Angelo Dringoli

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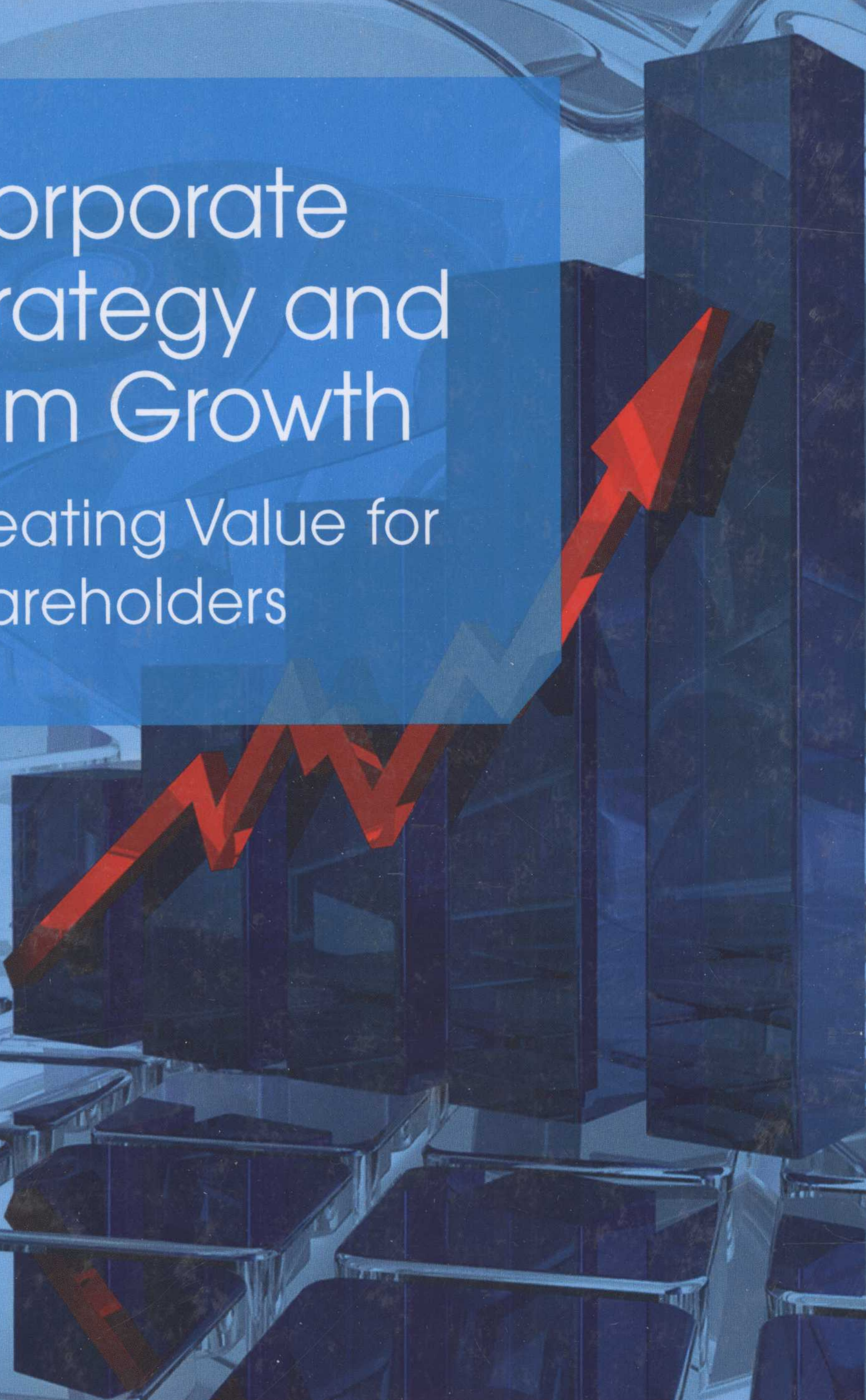

Corporate Strategy and Firm Growth

Creating Value for Shareholders

NEW PERSPECTIVES ON THE MODERN CORPORATION

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Angelo Dringoli

Faculty of Economics, University of Siena, Italy

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NEW PERSPECTIVES ON THE MODERN CORPORATION

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Abbreviations

a	Expenses to increase resources
A	Depreciation and amortization
b	Rate at which the marginal labour hours decline as the cumulative number of units produced increases
C	Current operating costs
CFO	Cash flow from operations
Cu	Unit cost of product
$D(0)$	Value of debt at initial date 0
$E(0)$	Value of equity at initial date 0
$EBIT$	Earnings before interest and taxes
$EBITDA$	Earnings before interest, taxes and depreciation
EBT	Taxable income
$FCFO(t)$	Free cash flow from operations in period t
g	Growth rate of cash flows
$H(Q)$	Labour hours required for producing the Qth unit
I_E	Investment in a growth strategy
INT	Interest expenses
kd	Cost of debt
ke	Cost of equity
m	Unit margin
NI	Net income
P	Product price in period t
P_B	Price of firm B
Q	Quantity of product produced or sold
R	Revenues
R_j	Value of resource j
S	Period up to the structural change (years)
t	Period of time (year)
T	Process or product lifetime (years)

$TC(Q)$	Total cost of producing quantities Q
TV	Terminal value of the firm
$V(0)$	Firm value at initial date 0
V_A	Value of firm A
V_{AB}	Value of merger AB
V_{acq}	Value of acquisition
V_B	Value of firm B
V_S	Value of a growth strategy
V_{SA}	Value of an acquisition strategy
V_{SD}	Value of a product diversification strategy
V_{SH}	Value of a horizontal expansion strategy
V_{SV}	Value of a vertical integration strategy
V_{SY}	Value of synergy
WC	Working capital (difference between current assets and current liabilities)
α	Labour hours required for producing the first unit of product
γ	Rate of decay in resource value
ΔWC	Change in working capital
ΔI	Capital expenditures
μ	Rate of accumulation in resource value
ρ	Weighted average cost of capital ($WACC$)
τ	Corporate tax rate
τ^*	Adjusted corporate tax rate

Preface

In this book we study the growth of the firm and the conditions for growth which creates value for shareholders.

The approach of the first part of the book is normative; it uses a theoretical analysis to show what managers should do to maximize shareholders' value through growth strategies and what the conditions are for favouring one or the other type of strategy. With this aim in mind we focus the analysis on the main strategies adopted by enterprises for growth: horizontal expansion, vertical expansion and product diversification.

The order of presentation reflects the actual growth of many firms: expansion starts within a core industry and it is undertaken to enhance or protect a firm's position in that business (horizontal expansion). Then, a firm moves outside its initial industry integrating its activities or phases along its value chain (vertical integration expansion) until over the years it becomes increasingly more and more diversified, entering different related industries and finally unrelated industries (product diversification expansion).

Each growth strategy is viewed as a decision directed at creating value for shareholders, exploiting the various opportunities offered by the environment and the internal firm resources. Each growth strategy implies different changes in the firm's system and causes different effects on the firm's long-term cash flows. Therefore, defining a growth strategy which creates value requires examining the internal conditions of the firm to be analysed, evaluating the dynamics of the external environment in which the firm operates and estimating the expected effects on the value of the company.

In order for a defined strategy to create value, it is also necessary to adapt the firm's organizational structure so as to effectively manage the increased complexity of the new business system. To reach this aim the organizational structures which can offer the best solution with respect to each growth strategy are analysed.

To evaluate whether or not a growth strategy can create value, we present some analytical models capable of specifying the relevant conditions under which each type of strategy can create value, both in the case of internal development and in the case of acquisition of other companies. These analytical models also allow us to identify the limits regarding the firm's size both of an internal or external nature.

The book highlights the fact that growth does not necessarily produce an increase in the enterprise and in the shareholders' value; that clearly results only under particular conditions. Thus, top managers must carefully evaluate every growth alternative.

The book is based on established research traditions. In particular a number of insights are drawn from three distinct bodies of research: the resource-based view of the firm; the organizational economics –in particular transaction costs analysis– and the fundamentals of corporate finance. All these theoretical traditions made a substantial contribution to the arguments advanced here.

In particular, the resource based view of a firm is the fundamental theoretical reference for our analysis. We believe growth strategies have to rest both on the dynamics of industry structure and on the existing firm's system characteristics that is the firm's resources, assets and capabilities. Heterogeneity of resources and their firm-specific characteristics form the basis of diversity and the strategic variety of firms.

In the second part of the book four cases of successful companies are presented. These companies are characterized by a decade of continuous growth, accompanied by a systematic creation of value for shareholders. The growth strategies of these companies are examined and their characteristics and effects are described, using analyses from the companies' annual reports over a period of years. The purpose of these cases is to highlight how a firm chooses and implements a defined growth strategy. Thus the cases provide a link between theory and practice, making the analysis more real and interesting.

The book is mainly directed at researchers and students in economics and management. As it offers useful tools for managerial decisions, we think it can also be of interest to managers and consultants.

The book contains 11 formal chapters and supplementary appendixes on related topics or background information. In particular, the appendixes provide additional focus on the concepts and theories presented in each chapter.

Chapter 1 begins with an introduction to growth strategies, the fundamental bases of strategies and the principal patterns of firm development. Chapter 2 provides the essential theory concerning the firm value and the evaluation of a growth strategy. Chapter 3 examines the characteristics of horizontal expansion strategies and the conditions under which they can create value. Chapter 4 shifts the focus onto product diversification strategies, examining the conditions for which they can create value. Chapter 5 addresses the economic rationale for vertical integration strategies. Chapter 6 examines the appropriate organizational models for managing large and diversified companies and Chapter 7 discusses the limits to the firm's size.

In these chapters the theoretical exposition is often followed by numerical examples and simulation. Furthermore, some appendixes are dedicated to recalling topics and knowledge of particular interest for the analysis: scale economies, learning economies, transaction costs, and so on.

Chapters 8, 9, 10 and 11 analyse four successful companies L'Oreal, Campari, Luxottica and Geox, showing their different growth patterns and explaining their behaviour over a long period of time. They allow us to verify the results of the theoretical analysis developed in the first part and offer useful empirical material for further research.

This book is the result of some years of research developed at the School of Economics at the University of Siena and at the LUISS University of Rome. Outside school I have learned a lot from my experience as a management consultant and as a member of the board of directors of some industrial companies and banks.

Prof. Angelo Dringoli

Siena, April 2011

To Simonetta and Tommaso

Contents

PART I

GROWTH STRATEGIES AND FIRM VALUE

1. Growth strategies: types and fundamental bases

INTRODUCTION AND OBJECTIVES

In this chapter we define the main strategies for a firm's growth and we also choose the criteria for their evaluation. We distinguish among horizontal expansion, vertical integration and product diversification strategies, focusing the analysis on growth as a means for creating value for shareholders. We also explain why a firm's resources are the fundamental base for growth strategies and the ultimate source for obtaining a competitive advantage and creating value through expansion. Finally, the existence of a typical evolutionary model of firm is discussed, considering the results of some important empirical studies concerning the growth of large industrial corporations. In the appendix a model is presented for identifying the firm's resources which are the base of growth strategies.

GROWTH AS A STRATEGIC DECISION

First of all, what do we mean by growth? Common sense tells us that growth is a process through which the size of a firm becomes bigger, but how do we measure the firm's size − by the number of employees, the revenue, the capital invested or the added value?

Considering the pitfalls and incompleteness of other variables, we will use both invested capital and sales as the basic measures of a firm's size. Thus, the growth of a firm substantially means the increase in its investments and consequently in its production and selling capacity. Generally, the growth of investments also determines the growth of sales, but that is not a necessary consequence if investments are directed at realizing a superior vertical integration, so influencing the firm's added value but not revenue. In other cases, investments can determine an increase in sales but a reduction in the number of employees, due to the increase of labour productivity obtained from new plants and machinery. Finally, the growth of sales can be considerably larger than the growth of investments, due to the outsourcing of firm operations and production phases or the putting together of alliances and joint ventures.

In any case, the growth of a firm is not a natural and evolutionary process, but the result of managerial decisions which are directed at modifying the size of the firm in order to reach a precise objective.

The growth of a firm can be favoured, first of all, by the environment dynamics. Consider, for example, the opportunities for growth offered by a rise in population and by the corresponding increase in income per capita.

Important opportunities for growth can also derive from the introduction of new products and processes which meet latent customers' needs or even create new models in customers' behaviour. Finally, the growth can be realised in order to increase the market share, so reinforcing a firm's competitive position against its competitors.

The growth of a firm, whether it is favoured by external factors or driven by internal forces, requires the use of additional financial resources that must be rightly remunerated, in order to avoid destroying the value of the invested capital. For this reason decisions concerning the growth of a firm must have a reference picture represented by the long-term dynamics of the external environment, especially of industry, as well as of the firm's resources. They are strategic decisions because they are irreversible in the short term, as they concern changes in specific and not transferable assets.

Furthermore, since growth is not an evolutionary process but a consequence of a deliberate choice, this choice must be taken only if it creates value for shareholders. Therefore, a growth strategy must be carefully evaluated.

TYPES OF GROWTH STRATEGIES

The growth of a firm can follow different patterns, according to the opportunities offered by the environment and the disposable resources the firm has. Growth can be carried out through horizontal expansion processes in the business in which the firm is already operating. Moreover, growth can be realised through entrance into a different business, related or unrelated to the business in which a firm is already operating.

We will distinguish three different growth strategies:

- horizontal expansion strategy;
- vertical integration strategy;

- product diversification strategy.

We refer to horizontal expansion when a firm expands its production and sales capacity in the existing market or in different local or international markets, continuing to operate in the same industry or business with the same product. The extension to different market segments through new types and models of the same basic product is also considered as a horizontal expansion.

We refer to vertical expansion when a firm decides to make directly operations or phases of activity located upstream or downstream with respect to the present activity or to make directly components or services which before were acquired from other firms.

Finally, we refer to diversified expansion, when a firm enters into different industries or businesses with substantially different products, related or unrelated to the existing ones. In this case we will distinguish between:

- related diversification, when businesses are related either by markets or by product technologies;
- conglomerate diversification, when businesses are not related either by markets or by product technologies.

In our view, the introduction of different new models or types of a given basic product directed at different market segments (for example a new type or model of sunglasses) does not constitute a diversification strategy, but a horizontal expansion strategy.

The proposed classification goes into less detail than those proposed by other authors (Ansoff, 1965; Rumelt, 1974; Rispoli, 1998), because it aims principally at emphasizing the fundamental difference between the structural firm changes required by growth strategies involving entrance into different industries and those involving further expansion and penetration into the industry in which a firm is already operating.

In economic terms, a horizontal strategy determines an increase in the quantities produced and sold of a given product; a vertical integration strategy determines an increase in the added value of a firm; and a diversification strategy determines the production and sale of a different product (Table 1.1).

As will be clarified in the following chapters, each strategy implies different changes in the firm structure and requires different resources for it to be successful. Also the environmental conditions favouring one or the other strategy are very different. Therefore, the analysis of the firm structure