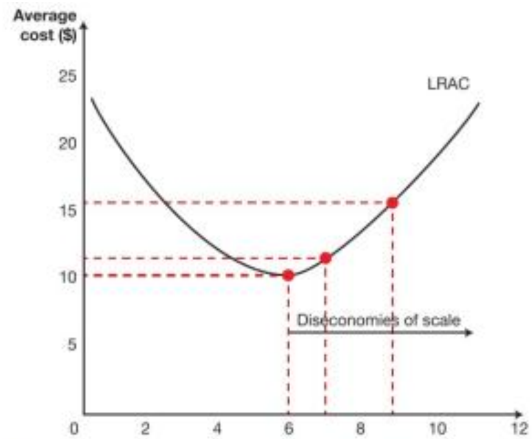
- Regulatory intervention. Mergers and takeovers in most countries can attract the attention of market regulators (i.e. people or organisations that make sure an industry is being run fairly). If they think that a merger or takeover acts against the interests of the consumer, they have the power to order an investigation.
- Drain on resources. Mergers and takeovers can cost a lot of money.
- Culture clash. When businesses merge, the integration process can be challenging because lots of changes have to be made. One of the main difficulties is merging two different cultures. It can be very difficult to impose a new culture on a business and there may be resistance (e.g. disagreements).
- • The alienation of customers. Companies that are growing too fast might lose touch with their customers. Too much attention and resources get focused on the process of growth. As a consequence, the needs of customers can be overlooked.
- Loss of managerial control. If growth is too rapid the company might get too big too fast. This can result in a loss of control by the senior executives. A bigger organisation means that additional layers of management are required.

SUBJECT VOCABULARY

acquisition the purchase of one company by another
backward vertical integration joining with a business in the previous stage of production
conglomerate a very large single business organisation made up of many different businesses producing unrelated products
forward vertical integration joining with a business in the next stage of production
globalisation (of a market) where markets become so large that products could be sold anywhere in the world
horizontal integration the joining of businesses that are in exactly the same line of business
integration the joining together of two businesses as a result of a merger or takeover
merger occurs when two (or more) businesses join together and operate as one
regulatory intervention control by the relevant authorities such as the Competition Commission
synergy the combining of two or more activities or businesses which creates a better outcome than the sum of the individual parts
takeover the process of one business buying another
vertical integration the joining of two businesses at different stages of production

8 Problems arising from growth

DISECONOMIES OF SCALE



▲ Figure 1 Diseconomies of scale

Diseconomies of scale may occur if a business expands the scale of its operations further than the minimum efficient scale. This is where long-run average costs rise as output rises. In Figure 1, when the business produces 6 million units the average cost is $10 per unit. This is the minimum efficient scale of operations and all economies of scale have been used up. From this point, higher levels of output result in rising long-run average costs.

SOURCES OF DISECONOMIES OF SCALE

There are a number of reasons why long-run average costs might rise as output is pushed above the minimum efficient scale. They fall into two groups - internal diseconomies of scale and external diseconomies of scale.

Internal diseconomies of scale: Internal diseconomies of scale are the rising costs caused by excessive growth in the business. Most internal diseconomies are caused by the problem of managing very large business organisations.

- Poor communication. Very large firms often suffer from poor communication. The flow of information between individual employees, departments, divisions or between head office and subsidiaries becomes more difficult to manage when a firm is very large. This is because the chain of command in such organisations may be long. The problems associated with internal communication in a very large organisation are discussed in more detail below.
- Control and co-ordination. TLarge businesses face challenges in controlling and coordinating their vast resources, requiring a larger number of managers and supervisors. For instance, Volkswagen faced issues in 2015 when emissions levels rose due to a "defeat device" in cars, suggesting the company's growth was unmanageable. The CEO of VW was reportedly unaware of this, highlighting the challenges faced by large organizations.
- Poor worker motivation. Motivation may suffer as individual workers become a minor part of the total workforce.
- Technical diseconomies. Overuse of plants, machinery, and equipment can lead to inefficiency and costly breakdowns. For instance, in the agricultural industry, overworking a tractor can cause engine overheating, reducing output. In the chemical industry, two smaller plants are more cost-effective than one large plant, allowing production to continue even with breakdowns.
- Bureaucracy. If a business becomes too bureaucratic, it means that too many resources are used in administration. Too much time may be spent filling in forms or writing reports. Also, decision making may be too slow and communication channels too long. If resources are wasted in administration, average costs will start to rise.

External diseconomies of scale: External diseconomies occur when an industry grows too big (rather than the individual firm). Rapid growth in an industry can result in the price of production factors rising sharply. This is because growing demand for them drives up the price.

INTERNAL COMMUNICATION

Internal communication in a business can be hindered by the growth of the management structure, leading to longer channels and increased error risk. This can result in misunderstandings and arguments, reducing productivity. However, rapid development in ICT has reduced these issues by enabling instant messaging and video conferencing, allowing staff members to communicate face-to-face from different geographical locations.

OVERTRADING

If a business grows too fast, there is a danger that it might suffer from overtrading. This is more likely to affect young, rapidly growing businesses. Overtrading occurs when a business tries to fund a large volume of new business without sufficient resources. As a result, it runs out of cash and, at worst, it can collapse.

Overtrading is most likely to occur if a business:

- does not have enough capital. It is fairly common for a new business to be undercapitalised. This means that it has started trading with insufficient capital. It does not have enough cash to buy the resources needed to meet the growing orders

- offers too much trade credit to customers. It may be tempting for a new business to allow its customers 90 or 120 days' trade credit. However, this means that the business has to wait that length of time, or more, to be paid. During this time it will be short of cash to buy the resources needed to meet new orders

- is operating with small profit margins. In order to make an impact in the market, a new business may offer its products at lower prices. However, with lower prices (and therefore lower profit margins), it may not generate enough profit to fund the growing volume of business.

SUBJECT VOCABULARY

overtrading a situation where a business does not have enough cash to support its production and sales, usually because it is growing too fast