

## *Methodology of the expansion of business*

### *a) Introduction*

In the business administration a phenomenon of escalation of the complexity of the administrative systems is taking place, in three aspects of management, organization and accounting both for normative external rules (audit, transparency, privacy, against money laundering, risk management, et cetera) and for internal needs. This requires growing costs of general and specific expenditures (elaboration and control of accounting and extra-accounting data, et cetera, such to make the theory of the “little is fine” much less defensible almost in all sectors. National and international authorities urge to aggregations and compactions of businesses to create more capitalistic and capitalized structures, such to be more competitive in the international markets and not to undergo the selection of the species, more and more ruinous, but to govern it with good probabilities of resistance. For example, normative pushes and moral suasion are in act in the bank and insurance sectors toward dimensional increase, especially in Italy where the capitalization and the dimension of the businesses can be considered inadequate for the international competition. It is changed or is changing the definition of territoriality once rewarding if bounded and now considered a restriction. The dynamism, become velocity, is a generally growing phenomenon that urges both vertical and horizontal restructurings and reorganizations. It seem it has become an essential need to conform to the consideration of the “doom to grow” and, when authorities do not impose it, it is the same management to bring it to the attention of the entrepreneur.

### *b) Growth lines*

The growth can happen for internal or external lines. The association of the two is the solution generally adopted, but a better representation of the phenomenon is the analysis of the two in separate way, without forgetting that the choices are changeable also because every productive sector has its own characteristics, that can constitute restrictions or new choices according to the cases.

- i) *Internal lines.* The line of growth, unless the existence of a great liquidity, is realized, generally, by increases in share capital, particularly advisable when the business is a listed corporation and can draw resources directly from capital markets. Less advisable is to turn to the banking system, that does not secure the stability of credit and imposes conditionings and inconsistent obligations with the necessity of a full operating freedom. After raised necessary funds for the expansion, the increase asks for investments in human and financial resources graded according the growth program; then the development of the trade strategy starts, this is intended to acquire new shares of market, that can consist in an expansion on own traditional market and or the entry in new markets before disregarded. In every case a new battle on the prices with the competitors begins, that do not stay inactive, with the outcome that often we end up acquiring shares of market expelled by the competitors and, so, of scarce quality and high risk, unless we go with the greatest caution and allow dilatations of the payments already rather long in the best conditions. The variable time takes, then, priority importance. An observation stands out immediately: the increase of the resources, made necessary by an expansion strategy, has to correlate the long-term expenses with the time of a net return of the investment; differently an expansion for its own sake is not a rational choice.
- ii) *External lines.* The expansion for external lines requests generally the recourse to merger and acquisition operations, preceded and or coordinated with operations of increases of capital, except there is a pre-existent abundance of financial resources freely available, as already affirmed in the preceding point i). We exclude, from the hypothesis considered here, expansions by trade agreements, which also in the case of physiological developments are for a temporary and uncertain duration. The substantial difference between this line and the previous is the direct acquisition of smaller companies, bearing the shares of market that the expanding corporation thinks to obtain by the absorption of target enterprises, for example: by the acquisition of counters or agencies in the case of

banks or insurances or divisions of businesses containing trading portfolios. When, instead, the target is a whole enterprise, the operations of expansion materialize by increases of capital followed a) by the total stakes or of majority; b) by contributions by the shareholders of the target corporation, with the consequent problems of share swap which are not always of easy solution; c) by company amalgamation, that gives more or less the same problems. We have to consider, in practice, that the target corporation, unless cases of difficult generational succession, is generally a corporation without organizational or economic-capital problems, that demand expensive turnarounds. If on the one hand this model of growth allows to be implemented in short times in appreciable advantage considering that the time variable is very important, on the other hand the period for the remedial interventions in the structure of the neo-acquired business can be rather long and expensive for expulsion of managers, early-retirements of workers, costs for forward rescission of work contracts, et cetera, besides the costs of turnaround of market portfolios and supply of financial resources for turnaround of capital and financial disequilibrium of the target corporation.

It is intuitive that, in most cases, the strategies of expansion are pursued by a mix of internal and external lines, mix that changes, in practice, with the position of the corporation and the real possibilities that can develop and of the conditions of the market of business of possible target business. It is certain that every strategy requires costs and grades of sustainability, whose consistence and fall-out effects on financial, capital and economic balances have to be considered with attention and prudence, in order to avoid what happened in the recent case of the German car manufacturer Porsche, that mistaking the calculations, instead of acquiring the VW ended up to be acquired by the target corporation. The economic history is rich of cases of inversion of the final targets and always by the miscalculation, omission of fundamental considerations, underestimate of the reactivity of the target, et cetera. We

have never to forget that the market is a chess game and both players has a its own king and it is sufficient an erroneous or superficial move to be checkmated.

*c) Preparation of the strategy*

The basic exigency is the clearness of a main target and of secondary targets ordered in according to scales of priority. We suggest to open the analysis with an organogram of targets and to examine them on vertical, horizontal or mixed line. The proposition follows of the strategy, that have to elaborate in correlation with the financial and patrimonial internal capacity and with the real possibilities offered by the market. For example, if available businesses on the market do not exist, the only strategy is the growth for internal lines. We cannot forget that the strategy is conditioned or, better, restricted by the objective of increase. For example, if a business wants to go from 700 to 1.000 of volume of sales, target and strategy have to be adjusted in accordance with such target. In a shooting competition it is necessary to know the distance of the target and the range of the weapon, differently the shot is useless.

We suggest the following ways:

- a) identification of the basic target, generally the growth to a value considered overridingly achieving, and of the times to realize such increase;
- b) preventive assessment of the internal resources disposable for the target without compromising the minimum stability of the financial equilibrium and of the existence, in general, of alternative resources (increase of capital, bank credit, et cetera);
- c) existence in the market of target company and consequential choice between internal or external growth;
- d) arrangement as many alternate business plans as are the possibilities and the possible ways of increase;

e) comparative evaluation between the various business plans and assessment of whether limits and constraints exist for each. Absent any limit, we have to choose the one, among various business plans with the lowest cost;

f) in case of limits (for example, for internal growth the resources would not permit to achieve the target in full and in the set times; the target, by the restriction of the internal resources, cannot be realized from 700 to 1.000, but it would stopped to 850). We have to choose if to restrict the target of growth or to make use other means. If, for these conditions, we consider to realize the target in the prefixed maximum measure, it becomes necessary a combination of the specific business plans already elaborated and make them converged in a unique business plan destined to go in operation;

g) only after these preventive analyses the corporation can expose itself in attempts of realization of the target. If, for example, the suggestion of external growth offered by the business plan is for an acquisition of an existing target corporation, the approach will have to develop for trials and errors, above all for what the price is concerned, that will derive from the relative business plan and from the limits of expense ensuing from it.

The way above defined is only exemplificative, because the mix of solutions is so variable that becomes difficult its generalization and every cases show combinations of problems and different solutions. Instead, it seems possible to suggest:

1.) the formation of the business plans has to precede every external action;

2.) the growth strategy and, so, the result of the formation of the business plan or of the business plans have to remain protected by the maximum confidentiality, because the externalization could determine a precautionary knowledge of the action by others with consequent preventive immediate reactions by competitors or rise of the price if target corporations exist.

3.) any growth either for internal lines or for external lines cannot be brought to conclusion concretely with immediateness, neither when the target of acquisition of an existing corporate is set.

The graduality of interventions is ineliminable and we can consider that hurried and little meditated actions can set to only illusory conclusions, after requesting expensive and dispersive remaking. So,

the plan, besides the graduality that implies the definition of all interim passages, requests the definition of schedule to realize the target with the largest probability of success. Indeed, the definition of the schedule in many cases could precede and bear on the definition of the plans. Being extraordinary operation, the preventive redaction of business plans no request, no as preliminary component, the determination of the time (years) for the realistic achievement of the target. For example, if it is estimated that the target is realizable in three years, the unique or the combined business plan will be at three consecutive periods.

Conclusively on the point, we have to remember that no strategy is good, if we trust to the *tâtonnement* or to random selection. It is still wise the suggestion of Sun Zu (Fifth century b.C.) in his famous *Art of the war*: «*The victorious strategists have already triumphed before giving battle, the losing have already given battle before still to pursue the victory*», that, applied to the entrepreneur, means to study and to prearrange targets and solutions before the beginning.

#### ***d) Strategic choices of the operations of increase.***

After formulation of the business plans concerning the various types of possible growth, the management faces a quantity of revised data still too analytical and so he needs an instrument that can synthesize the strategic choices that helps in choosing of growth instead of other.

We propose here a mathematical model in support to the strategic choices to identify the breakeven point, that is the point in which one choice is more convenient than another, beginning from the probability of success of every separate strategy.

The probability of success of a strategic choice (acquisition or internal increase) is the basic figure of the analysis of the business plans. Its calculation can be made by comparing the liquidity, financial and economic indexes included in the various business plans.

So, let the probability of success  $p_A$  for the external growth (acquisition) and  $p_I$  for the internal growth and assuming that the target of the management is for the increase of the profits ( $\pi$ ), obtained from Returns minus Costs (R-C), the two strategic choices are confronted:

1) if the business acquires another company, we would find:

$\Delta R$  = additional returns with probability  $p_A$

$\Delta C$  = additional costs to sustain

$f$  = fixed cost to sustain for the acquisition of the business

2) If the business grows internally we would find:

$\Delta R$  = additional returns with probability  $p_I$

$\Delta C$  = additional costs to sustain

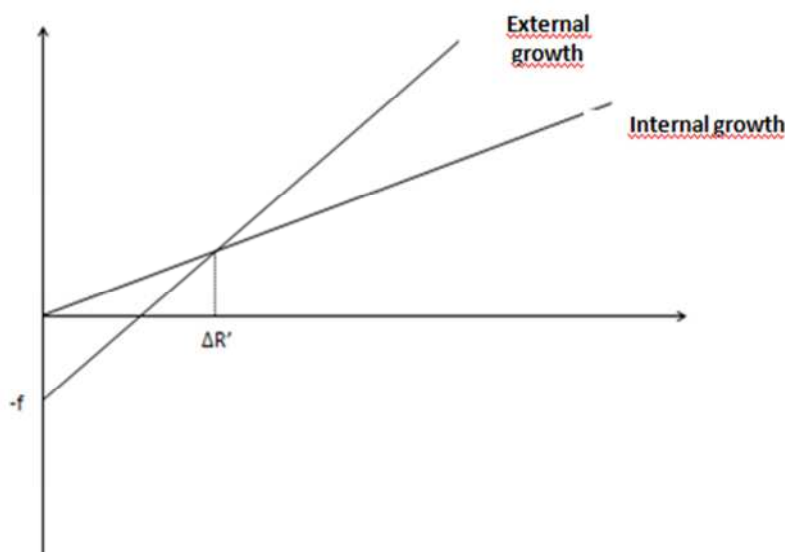
What is the strategy to pursue?

The firm finds it is reasonable to acquire another company and not to grow internally if:

$$p_A \Delta R - \Delta C - f > p_I \Delta R - \Delta C$$

$$\Rightarrow p_A \Delta R - f > p_I \Delta R$$

**Graphical presentation:**



$\Delta R'$  is the breakeven point, that makes indifferent the two strategic choices; a value larger than that means it can be convenient to pursue the internal growth,

$f$  is the fixed cost for the acquisition of the external company, that, in the economic analysis of the strategy, is equivalent to the goodwill (in the sense of surplus), that a business is inclined to pay to realize a faster growth, as we can observe from the inclination of the same line.

Conclusion on the graphic model:

- If  $p_A \leq p_I$ , the best choice is always of the internal one, because it assures probabilities of success at least equal to the external growth without paying the cost of acquisition  $f$ ;
- if  $p_A > p_I$ , the best choice depends by the amount of the estimated increase of the revenues ( $\Delta R$ );
- if  $\Delta R < \Delta R'$ , the best choice is that of internal growth. This because the amount of the estimated increase of the revenues is so small that is not convenient to pay the fixed cost of acquisition;
- if  $\Delta R > \Delta R'$ , the most convenient is that of the external growth, because the awaited increase of the revenues is enough to repay the fixed cost.

*Pietro e Giulia Bonazza*