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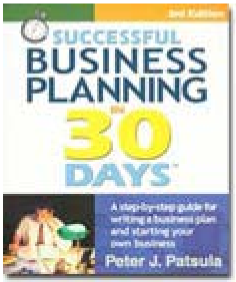

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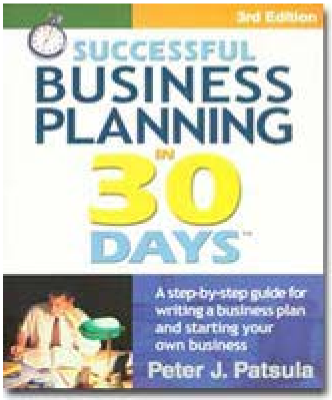

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PERSONAL PLANNING

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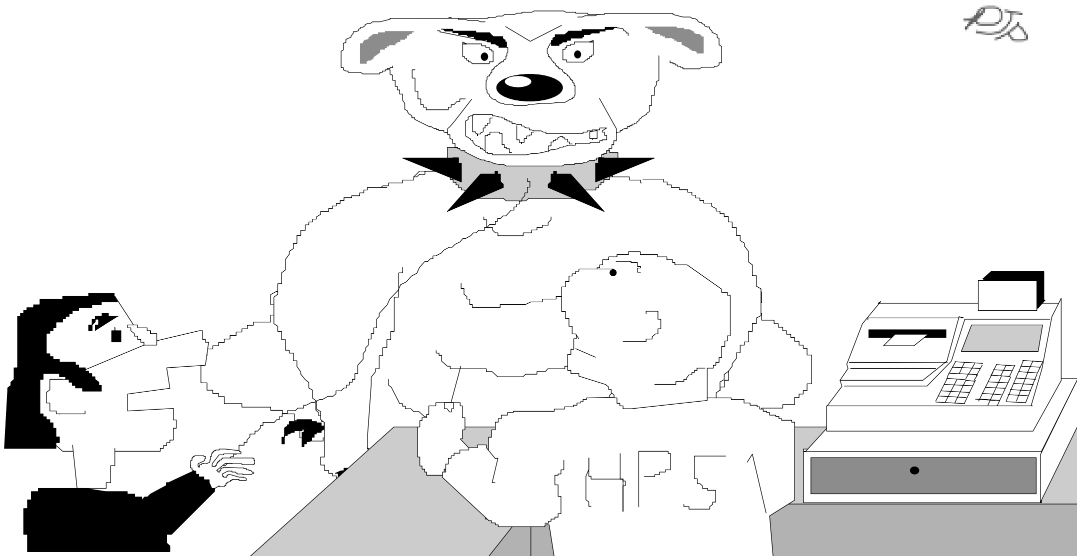

“Brutus here wants 300 . . . no make that 1000 bags of your New Improved Puppy Chow . . . and he wants a discount!”

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WEIGHING THE PROS & CONS OF EXPANSION

GROWTH is essential to the well being of any business. It is usually the result of increased revenues – and additional profits. However, growth can also be the result of planning, whereby strategic objectives (dealt with in more detail in Guidebook #39) are carefully organized, guided and nurtured and above all else, monitored for results.

In both cases however, management should not allow growth to occur at a rate faster than they can control. Explosive growth can create a dangerous situation in which more problems are created than solved.

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PLANNING FOR GROWTH

BEFORE YOU commit yourself to any serious expansion, you first need to determine whether you and your business are indeed ready to expand. If you meet the necessary requirements and conditions, you then need to set some parameters on how fast you should expand and how big you would like to become. Finally, to monitor and control your efforts, you need to put together an expansion budget.

The key to success is balanced profitable growth. ***SUPERTIP***

NOTE Big is no good if your foundation is weak. A giant with skinny legs is an invitation to be tripped.

When Should You Actively Pursue Growth?

Consider expanding your operations if and when you meet all or most of the necessary requirements and conditions of expansion as outlined below:

Expand after reading up on how other companies did it and prospered. To understand some of the challenges you face ahead, start reading Inc., the *Wall Street Journal* and some of the other general business publications such as *Business Week*, *Forbes* and *Fortune*, which all contain stories about successful growing businesses.

Expand only if your business is already profitable. Profitability is important to business growth because it makes it

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easier to obtain the financing needed to expand. However, this is the opposite of how accounting systems are normally operated for tax purposes. To reduce taxes, accountants and business owners often try to show a loss or as little profit as possible, which allows the business to retain more cash. From this standpoint, perhaps your business should be profitable for several years before you initiate a growth phase.

Cartels are like babies: we tend to be against them until we have one of our own.
LORD MANCROFT

NOTE To remain profitable when expanding, a balance must be maintained between asset and liability items on your balance sheet and operating items that are on your expense and income report. For example, if accounts receivable on your balance sheet average $50,000 and sales average $500,000 per year, a balance of 10 percent exists between these items. If growth is obtained in part by offering easier credit terms, the balance could be altered if the accounts receivable average $150,000 and are used to support sales of $100,000.

Expand when you can project increased profits. A primary reason for pursuing growth is to increase profit. There are two components that can be increased – the absolute dollar amounts of sales or the profit as percentage of sales. If these two can be achieved simultaneously, the resulting growth will be very rewarding.

Expand when you can spot the telltale signs of saturation in your present facility. If you are experiencing bot-

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tlenecks in your company, think about adding to your facilities. Determine how many additional customers you could service by building up or out and compare the additional sales to the cost of construction and temporary inconvenience. For example, if you own a grocery store and have been noticing an increased number of abandoned carts, this could mean, that shoppers are filling their carts and then leaving when they realize the checkout line is too long. This serious problem can be solved by increasing your number of checkouts.

Excellent firms don't believe in excellence – only in constant improvement and constant change.
TOM PETERS

Expand when you can spread existing fixed costs over a large sales volume. When expansion can result in spreading existing fixed costs over a large sales volume, the decision to increase size is justified. However, whenever you have to increase fixed costs to attain higher sales levels, investigate the proportion of the increase before proceeding with growth plans.

NOTE Many managers of unprofitable businesses believe the solution to their problems is to grow in order to spread fixed costs over a larger number of units, thereby improving the gross margin of the business. This is mistake. Fix your problem first. Don't make the hole bigger.

Expand when your business is in the "growth stage" of its business cycle. New small businesses will most likely experience several different stages during its life span. If it meets with customer acceptance, it will survive, begin to

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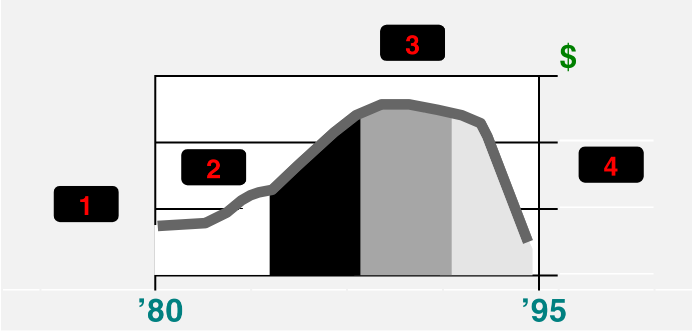
grow and pass through a perhaps turbulent adolescence, attain maturity, and then eventually fade away. This life cycle can be simplified into four distinct stages (see figure below:

- survival stage
- growth stage
- maturity stage
- decline stage

Survival Stage – During the initial stage of the business life cycle, the entrepreneur starts up operations, hoping to carve out a niché in a particular industry. This introductory stage is the most perilous of the four; success or failure lies in the offing. At this point, the entrepreneur will usually directly control all the major business functions. If tight reins are held on spending, the business will survive. After a certain point of time, sales growth rates will level off and eventually peak.

Growth Stage – The second stage of a businesses life cycle is characterized by more accelerated progress due to market forces or internal planning. It is the most exciting stage.

Life Cycle of a Business



Survival – Growth – Maturity – Decline

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Growth is marked by the consolidation and strengthening of the company's position relative to its competition, an ascending sales curve, and a growing number of employees. The owners may purchase more capital equipment, from previous profits, thus increasing the total value of company assets. In addition, more capital may be brought in, perhaps by taking on one or more partners, borrowing substantial sums from a financial institution, or selling some of the corporation's stock. Over time, supervision is delegated to more and more new employees evolving into several layers of management between owner, rank and file.

I tell my daughter, "Always say yes, because nothing ever happens to girls who say no." It's true in business and it's true in life. "Will you stay late and work?" If you say no, nothing good is going to happen to you. "Can you take this extra assignment?" If you say no, nothing is going to happen to you. You have to learn to say yes.

LOIS WYSE

President of Wyse Advertising

During this stage, profits are excellent. Some firms even consider such moves as acquisitions and mergers in addition to internal growth and relocation.

Maturity Stage – Eventually, the company appears to reach its limits in size and performance. Growth slows down to a mere crawl, the future begins to look bleak.

Decline Stage – At the end of the third stage, decline is inevitable. Unless, serious restructuring takes place, as occurred in the second stage, one can

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only sit and wait for the demise of the company. No-growth situations inevitably lead to decay.

Expand when your competition is starting to change for the worse. If your competition is heading into a downward spiral, in their wake is the opportunity for you to expand. Look at improving quality, price, product line, exclusivity, service reliability, location, warranties, delivery and courtesy services.

Business is war.
JAPANESE MOTTO
Michael Crichton, Rising Sun

How Fast Should You Expand?

After meeting all the necessary requirements and conditions of expansion, you need to implement strategies and preparations to control your growth bearing in mind that controlled growth is better than explosive growth. Controlled growth is growth that is cautious, carefully charted, and carried along through regular planning sessions, periodic progress reviews and program modifications.

On the other hand, explosive growth is growth that embraces a substantial element of peril that may actually destroy the potential of a budding company. When not backed by sales, it scares most bankers and investors and can lead to serious complications.

To protect yourself from the dangers of explosive growth and help implement controlled growth policies:

Learn to let market forces determine the size of your company. Other than

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merging or buying other companies, it is in response to market needs that your company should grow and shrink, not management's' goals. In other words, as sales increase, allow your company to expand naturally, don't force it. Likewise when sales decrease, make sure your company can contract so your overhead doesn't suck up all your profits.

Business is talking a pile of cash, doing something with it, and winding up with a bigger pile of cash.
LEONARD P. SHAYKIN
Managing Partner

If you fail to adhere to this principle, eventually you and your company will lose touch with reality. Your blind ambition will drive you into financial peril. Remember that growth should be healthy and manageable not skyrocketing and out of control.

Learn to recognize the symptoms that indicate dangerous explosive growth. Dangerous explosive growth can be spotted by excessive numbers of employees, climbing employee turnover rates and loss of marketing coordination and control. Furthermore, dangerous explosive growth can be spotted by:

- confused lines of authority
- general dissatisfaction and even dissension among customers and employees
- improperly trained department heads and supervisors
- increased overhead
- proliferation of departments
- runaway advertising costs

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- slipping profit margins despite increasing sales

Learn what to expect during your growth phases. In addition to protecting yourself from the dangers of explosive growth, you should also prepare yourself for the following growing pains:

According to small business expert and best selling author Peter Drucker, the smaller companies that can grow into medium-sized companies are the ones that will inherit the 1990's and beyond. ***SUPERTIP***

Increased Personal Commitment – Expect that your personal involvement and commitment to the business will increase during a growth cycle. Consider personal sacrifices and the sacrifices of people you associate with, including family.

Increased Pressure – Expect additional pressure on the time and resources needed to run the business, because it will take time and energy to organize the financial aspects of growth.

Increased Pressure to Reduce Prices – Reducing prices to achieve growth is a strategy you might not initially plan but must do to sustain growth after commitments have been made.

Reductions in Cash Flow – When expanding, your cash balance will normally decrease for a while, and then show a gain. However, this gain will occur only if the business becomes profitable. It is also difficult to predict when growth in cash flow should begin. As a general rule, it should be within the first year of expansion, preferably by the third of fourth month; how-

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ever, this may vary.

Strive to keep your growth balanced. The financial and operational aspects of growth must be balanced when you expand your business. During a growth phase, for example, the marketing function of the business may extend beyond the business's financial capacity to sustain growth. When this occurs, you must relax your marketing efforts and consolidate your gain or risk overextending yourself.

Elephants have a hard time adapting. Cockroaches outlive everything.
PETER DRUCKER

How Big Should You Strive to Become?

After setting some parameters on how fast you should grow, the third step of your expansion plan is to determine how big you should become. However, as you mull this over – contemplating over the dangers of overextending yourself and the missed opportunities of selling your company short – keep in mind that there's no such thing as the perfect size for a small business, only perfect sizes for certain kinds of businesses.

In other words, some businesses such as beauty salons should never become truly big, and other companies such as semi-conductor manufacturers should realize that they will never be truly able to function properly until they achieve a certain size.

To help you put this into better perspective, consider the following intrinsic strengths of both large and small companies:

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To their Advantage
BIG Companies Have . . .

Financial Resources – This, without question, represents the most important competitive advantage of larger companies. The lack of financial resources influences and often restricts many decision in smaller companies.

High production rates usually mean lower average operational costs and more competitive pricing.

Economies of Scale – Large firms can build large plants and manufacture their products in large quantities, thereby benefiting from economies of scale. High production rates usually mean lower average operational costs and more competitive pricing. In a small start-up, you must first develop, build, sell and generate cash flow from one or two products before you have the resources to consider adding more to your product line.

*Greater Potential for Investment in Product Development and Marketing –*Large companies can undertake product developments that require millions of dollars and years of R&D. They can establish large sales organizations and undertake huge introductory marketing promotions. The large firm can also have an extensive line of complementary products rather than a few isolated products. Many experts believe that a company has to be big enough to do a few things well.

Momentum – Big companies have momentum. Which means they have the ability to go through down periods and survive a few bad decisions with a minimum of disruption. They have the ability to weather a re-

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cession, a bad product, and changes in management.

NOTE Momentum is achieved through strong marketing. Strong marketing is one of the most difficult, time consuming and costly skills for a small company to develop.

Credibility – Imagine trying to sell an expensive product to someone who has never heard of your company. You will soon learn how difficult it is to persuade a tough purchasing agent that your company, operating on a shoestring, will stand behind its product. The purchasing agent doesn't even know if you will even be around in a year or two. Small companies lack credibility. No purchasing agents have ever been fired for buying IBM.

The key to the future is the midsize company – big enough to spend on technology, small enough to change.
TOM PETERS
Business Consultant

Support Organizations – Large firms have support organizations or departments that carry out necessary functions almost invisible to everyday customers. Included are quality control, purchasing, incoming inspection, and marketing. These support organizations however, require big investments of time and money to set-up.

To their Advantage SMALL Companies Have . . .

Greater Flexibility – Small companies are more flexible and have the ability to react much faster on almost any issue than big companies. They can respond rapidly to changes in their competitor's product line or marketing strategy,

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and can also customize their products to better meet their customers' unique needs. And even though they often have no human resources to spare, nothing prevents them from networking or utilizing consultants and other outside personnel, or exploring more efficient methods of working.

NOTE Small businesses can also adapt to new technology faster. To prove this point, consider for example that there are corporations out there still running on mainframes.

More Innovative – According to INC. Magazine, a National Science Foundation study found that "Small firms produced about four times as many innovations per research and development dollar as medium-sized firms and about twenty-four times as many as large firms."

One of the major advantages of pursuing horizontal or vertical diversification is that it can balance seasonal or yearly cycles in your business, or it can be used to balance a multi-year cycle influenced by economic conditions. ***SUPERTIP***

Studying the same subject, the economist Burton Kelin found that major firms are seldom if ever responsible for the major advances in their industries.

Faster Decision-Making Process – In a small company, managers can make decisions in almost every aspect of the business in days rather than weeks months or years.

Determination to Succeed – Small companies are smaller but try harder.

More Fun – An atmosphere of fun and ex-

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citement can be a powerful strength and is more likely to be found in a small company where everyone knows each other. This is one reason so many large companies are desperately trying to introduce entrepreneurial spirit into their operations.

Senior People Working Below their Highest Skill – In small companies, employees often work below their highest skill. People don't rise, as the Peter Principle explains, "to their level of incompetence."

Putting Together an Expansion Budget

The problem usually associated with expansion is underestimating costs. Managing the finances of a growing business requires persistence. Therefore, critical to any plans for expansion is a budget, or the allocation of funds to those activities that will bring about growth.

The disadvantages of borrowing too much are increased interest costs and exceeding equity limitations. The disadvantage of not borrowing enough is getting halfway through a project and discovering there are not enough funds available to complete it. There is a fine line between not having enough money and having too much money.

Business is like riding a bicycle. Either you keep moving or you fall down.
JOHN DAVID WRIGHT

Financing Your Expansion – In a growing business, financial resources are often viewed as the major factor limiting growth potential. There are two methods of improving your financial base: **a)** grow gradually and allow profits to fund additional growth; and **b)** seek outside fund

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(debt or equity funding. Either approach will consume time and energy.

The Pros & Cons of Using Leveraged Funds – If you invest $100,000 in a business and borrow $200,000 for a total investment of $300,000, your equity position is 33 percent. With $300,000, you can grow faster than if you used only your $100,000.

Consider the following example: If you used your $100,000 to obtain $200,000 and if the debt charge was 10 percent while your return on the entire project was 15 percent, the resulting rate of return on your original $100,000 would be a whopping 25%.

(15% x $100,000) + [$20,000 x (15% - 10%)] =

$15,000 + $10,000 =

$25,000

Slow and steady wins the race.
AESOP
"The Hare and the Tortoise"

However, be warned that the financial leverage concept works only as long as your business is profitable and the return on investment exceeds the debt expenses. If for example, the return on your investment dropped to about half at 7%, your return rate on your equity portion would shrink to a meagre 1%, due to the fact that $7,000 you made off your $100,000 was gobbled up by a $6,000 loss on interest payments.

(7% x $100,000) + [$20,000 x (7% - 10%)] =

$7,000 - $6,000 =

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$1,000

NOTE During an expansion phase your accounting system should be reevaluated because the number of transactions will increase. This evaluation should include looking at cash-based versus accrual accounting; single- versus double-entry accounting; fiscal year and form of ownership.

The existing debt position for the business must be balanced with equity, or additional equity must be obtained to balance future debt.

The Importance of Keeping your Debt Position Balanced with your Equity Position – The existing debt position for the business must be balanced with equity, or additional equity must be obtained to balance future debt. The rule of thumb is for the equity position on a balance sheet expressed as equity divided by assets, to range from 30 to 50 percent.

If your business has an equity position of less than 30 percent and you wish to obtain financing for growth, a certain amount of money will have to be injected as equity to finance additional debt.

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Methods of Expanding Your Operations

Relocation – If it appears unlikely that you can draw more customers to your present location (at a reasonable cost), consider moving closer to your customers. A location on Main Street, in a shopping mall or an industrial park may cost you more in rent, but if you gain exposure to new customers, it may be a sound investment.

Horizontal Diversification – Horizontal diversification involves adding other similar products or business lines. An example of horizontal diversification is a business that manufactures and sells soft drinks. Seeing a new market for bottled water, it then starts bottling water. The bottled water is related to its current activity and uses some of the same equipment, thus reducing overhead costs.

Downward Vertical Diversification – If your profits depend on the prices you pay for raw materials, your most profitable growth strategy may be to buy a farm, mine or processing plant to produce your own materials. This strategy also may make sense if you product quality is based on a consistent supply of goods at an acceptable quality level.

Upward Vertical Diversification – Typically, most small manufacturing start-ups are forced to use existing marketing channels and sell through established manufacturer's representatives, independent wholesales, jobbers or dealer who have access to the market. As you grow, however, it makes sense to analyze your distribution system to see when you can improve your situation by:

- hiring your own sales team
- contracting with distributors
- buying a truck fleet
- opening your own wholesale operation
- opening retail stores or factory outlet stores
- or, doing anything else you need to do to get closer to your market.

Remember that every time someone gets between you and your customer, it either reduces your revenue or increases your operating costs. Furthermore, it impedes the provider-consumer communication that is essential to a good marketing program.

Other Methods of Expanding Your Operations:

- ❑ Adding Retail Outlets
- ❑ Direct Marketing
- ❑ Exporting
- ❑ Franchising
- ❑ Joint Ventures
- ❑ Licensing
- ❑ Relocation
- ❑ Private Label Resale
- ❑ Network Marketing