SIZE OF BUSINESS (1.3)

(Chapter 3 - AS level 1.3)

It is common to compare businesses by their size. Why is it important to know ‘how big’ a business is or ‘how many’ small businesses there are in a country? There are multiple groups of people that are interested in measuring business size :

- **Managers** will want to know if their business is becoming relatively larger than others in the industry - so they can also measure success
- **Governments** might wish to give assistance to ‘small’ firms, so will need a measure of size
- **Potential investors** may wish to compare the size of the business with close competitors – to decide which one is the best investment
- **Customers** may prefer to deal only with large firms, assuming they are more reliable

None of the measures of business size is perfect - and in some cases they cannot be relied upon. Also, do keep in mind that the book heavily emphasises that ***profit is not a measure of business size.***

The 5 ways to measure business size are as follows :

1. Number of employees

This is the simplest measure - as it's easy to understand. A shop run by just a singular owner or their family is small. It is also clear that a firm employing many staff is likely to be large. However, there are problems. How about a business that needs to employ only a few people – such as a highly automated large manufacturing company that relies mostly on machines?

2. Revenue

Revenue is the total value of sales made by a business in a given time period. Revenue is commonly used as a measure of size when comparing firms in the same industry.

The issue with using revenue as a measure of business size is that It is less effective when comparing firms in different industries - because some might be engaged in ‘high-value’ production (such as precious jewels) and another might be in ‘low-value’ production (such as cleaning services.)

3. Capital employed

Capital employed is the total value of all long-term finance invested in the business. The amount of machinery a business owns falls under its capital employed. So it can be said that a manufacturing business that uses a lot of machines is a large business.

The issue with using capital employed as a measure of business size is that it's inefficient when measuring a labour intensive business - which is a large business that employs many workers but doesn't use much machinery (for example, a postal service). This won't be seen as a large business in terms of capital employed, even though it is.

4. Market capitalisation

Market capitalization is the total value of a company's sold shares.It can be used only for businesses that have shares quoted on the stock exchange (public limited companies).

It is calculated by this formula :

Market capitalisation = current share price × total number of shares issued

The issue with using market capitalisation as a method of measuring business size is that as share prices tend to change every day - so this form of comparison is not a very stable one. For example, a temporary but sharp drop in the share price of a company could appear to make it much 'smaller' than it normally is.

5. Market share

Market share refers to the sales of the business as a proportion of total market sales. So basically the sales of a business in comparison to the market its selling in. It is useful for making comparisons between firms in the same industry. However, it is of no use to make comparisons between firms in completely different industries. Another issue is that when the size of the total market is small, a high market share will not indicate a very large firm.

The formula for market share is :

$$\text{Market Share} = \frac{\text{Total Sales of the Company}}{\text{Total Sales of the Market}} \times 100$$

The importance of small businesses

Small firms (including micro-enterprises) are very important to all economies and to the industry in which they operate. Due to this fact most governments are willing to offer special support for small businesses because of the economic benefits they offer.

Benefits of small businesses to the economy

- **Creates jobs** - reducing unemployment + **contributing to the growth of the economy**
- Small firms can **create competition** for larger businesses - which can force them to offer better quality products and lower prices for consumers. Without this competition, larger firms could exploit consumers with high prices and poor service
- **New business ideas** can be provided by new entrepreneurs
- Small firms can **supply goods and services** to important industries in a country
- New businesses can **create more variety and choice** for consumers - in the form of new services or products

Ways governments support and help small businesses

- **Reduce the rate of profit tax -** so that small businesses are able to retain more profits to help them expand/fund their operations
- **Offer loan guarantee schemes** - this is a government-funded scheme that guarantees the repayment of a certain percentage of a bank loan should the business fail. This makes banks much more likely to lend to newly formed businesses
- **Offer workshops that provide advice**, **information** and **support** - assisting new entrepreneurs in learning how to operate their new business
- **Provide new businesses with grants -** money that's given to your business that you don't have to pay back
- **Provide low cost premises** - provide land at low cost or low rent for new firms
- **Give tax breaks/ holidays** - high taxes are a disincentive for new firms to set up. Governments can thus withdraw or lower taxation for new firms for a period of time

Advantages of being a small business

✔ Can be **managed easily** and controlled by owner(s)
✔ Often **able to adapt quickly** to meet changing customer needs
✔ **Offer personal service** to customers - good relationships encourage them to repurchase
✔ **Easy to set up** and less workers so also easier to control - in comparison to larger businesses
✔ Can sometimes **benefit from government assistance**

Disadvantages of being a small business

✖ **Limited access to sources of finance -** investors hesitant to loan, governments not always willing to help
✖ the owner has to carry a **large burden of responsibility**
✖ May **not be diversified** (selling into multiple markets) having nothing to fall back on if their one business fails
✖ **Few opportunities for economies of scale** (the cost advantages that a business can experience by expanding their scale of production - like buying in bulk)
✖ May **not be able to afford specialist managers -** owner may lack sufficient knowledge

Why some businesses remain small

Not all businesses grow. Some stay small, employ a handful of workers and have little output. The reasons for this include.

- **Type of industry**: some firms remain small due to the industry they operate in. Examples of these are hairdressers, car repairs, catering, etc, which give personal services and therefore cannot grow.
- **Market size**: if the firm operates in areas where the total number of customers is small, such as in rural areas, there is no need for the firm to grow and thus stays small.
- **Owners' objectives**: not all owners want to increase the size of their firms and profits. Some of them prefer keeping their businesses small and having a personal contact with all of their employees and customers, having flexibility in controlling and running the business, having more control over decision-making, and to keep it less stressful.

Family businesses

Family-owned businesses are those that are actively owned and managed by at least two members of the same family. In many cases, the family that founded the business retains complete ownership of it. Most family owned businesses remain small, but not all. Family businesses have several strengths and weaknesses.

Strengths of family businesses

✔ **Employees tend to be committed and loyal -** with shared values and culture

✔ Since most family businesses are small, they **tend to be flexible** with quick decision making - with family members often playing different roles

✔ **Reliability and pride -** because family businesses have their name and reputation associated with their products, they strive to increase the quality of their output and to maintain a good relationship with their stakeholders

Weaknesses of family businesses

✖ **Succession/continuity problem** - many family businesses fail to be sustainable in the long term. This high rate of failure can be due to lack of skills and ability of later generations or the fact that often jobs are given to incapable family members because they are family

✖ **Informality** - because most families run their businesses themselves, there is usually little interest in setting clear and formal business practices and procedures. A lack of professional boundaries can lead to internal conflicts

✖ **Traditional** - there can be a reluctance to change and to adapt to modern ways, preferring to run things the way it has always been. The inability to adapt may lead to business failure

✖ **Conflict** - Problems within the family may reflect on management of the business and make effective decisions less likely

Business growth

The owners of many businesses do not want the firm to remain small – although some do, for reasons of **remaining in control**, **avoiding taking too many risks** and **preventing workloads** from becoming too heavy. Most businesses will want to expand their operations in order to get more profits, increase their market share and experience the benefits of economies of scale.

Business expansion can take place in 2 ways :

- **Internal growth** - Also known as organic growth, which is done through expanding existing operations and opening new ones
- **External growth** - is growth through integration with another business

Internal growth

Internal growth or organic growth is the expansion of a business by means of increasing sales and opening new branches, shops or factories. An example of internal growth would be a retailing business opening shops in towns and cities where it previously had none.

Advantages of internal growth

✔ **Less risky** than taking over/merging with another business

✔ **Relatively inexpensive** - as its done over a longer period of time and is financed through through internal funds (i.e retained profit)

✔ Allows the firm to **remain totally in control** - much less chance of management issues like external growth

Disadvantages of internal growth

✖ It is a **slow form of growth** - often taking months/years

✖ Growth can be **limited** depending on the industry

(Chapter 7 - A Level 1.3)

External growth

External growth is business expansion that occurs when two or more businesses join together into one large business. Often referred to as 'integration'. This form of growth can lead to rapid expansion - However, it often also leads to management problems. This can be the result of conflict between the two teams of managers or conflicts of culture and business ethics.

External growth by integration can be done through a **merger** or **takeover**. A 'friendly' merger of two businesses or a 'hostile' takeover of one by another can lead to 'stakeholder conflict'. This means some stakeholders will benefit more than others. For example, if a merger is unable to achieve **synergy -** the shareholders of the businesses might not benefit as intended.

Merger is an agreement by shareholders and managers of two businesses to bring both firms together under a common board of directors with shareholders in both businesses owning shares in the newly merged business.

Takeover when a company buys more than 50% of the shares of another company and becomes the controlling owner of it (happens in public limited companies mostly)

Synergy literally means that 'the whole is greater than the sum of parts', so in integration it is often assumed that the new, larger business will be more successful than the two, formerly separate, businesses were.

External growth can be largely classified into 3 types :

- **Horizontal integration -** same industry, same stage of production
- **Vertical integration (backward and forward)** - same industry, different stage of production
- **Conglomerate integration -** different industry

Horizontal integration

Horizontal integration is integration with firms in the same industry and at the same stage of production. For example - when a firm that manufactures furniture merges with another firm that also manufacturers furniture

Benefits of horizontal integration :
✔ **Reduces number of competitors** in the market, since two firms become one
✔ Merging will allow the businesses to have **more control over market** - like setting prices
✔ **Increased influence** over suppliers and government
✔ Opportunities of **economies of scale**

Disadvantages of horizontal integration :
✖ May be accused of **monopolising** - which can bring bad publicity

Impact of horizontal integration on stakeholders :
- Customers - now have less choice, and prices may either rise/fall
- Workers - may lose jobs as their positions become redundant as jobs are duplicated
- Suppliers - Able to supply more but may be forced to cut cost of supplies

Vertical forward integration

Vertical forward integration is integration with a business in the same industry but a customer of the existing business. For example, when a firm that manufactures furniture merges with a furniture retail store.

Benefits of vertical forward integration :
✔ Merger gives an **assured outlet** (store) for their product
✔ The retailer can be **prevented from selling the goods of competitors**
✔ Manufacturer now has **control over how their product is marketed**

Disadvantages of vertical forward integration :
✖ Lack of experience in this sector of the industry – a successful manufacturer does not necessarily make a good retailer

Impact of vertical forward integration on stakeholders :
- Customers - may resent lack of competition in the retail outlet because of the withdrawal of competitor products which will lead to less choice
- Workers - may have greater job security because the business has secure outlets, and potential career opportunities + gain new experience
- Managers - may have issues controlling a business in another sector

Vertical backward integration

Vertical backward integration is backward integration with a business in the same industry but a supplier of the existing business. For example, when a firm that manufactures furniture merges with a firm that supplies wood for manufacturing furniture.

Benefits of vertical backward integration :
✔ Merger gives **assured supply** of essential components
✔ Gives **control over quality, price and delivery** times of supplies
✔ Business now **control supplies of materials to competitors**

Disadvantages of vertical backward integration :
✖ May **lack experience** of managing a supplying company – a successful steel producer will not necessarily make a good manager of a coal mine
✖ Supplying business may become **complacent/lazy** due to having a guaranteed customer

Impact of vertical backward integration on stakeholders

- Customers - will have limited choice if business no longer supplies to competitors, but also may receive better quality products since business has control over supply quality
- Senior managers - may have problems controlling a business in another sector
- Workers - may have opportunity of greater career opportunities and gain new experience

Conglomerate integration

Conglomerate integration is when one firm merges with a business in a different industry. This is also known as 'diversification'. For example, when a firm that manufactures furniture merges with a firm that produces clothing.

Benefits of conglomerate integration :
✔ Business is able to **diversify** their operations and spread risks by moving into different products and markets
✔ There could be a **transfer of ideas** between the two businesses even though they are in different industries, which can lead to good things

Disadvantages of conglomerate integration :
✖ Potential **lack of management experience** in the acquired business sector

Impact of conglomerate integration on stakeholders

- Managers - potential greater career opportunities but may struggle with running new separate industry
- Workers - have more job security because risks are spread
- Shareholders - won't benefit if businesses are unable to achieve *synergy*

Reasons why a merger/takeover may not achieve objectives (i.e synergy)

- A **clash of management styles** and **cultures** between the two businesses
- The **motivation of the workforce** may fall if redundancies (people being fired because their jobs are no longer required) are done to save costs
- The **problems of managing a much bigger business** outweigh the potential cost savings
- Customers may seek alternative options if the **quality of products/services falls**

The importance of joint ventures and strategic alliances in external growth

Joint ventures and **strategic alliances** are most common in technology, manufacturing and when developing new markets.
In a **joint venture**, the companies start and invest in **a new business that is jointly owned by both of the parent companies**

A strategic alliance is a legal agreement between two or more companies to share access to their technology, assets and customer information. A strategic alliance does not create a new company.

Advantages of joint ventures and strategic alliances

✔ Able to pool finance and skills to develop new ventures

✔ Sharing of risks, especially for new projects

✔ Gaining access to new markets

✔ Gains new expertise without having to recruit new employees

Disadvantages of joint ventures and strategic alliances

✖ Can fail if there is poor communication between managers - who's in charge?

✖ Risk of clash between cultures and leadership styles

✖ Unclear role of each company can lead to poor decisions

✖ Must share profits

Problems that come with rapid growth and how to overcome them

- **Lack of capital** - expansion can be expensive. The cost of a takeover/merger can be very high. A way to overcome this is selling additional shares (if a limited company) or be sure you raise enough finance before expansion/takeover

- **Lack of management expertise -** if growth is slow then it is usually easier to manage. Rapid growth can put strain on existing managers and lead to poor decision making. A way to overcome this would be by preparing the managers before the integration takes place, or hiring managers who are experienced