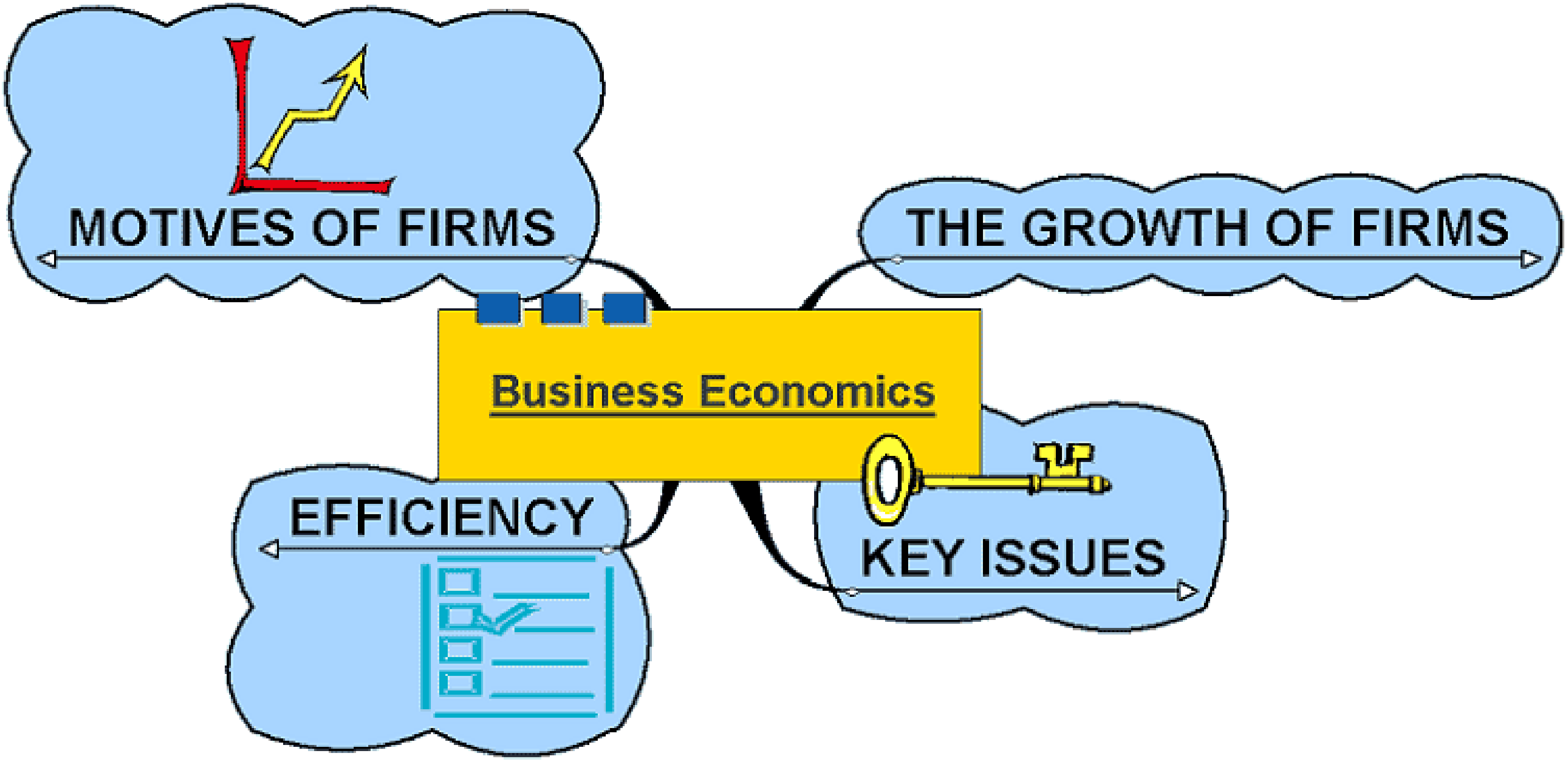
Business Economics

Prof. Madona Robinston
Assistant Professor in commerce,
St. Xavier's College (Autonomous),
Palayamkottai.

Business Economics



The Growth of Firms

Internal Growth:

- Generated through increasing sales
- To increase sales firms need to:
  - Market effectively
  - Invest in new equipment and capital
  - Invest in labour

The Growth of Firms

External Growth:

- Through amalgamation, merger or takeover (acquisitions)
- **Mergers** – agreed amalgamation between two firms
- **Takeover** – One firm seeking control over another
  - Could be ‘friendly’ or ‘hostile’

The Growth of Firms

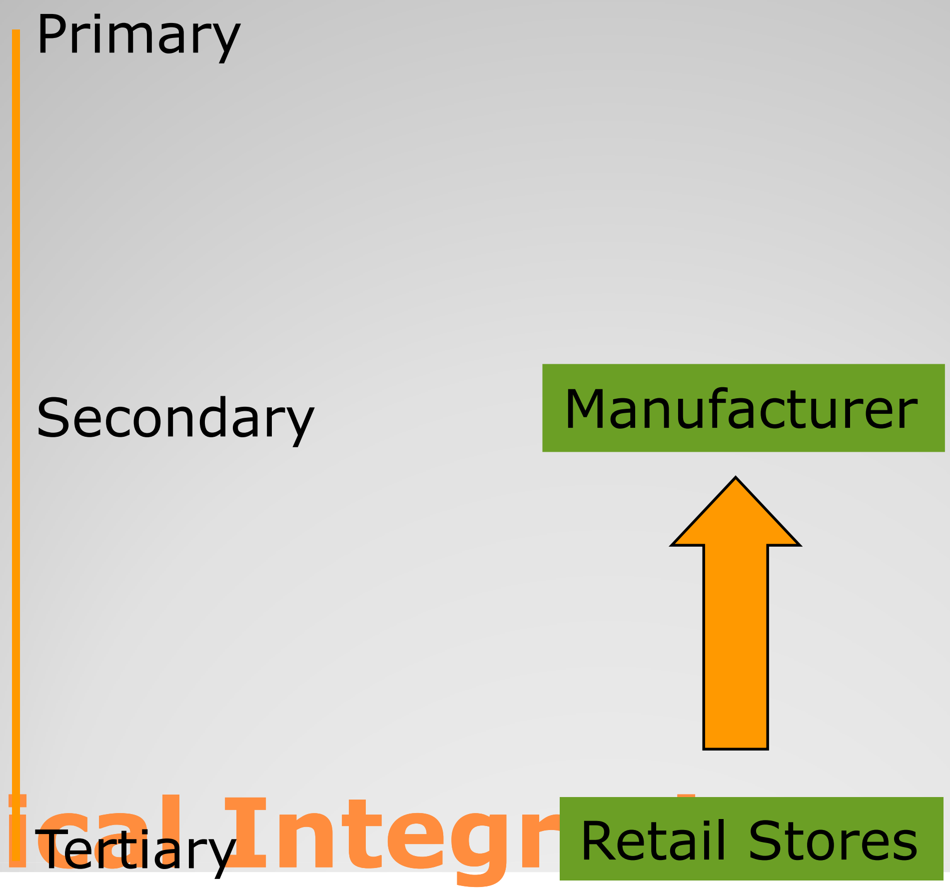
External Growth

- Vertical Integration
- Horizontal Integration
- Conglomerate Merger

External growth – types of acquisition:

- Vertical integration – amalgamation, merger or takeover at different stages of the productive process

The Growth of Firms



Vertical Integration Backwards – acquisition takes place towards the source

Vertical Integr

Vertical Integration

Primary

Dairy Farming Co-operative

Secondary

Cheese Processing Plant

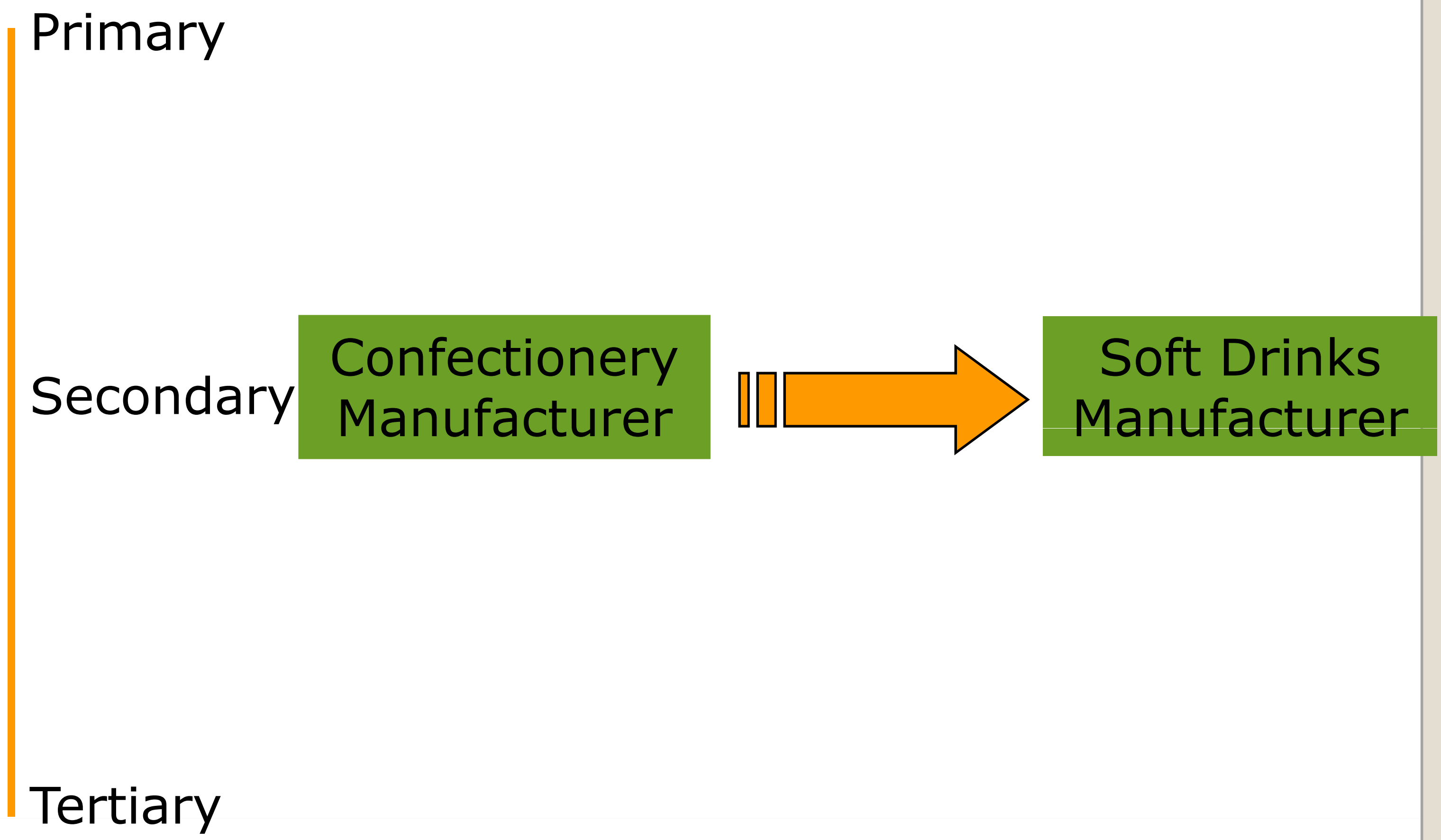
Tertiary

Vertical Integration Forwards – acquisition takes place towards the market

- Amalgamation, merger or takeover at the **same stage** of the productive process

Horizontal Integration

Horizontal Integration



- Amalgamation, merger or takeover of firms in different lines of business.

Conglomerate Acquisition

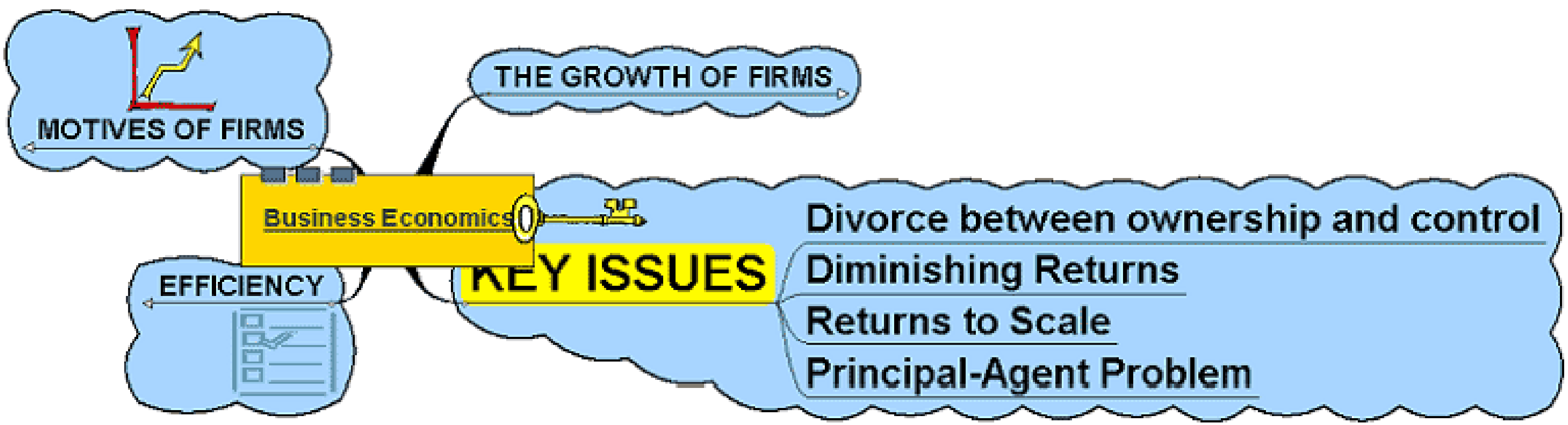
Motives

- Cost Savings
  - External growth may be cheaper than internal growth – acquiring an underperforming or young firm may represent a cost effective method of growth
- Managerial Rewards
  - External growth may satisfy managerial objectives – power, influence, status
- Shareholder Value
  - Improve the value of the overall business for shareholders
- Asset Stripping
  - Selling off valuable parts of the business
- Economies of Scale
  - The advantages of large scale production that lead to lower unit costs

Motives

- Efficiency
  - Improve technical, productive or allocative efficiency
- Synergy
  - The whole is more efficient than the sum of the parts (2 + 2 = 5!)
- Control of Markets
  - Gain some form of monopoly power
  - Control supply
  - Secure outlets
- Risk Bearing
  - Diversification to spread risks

Key Issues

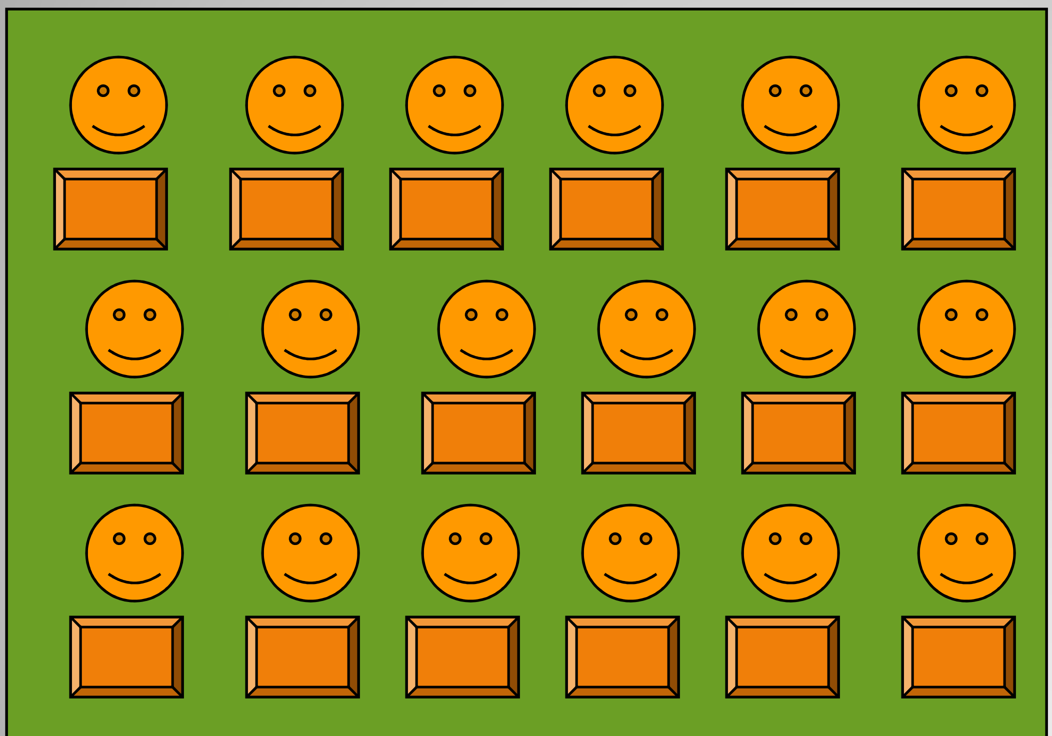

MOTIVES OF FIRMS
THE GROWTH OF FIRMS
Business Economics
KEY ISSUES
Divorce between ownership and control
Diminishing Returns
Returns to Scale
Principal-Agent Problem
EFFICIENCY

- **Divorce between ownership and control – who runs the business?**
  - Shareholders?
  - Board of Directors?
- **Principal-Agent Relationship:**
  - Shareholders act as principals, Board as agents – principals expect agents to act in **their** interest
  - Sub-contracting work operates on a similar basis
  - Contracts and compensation procedures to ensure agents act on behalf of principals

Key Issues

Key Issues

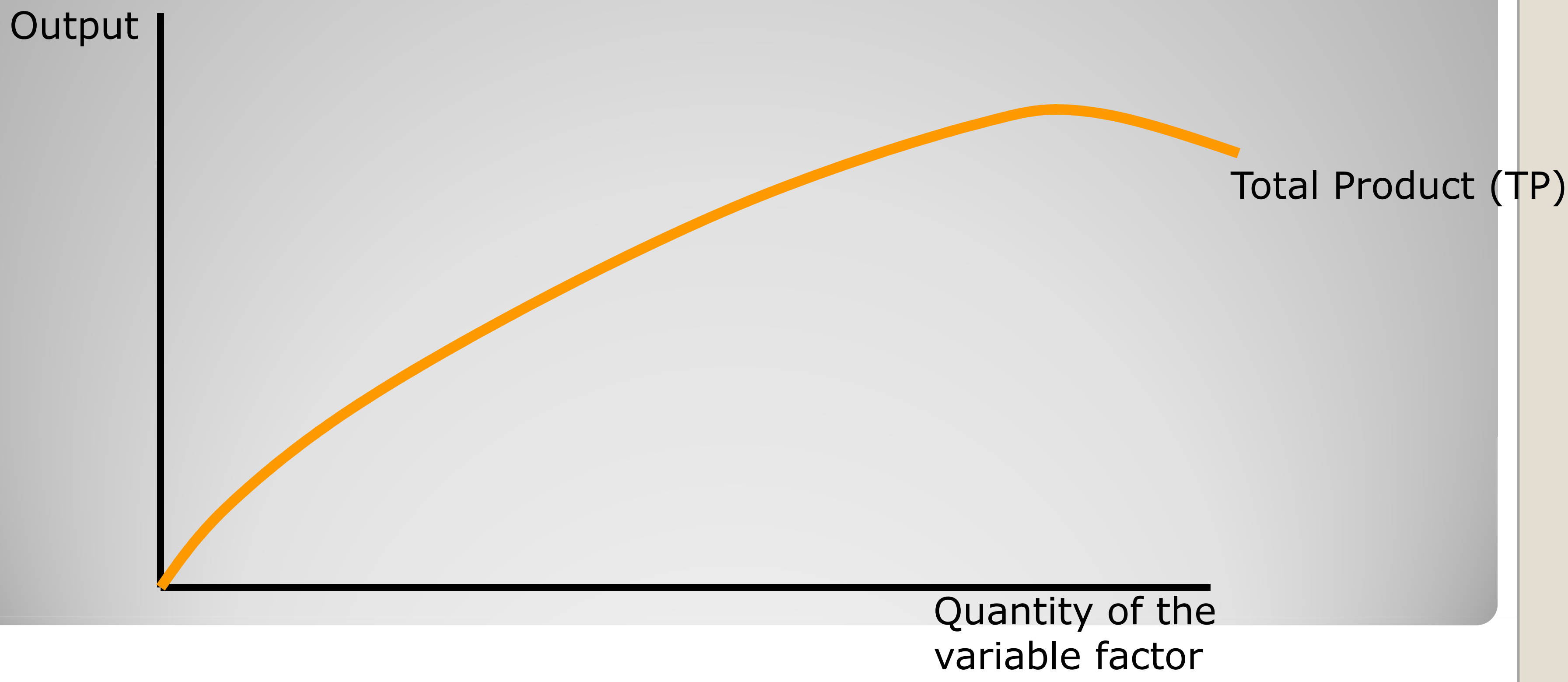
- **The Law of Diminishing Returns:**
  - Increasing successive units of a variable factor to a fixed factor will increase output but eventually the addition to output will start to slow down and would eventually become negative
- To prevent diminishing returns setting in, <u>all factors</u> need to be increased – returns to scale



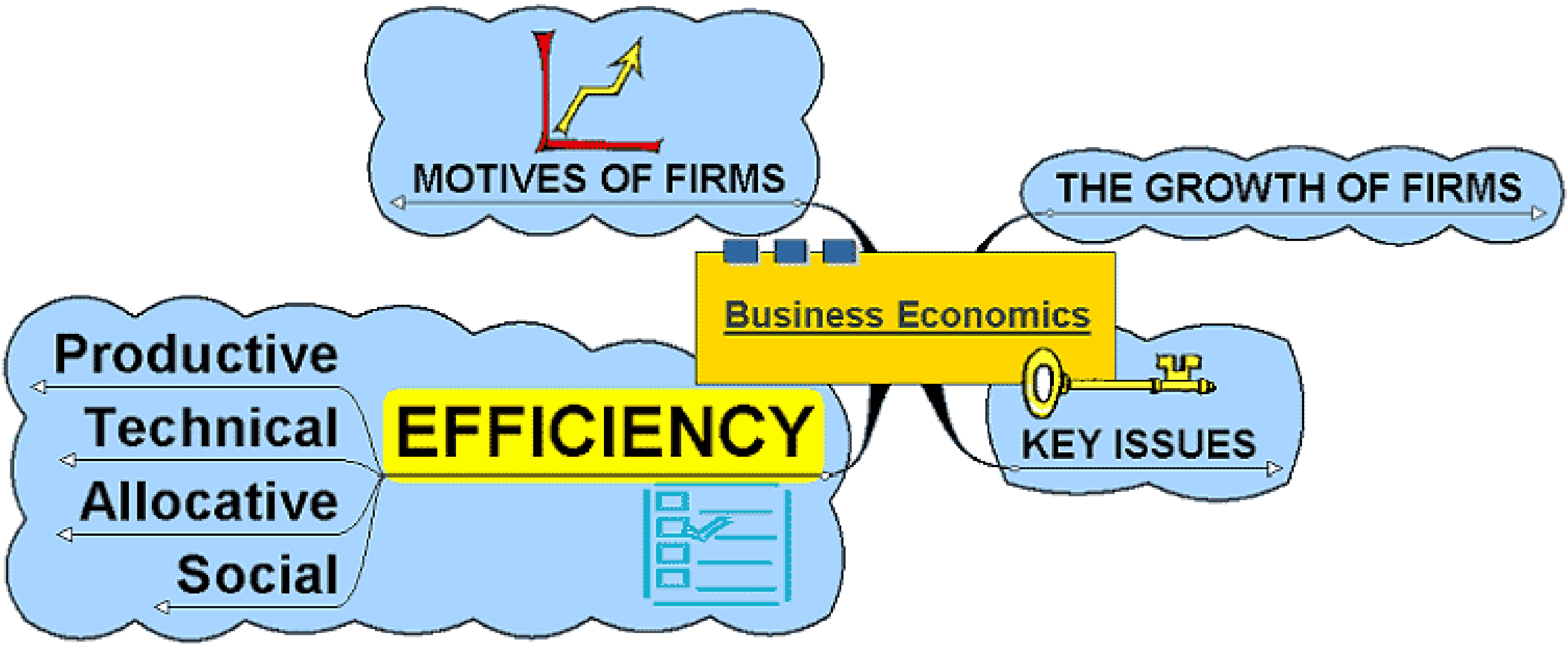
Key Issues

Diminishing Returns – assume the amount of land/plant was fixed. Adding labour and capital units would initially increase output but the rate at which output would rise will start to decline and eventually would become negative unless the amount of land/plant was increased to accommodate the increase in variable factors.

Diminishing Returns – Graphical representation



Efficiency



MOTIVES OF FIRMS
THE GROWTH OF FIRMS
Business Economics
Productive
Technical
Allocative
Social
EFFICIENCY
KEY ISSUES

Productive

- **Lowest Cost**
  - Productive efficiency can be achieved where the same output could be produced at lower total cost
  - Achieved through re-organisation (e.g. to cell production), investment in new technology, training for staff and so on

Technical

- **Minimum inputs**
  - Technical efficiency can be achieved if the same output can be produced using fewer inputs
  - Can be achieved using labour saving devices, more efficient machinery, more effective re-organisation of restructuring and so on

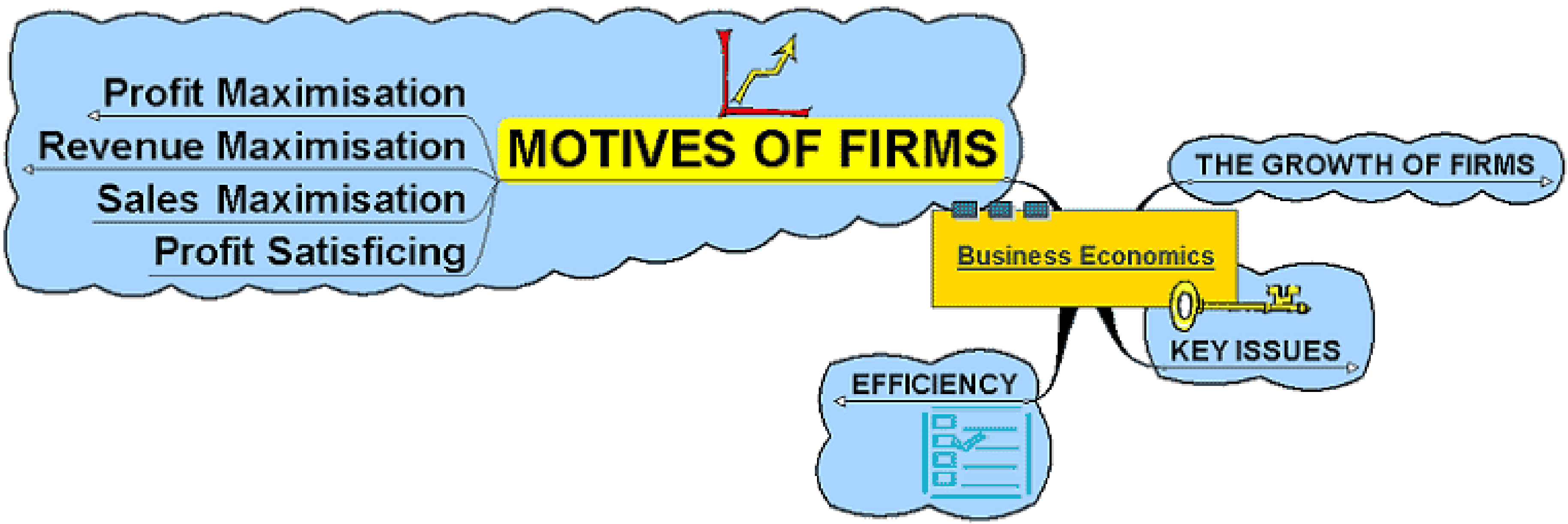
Allocative

- Needs of Consumers (P = MC)
- Allocative efficiency occurs where the goods and services being produced match the demand by consumers
- P = MC – the value placed on the product by the buyer (the price) = the cost of the resources used to generate the good/service

Social

- MSC = MSB
- Social efficiency occurs where the private and social cost of production is equal to the private and social benefits derived from their consumption
- A measure of social welfare

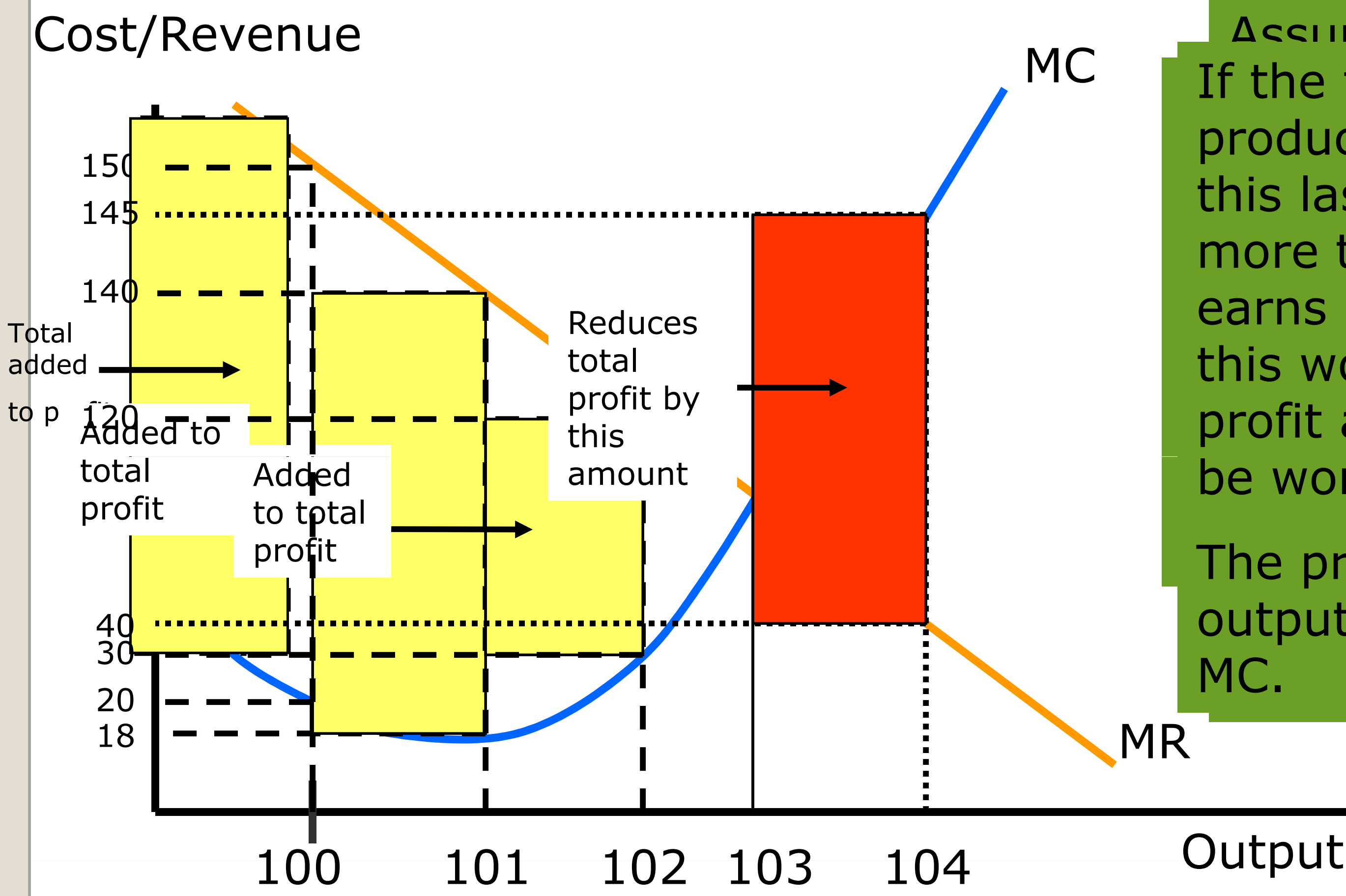
Motives of Firms



Profit Maximisation

- Profit maximisation – assumed to be the standard motive of firms in the private sector
- Profit maximisation occurs where Marginal Cost = Marginal Revenue
  - **MC = MR**
- The firm will continue to increase output up to the point where the cost of producing one extra unit of output = the revenue received from selling that last unit of output
- This assumes that firms seek to operate at maximum efficiency

Profit Maximisation – Diagrammatic Representation



If the firm were to produce the 104th unit, this last unit would cost more to produce than it earns in revenue (-105) this would reduce total profit and so would not be worth producing.

The profit maximising output is where MR = MC.

Revenue Maximisation

- Total Revenue
- Average Revenue
- Marginal Revenue
- In this model the policies to achieve revenue maximisation may be different to those adopted to maximise profits

Other Objectives of Firms

- **Sales maximisation:**
  - Attempts to maximise the volume of sales rather than the revenue gained from them
- **Share Price Maximisation**:
  - Pursuing policies aimed at increasing the share price
- **Profit Satisficing:**
  - Generating sufficient profits to satisfy shareholders but maximising the rewards to the managers/board and avoiding attention from rivals or regulatory authorities

- Modern firms have to attempt to match competing stakeholder needs:
  - Shareholders
  - Employees
  - Consumers
  - Suppliers
  - Government
  - Local communities
  - Environment

Behavioural Objectives

Behavioural Objectives

- Firms may have to balance out their responsibilities:
  - ‘Fat cat pay’
  - Management rewards – bonuses, etc.
  - Social and environmental audits
  - Employee welfare
  - Meeting consumer needs
  - Paying suppliers on time
  - Satisfying shareholders and ‘The City’ about its policies, plans and actions