Edexcel Economics (A) A-level

Theme 3: Business Behaviour and the Labour Market

3.1 Business Growth

Detailed Notes

3.1.1 Sizes and types of firms

Reasons why some firms tend to remain small and why others grow:

Firms grow for a number of reasons: to make more money, to gain monopoly power and for greater security.

- By growing, a firm will be able to experience **economies of scale** which helps them to decrease their costs of production. They will also be able to sell more goods and therefore make **more revenue**. Together, these will help a firm to make a **larger profit**: and many firms are motivated by profit.

- A larger firm will hold a greater share of their market. This will give them the ability to **influence prices** and **restrict the ability of other firms to enter the market,** helping them to make profits in the long run. Monopoly power often means firms have **monopsony power**, and so will be able to reduce their costs by driving down the prices of their raw materials.

- A larger firm will have more security as they will be able to **build up assets and cash** which can be used in financial difficulties. Moreover, they are likely to sell a **bigger range of goods in more than one local/national market** and so they will be less affected by changes to individual products or places.

However, not all firms grow. Some remain small because of constraints on growth: the size of the market, access to finance, owner objectives and regulation. Not all firms want to grow.

The principal agent problem:

In many large firms, there is **separation of ownership and control:**

- Firms are **owned by their shareholders**, who play no part in the day to day running of the business.
- The **chief executive and senior managers work** for the company and control day-to-day decision making.
- Shareholders are represented by a Board of Directors, who oversee the way the business is run. They are able to **vote directors onto and off** the Board of Directors at the AGM. However, this often makes little difference and shareholders have more power through **buying and selling shares**: if share prices drop significantly, the board may be encouraged to change their strategy.

This separation causes problems due to the **differing aims of the two stakeholders:**

- The owners will want to maximise the returns on their investment so will want to **short run profit maximise.**
- However, directors and managers are unlikely to want the same thing: as employees, they will want to **maximise their own benefits**.

This is the principal agent problem, where **one group, the agent, makes decisions on behalf of another group, the principal.** In theory, the agent should maximise the benefits for those whom they are looking after but in practice **agents have the temptation to maximise their own benefits.** It is for this reason that many firms are **not run to profit-maximise but to profit satisfice**; a concept looked at in unit 3.2. The issue could be overcome by giving managers shares in the business or linking their bonuses to profits, this will mean that they personally will gain from higher profits.

<u>An extreme example of this problem is the Enron Scandal (2001). The executives used loopholes to hide billions of dollars in debt from the Board of Directors. The shareholders filed a lawsuit to the firm and the executives when share prices fell from nearly $100 to less than $1 in just over a year.</u>

Public and private sector:

In the UK, the economy is split into private and public sector:

- The private sector refers to that part of the economy that is **owned and run by individuals or groups of individuals,** including sole traders and PLCs.

- The public sector refers to that part of the economy which is **owned or controlled by local or central governmen**t. The purpose of these organisations is to provide a service for UK citizens and profit making is not their main aim, some may even make a loss which is funded for by the taxpayer.

Profit and not-for-profit organisations:

The private sector can be split into for profit and not-for-profit organisations:

- Almost all private sector organisations are run to make a profit and to **maximise the financial benefits for their shareholders**. They may not necessarily profit-maximise, but their long term goal is to make money.

- Some private sector organisations are not-for-profit. Any profit they do make is used to support their aim of **maximising social welfare** and helping individuals and groups**.** These organisations include charities and smaller organisations who aren't large enough to be classified as charities.

3.1.2 Business growth

Organic growth:

There are two main types of growth: internal/organic growth and integration. Organic growth is where the firm grows by **increasing their output**, for example increased investment or more labour. They may open new stores, increase their range of products etc. Almost all growth of firms is organic.

An example of a firm who grew through organic growth is LEGO. They introduced new products, such as Lego Friends and board games to expand their customer base.

Advantages:

- Integration is **expensive, time-consuming and high risk**, with evidence suggesting that the long-term share price of the company falls following integration. Firms often pay too much for takeovers and integration is often poorly managed with many key workers tending to leave after the change.
- The firm is able to **keep control** over their business.

Disadvantages:

- Sometimes another firm has a **market or an asset** which the company would be unable to gain through organic growth. For example, integration would allow a European company to expand into the Asian market which it has no expertise in.
- Organic growth may be **too slow** for directors who wish to maximise their salaries.
- It will be more difficult for firms to get **new ideas.**

Forward and backward vertical integration:

Integration is growth through amalgamation, merger or takeover. A merger or amalgamation is where two or more firms join under common ownership whilst a takeover is when one firm buys another.

Vertical integration is the integration of firms in the **same industry but at different stages in the production process**. If the merger takes the firm back towards the supplier of a good, it is **backwards integration**. **Forward integration** is when the firm is moving towards the eventual consumer of a good.

Tesco's £3.7bn takeover of Booker in 2018 is an example of vertical integration. It has led to an increase in sales for Tesco.

Advantages:

- There is **increased potential for profit** as the firm takes the potential profit from a larger part of the chain of production.

- There will be **less risks** as suppliers do not have to worry about buyers not buying their goods and buyers do not have to worry about suppliers not supplying the goods.
- With backward integration, businesses can **control the quality of supplies** and **ensure delivery is reliable**. Moreover, they don't have to worry about being charged high prices for supplies, keeping **costs low** and allowing lower prices for consumers. This can increase competitiveness and sales.
- Forward integration secures **retail outlets** and can restrict access to these outlets for competitors.

Disadvantages:

- Firms may have **no expertise** in the industry they took over, for example a car manufacturing company would have deep knowledge of car manufacturing but little knowledge of selling cars and vice versa.

Horizontal integration:

This is where **firms in the same industry at the same stage of production integrate**.

In 2015, AstraZeneca acquired ZS Pharma for $2.7bn. It gave them access to new compounds and was a long term deal intended to strengthen a specific sector of their business. Other well-known examples are Currys and PC Worlds and Arcadia, who own Topshop, Evans, Dorothy Perkins etc.

Advantages:

- This helps to **reduce competition** as a competitor is taken out and **increases market share**, giving firms more power to influence markets.
- Firms will be able to **specialise and rationalise**, reducing the areas of the businesses which are duplicated.
- The business is able to grow in a market where it **already has expertise**, which is more likely to make the merger successful.

Disadvantages:

- The problem is that it will **increase risk** for the business as if that particular market fails, they have nothing to fall back on and will have invested a lot of money into that area. They are 'placing all their eggs in one basket'.

Conglomerate integration:

This is where **firms in different industries with no obvious connections integrate**. They can sometimes be linked by common raw materials/technology/outlets.

Today, this is uncommon but it was popular in the 1960s and 1970s. General Electric was founded as a lighting business and is now involved in aircraft, water, oil and gas, financial

services, healthcare, energy, aviation, rail and software. It is a successful model because they conduct extensive market research and remain as market leaders in relevant industries.

Advantages:

- It is useful for firms where there may be **no room for growth in the present market**.
- The range of products **reduces the risk** for firms and if a whole industry fails, they will still survive due to the other parts of the business.
- It will make it **easier for each individual part** of the business to expand than if they were on their own as finance can be easily obtained and managers can be transferred from company to company within the firm.

Disadvantages:

- The problem with this is that firms are going into markets in which they have **no expertise**. It can often be **damaging** for the business.

Constraints of business growth:

- **Size of the market:** A market is limited to a certain size and so not all businesses are able to mass produce because their goods would not be bought by consumers. This can happen no matter how big the market is, and there will always be limits on growth. In particular, niche markets (specific products that few people want) and markets for luxury items or restricted prestige markets make it difficult for businesses to grow.

- **Access to finance:** Firms use two main ways to finance growth: retained profits and loans. If firms do not make enough profit or have to give out too much to shareholders, they will not be able to use retained profits to grow. Banks may be unwilling to lend firms money, particularly smaller businesses that they see as high risk. As a result, firms will be unable to grow as they can't finance it.

- **Owner objectives:** Some owners may not want their business to grow any further as they are happy with their current profits and do not want the extra risk or work that comes with growth.

- **Regulation:** In some markets, the government may introduce regulation which prevents businesses from growing. For example, the UK government regulates the number of pharmacies in a local area and an existing pharmacy can only expand by buying another company. Competition law, which prevents monopolies, can restrict growth as any merger which creates a company with more than a 25% market share can be forbidden from taking place.

3.1.3 Demergers

A demerger is a business strategy in which a **single business is broken into two or more components**, either to operate on their own, to be sold or to be dissolved.

In 1997, Pepsi announced a demerger of its Pizza Hut, KFC and Taco Bell restaurants to focus on competition with Coca Cola. This was welcomed by shareholders as the restaurants had failed to live up to expectations.

Reasons for demergers:

- **Lack of synergies**: This is when the different parts of the company have no real impact on each other and fail to make each other more efficient. Lack of synergy means managers are splitting their time between areas which are so different it could lead to diseconomies of scale; firms may split in order to avoid these diseconomies.

- **Value of the company/share price:** Some companies demerge because the value of the separate parts of the company is worth more than the company combined. This is because some parts of the business are operating well and have potential to grow but the overall value is brought down because of the lack of success or lack of potential for growth of other parts of the business. Financial markets talk about 'creating value' by splitting up companies like this.

- **Focussed companies:** Some people believe if the company and the management are more focussed on individual markets they become more efficient and successful, and make higher profits. Management have limited time and skills and there are unable to spend the required time to make all areas of a huge diverse business successful. By focusing on one area, managers can improve their skills and knowledge and become more successful.

- They may also want to avoid attention from the **competition authorities**.

Impacts:

- **Workers:** Workers could gain or lose through a demerger. Separate firms may need their own managers and leaders so people could get a **promotion**. However, the goal of making the firm more efficient may result in **job losses**.

- **Businesses:** Concentrating on a smaller core business may enable it to be more **efficient** and concentration may lead to more **innovation** and surviving higher competition. However, the smaller size of the business could lead to a **loss of economies of scale** and reduce efficiency.

- **Consumers:** Again, consumers could gain or lose. They may gain from innovation and efficiency, leading to **better products and cheaper prices**. However, demerged firms may be less efficient through loss of economies of scale or **raise prices/reduce quality or range of goods** as they become motivated by profits.