7 Growth

Definition

Growth means expansion, either due to rising sales or by increasing the scale of an enterprise by means of a takeover.

Linked to: Corporate objectives, Ch 1; Corporate strategy, Ch 2; The competitive environment, Ch 6; Reasons for staying small, Ch 10; International trade and business growth, Ch 28

7.1 Reasons why firms grow

Some firms can end up growing by accident. This is called unplanned growth. A good example is Baggit, which is now one of India's leading suppliers of luxury handbags. Nina Lekhi set up the business when she dropped out of university. Initially, Lekhi did not take her own business seriously; it was just a hobby. Fortunately, her brightly coloured bags proved to be very popular with Indian women who loved her bold designs. More and more retailers wanted to stock Baggit, which meant that Lekhi had to take on more staff and expand.

On the other hand, many firms grow in order to achieve an objective. This is called planned growth. The reasons for planned growth include:

- to increase profits
- to achieve economies of scale
- increased market power
- increased market share
- increased profitability.

To increase profitability

Many firms choose to pursue growth because they hope that it will cause their profits to rise. In August 2014, Netflix, an American company that sells streamed films and TV series, announced its intention to grow by launching its service in France and Germany. In 2013, Netflix made a total profit of £80 million from 30 million subscribers. This implies that it made a profit of £2.67 per customer. Assuming that Netflix proves as popular in France and Germany as it has in America and Britain, an additional 10 million French and German subscribers would add £26.7 million to Netflix's bottom line.

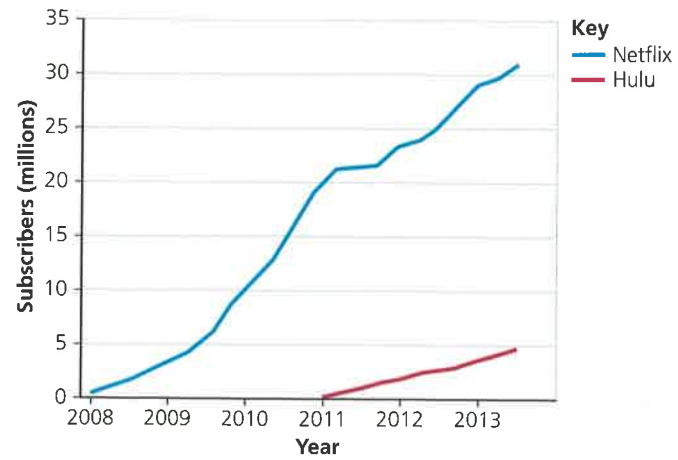


Figure 7.1 Netflix vs Hulu: millions of subscribers (source: Netflix and Hulu company data where available; author estimates otherwise)

To achieve economies of scale

Growth in the long run can cause cost per unit to fall due to **economies of scale**. This boosts competitiveness. This was the reasoning behind the merger of Carphone Warehouse and Dixons. Business leaders are attracted to growth by economies of scale, but often forget the drag caused by diseconomies (see below).

What businesses crave, more than anything else, is control. Growth itself is hard to control, but if it enables the business to become the market leader, with huge economies of scale, it may become virtually impossible for any competitor to hit back. Wrigley, with over 90 per cent share of the UK market for chewing gum, can't really be hurt by rivals; when Cadbury tried with its Trident gum brand, it spent many millions on an eventual failure. This is why businesses such as Amazon and Google worked so hard at growth (often profit-free) in their early years.

Economies of scale can be broken down into two types:

- Internal economies of scale: these are the economies that can arise within the business as its scale of operation expands, such as managerial, purchasing and technical economies.
- External economies: these may arise outside the business as it – or, more commonly, the whole industry – grows. For example, the West Midlands has long been an important area for car manufacturing in the UK. This attracted major car component supplier GKN to set up factories nearby. So Jaguar Land Rover's Solihull factory benefits from the external economy of scale of cheaper components from suppliers set up nearby. Another external economy of scale occurs when local education authorities respond to the growth of an industry by setting up colleges that specialise in teaching relevant vocational skills. This makes it cheaper for the companies to employ the staff they need.

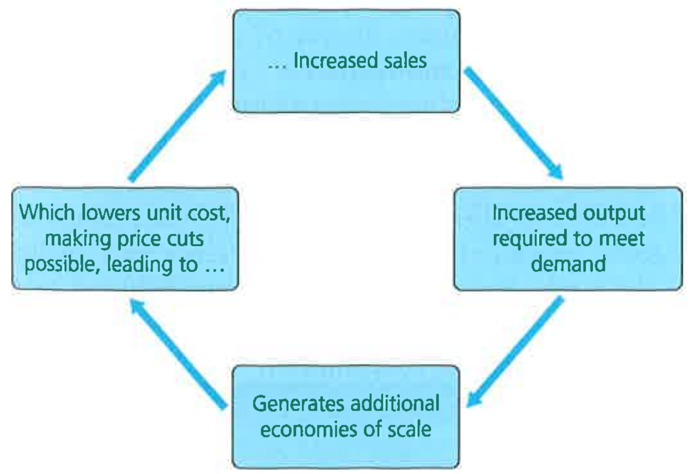


Figure 7.2 Logic circle: economies of scale

Increased market power over customers and suppliers

Power over customers

Colgate-Palmolive is an example of a company that has achieved a position of **market dominance** via growth. The company leads the global toothpaste market with a share of over 40 per cent. Colgate has a broad product portfolio ensuring that all market segments are covered, from 'gleaming white' to 'sensitive teeth'. Colgate's huge market share gives it substantial negotiating power with supermarkets and other distributors. This enables it to charge higher prices, whilst simultaneously benefitting from economies of scale. In 2015 Tesco's new strategy for boosting profits was to cut down on the number of suppliers, thereby ordering in bigger bulk from only one or two manufacturers. Many other companies would have been worried; not Colgate, as its market power is too great for Tesco to drop it.

Power over suppliers

In addition to its market power when dealing with customers, Colgate has a great deal of leverage in relation to its suppliers. In 2014 the company announced that it was building a factory for making its own toothbrushes. This puts pressure on current toothbrush-makers (suppliers) – forcing them to compete fiercely in order to win further Colgate contracts.

Some companies have been accused of abusing their market power. In August 2015 Topshop owner Arcadia upset clothes manufacturers by suddenly imposing a 2 per cent added discount, i.e. knocking 2 per cent off the pre-agreed prices being charged by suppliers. Tough negotiations over price and delivery dates are normal; but imposing an extra cut ('we're knocking 2 per cent off the bill') strays towards an abuse of market power.

Increased market share and brand recognition

There can be conflicts of interest between a company's internal stakeholders, but all love an increase in market share and brand recognition. Implicitly jobs are made safer, promotion prospects are better and profits can bloom. Furthermore increased market share can only be achieved by taking sales from your rivals, eating into their profitability and thereby undermining their ability to finance growth. To increase market share there are two main strategies:

- Work harder on innovation, perhaps by increasing the research and development budget; this should improve the long-term quality of the new product development pipeline; the goal is to be Apple rather than Nokia.
- Invest more heavily in branding and marketing, to try to differentiate your products more clearly.

Brand recognition can be both cause and effect of increased market share. If clever advertising boosts the image and recognition of your brand, that should help build market share. In the same way, rising market share leads to better distribution and therefore wider brand recognition. That, in turn, makes it easier to persuade retailers to stock new products launched under the same brand 'umbrella', e.g. the 2015 launch of Cadbury Dairy Milk 'Puddles'.

Increased profitability

If growth achieves greater economies of scale than diseconomies, **average costs** will fall in real terms. That would help to improve operating profit margins, allowing the twin benefit of rising revenues and rising margins. This can be the route to dramatic increases in profit. In Table 7.1 we can see how the fantastic growth of Costa Coffee has led to steady rises in operating profit margins (a good measure of profitability). This is only possible when total costs are falling in relation to revenue. Between 2009 and 2015 Costa sales rose 245 per cent, but profits by 483 per cent – nearly twice as much.

	Revenue (£ms)	Profit (£ms)	Operating profit margin (%)	Number of stores
2009	276.3	22.7	8.22	1,300
2010	340.9	36.2	10.62	1,600
2011	425.0	50.5	11.88	1,871
2012	541.9	69.7	12.86	2,203
2013	669.9	90.1	13.45	2,527
2014	807.7	109.4	13.54	2,861
2015	951.9	132.4	13.91	3,080

Table 7.1 Rising profitability at Costa Coffee, 2009–2015 (source: notes to Whitbread accounts)

Figure 7.3 Costa Coffee shop

7.2 Problems arising from growth

Diseconomies of scale

When firms grow, total costs rise. But why should costs per unit rise? This is because growth can also create **diseconomies of scale**. The most important of these is worsening internal communication.

Poor internal communication

Communication can be a significant problem when a firm grows. Effective communication is dependent on high levels of motivation. Communication is only effective if the person being communicated with is willing to listen. If growth has left the workforce with a feeling of alienation, communication can deteriorate alongside productivity. A second reason for poor communication in large organisations is that the methods chosen to communicate may be less effective. As a firm grows, it may become necessary to use written forms of communication more frequently. Unlike verbal communication, written communication is less personal and therefore less motivating. Written messages are easier to ignore and provide less feedback. Relying too much on written forms of communication could result in an increase in the number of expensive mistakes being made. It is also inevitable that growth leads to new managerial layers being added. With more layers of hierarchy, vertical communication becomes slower and more ineffective. This reduction in efficiency leads to increasing unit costs as the organisation grows.

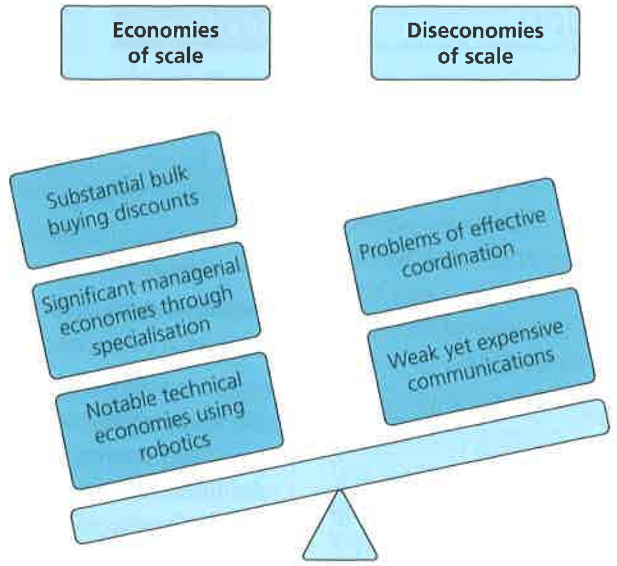
Poor employee motivation

When firms grow, one consequence of poor internal communication is reduced personal contact between staff and management. In large organisations there may be a sense of alienation. If staff believe their efforts are going unnoticed a sense of indifference may spread. This is what happened at Tesco between 2010 and 2014.

Poor managerial coordination

Poor internal communication also affects coordination. In a small firm coordination is easy. The boss decides what the goals are, and who is doing what. As firms grow, it becomes harder for the person at the top to control and coordinate effectively. The leader who refuses to **delegate** 'drowns' under the weight of work. The leader who delegates finds (later) that manager A is heading in a slightly different direction from manager B. Regular meetings are arranged to try to keep everyone focused on the same goals through the same strategy. But not only are such meetings expensive, they are also often poorly attended and lead to grumbles rather than insight. Coordination works well and cheaply in a small firm, but is expensive and often ineffective in large corporations.

Figure 7.4 Logic balance: when economies outweigh diseconomies



Overtrading

A dangerous problem created by **organic growth** is overtrading. This occurs when a business suffers from cash-flow problems because it has tried to expand too rapidly with insufficient cash in the bank. When firms grow, cash flow can quickly become negative. This is because expansion creates additional cash outflows that occur before the extra cash inflows arrive. To prevent overtrading firms must forecast the cash-flow implications of growth and raise the additional working capital required well before the expansion programme begins. Banks and investors are willing to invest in a promising business that has sound financial management. If a business suffering from overtrading tries to borrow, a bank manager will probably refuse.

Real business

In 2011 Express Cafés Ltd was bought by a private company from the large Compass Group plc. From its Shropshire base it was soon able to claim to be the country's biggest supplier of small-unit temporary catering to sporting and music events and festivals. The business grew rapidly, picking up contracts for the 2014 Ryder Cup and Aintree Racecourse. Then in 2014 it made another leap forward, signing a deal with Levi Roots for 'Jammin' Jerk Burger' vans to go to the Reading Festival and the Formula 1 British Grand Prix. But in late October 2014 it went into voluntary liquidation, i.e. the directors closed the business down. Its growth had outstripped its ability to find the cash to pay the bills.

Five whys and a how

Questions	Answers
Why do newly established firms need to grow quickly?	To hit their break-even sales level. Most start-ups are short of cash; therefore, they cannot survive for very long if they are losing money.
Why might Costa Coffee's profit margin (see Table 7.1) start to fall in future?	Perhaps because the diseconomies it faces as it grows even bigger may start to outweigh the economies of scale.
Why might growth cause a firm to become more efficient?	Increasing output within existing facilities allows fixed costs to be diluted over more units of output. Growth can also allow a firm to benefit from economies of scale.
Why might diseconomies of scale outweigh economies of scale?	In a service business especially, there may be relatively few economies of scale, so problems such as weak and costly internal communication can hit overall efficiency.
Why might the founder of a small business need to delegate in order to let the business grow?	As the business grows, the boss may suffer from information overload without delegating. As a result, growth opportunities may be handled badly.
How might overtrading affect a business?	It creates the risk that bankers and other creditors may lose confidence in the management, making them reluctant to allow further credit. That would hasten a liquidity crisis.

7.3 Growth – evaluation

Many people in business believe that if you're not growing, you're dying. This is understandable, given the constant pressure of competition, but tends to underestimate the problems caused by growth. It's unlikely to be a coincidence that just as Toyota, then General Motors, then Volkswagen were about to be crowned number one global car maker (in the period 2009–2015) each hit a crisis caused by internal failings. Management eyed the prize a bit too greedily – to devastating effect.

If growth is unexpected and rapid, overtrading is the obvious risk. Less obvious is that as a business gets steadily bigger it becomes steadily slower at 'knowing what it knows'. People within the organisation know where the wheels are squeaking and about customer dissatisfactions – but this knowledge may fail to get to the boardroom – or reach it too late. Good decisions require full knowledge of what's going on. Bosses always struggle to get that, especially when growth means that more people are getting in between the top and bottom of the organisation.

Key terms

Average cost: this is the cost of producing one unit of output. It is calculated by dividing total cost by the current output level.

Delegate: passing authority down the hierarchy.

Diseconomies of scale: factors that cause average costs to rise as the scale of output rises.

Economies of scale: factors that cause average costs to fall as the scale of output increases.

Market dominance: describes a situation where a firm sells a product that achieves a very high market share. This ascendancy over the competition enables the dominant firm to raise prices without losing too many customers. According to the EU, firms that have a market share of more than 40–45 per cent are considered dominant.

Organic growth: comes from within the business, as compared with inorganic growth achieved by takeovers or mergers.

7.4 Workbook

Revision questions

(35 marks, 35 minutes)

1 In your own words, explain the value to a business of its growth being planned. (3)

2 a) Using examples distinguish between external and organic growth. (3)

b) Identify and explain one problem a firm might encounter as a result of rapid growth. (4)

3 The iPad has been a very successful product for Apple. Table 7.2 shows the number of iPads sold and the revenues generated worldwide since launch.

a) Calculate the percentage growth in the number of iPads sold between 2010 and 2011. (3)

b) Describe what happened to sales growth in terms of the number of iPads sold in the years after that. (4)

c) Using the information provided, calculate the average price of an iPad in each year shown. What conclusions can you draw? (6)

d) In July 2014 Apple announced that in the last three months only 13.2 million iPads were sold, compared with 16.3 million the quarter before. Should Apple be worried? (6)

4 Explain three difficulties that a sports retailer such as Sports Direct might face when attempting to grow organically. (6)

Year	2010	2011	2012	2013	2014
Units	7.46 million	32.4 million	58.31 million	71.03 million	67.98 million
Revenue	$4.96 billion	$20.36 billion	$30.95 billion	$31.98 billion	30.28 billion

Table 7.2 Number of iPads sold and revenues generated since launch in 2010

Revision activities

Data response

Stagecoach

Stagecoach is one of the biggest suppliers of public transport in the world, operating in eight countries, running 13,000 trains and buses, employing over 35,000 people. In 2014 the company's turnover was close to £3 billion, netting shareholders an operating profit of £223 million.

The business was not always this big. When Stagecoach was set up in 1980 it started with just three buses. The company's employers were the three founders: Brian Souter, who went on to be chief executive, did the driving, whilst his wife, Ann Gloag, made snacks to sell to their passengers. Robin, her brother, was the maintenance man.

Throughout Stagecoach's history, growth has always been the dominant corporate objective. In the early 1980s Stagecoach grew by buying out its local rivals. It also bought buses from local councils when they were privatised. In the 1990s there was a change in strategy as the company switched to organic growth. Instead of spending money on expensive takeovers, Stagecoach would expand its market share by stealing its rivals' passengers. The main method used to grow market share was low fares, which were designed to under-cut the competition. On several occasions Stagecoach was found guilty of predatory pricing, which involves cutting prices below average cost with the deliberate intention of forcing a rival out of business.

In more recent times Stagecoach has grown by diversifying. For example in Sheffield it runs trams, local train services, as well as bus services. This allows Stagecoach to set timetables for different modes of transport in order to minimise waiting time for passengers who need to change from one mode of transport to another in order to complete their journey. The company would like to offer passengers the same type of 'integrated' transport service in other British towns and cities.

Questions (30 marks; 35 minutes)

1 Explain how growth might help a transport company like Stagecoach to increase its profits. (4)

2 Apart from a desire to generate higher profits, explain two other reasons why a company might choose growth as its corporate objective. (6)

3 Evaluate the possible effect on its stakeholder groups if Stagecoach is able to achieve its ambition of running all forms of public transport in certain towns and cities. (20)

Extended writing

1 Table 7.1 shows that Costa Coffee grew by 245 per cent in terms of revenue in the period 2009–2015. Evaluate the problems it might face as a result of this pace of growth. (20)

2 Recently Barclays Bank declared an annual profit of over £3.5billion. At the time the chief executive revealed that the bank had cut 11,500 jobs in the previous year, and its intention in the coming year was to double this number of job losses. Evaluate the advantages and disadvantages of these management decisions. (20)