1.5 Growth and Evolution

SL/HL

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Learning Outcomes

- 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-
  - Mergers and acquisitions (M&As)
  - Takeovers
  - Joint ventures
  - Strategic alliances
  - Franchising

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Economies and Diseconomies 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 and attract more customers** because lower average cost could mean combination of lower prices being charged to customers and a higher profit margin earned on each item sold.

Figure 1: Businesses with a larger output can lower their average costs of production compared to smaller businesses

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Diseconomies of Scale**

- **Diseconomies 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.

How is Average Cost calculated?

- Average cost is cost per unit of output. It is calculated by dividing total cost (TC) by the quantity of output (Q)
- (Example- Total cost of producing 10 laptops is $10,500 so AC will be (TC/Q) which is $10,500/10 = $1050

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How is Average Cost calculated?

- AC includes AVC and AFC. AFC is calculated by dividing the total fixed cost (TFC) by level of output, i.e. AFC= TFC/Q. Similarly, AVC is calculated by dividing the total variable cost by level of output, i.e. AVC= TVC/Q

- So long as a business can spread its fixed costs of production over a larger quantity of output, average costs should fall, allowing the firm to benefit from economies of scale.

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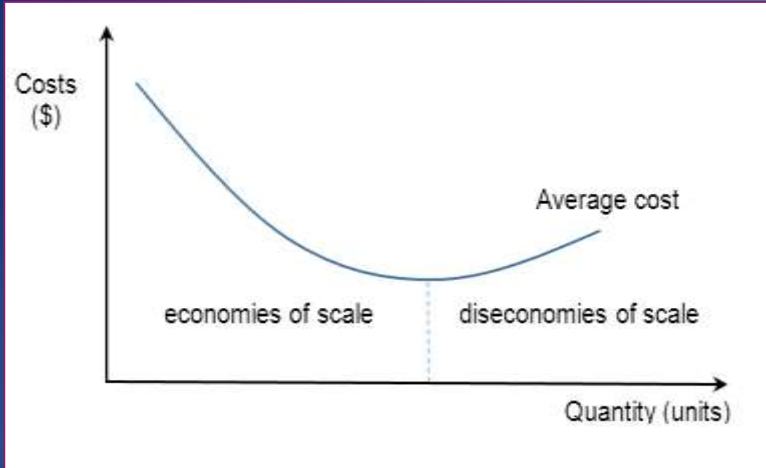

The level of output where the average cost of production is at its lowest value is called the **optimal output level**, i.e., the level of output where economies are fully exploited. At this level of output, profit is maximized.

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Internal Economies of Scale-are cost reductions that can be achieved inside the company when it expands its output. They may occur in different ways:

- **Purchasing (bulk buying):** 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.
- **Risk bearing economies of scale:** Large businesses can bear greater risks than smaller firms due to a greater product portfolio. Hence, inefficiencies will harm smaller firms to a greater extent.
- **Managerial economies of scale:** Larger businesses can afford to hire specialist functional managers, thus improving the organization's efficiency and productivity which then leads to lower average costs of output for larger firms.

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Internal Economies of Scale-are cost reductions that can be achieved inside the company when it expands its output. They may occur in different ways:

- **Financial economies of scale:** large firms get lower interest rates for loans, overdraft and mortgages when they borrow, because they represent lower risk compared to small competitors, thus lowering AC / unit

- **Technical (efficient machines):** large company is able to invest in equipment that makes the business more efficient and results in a lower average cost of production

- **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

- **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).

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External Economies of Scale –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.

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Diseconomies of Scale

Diseconomies 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.

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Internal Diseconomies 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

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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.

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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.

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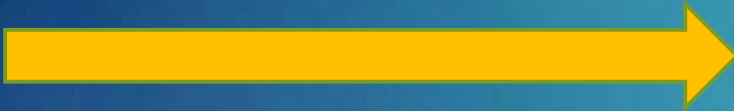
What is Growth?

Growing a business means expanding the business. However, growth can be measured in different ways



- Growth in sales revenue
- Growth in profit
- Growth in market share
- Number of customers
- Number of employees
- Number of retail outlets or stores
- Value of the business

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Reasons for business to grow

- Economies of Scale
- Sources of Finance
- Recruitment and retention of employees
- Brand awareness & brand loyalty
- Spreading risk
- Greater choice to customers

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Reasons for business to grow or being a large business

- Privacy
- Ownership & Control
- Autonomy
- Financial risk
- Small market size
- Specialization

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Internal vs. External Growth

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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

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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 about the benefits of the product
- **Producing improved and better product**-improve he design and features through innovation
- **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**- regular installments over 12-14 months for expensive products (EMI)
- **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

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Evaluation of internal Growth

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 Existing owners and shareholders maintain control	**Limited resources** Might have limited resources to grow business
Relatively inexpensive When businesses grow internally, it costs less and they often decide to use internal sources of finance, such as retained profit, for expansion.	**Diseconomies of scale** Higher unit cost of production arise from internal growth, causing communication problems and slower decision making as business grows
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	**Shortage of cash** More employees means more salaries to pay; might not be able to retain a good cash flow position

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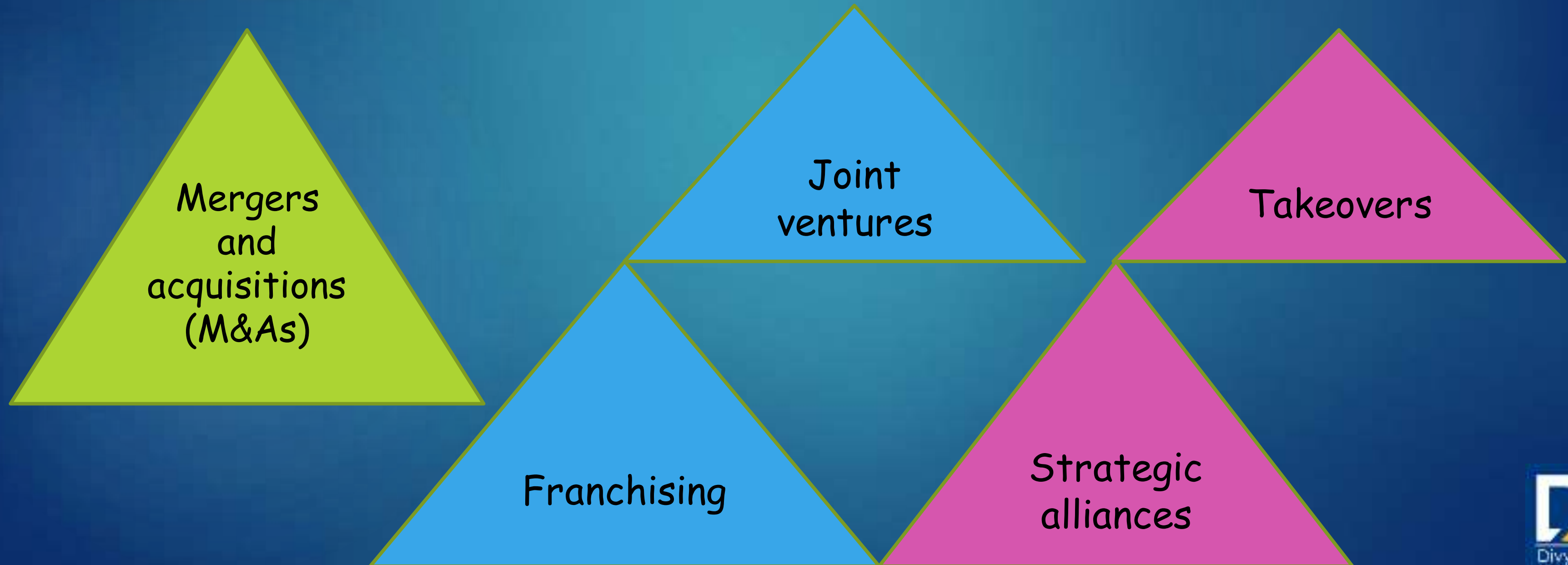
External growth**-refers to the expansion and evolution of a business by using third party resources and organizations rather than relying on internal sources and activities. That is, the company works with another company in order to expand.

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



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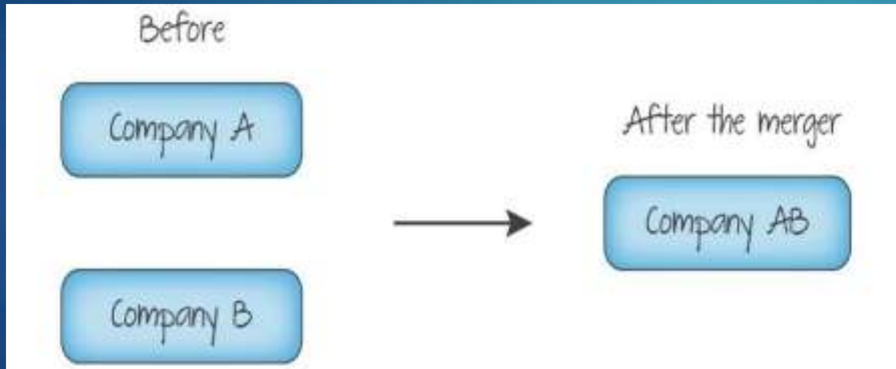
A business can grow externally in several ways-

- 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.



Merging between UK's British petroleum and US oil company Amoco to form BP Amoco

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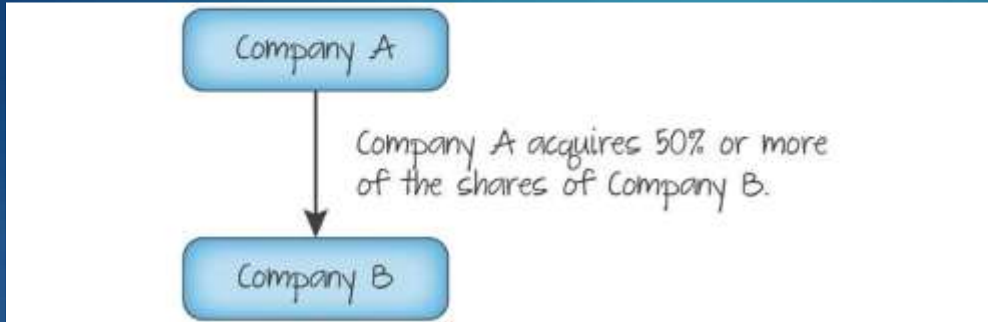
A business can grow externally in several ways-

- 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.



Meta (formerly Facebook) has purchased many smaller companies such as Instagram and WhatsApp in order to access technology and know-how that it did not have 'in house'

- 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.

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Types of M & A

- When a merger or acquisition occurs between two or more companies operating within the same industry (i.e. they are competitors), this is called a **horizontal M&A.** An example was the acquisition of The Body Shop by L'Oréal (the world's largest cosmetics and beauty firm) back in 2006

- When an acquisition occurs between two or more companies operating in different stages of the production process, this is called a **vertical M&A**

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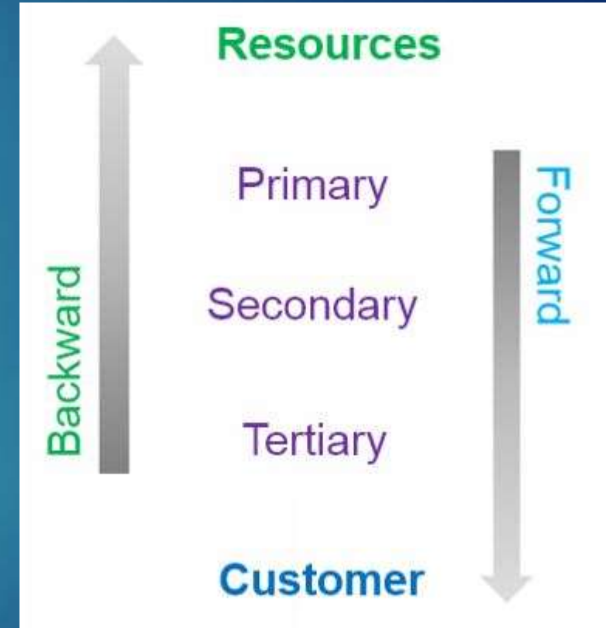
Types of vertical M & A

- If the purchaser buys a company closer to the consumer in the chain of production, this is known as a **forward vertical M&A**. Example: Coffee manufacture acquiring a chain of coffee shops

- If the purchaser buys a company further away from the consumer in the chain of production, this is known as a **backwards vertical M&A**. Example: Coffee manufacturer amalgamating with supplier of coffee beans



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Types of M & A

- when two businesses in unrelated industries engage in a merger or takeover. This type of integration is known as a **conglomerate M&A.** In a conglomerate, one company owns a controlling stake in several smaller companies, conducting business separately and independently. It helps to diversify business risk.

- **Example:** For example, Berkshire Hathaway is one of the world's largest multinational conglomerates, with operations in an array of industries, such as: property (real estate), insurance, diamonds, food processing, toys, confectionery, home furnishing, newspaper publishing, computing, clothing, aerospace, and airlines

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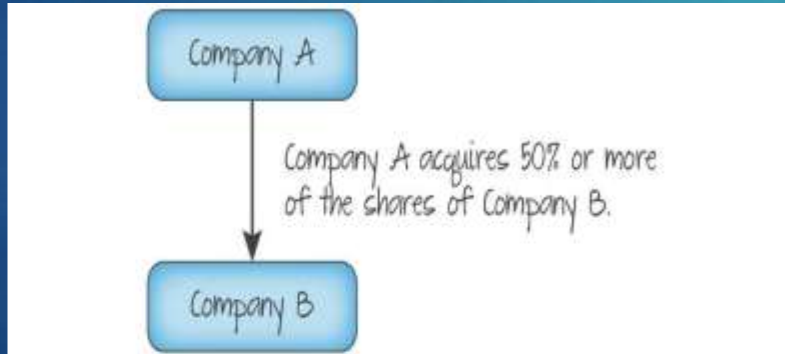
❑ Takeovers

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.



For example, Take over of Twitter by Elon Musk in November 2022,

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Evaluation of M&A, takeovers and Joint ventures- External Growth

Quick growth strategy in expansion if the organization wishes to enter new markets (with new/existing products in new/existing markets)	**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 eexpensive. 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	**Diseconomies of scale** The newly formed company can be too large to manage efficiently, i.e. it may experience diseconomies of scale.
Synergy Firms have access to each other's resources such as finance, technologies, management expertise etc. to increase productivity, sales reveue and profits	**Cultural clash** Possibility of a culture clash between organisations involved (difference in corporate culture might have a negative effect on business)

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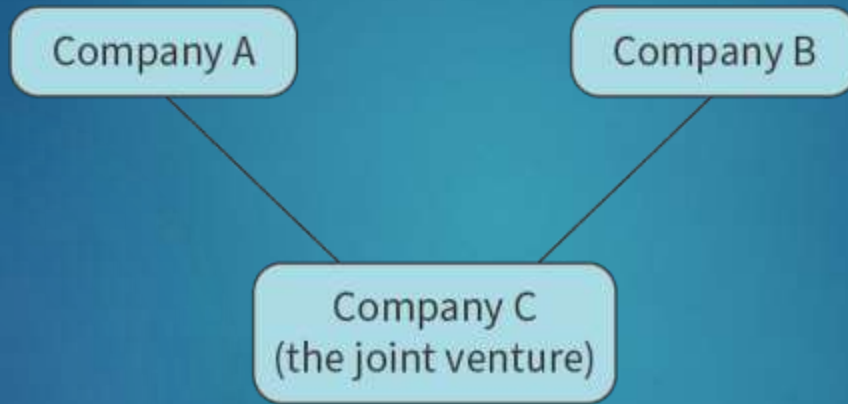
A business can grow externally in several ways-

- 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.

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A business can grow externally in several ways-

- **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)

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Evaluation of Strategic Alliances- External Growth

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 is 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.

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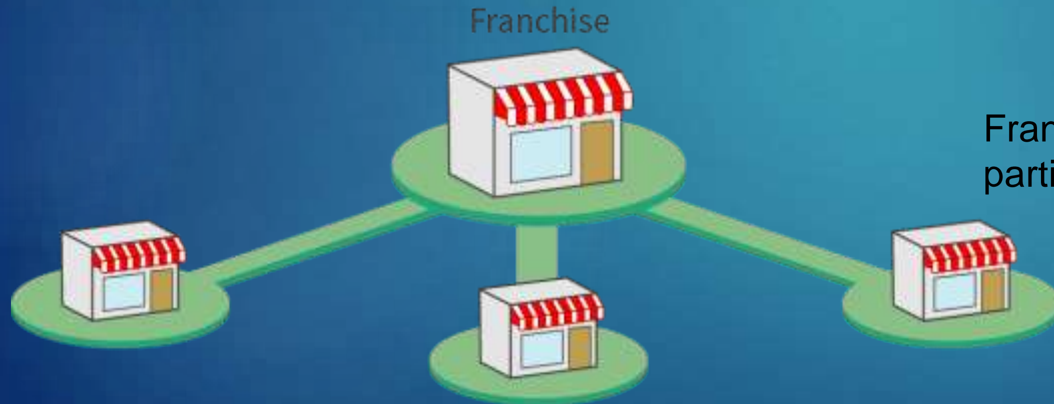
Franchising

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. Franchisee pays the license fee and royalty payment(commission) based on the sales revenue



Franchising refers to an arrangement between two parties: the franchisor and the franchisee.

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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 inplement **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.

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Evaluation of Franchising-

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 fro**m rapid growth without having to worry about running costs** such as recruitment, training and development, staff slries 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).

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For detailed explanation of points refer to notes in key concepts section of Revision zone!!

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