Section 3.2 Business growth

8 Organic growth

Definition

Organic growth comes from within a business, either from rising customer demand, or from the company launching successful new products or new outlets.

Linked to: Impact of external influences, Ch 5; Growth, Ch 7; Mergers and takeovers, Ch 9; Reasons for staying small, Ch 10

8.1 Distinction between inorganic and organic growth

Inorganic growth comes from outside a business. The most obvious example is a **takeover** bid such as Facebook's £11.4 billion purchase of WhatsApp in 2014. Instead of developing its own rival product and competing with the established WhatsApp messaging service, Facebook took the easy (but expensive) approach of buying the business, its products and its 450 million existing customers. Facebook was buying growth rather than creating growth from its own resources. Usually inorganic growth is the path taken by firms that are weak at innovation and product development, though in this case, Facebook's Mark Zuckerberg claimed that WhatsApp was just a great **strategic fit**.

Organic growth is a safer, but slower, method of growth than takeover. Its safety comes from the avoidance of the culture clashes involved in many takeovers. Steady growth also avoids the need to add debt to a company's balance sheet, since finance is more likely to come from retained profits. However, a reliance on organic growth could lead firms to miss out on surges of growth in their industry if they fail to develop sufficient capacity to cope with the potential demand. For example, when Coca-Cola saw the increasing consumer interest in juices and smoothies, it chose to buy up Innocent Drinks instead of developing its own brands.

Real business

Rapid organic growth

In 2010, General Motors (GM) was number one in China, selling nearly 2 million cars. Despite the financial troubles in America that forced the US government to bail it out, GM chose to keep this growth going by building nine new factories in China. It announced that it expected its sales in China to rise to 3 million by 2015. In fact sales grew organically to 3.5 million by 2014, so it hugely outperformed. The rapid pace of growth in China should have been great news for the US taxpayer, but the government sold its GM shares a bit too early – in December 2013.

Innovation within a business

Chapter 23 of the AS book (*Business Year 1* for Edexcel). focuses on innovation within a business (sometimes called intrapreneurship). This relates perfectly to the second-year theme of organic growth. For firms to grow from within their financial and human resources, clever ideas are needed backed by the drive to succeed. Intrapreneurs show the skills and dynamism of small business entrepreneurs, but within a corporate setting. The success of design guru Jonathan Ive at Apple is a good example of intrapreneurship.

8.2 Methods of growing organically

In 2009, newspapers ran a series of dismissive headlines about German retailer Aldi's decision to offer £40,000 starting salaries to graduate trainees. With Marks & Spencer offering just £25,000, Aldi's move was taken as a sign of desperation rather than ambition.

Figure 8.1 Aldi offers graduates a £40,000 starting salary

Yet since then, between 2010 and 2015, discount grocer Aldi doubled its share of the UK market from 2.8 to 5.4 per cent. Marks & Spencer stood still. Perhaps there's a German term for 'the last laugh'.

Organic growth may be sparked by external forces (for Aldi, the 2009 recession was a gift) but for continuous market share growth good management must be a factor. Fundamentally, organic growth is a function of financial and human resources; of the two, most bosses would say people are the main priority. At Google, the desire to keep staff committed to the business has led to remarkable working conditions and benefits. In the terms of Professor Herzberg, Google provides hygiene factors that go above and beyond meeting every need – to avoid job dissatisfaction (the work itself should provide the upward satisfactions). What could be called Googleperks include:

- free breakfast, lunch, and dinner; the organic food is chef-prepared
- free health and dental care; on-site doctors; free haircuts; free dry cleaning
- subsidised massages; free gyms and swimming pools
- 'nap pods'; on-site video games, football, ping pong.

(Source: www.google.co.uk/about/careers)

Ultimately, organic growth is the attempt to achieve success from within the company's staff, its culture and its resources. When this works well, the results can be outstanding. UK examples of this approach include JCB and Ted Baker plc. In some ways Ted Baker's success has been the more remarkable because it is a public limited company (plc) and therefore subject to outside shareholder pressures. But since it went public in 1997, Ted Baker has grown in what the strategy statement on its website calls 'considered expansion, controlled distribution and carefully managed development (of overseas markets)'. Ted Baker has never taken over another business – and never taken any risks with debt. Its dependence on debt is often 0 per cent and never rises above 5 per cent. In other words, Ted Baker's approach to organic growth even includes wanting to grow from within its own financial resources. Some outside shareholders might have complained at times about this cautious approach – but if they had held onto their shares they wouldn't have minded growth from 140p in 1997 to 2,800p in 2015. And over all that period Ted Baker has rarely made a serious mistake. It has gone from a men's shirt-only shop in Glasgow to a business with over 250 shops globally, and with womenswear outselling menswear. Its website boasts that Ted Baker has never advertised, therefore having to rely on word of mouth and stylish, quirky window displays. It is a remarkable success story.

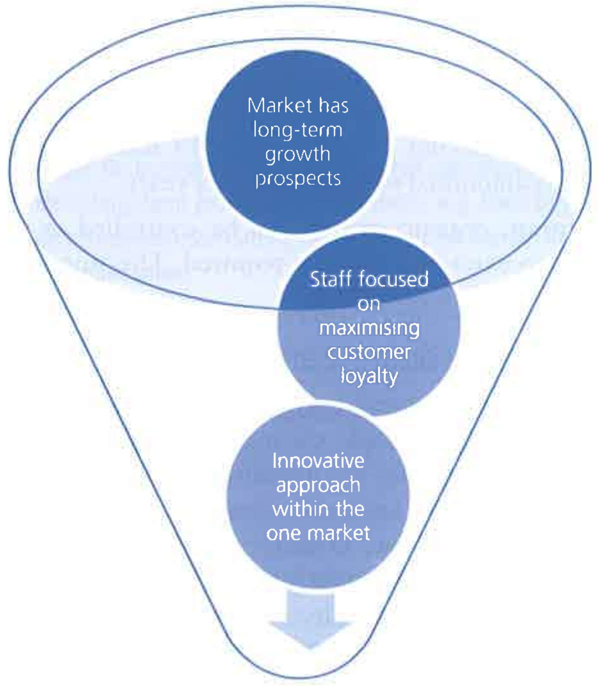

Figure 8.2 Logic funnel: successful organic growth

'Word of mouth marketing is a crucial component of organic growth for start-ups.'

David Rusenko, founder, Weebly Inc.

8.3 Advantages of organic growth

Organic growth has many advantages, especially for a business that is growing satisfactorily. Among these advantages are the following.

Keeping it personal

Ted Baker is not a person; the person behind the brand is Ray Kelvin, who founded the business. For someone like him, it's a huge thrill to build up the company steadily. It enables him to influence the 2,800 staff – and to maintain the entrepreneurial culture. A takeover of another business would be far more likely to force Kelvin (or the directors) to look for a new, professional business manager to handle the consequences of the acquisition and take the company forward.

Minimising financial risk

It is fair to suggest that almost every takeover bid increases the debt level of the predator company. So inorganic growth is associated with debt. When Kraft bought Cadbury for nearly $20 billion in 2010, it needed to issue a huge amount more share capital to finance the deal. It also borrowed a lot more from American banks, making analysts worry about the huge interest payments it would be having to make (by 2013 Kraft's interest payments amounted to $500 million a year).

By contrast, organic growth can be controlled so that little or no extra borrowing is required. This minimises financial risk.

Providing a secure career path

Takeovers lead to a battle between staff for the single job of the future. For example, the marketing directors from each business battle for the one director position for the future. Many people are made redundant and many good members of staff leave. Organic growth means steady development of the business, with career opportunities opening up quite regularly. Well-run businesses give staff the opportunity to develop steadily from the shop floor to management and then leadership positions.

8.4 Disadvantages of organic growth

If the business has a single, simple focus, such as rolling out Costa Coffee bars around the world, it is fair to suspect that this might become rather predictable and dull. Consequently talented, ambitious and creative people might find work elsewhere. A single focus might backfire if a new competitor or changes in consumer taste make it necessary to rethink the strategy. This seemed to be a problem for Tesco in the period 2010–2014. Organic growth lacks the sudden opportunity (and threat) represented by a takeover bid or merger.

Other disadvantages of organic growth include:

- The difficulty of getting scale to match your competitors, especially if they are involved in takeover or merger activity; in other words, while you're growing gradually, they may be leaping ahead – giving them economies of scale that you cannot access (see Figure 8.3).

'Organic growth does not lend itself easily to moving into entirely new markets or developing completely new products.'

Touch Financial website

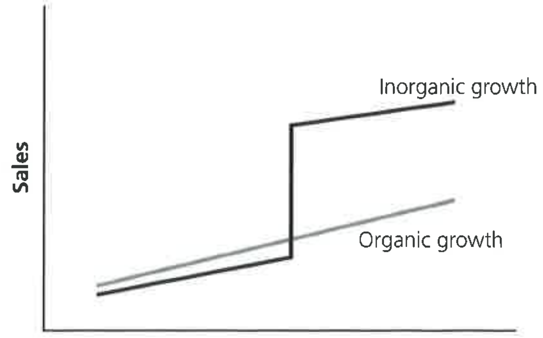

Figure 8.3 Organic vs inorganic growth

- Many products have relatively short life cycles. For those that have, it's vital to generate as much cash as soon as possible. Slow, organic growth may mean missing much of the economic opportunity from the growth and maturity phases of the life cycle. So it may be better to try to leap ahead while the going is good.

Five whys and a how

Questions	Answers
Why is internal growth called 'organic'?	Because it's like a plant growing steadily, day by day. No plant grows in sudden leaps forward.
Why might it be risky to grow slowly?	If a market is growing rapidly, slow growth by an individual business means losing market share – which might mean shops stop distributing your product.
Why might it be risky to grow in leaps and bounds, through takeover or merger?	Because long-term success hinges on the quality, motivation and culture of middle management – takeovers risk undermining a common sense of purpose (and carry higher financial risks).
Why might organic growth be risky, if it's financed from within?	Although (external) bank loans increase gearing, financing from within can mean too little capital – risking a liquidity crisis.
Why might an organic food producer decide to grow inorganically?	Why not? There's no link between organic food and organic growth. Of course an organic food producer such as Yeo Valley might choose to buy another such as Rachel's Organic.
How might organic growth be achieved rapidly?	If the demand is there (such as for Apple's iPhone 6), organic growth can be rapid as long as enough capital and manpower can be found to boost supply.

'For years I have made the point that progress is made not by high growth in any individual year, but by maintaining an expansion over a sustained period.'

Ian Macfarlane, Australian politician

8.5 Organic growth – evaluation

Fantastically successful businesses such as Apple, Costa, Ted Baker and Domino's have operated a largely or wholly organic strategy. Yes, Apple bought Beats Electronics in 2014, but headphones could only ever be a tiny part of Apple's long-term strategy.

Choosing organic versus inorganic growth is largely a statement of confidence in your business and the business model, in its culture and in the staff who work there. So even if organic growth sometimes seems strategically wrong, it may send out a signal to staff that emphasises loyalty and faith. That could result in a lot of potential benefits for the business.

Key terms

Inorganic growth: inorganic growth is via merger or takeover, not from within the business.

Strategic fit: buying another business that can provide a real boost to long-term growth and profitability, e.g. Mars buying Wrigley (massive cost-cutting potential but no overlap in terms of consumer sales).

Takeover: when one business buys majority ownership in another, thereby gaining full control.

8.6 Workbook

Revision questions

(25 marks; 25 minutes)

1 Explain two ways in which a business such as Jaguar Land Rover can achieve organic growth. (6)

2 In 2015, Costa Coffee set out a plan to expand in China from 350 outlets to 900 outlets by 2020. Explain how a clear target might make it easier to achieve organic growth. (5)

3 Why might financial resources prove a stumbling block to achieving organic growth? (4)

4 Working conditions such as those at Google are hugely expensive for the company. Are they relevant to the achievement of organic growth? Explain your answer. (4)

5 Explain the possible disadvantages of organic growth for a business such as SuperGroup plc, owners of the clothing brand Superdry. (6)

Revision activities

Data response

Domino's organic growth

Late in 1999, Domino's Pizza UK announced that it was accepting orders placed online. Nobody really noticed or cared. Ten years later, in 2009, online orders represented a quarter of all Domino's sales. By then it was acknowledged that the company's rapidly growing share of the pizza business owed a great deal to online sales. Five years later, in 2014, online ordering passed 50 per cent of total Domino's sales for the first time. The move to online was at the heart of revenue growth from £25.6 million in 2009 to £294.4 million in 2014 – providing a stunning annual growth rate of 17.7 per cent. Profits over that same 15-year period grew at an average of 25.2 per cent a year: organic growth on an amazing scale.

Part of the increase has been down to store openings, from 200 in 1999 to 900 by the start of 2015. This growth has overwhelmingly come from franchising; by 2014, the average franchisee owned eight Domino's outlets. One other factor has been important, though. In 2009, the business made a public confession that its pizzas had come joint bottom in a survey of customer attitudes to the taste of pizzas. This led to two new strategies:

- Spending six months experimenting to find better dough and better toppings – then a complete revamp of all their ingredients and flavours.
- Bringing back in-house the IT skills involved in programming the software that controlled the timing and efficiency of online ordering and delivery. Moving away from outsourcing proved a winner, as dedicated full-time staff made the delivery process faster than ever.

Despite 2010 being a year of recession, like-for-like sales at Domino's UK rose by 11.9 per cent – largely thanks to the new strategy. Overall, the Domino's story shows the potential of an organic growth strategy. Focus on making your products and processes better has worked at Domino's – just as it has at Costa Coffee and at Ted Baker.

Questions (40 marks; 45 minutes)

1 Assess two possible advantages to Domino's of pursuing an organic growth strategy. (8)

2 Assess the possible advantages to Domino's of pursuing a franchising development model for the business. (12)

3 To what extent does the Domino's case prove that the quality of the product itself is the single most important part of any long-term business strategy? (20)

Extended writing

1 Evaluate the extent to which organic growth could work for a brand new social networking site. (20)

2 After more than 20 years of organic growth, a new boss of Ted Baker plc decides to accelerate growth by buying a 100-shop chain of French fashion retail outlets. Evaluate the extent to which that might undermine the organic growth model. (20)

9 Mergers and takeovers

Definition

Mergers are where two firms of similar size agree to join forces permanently, creating a new company that is twice the size of each predecessor.

Takeovers occur when one firm buys a majority of the shares in another and therefore achieves full management control.

Linked to: Ansoff's Matrix, Ch 3; Impact of external influences, Ch 5; Growth, Ch 7; Organic growth, Ch 8; Reasons for staying small, Ch 10; Corporate culture, Ch 16.

9.1 Introduction

Every time a company's shares are bought or sold on the stock exchange, there is a change in the ownership of that company. However, the significant changes occur when a majority of shares is bought by an individual or company. Any individual or organisation that owns 51 per cent of a company's shares has effective control over that company. To successfully take over a company, a firm (or individual) must therefore buy 51 per cent of the shares. In America, this process is called mergers and acquisitions (M&A), acquisitions being another word for a takeover.

9.2 Reasons for mergers and takeovers

Some examples of takeovers and the reasons for them are given in Table 9.1.

Growth

The fastest way for any firm to achieve significant growth is to merge with, or take over, another company. The motives behind the objective of growth may be based on any of the reasons outlined below. However, as a basic motive behind mergers and takeovers, growth is often the overriding factor.

Figure 9.1 Mergers and takeovers are the fastest way to achieve growth

Cost synergies

Cost savings are often used as a primary argument for corporate integration. It is suggested that economies of scale will arise from operating on a larger scale. If two businesses merge, output will increase. As a result, they are more likely to benefit from economies of scale, such as cheaper bulk purchasing of supplies. Synergies are the benefits from two things coming together. In this context, it is that the two firms together will have lower costs (and higher profits) than the two firms separately. In effect, **synergy** means that 2 + 2 = 5.

> 'Promises of synergy are rarely fulfilled.'
>
> *Tim Hindle,* The Economist

Diversification

This means entering different markets in order to reduce dependence upon current products and customers. Diversification is a way of reducing the risk faced by a company. Selling a range of different products to different groups of consumers will mean that, if any one product fails, sales of the other products should keep the business healthy. The simplest way to diversify is to merge with or take over another company. This saves time and money spent developing new products for markets in which the firm may have no expertise. This is why Mars bought Wrigley – in case there was a consumer shift away from high-calorie chocolate towards chewing gum.