CHAPTER 8: Organisational objectives, growth and scale

Key Revision Points

The Objectives of Organisations

Organisational goals can be classified into a number of categories:
- Those that aim to make a profit for their owners
- Those that aim to maximise benefit to society
- Those that aim to maximise benefits to their members

The following sections look in detail at more specific objectives of business organisations.

- **Profit maximisation**

Economic theory is very much based on the notion of the profit-maximising firm. However simple models of profit maximisation are open to question.

These are some important limitations on profit maximising theories:

- **Market share maximisation**

A firm may pursue a policy of maximising market share independently of a short-term profit maximising objective. Domination of a particular market may give stability and security to the organisation. This might be regarded as a more attractive option for the management than maximising profits.

- **Corporate Growth**

As an organisation grows, so too does the power and responsibility of individual managers. However, such enthusiasm for growth could lead the owners of the business to pursue diversification into possibly unknown and unprofitable areas.

- **Satisficing**

The argument has been advanced that managers aim for *satisfactory* rather than *maximum* possible profits. Provided that sufficient profit is made to keep shareholders happy, managers may pursue activities that satisfy their own individual needs.

There has been a growing tendency for the owners of a business to give senior managers of the business contracts of employment that are related to profit performance.

- **Survival**

For many organisations, the objective of maximising profit is a luxury for management and shareholders alike - the overriding problem is simply to stay in business.

- **Loss making**

Situations can arise where it may be more tax efficient for the company as whole to continue making a loss rather than buy in the product at a cheaper price from an outside organisation.

- **Personal Objectives**

Many businesses, especially smaller ones, appear to be pursuing objectives that have no economic rationality.

Many small businesses fail in a competitive environment where personal objectives cannot be achieved without undue economic sacrifice (e.g. it has been estimated that over 80 per cent of all new restaurants fail within two years of opening).

- **Social Objectives of Commercial Organisations**

Occasionally, commercial organisations have overt social objectives of one form or another, usually alongside a financial objective, for example a requirement that the organisation must at least break even.

The social responsibility of organisations, and the views of the critics, who are cynical about firms' social objectives, are discussed further in Chapter 5.

- **Maximising Benefits to Consumers**

The co-operative movement was originally conceived to eliminate the role of the outside shareholder, allowing profits to be passed back to customers through a dividend which is related to a customer's spending rather than their shareholding.

During the 1990s, building societies have been keen to promote the fact that they do not have any shareholders to satisfy, and can therefore pass on savings to members.

- **Maximising Public Benefits**

In many government and charity organisations, it is difficult to talk about the concept of profit or revenue maximisation. Instead, the organisation is given an objective of maximising specified aspects of public benefit, or 'externalities', subject to keeping within a resource constraint.

There is frequently a gap between the publicly stated objectives of a public sector organisation and the interpretation and implementation of these objectives by the staff concerned. As in a private sector organisation, management in the public sector could promote secondary objectives.

In recent years, more pressure has been placed on public services such as education and defence to operate according to business criteria. As suppliers of services, public sector organisations are increasingly being set quantified objectives that reflect the needs of their clients.

- **Complexity of Objectives**

A number of possible objectives for organisations have been suggested. In practice, an organisation is likely to be pursuing multiple objectives at any one time. Furthermore, objectives are likely to change through time.

Organisational size and growth

Like most living organisms, businesses have an almost inherent tendency to grow. In this section, the reasons for growth and the options for growth that are open to business organisations are explored.

Small and Medium sizes Enterprises (SMEs)

The term small business is therefore a relative one, based typically on some measure of numbers of employees or capital employed.

Despite the tendency of firms to grow, there has been renewed interest in the role of small businesses within the economy. It is suggested that many of Britain's competitors, such as emerging Far Eastern economies, have attributed their growth to a strong small business sector.

Advocates of small business argue that they are important to the economy for a number of reasons: Most large firms started off as very small businesses, so it is important to the health of the economy that there is a continuing supply of growing companies to replace those larger firms that die.

It is not only small entrepreneurs who have been creating new small businesses, for larger organisations have also recognised their value and have tried to replicate them at a distance from their own structure.

While small business has certainly seen resurgence in recent years, it should also be recognised that they have a very high failure rate.

- **Marketing advantages of small businesses**

Small businesses survive and prosper where they are able to exploit the marketing advantages of being small. The following are often cited as key competitive advantages:

- Greater adaptability than larger firms and rapid decision-making processes
- Good innovators, especially where large amounts of capital are not required and where they operate in markets dominated by a small number of larger companies
- Small business owners can be a vociferous group which governments seek to appease with concessions, especially in markets where they are large numbers of small businesses.
- Small businesses have often been exempted from statutory duties that apply to larger companies.
- Small firms can spend more time with their customers than their larger rivals.

Reasons for Growth

An organisation can grow for a number of reasons:

- The markets in which the organisation operates may be growing, making growth in output relatively easy to achieve.

- A critical mass may exist for the size of firms in a market, below which they are at a competitive disadvantage.
- An overt policy of growth is often pursued by organisations in an attempt to stimulate staff morale.
- Higher rates of growth can bring greater status and promotion prospects to managers of an organisation.
- Some organisations may grow by acquiring competitors in order to limit the amount of competition in a market.

Organisational Scale

There is continuing debate about whether there is an 'ideal' size for business organisations. In fact, there are advantages and disadvantages of large firms and they can be found coexisting with much smaller firms in most sectors.

- **Economies of Scale**

In many sectors, large organisations have advantages over smaller ones. These are some of their principal advantages:

- In some industries there are significant economies of scale in production processes. This is particularly true of industries where fixed costs of production are a high proportion of total costs.

- Larger firms may be able to acquire their inputs on more advantageous terms in the first place.

- Large-scale production can allow for economies of scope, by allowing a wider range of goods and services to be offered.

- A company's promotion effort can be much efficient where it is aimed at a large-volume national (or even international) market, rather than a purely local one.

- Investors generally prefer companies that have a proven track record of stability.

- By operating at a larger scale with a broad portfolio of products, cross-selling can be facilitated.

Globalisation and Multinational organisations

Markets are becoming increasingly globalised, forcing firms in many sectors to see their market not just as the domestic economy, but the whole world.

Companies operating at a large scale are able to maintain a cost-effective position at the leading edge of design through investment in research and development whose cost can be spread over a large volume of output.

By expanding overseas, a company that has developed a strong brand can stretch the coverage of that brand.

International markets are becoming increasingly homogenised. The car industry serves as a good example of one where distinctive national preferences have diminished.

Growth and Organisational Life Cycles

Many have suggested that organisations also go through a life cycle. There is evidence that an organisation's goal may change over time.

A number of factors trigger the different stages in the life cycle of an organisation. These can be external threats and opportunities or the emergence of internal strengths and weaknesses.

By identifying a company's stage in the life cycle, the major objectives, decisions, problems and organisational transitions needed for the future can be anticipated.

- **Types of Organisational Growth**

Growth of organisations can be analysed in terms of:
1. The object of the growth, which can be defined in terms of the development of new markets and/or new products
2. Organisational issues about how the growth is achieved.

- **Product/Market Expansion**

Four types of growth strategy can be identified, each associated with differing sets of problems and opportunities for organisations.
- *Market penetration strategies*
- *Market development strategies*
- *Product development strategies*
- *Diversification strategies*

In practice, most growth that occurs is a combination of product development and market development.

- **Portfolio Planning**

Over reliance on one product, aimed at one segment, can make the survival of the organisation dependent upon the fortunes of this one product / segment and its liking for its product. In any event, the fact that most markets change to some extent over time, and products generally go through some form of lice cycle would imply that a company would eventually go into decline.

Risk spreading is an important element of portfolio management which goes beyond marketing planning.

One popular portfolio planning model – the Boston Consulting Group (BCG) "Growth-share" matrix places a company's products or business units into four categories based on their market growth and market share relative to the largest competitor.

- **Organic Growth**

The initial investment by the organisation results in profits, an established customer base and a well-established technical, personnel and financial structure. This provides a foundation for future growth. In this sense, success breeds success.

- **Growth by Acquisition**

Growth by acquisition may appear attractive to organisations where organic growth is difficult. In some cases it may be almost essential in order to achieve a critical mass which may be necessary for survival.

Growth by acquisition can take a number of forms. The simplest form is the agreed take-over. While the majority of take-overs are mutually agreed, circumstances often arise where a take-over is contested.

For public companies, the Stock Exchange imposes strict rules about how a take-over bid may be conducted, covered by the City Code on Take-overs and Mergers.

- **Mergers**

A merger is a variation on a take-over where two existing companies agree to set up one new company which issues shares to the shareholders of each of the existing companies in agreed proportions.

Mergers, like take-overs, also run the risk of being blocked by regulatory authorities on the grounds that they may restrict the extent of competition.

- **Joint Ventures**

Diversification into new business areas can be risky, even for a cash-rich business. One way forward is to set up a joint venture where companies with complementary skills and financial resources join together.

- **Management Buy-outs**

A buy-out is an autonomous company which is created by the management and/or employees of an organisation buying part or all of the business of their former employers.

Horizontal and Vertical Integration

Horizontal integration occurs where firms involved in the same stage of manufacture of a product amalgamate to achieve greater economies of scale and- subject to Competition Commission approval - to reduce the level of wasteful competition in a market.

Vertical integration occurs where a company acquires either its suppliers (backward integration) or its distributors (forward integration).

Sources of Finance for Growth

Companies can raise risk capital (often referred to as *equity* capital) from shareholders for which a relatively high rate of return will be required. To supplement this, companies use a second and relatively less expensive form of *loan* finance.

The relationship between the two is referred to as *gearing.*

- **Methods of Raising Equity Capital**

For a private limited company, the sale of shares cannot be advertised to the public, so they have to be placed privately.

To gain access to significant amounts of new equity capital from a much wider financial community, a private company may 'go public' by forming a public limited company.

- **Private equity capital**

A private equity company essentially uses cheap loan capital to purchase the share capital of a public company. After cutting the company's operating costs, and selling surplus assets, the private equity company would sell on the company, either to a trade buyer, or as a re-flotation on the stock market. The key to success for this kind of financing is the availability of cheap loans to replace the relatively expensive equity capital.

- **Retained Earnings**

While retained earnings may seem an easy source of finance for a company, there is a danger that if it does not achieve an adequate internal return on these retained earnings, it may become the subject of a take-over bid from another company that considers that it could manage the capital of the business more effectively.

- **Loan Capital**

Debentures are loans to a company carrying interest at a fixed rate and are generally repayable on a specified date. Debenture holders receive priority over shareholders for annual income payments and when the assets of the business are liquidated.

- **Other sources of finance**

Shares and debentures provide long-term finance for long-term growth. In recent years the distinction between the two has sometimes become blurred with new forms of "mezzanine" financing which are essentially debentures, but carry some of the risk and rewards' more commonly associated with equity capital. In the short term, the survival of many companies is influenced by being able to collect money due to them as quickly as possible. Some companies resort to **factoring** by selling a debt they are owed to a finance company and receiving payment, less a premium, immediately. On the other hand, firms seek to delay paying their debts to suppliers for as long as possible, thereby providing an additional source of short-term finance.

Limits to Growth

There are limits to how far and how fast a company can grow.

Growth by acquisition is commonly associated with high borrowings resulting in a high level of gearing.

The ability of the management structure of a company to respond to growth sets a further limit to growth.

Legislative constraints are increasingly limiting the ability of firms to grow.

The need to compete from a position of strength needs to be balanced against regulators' increasing concern that the competitiveness of markets should be maintained.

- **De-mergers**

A number of conglomerates have split themselves up in a reversal to the process of merging, sometimes referred to as de-merging. The initial cause of a de-merger is often the recognition that shareholders' total share value would increase if they had shares in two or more separate businesses rather than the one conglomerate holding company.