IB Business Management HL

1.5 Growth & Evolution

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To grow or not to grow?
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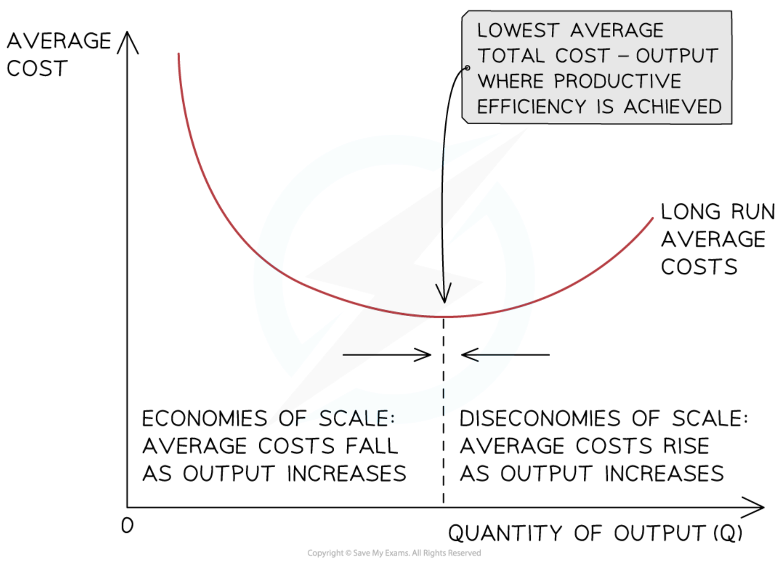
An Introduction to Economies & Diseconomies of Scale

- As a business grows, it can increase its **scale of output and** generate efficiencies that lower its **average costs (cost per unit)** of production
  - These efficiencies are called economies of scale
  - Economies of scale help large firms to **lower their costs of production** beyond what small firms can achieve

- As a firm continues increasing its **scale of output**, it will reach a point where its **average costs (AC)** will start to **increase**
  - The reasons for the increase in the average costs are called diseconomies of scale



Economies of scale occur when average costs decrease with increasing output & diseconomies of scale occur when average costs increase with increasing output

Diagram Analysis

- With relatively low levels of output, the businesses average costs are high
- As the business increases its output, it begins to benefit from **economies of scale** which lower the average cost per unit
- At some level of output, a business will **not be able to reduce costs** any further - this point is called **productive efficiency**
- Beyond this level of output, the average cost will begin to rise as a result of **diseconomies of scale**

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Exam Tip

A common error made by students is asserting that production costs will fall as output increases. This is not correct.

As output levels increase, total production costs rise but, as a result of economies of scale and the c**osts of production being spread across more units of output**, the **average costs** of production fall.

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Internal Economies of Scale

- **Internal economies of scale** occur as a result of the growth in the scale of production **within the business**
  - The firm can benefit from lower **average costs (AC)** generated by factors **from inside the business**

Types of Internal Economies of Scale

Type	Explanation
Financial economies	• Large firms often receive **lower interest rates on loans** than smaller firms as they are perceived as being less risky • A cheaper loan **lowers the cost per unit** (average cost)
Managerial economies	• Occurs when large firms can employ **specialist managers** who are more efficient at certain tasks and this efficiency lowers the average cost (AC) • Managers in small firms often have to fulfil multiple roles and are less specialised
Marketing economies	• Large firms **spread the cost of advertising** over a large number of sales and this reduces the AC • They can also reuse marketing materials in different geographic regions which further lowers the AC
Purchasing economies	• Occur when large firms buy raw materials in greater volumes and receive a **bulk purchase discount** which lowers the AC
Technical economies	• Occur as a firm can use its machinery at a higher level of capacity due to the increased output thereby **spreading the cost of the machinery** over more units & lowering the AC
Risk bearing economies	• Occur when a firm can spread the risk of failure by **increasing its numbers of products** i.e greater product diversification - less failure lowers AC

External Economies of Scale

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- **External economies of scale** occur when there is an increase in the size of the **industry** in which the firm operates
  - The firm can benefit from lower **average costs (AC)** generated by factors **outside of the business**

Sources of External Economies of Scale

Source	Explanation
Geographic Cluster	• As an industry grows, ancillary firms move closer to major manufacturers to cut costs & generate more business • This **lowers the AC** e.g. car manufacturers in Sunderland rely on the service of over 2,500 ancillary firms
Transport Links	• **Improved transport links** develop around growing industries to help get people to work & to improve the transport logistics • This **lowers the AC** e.g. Bangalore is known as India's Silicon Valley & transportation projects have been successful in transforming the movement of people & goods
Skilled Labour	• An increase in skilled labour can **lower the cost of skilled labour**, thereby **lowering the AC** • The larger the geographic cluster, the larger the pool of skilled labour
Favourable Legislation	• This often generates significant reductions in AC as **governments support certain industries** to **achieve their wider objectives**

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Diseconomies of Scale

- As a firm continues increasing its **scale of output,** its average costs per unit will start to **increase** at some point
  - The reasons for the increase in the average costs per unit are called **diseconomies of scale**

Types of Diseconomies of Scale

Diseconomies	Explanation
Management Diseconomies	• Occur when managers work more in their **self interest** than in the interest of the firm ◦ E.g. Managers become territorial & obstructive thus reducing efficiency and increasing the AC
Communication Diseconomies	• Occur when a firm's organisational structure becomes more complex with multiple layers of management resulting in communication difficulties • This leads to slow responses and increased average costs
Geographical Diseconomies	• Occur when a firm has widespread bases of operations across **multiple geographic locations** • This leads to logistical & communication challenges which can raise average costs
Cultural Diseconomies	• Occur when a firm expands into foreign markets in which workers have very different **work or productivity norms** • Particularly during the early stages of expansion this leads to production disruption which can raise the average costs

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To grow or not to grow?

Reasons for Growth

- Many firms start small & will grow into large companies or even **multi-national corporations** (Amazon started in a garage)

Reasons why Businesses grow

Owners or management **desire** to run a large business & continually seek to grow it	Owners desire higher levels of market share and **profitability**	The desire for stronger market **power** (monopoly) over its customers and suppliers
Desire to **reduce costs** by benefitting from economies of scale	Growth provides opportunities for product diversification	Larger firms often have easier access to **finance**

Exam Tip

One of the goals of growth is to improve profitability. It's important to remember the distinction between profit and profitability. Profit is the absolute amount of money a company makes, while profitability is a measure of **how efficiently** a company generates profit relative to its revenue or investment. Profitability is usually expressed as a percentage and is calculated by dividing the profit by the revenue.

Reasons to Remain Small

- In 2021, 98.9% of firms in the European Union were considered to be **small firms** with less than 49 employees
- Some firms start small & will grow into large companies or even **multi-national corporations** (Amazon started in a garage)
- While many firms grow, others do not or they **intentionally choose** to remain small

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Reasons why Small Firms Exist

They offer a **more personalised service** and focus on building relationships with their customers (excellent customer service)	They are unable to **access finance** for expansion	They provide a product that is in a niche market - smaller market size but can be **very profitable**
By remaining small, there is a high ability to **respond quickly** to changing customer needs/preferences	Rapid growth can cause diseconomies of scale which can be difficult to deal with and so many owners choose to avoid these	Owners goal is not **profit maximisation** but rather an acceptable quality of life (satisficing)

- Many changes in technology favour large scale operations but others can work to the advantage of small firms
  - The Internet offers **low cost access** to market for many firms

- Modern technology can work in favour of the **small-scale and personalised** businesses rather than the mass produced and impersonal
  - **Niche markets** can be targeted profitably by small firms that have relatively **small overheads** and do not need to achieve the volume of sales required by larger competitors
  - This is especially true where technology **reduces the cost differential** between the mass produced and the niche product

An Evaluation of Remaining Small

Advantages	Disadvantages

• Small firms often provide **highly customised** goods/services e.g. pet grooming in the customer's home • They often create **personal relationships** with their customers which helps to generate customer loyalty and word-of-mouth advertising • They often provide **very unique products** which are sold in small quantities at high prices - this can be very profitable • Smaller firms can respond quickly to **changing market conditions**	• Small firms are more susceptible to **changes in the wider economy** than large firms, especially during recessions • Less **financial resources** available to them, including access to larger bank loans - some smaller firms are unable to access any loans at all • It is harder to recruit/retain staff as the **wage & non-wage benefits** are less competitive than those offered by bigger firms • Owners may struggle to take a **holiday/sick leave** as revenue slows/stops coming in when they stop working • Small firms struggle to generate economies of scale as the volume of output is significantly lower than that of larger firms resulting in lower profit margins

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Exam Tip

Do not focus too much on making a judgement about whether businesses are better big or small. Businesses of all sizes can - and do - succeed.

It is more important consider whether the size of the business allows it to achieve its mission and whether other factors such as its culture and organisational structure contribute to its success.

Types of Business Growth

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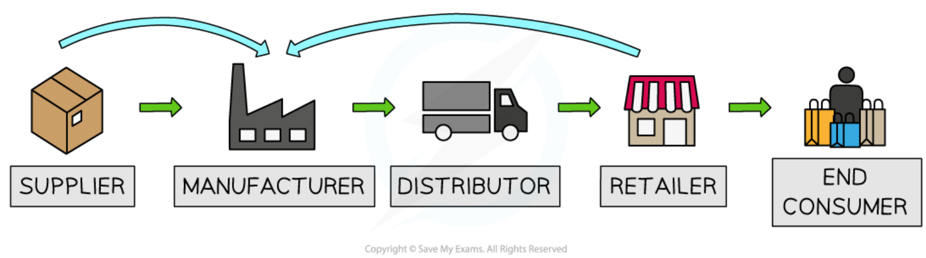
Internal (organic) & External (inorganic) Growth

- The growth of firms can be **internal** (organic) or **external** (inorganic)

- **Internal growth** is usually generated by
  - Gaining greater market share
  - Product diversification
  - Opening a new store
  - International expansion
  - Investing in **new technology**/production machinery

- **External growth** usually takes place when firms merge in one of three ways
  - Vertical integration (forward or backwards)
  - Horizontal integration
  - Conglomerate integration



A diagram that illustrates how a firm can grow through forward or backward vertical integration

- **Forward vertical integration** involves a merger or takeover with a firm further forward in the supply chain
  - E.g. A dairy farmer merges with an ice-cream manufacturer

- **Backward vertical integration** involves a merger/takeover with a firm further backward in the supply chain
  - E.g. An ice-cream retailer takes over an ice-cream manufacturer

The Advantages & Disadvantages of Internal Growth

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- Firms will often **grow internally** (organically) to the point where they are in a financial position to **integrate** with others
  - Integration speeds up growth but also creates new challenges

The Advantages & Disadvantages of Internal Growth

Advantages	Disadvantages
• The **pace of growth** is manageable • **Less risky** as growth is financed by profits & there is expertise in the industry • Avoids diseconomies of scale • The management know & understand **every part** of the business	• The pace of growth can be slow & frustrating • Not necessarily able to benefit from economies of scale • Access to **finance** may be limited

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Mergers & Acquisitions (M&As) & Takeovers

- A **merger** is a mutual agreement between two or more businesses to **join together** as a single business
  - In 2022 *Moj* and *MX Takatak*, India's two leading video-sharing platforms merged, combining 300 million monthly active users with the aim of becoming a serious competitor to China's *Tiktok*
  - The *Walt Disney Company* and *21st Century Fox* merged in 2018 to **gain a higher market value and share** (the new company achieved a market share greater than 90%)

- An **acquisition** occurs when one company **takes complete control** over another by acquiring more than 50 per cent of its share capital
  - A **friendly takeover** is where acquisition has the **approval** and **support** of the directors of the target company
    - In 2014 *Facebook* acquired mobile messaging company *Whatsapp* for around $19 billion with a shared mission to 'bring more connectivity and utility to the world by delivering core services efficiently and affordably'
  - A **hostile takeover** occurs **against the will** of the target company's board of directors
    - The US food giant Kraft completed its hostile takeover of Cadbury Plc in 2010 by increasing its initial bid to shareholders by over $3 billion

An Explanation of the Advantages & Disadvantages of Each Type of Growth

Type of Growth	Advantages	Disadvantages
Vertical Integration (Inorganic growth)	• Reduces the **cost of production** as middle man profits are eliminated • Lower costs make the firm more **competitive** • Greater control over the supply chain **reduces risk** as access to raw materials is more certain • **Quality** of raw materials can be controlled • Forward integration adds **additional profit** as the profits from the next stage of production are assimilated • Forward integration can increase **brand visibility**	• **Diseconomies of scale** occur as costs increase e.g. unnecessary duplication of management roles • There can be a culture clash between the two firms that have merged • Possibly **little expertise** in running the new firm results in **inefficiencies** • The price paid for the new firm may take a long time to recoup

Horizontal Integration (Inorganic growth)	• Rapid increase of **market share** • Reductions in the cost per unit due to economies of scale • Reduces competition • Existing knowledge of the industry means the merger is more likely to be successful • Firm may gain new **knowledge or expertise**	• **Diseconomies of scale** may occur as costs increase e.g. unnecessary duplication of management roles • There can be a culture clash between the two firms that have merged
Conglomerate Integration (Inorganic growth)	• Reduces overall **risk** of business failure • Increased size & connections in new industries opens up **new opportunities for growth** • Parts of the new business may be **sold for profit** as they are duplicated in other parts of the conglomerate	• Possible **lack of expertise** in new products/industries • **Diseconomies of scale** can quickly develop • Usually results in job losses • **Worker dissatisfaction** due to unhappiness at the takeover can reduce **productivity**

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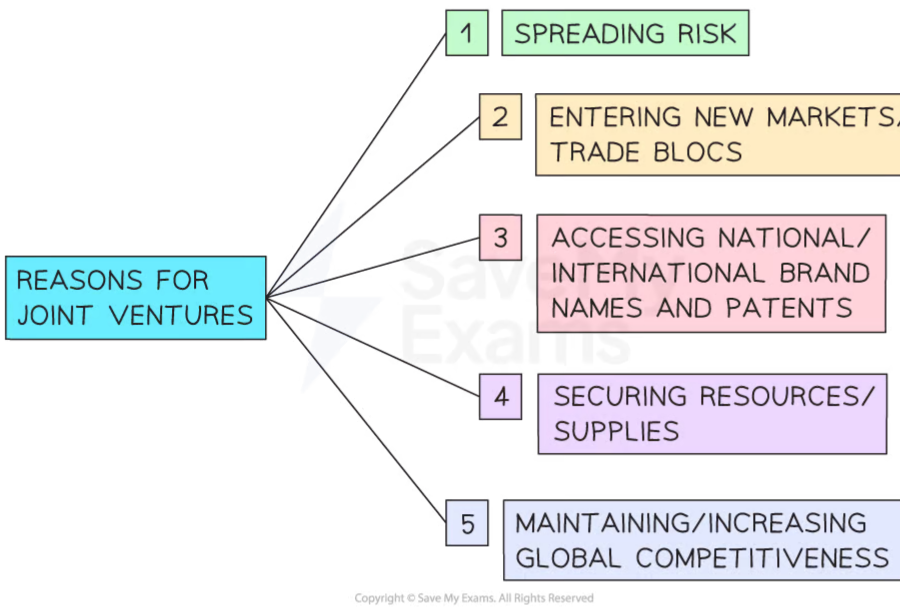
Joint Ventures

- **A joint venture** occurs when two businesses join together to share their knowledge, resources and skills to form a separate business entity for a specified period of time
  - E.g. The mobile network EE is a joint venture formed by the French mobile network, Orange and the German mobile network, T-Mobile

- Businesses may choose a joint venture to reach a new market as it may be more cost effective than exporting, licensing and franchising



Key reasons for global mergers and joint ventures

Spreading Risk

- Businesses operating in different markets spreads the risks associated with **fluctuating economic conditions**
  - If there is an economic downturn in one market, they may still gain sales in another market that is less affected

Entering new markets/trading blocs

- Entering a market using a joint venture is a quicker method than using organic growth
- In emerging economies, many governments inisist that foreign businesses can only **operate as a joint venture** as this can benefit domestic businesses
- Forming a joint venture with a local company allows the joining business to **gain knowledge and business of the local markets**

Accessing national/international brand names/patents

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- A **patent** is the legal right given by the government to an individual or business to make, use or sell an invention and exclude others from doing so
- The process of developing intellectual property can be a long and expensive process
  - Working in a joint venture may allow a businesses can use to get access to intellectual property or a business with a strong reputation

Securing resources/supplies

- Businesses can create joint ventures with another business which have access to resources e.g land and raw materials
  - This allows business to quickly gain access to resources which helps to speed up the production process
- Businesses have to be aware of any **ethical issues** concerning the resources as this can damage the reputation of the business e.g. perhaps being unaware that the company they are joining with uses child labour

Maintaining/increasing global competitiveness

- Businesses can increase their **global dominance** by working in a joint venture with another business
- By expanding in this way, even for a short period, a business can benefit from economies of scale which leads to lower costs
  - Businesses can reduce prices which can increase sales, leading to a higher **market share**

The Advantages & Disadvantages of Joint Ventures

Advantages	Disadvantages

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• **Economies of scale** gained from costs spread over larger output can lead to increased profit margins
 	
• Both businesses **retain their own identity** as the joint venture is set up as a separate business for a limited period of time
  ◦ When the joint venture comes to an end the partners continue to operate their original businesses as before
 	
• **Opportunity to enter new markets** which otherwise may be closed to the business
 	
• Joint ventures often involve the **exchange** of technology, expertise, or specialised knowledge
  ◦ This can enhance the capabilities of the venture and provide access to new opportunities
	• In a joint venture **both businesses have a say** in decision-making
	  ◦ This shared control can lead to **conflict** especially if the partners have different management styles or strategic goals
	
	• Reaching agreement may require **extensive negotiations** which can slow down the decision-making process
	
	• Sharing sensitive information such as trade secrets can be a concern if the partners are competitors
	
	• A culture clash between the two businesses can affect the quality of the business, leading to poor sales
	
	• Joint venture partners **share both profits and costs**
	  ◦ If one partner contributes more resources or effort than the other there may be disagreements about the distribution of profits leading to conflicts

Franchising

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- Franchising is a business model where an **individual (franchisee)** buys the rights to operate a business model, use its branding and software tools and receive support from a **larger company (franchisor)** in exchange for an initial lump sum plus ongoing fees
- Franchising is a popular way to achieve **rapid global growth**
- The franchisee operates the business under the **franchisor's established system** and receives training, marketing support, access to software and other systems and ongoing assistance
    - Examples of global franchises include Domino's Pizza, KFC and Burger King

Some of the many food franchises available

- The franchise model is a popular strategy for **growing a business**, offering both advantages and disadvantages to the business owners

The Advantages & Disadvantages of Growth Generated by the Franchise Model

Advantages	Disadvantages

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• **Rapid Expansion:** Franchising allows for accelerated growth compared to traditional expansion methods
 	
• **Capital Injection:** Franchisees typically invest their own money to set up and operate their franchise units
  ◦ This relieves the franchisor from the burden of funding the expansion, reducing financial strain on the parent company
 	
• **Local Expertise:** Franchisees are often local entrepreneurs who possess in-depth knowledge of their markets
 	
• **Motivated Operators:** Franchisees are more likely to be highly motivated and dedicated to ensuring their business thrives, as their financial success is directly linked to the performance of their franchise
 	
• **Brand Recognition:** With each new franchise unit, the brand's visibility and presence increases
	• **Loss of Control:** Franchising involves granting a degree of control to franchisees and this may lead to variance in product standardisation and quality
	
	• **Shared Profits:** Franchisees typically pay ongoing royalties to the franchisor, reducing the overall profit margin for both parties and for the franchisor it limits the potential earnings compared to fully owned units
	
	• **Reputation Risks:** The actions of individual franchisees can impact the overall brand reputation
	  ◦ A single poorly managed or customer service failure at a franchise location can have a negative impact on the entire franchise network
	
	• **Initial Investment and Support Costs:** The franchisor must invest in establishing and maintaining a comprehensive franchise support system
	  ◦ This includes developing training programs, operational manuals, and ongoing assistance to ensure consistent quality across franchise units
	
	• **Legal and Regulatory Compliance:** Franchising involves navigating complex legal frameworks, including franchise disclosure documents, contracts, and compliance with franchise regulations

Exam Tip

A franchise is not a form of business ownership - it is an alternative to starting up a brand new business from scratch.

In most cases franchisors require businesses to operate as private limited companies as this ownership type is considered to have more stability than sole traders or partnerships.

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Strategic Alliances

- Strategic alliance agreements are **similar to joint ventures**
  - Businesses collaborate for a period of time to achieve a specified goal
  - They agree to **work together for their mutual benefit**
  - Resources are often shared

The Main Differences Between Joint Ventures & Strategic Alliances

Difference	Explanation
The Nature of the Relationship	• A joint venture involves the **creation of a new legal entity** by two or more businesses • A strategic alliance is a **cooperative arrangement** between two or more companies **without the formation of a new legal entity**
Ownership & Control	• In a joint venture the participating companies **jointly own and control** the new entity • In a strategic alliance each participating company **retains its ownership** and control and **makes its own decisions**

Duration	• Joint ventures are often intended to be **long-term** or permanent collaborations
	  ◦ Each company make significant investments and commitments to the joint venture with the expectation that shared operations will be ongoing
	• Strategic alliances can **vary in duration**
	  ◦ They are generally formed for a specific project and can be terminated once the agreed-upon goals are achieved

Scope	• Joint ventures usually have a **broad scope** of collaboration • Strategic alliances are usually focused on a **specific area** of cooperation ◦ Companies join forces to **pursue a particular goal** such as entering a new market or conducting research and development