Chapter 5: Growth and Evolution

What you should know-

- Internal and external economies and diseconomies of scale
- The difference between internal and external growth
- Reasons for businesses to grow
- Reasons for businesses to stay small
- External growth methods

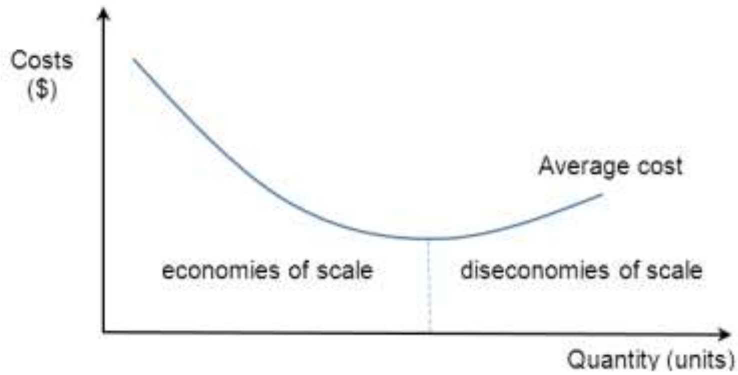
  1. Mergers and acquisitions (M&As)
  2. Takeovers
  3. Joint ventures
  4. Strategic alliances
  5. Franchising

Economies of scale

Economies of scale enable a business to benefit from **lower average costs (the cost per unit)** by increasing the size of its operations. It helps companies to gain **competitive advantage** because lower average cost could mean combination of lower prices being charged to customers and a higher profit margin earned on each item sold.

Diseconomies of scale

D**iseconomies of scale** will occur if the **firm grows beyond its ability to operate efficiently**. This causes **the firm's average costs of production to rise** due to problems such as miscommunication, misunderstandings, and poor (inefficient) management of resources.



The level of output where the average cost of production is at its lowest value is called the **optimal output level**, i.e., the level of output where economies are fully exploited. At this level of output, profit is maximized.

Economies of scale can be either internal or external

Internal economies of scale:** are cost reductions that can be achieved inside the company, and are within its control when it expands its output are known as internal economies of scale. They may occur in different ways

They may occur in different ways:

Type	Explanation
Financial economies of scale	Large firms can borrow large sum of money at lower rates of interest compared to smaller competitors because the larger organizations are seen as less risky to financial lenders due to proven track record and a diversified range of products. By contrast, smaller firms such as sole traders not only tend to struggle to raise external sources of finance, but are also charged higher interest rates on their borrowings due to higher degree of risks involved. There is also strong competition amongst commercial banks to lend money to large multinational businesses. Hence, a large and established business looking to borrow money is likely to be able to choose a lender that offers the most attractive (the lowest) interest rates, with preferential repayment terms and conditions.
Technical economies of scale	Modern technology enables businesses to produce very high levels of output at much lower unit costs than smaller firms can do. Large firms can afford to use sophisticated and specialized machinery to mass produce their output.

	However, as mass production uses expensive capital equipment, only very large businesses can afford the level of capital investment required. The high fixed costs of their capital equipment and machinery are spread over the huge scale of output thereby reducing average costs of each product. *(only for understanding) For example, due to the extremely large scale of its production, the Foxconn's mega factories in Taiwan and China can produce iPhones and iPads 24/7 for Apple. The high fixed costs of their capital equipment and machinery are spread over the huge scale of output being produced for Apple, thereby reducing Foxconn's average costs of each product.* By contrast, small businesses find no practical reason for use of such technology. Even if small firms could afford to purchase the latest capital equipment and production technologies, they would be unlikely to keep these operating continuously due to the lower demand for their products.
Purchasing(bulk-buying) economies of scale	Large firms can lower their average cost by buying resources in bulk (raw materials, components, semi-finished goods and finished goods). The more items purchased at one time, the larger the savings (discounts) that their suppliers are likely to offer, thereby leading to a lower average cost of production. Although small businesses can also gain some purchasing economies of scale due to bulk-buying discounts, the larger the order, the greater the reduction in unit costs. Hence, larger firms gain far more from purchasing economies of scale than smaller firms.
Managerial Economies of Scale	A sole trader often has to fulfil the functions of marketer, accountant and production manager. As people cannot be equally at everything, specialization leads to higher productivity. By contrast large firms can afford to hire specialist managers for different functional areas of the business such as Marketing, Finance, Production (Operations management) and Human Resources (HR). Through growth, a larger business can avoid the duplication of tasks in planning, communications, marketing, distribution, and production processes, all of which help to increase efficiency.
Marketing economies of scale	Larger businesses can spread their fixed costs of marketing by promoting and advertising a greater range of brands and products, lower AC/unit

	(Only for understanding) For example, global firms such as Nike, Toyota, Samsung, and The Walt Disney Company can spread the high costs of advertising and promotion by using the same marketing campaign across the whole world for all of their products.
Specialized economies of scale:	Larger firms can afford to hire and train specialist workers, which help to boost output, productivity, and efficiency (thereby cutting average costs of production). This type of economies of scale results from the division of labour of the workforce (rather than the specialization of managers) in different parts of the production process. Division of labour happens when the production process is split into different tasks and each worker repeatedly performs one of these tasks. When workers are trained in just one task (or a narrow range of tasks) and specialize in it, efficiency and output can be increased because the worker is able to complete her/his assigned task faster and more effectively. Also, less time is wasted moving from one workstation to another.

External Economies of scale

It occurs outside the business and are beyond the internal control, average cost of production falls as the industry as a whole (rather than the firm itself) grows. This means that all firms in the industry benefit.

- **Technological progress:** increases productivity within the industry, Internet has created huge cost savings for e-commerce businesses

- **Improved transportation network:** helps to ensure prompt deliveries. Congestion increases business costs while reducing revenues

- **Locally available skilled labour:** availability of skilled labour in the local area helps to cut recruitment cost without compromising the productivity levels

- **Regional specialization:** If a country has a specialization in specific goods, it brings expertise, suppliers, thus helping to reduce average costs.

Diseconomies of scale

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Diseconomies of scale can be either internal or external

Internal Diseconomies of scale occur due to problems within the organization, which cause productivity to fall and inefficiencies to occur. Most of these problems arise due to mismanagement of internally large organisations.

- **Control and communication problems:** As organisations grow and become more complex, there may be several layers of management between the CEO and employees, making efficient communication more difficult, management may not be able to control firm, raising AC / unit

- **Isolation and loss of identity:** as firm grows, workers may feel demotivated and work less efficiently, without any corresponding increase in productivity, raising AC / unit

- **Poorer Working relationships:** With a larger workforce, senior Managers are more likely to become detached from staff can reduce their morale and productivity thereby raising its unit cost
- **The amount of Bureaucracy:**(administration, paper work, procedures and company policies) is likey to increase as business grows. Bureaucracy often gets in the way of doing things efficiently, thereby increasing Average cost of production.

External diseconomies of Scale - occur when issues outside of the organization raises the average costs of production for all businesses in the industry.

- **Too many businesses in the same area:** increases cost of rent without increasing the output, hence unit cost will rise

- **Locally available skilled labour:** Since workers have greater choice from a large number of employers in the local area, businesses might have to offer higher wages and financial rewards to retain workers.

- **Traffic congestion:** delayed deliveries due to the overcrowding

- **Limited Infrastructure:** can slow down deliveries and raise costs of production

Reasons for business to grow

Economies of Scale

Large organizations benefit from economies of scale (cost-saving benefits of operating on a larger scale). This reduces their unit costs of production, so the large firm is in a position to charge lower prices to their customers, yet be able to offer more choice for their customers. This makes larger firms more competitive and attractive to customers.

Sources of finance

Large organizations have greater access to a wider range of sources of finance, such as share issues and the ability to borrow funds at a cheaper rate due to their reputation and size. Having more sources of finance can enable these organizations to become even larger as they pursue their growth objectives.

Spreading risk

Large organizations tend to be less of a risk for the owners, investors and creditors (such as banks and suppliers). By contrast, smaller firms are far more likely to fail, so are a higher risk for owners, investors and creditors. For example, small organizations are more at risk of failing during a recession

Recruitment and retention of employees

Larger organizations tend to be able to pay their workers higher wages and salaries. This will help to attract and retain better skilled workers, thereby improving the larger firm's productivity and profitability in the long-term.

Brand awareness and brand loyalty

Customers are generally attracted to well-known brands of larger companies, due to brand recognition and brand loyalty. The power of branding suggests that customers trust well-established brand names and are prepared to pay a premium price for them. In many cases, larger firms have the resources to provide better customer services, such as after-sales care.

Reasons for business to grow or being a large business

Privacy

The owners of small businesses can enjoy greater privacy as their financial accounts do not have to be made public. By contrast, the rivals of a large company have access to their balance sheet and profit and loss account.

Ownership and Control

Many small business owners may not want to expand so that they can retain ownership and control of their own business. Becoming a much larger organization often involves selling shares on a stock exchange, and whilst this can raise a significant amount of finance, it dilutes ownership and control of the company

Autonomy

The owners of small organizations enjoy autonomy (independence in decision making). They have complete control and ownership of the business, so can make their own, independent decisions. Unlike large companies, the owners of small organization do not face pressures from a board of directors and shareholders.

Low Financial risk

As the costs of running large global business are huge (like R & D, marketing, recruitment and training), the financial risks are also huge. By contrast, owners of small businesses can better manage and control their finances

Specialization

Smaller firms can specialize in providing goods and services that larger organization find unprofitable to supply. Small firms that specialize in niche markets, such as sporting equipment for paddle boarding or fencing, can be highly profitable and earn extremely high profit margins. Operating in niche markets also means the firm benefits from very limited competition.

Internal vs. External Growth

Internal growth is called as organic growth is carried out by the organisation itself without working with a partner. It uses its own capabilities and resources to increase the sales of its operations and sales revenue. The main source of organic growth is retained profits, borrowings and issue of shares

Large companies can also sell shares on a public stock exchange to raise finance for expansion, whilst new companies can raise share capital (to fund business growth) from an initial public offering (IPO) on the stock exchange

A business can grow internally in several ways-

- **Changing price-**more customers tend to buy a product at lower price

- **Effective promotion-** people are more likely to buy the product if they are reminded, informed or persuaded about the benefits of the product

- **Producing improved and better product-**through methods such as market research, innovation and new product development, business can produce products that are appealing to the market, thereby raising their sales

- **Sell through greater distribution network-** Coca-Cola is widely available throughout the world in different places in supermarkets, airlines, restaurants and vending machines

- **Offer preferential credit-** customers are more likely to make a purchase if they are offered the option to 'buy now and pay later'. Allowing customers to pay in regular installments over 12-14 months for expensive products (EMI) can attract more customers to the market.

- **Increase capital expenditure-** internal expansion to new locations or introduction of new technology to improve productivity

- **Providing overall value for money-**quality, after sales care, maintenance cost and environmental considerations as customers look for more than just the price when making purchasing decision

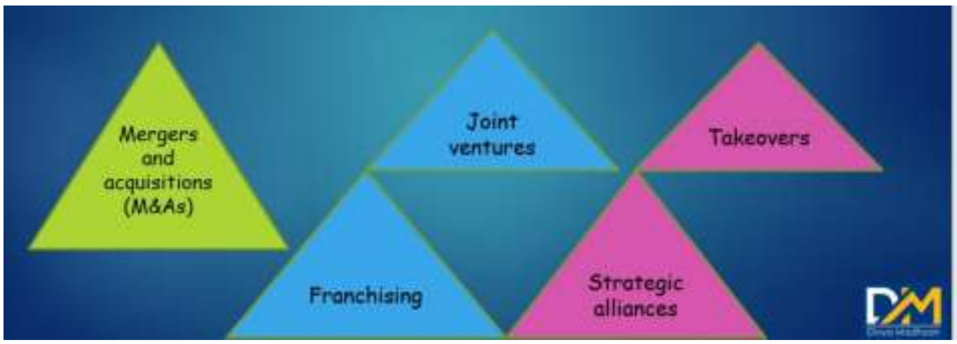
EVALUATION OF INTERNAL GROWTH

Advantages	Disadvantages
Less risky When a business grows with its own resources, no other party is involved. This means that managers have more control over the resources used to grow and the way in which the business chooses to grow.	**Slower growth** Growing only with the resources of the company may take a long time, larger competitors might enter the market.
Better control and coordination It is often easier to grow internally than to rely on external sourcesshareholders maintain control. Internal growth enables the organisation to maintain control whereas external growth can lead to loss of control and ownership of the business.	**Restructuring** Although a sole trader can control and coordinate the business quite easily, if it grows into a multinational company then the organizational structure has to be changed. Restructuring takes time, effort and money, such as training needs
Less expensive When businesses grow internally, it costs less and they often decide to use internal sources of finance, such as retained profit, for expansion. If they avoid using external sources of finance	**Cash flow problems** Growth can be expensive and if businesses do not see an increase in revenues right away, they may have cash flow problems.

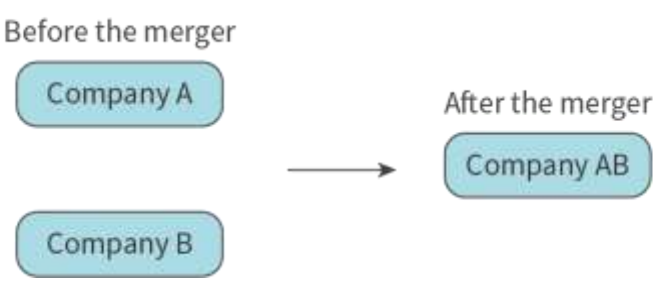
, such as bank loans, they can avoid interest rate payments or giving up equity in the business.	
Maintains a corporate culture When there is a merger or takeover, cultural clash arises but internal growth is free from problems related to cultural clashes or conflicting management styles	**Diseconomies of scale** Higher unit cost of production arises from internal growth causing communication problems and slower decision making as business grows

External growth-refers to the expansion and evolution of a business by using third party resources and organizations rather than relying on internal sources and activities. That is, the company works with another company in order to expand.

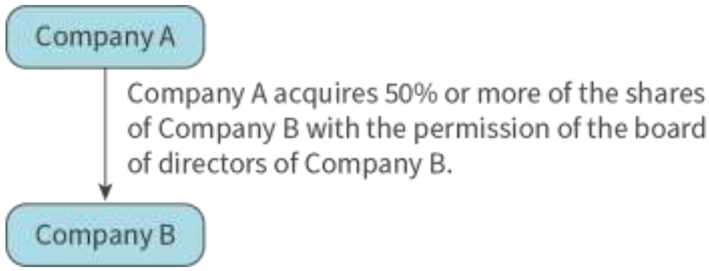
The five methods of external growth (inorganic growth) specified in the syllabus are:



- **A merger** takes place when two or more companies agree to form a single, larger company thereby benefiting from operating on a bigger scale. The merger usually requires a new company name to be used with a new legal identity, along with a Board of directors that is composed of executives from both or all the companies involved.

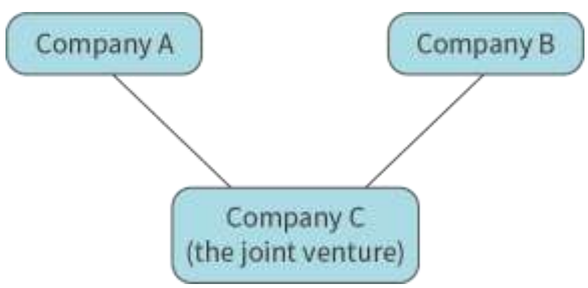


- **An acquisition** involves one company buying a controlling interest (majority stake) in another company with the agreement of the directors and shareholders of the target company. Company A becomes the parent company and Company B becomes the subsidiary company. In some cases, the parent company acquires a majority stake (over 50%), rather than 100% of the subsidiary. In any case, both companies continue to exist as legal entities, but A 'controls' B due to its ownership interest.



- **Takeovers,** like mergers, a **takeover** involves a company purchasing a controlling interest (majority stake) in another company. However, unlike mergers and acquisitions(M&As), **takeovers** are almost always hostile in nature as it occurs without the permission or agreement of its company or board of directors. The purchasing company will usually try to purchase a majority of shares of the other company, either directly from shareholders or through stock markets.

- **A joint venture (JV)** is an external growth method that involves two or more organizations agreeing to create a new business entity, usually for a finite period of time. The newly created business is funded by its parent companies. They split the costs, risks, control and rewards of the business project. They involve the creation of a separate entity that can be dissolved at the end of the project, without compromising the businesses of the parent companies.



  - **Strategic alliances (SA)** are created when two or more organizations join together to benefit from external growth without having to set up a new separate entity or to make major changes to their own business models. Examples include: The firms in the SA share the cost of the product development, operations and marketing but remains an independent organisation.

    - Apple and MasterCard (the first credit card company to offer Apple Pay)

- General Motors and Lyft (a strategic alliance set up to develop a driverless car)
- Spotify and Uber (riders can listen to their own playlists)
- Star Alliance (one of the largest airline alliances consisting of 27 airlines

Evaluation of M & A, Joint ventures and takeovers

Advantages	**Disadvantages**
Quick growth These are relatively quick growth methods, especially if the organization wishes to enter new markets (with new/existing products in new/existing markets). They are all faster methods of expansion than internal growth and evolution	**Loss of control** There is potential loss of management control of the company, especially in the case of a hostile takeover of the business. M&As often cause redundancies of senior managers.
Greater market share Integrated company is likely to benefit from higher sales revenue and larger customer base	**Expensive** It is typically expensive. For a company to buy out a rival firm is often unaffordable.
Economies of scale Operating on a large scale helps to lower unit cost of production thereby increasing firm's competitivess or profit margins For example, backward vertical integration enables the firm to gain from having direct access to its supplier, thereby cutting average costs of production	**Cash flow problems** Growth can be expensive and if businesses do not see an increase in revenues right away, they may have cash flow problems.
Synergy Firms have access to each other's resources such as finance, technologies, management expertise etc. to increase productivity, sales reveue and profits	**Diseconomies of scale** The newly formed company can be too large to manage efficiently, i.e. it may experience diseconomies of scale. This can happen due to several reasons, such as a lack of effective cost control, culture clashes, resistance to change, and a loss of focus on core business operations
Spreading risk M&As enable the larger organization to spread its fixed costs and risks, and to share its resources and expertise. This can improve the larger company's chances of success.	**Cultural Clash** Possibility of a culture clash between organisations involved (difference in corporate culture might have a negative effect on business). There are likely to be challenges faced by employees who may need to adapt to new working practices, company policies, and management styles.

Evaluation of Strategic Alliances

Advantages	Disadvantages
❑ As with a JV, members of a strategic alliance can benefit from the pooling of resources in a business project. This created synergies, such as the sharing of: industry expertise, research and development, financial resources, distribution channels, and the spreading of risks	❑ Unlike a JV, there are few barriers to entry and exit in a strategic alliance. For example, as it is much easier for members to pull out of a strategic alliance, they may be less committed.
❑ Businesses in a SA retain their individual corporate identities, without the expenses of establishing a new company with its own legal status (as in the case of joint ventures). This also means it is usually quicker to set up a SA than a JV.	❑ Many strategic alliances are only short-term agreements. This can limit the options for an organization's external growth strategies.
❑ As with a JV, a strategic alliance fosters cooperation rather than competition. In theory, if there is less competition, profits should rise.	❑ As there can be numerous members in a SA, the business organization in question is exposed to the potential mistakes or misconduct of member firms in the alliance.
❑ It s more straightforward to terminate a SA than a JV, or to demerge, if the alliance does not work out for whatever reason.	❑ As with all cases of working with and relying on third parties, there is the potential of conflict and misunderstandings. Communication problems, divergent corporate cultures and perspectives, and mistrust are key reasons for the failure of many strategic alliances.

Franchising

Franchising is a growth method that involves two parties, with the **franchisor** giving the licensing rights to a franchisee to sell goods and services using the franchisor's name, logo, brands and trademarks. In return of this benefit, the purchaser of the franchise (known as franchisee) pays the license fee to the parent company (known as franchisor). The franchisee also pays a royalty payment(commission) based on the sales revenue

Evaluation of franchising

Advantages and Disadvantages for the franchisee/ Entrepreneur	
Advantages	**Disadvantages**
❑ **Lower start-up cost** as the business idea has already been established by the franchisor such as market research and product development	❑ Franchisees have to pay a **significant percentage of their revenues** to the franchisor as royalty payments
❑ Franchisees receive **ongoing support and expert advice** from the franchisor, such as upskilling training, market research findings, and legal advice. This improves the chances of success for the franchisees	❑ Franchisees cannot implement their **own ideas as they are regulated by franchisors.** This constrains entrepreneur's talent
❑ **Low risk** since the franchisor has a tried and tested formula so the chances of business success are high	❑ Buying a franchisee might be very **expensive** and there is no guarantee that this start-up costs and running costs of the business can be recovered
❑ franchisee benefits from the **brand recognition and brand loyalty** established by the franchisor. Hence, there are opportunities for the franchisee to earn large profits.	❑ Like the franchisor, each individual franchisee is at **risk of a damaged reputation** if another franchisee of the business makes a serious blunder.

Advantages and Disadvantages for the franchisor	
Advantages	**Disadvantages**
❑ The company can **experience rapid growth** without having to risk large amounts of money as the franchisee pays for the rights, ranchisors receive royalty payments from the franchisee, usually set as a percentage of the sales revenues. They also usually charge franchisees joining fee. Hence, it can be cheaper and faster for internal growth.	❑ The franchisor's **corporate image and brand reputation is at risk** if a franchisee is negligent and/or incompetent

❑ It allows the company to have **national and international presence** without the higher costs od internal growth or M & As (as the franchisee helps to finance the expansion)	❑ It can be difficult **to control the daily operations of all franchisees** to get them to meet the quality standards set by the franchisor
❑ The franchisor benefits from **rapid growth without having to worry about running costs** such as recruitment, training and development, staff salaries and the purchase of stocks	❑ The franchise method of **growth is not applicable to all businesses as they lack the expertise,** resource and brand awareness to attract buyers (franchisees).