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Planning Corporate Expansion

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Expansion for the sake of expansion solves no problems and covers no shortcomings. Rather a company must be very sure all is well in its own house before looking for new worlds to conquer —

PLANNING CORPORATE EXPANSION

by David F. Linowes
Laventhol, Krekstein, Horwath & Horwath

DURING World War II, when Americans were trying to conserve everything, including food, so that they could feed the great war machine, the Army designed a poster for display in some of the mess halls. This poster read, "Don't be a pelican. Don't let your tray hold more than your belly can." And the picture showed a pelican with a very large beak and a much smaller belly.

Expansion-minded businessmen would be well advised to heed this admonition not to try to expand beyond the company's capacity to digest. A company that cannot control and manage its present operations should not look for new fields to conquer. To plunge into a major expansion program or a large acquisition, even if it comes off, could leave management quoting Pyrrhus, king of Epirus, after a victorious battle against the Romans, "Another such victory and we are undone."

Correct timing is essential—but how does one know when time and opportunity are right? For success in any endeavor it is first of all essential to be alert and alive to opportunity. There are certain conditions, however, that should be apparent in a business enterprise as a prerequisite for expansion. We are not, of course, talking here about the normal expansion that comes from gradual sales increases or periodic improvements of product lines. We are talking about a major expansion move—such as biting into a new market, adding new items to a product line, or plunging into an entirely new industry in a

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significant way. Any one of these goals can be achieved by adopting new products developed internally or brought in from the outside or by acquiring an entire company. Acquiring a new product places a strain on management. However, acquiring an entirely new company places a *great* strain on management.

Too often management does not devote adequate time and energy to planning for the long term. This is inevitable when aspects of present-day operations have important shortcomings; for example, when the marketing manager is weak, top management must put extra effort into backing him up and cannot give proper attention to future moves. Many organizations today are suffering from such weak links in the management chain; for some, the condition seems chronic. And a corporate body that is impaired is in no position to undertake a major expansion move.

When not to expand

Expansion or diversification is not a panacea. When adverse conditions prevail, executive management should not consider undertaking a significant move. Rather, all efforts should be directed toward correcting the existing weaknesses. Only then should management look for new markets to conquer, new needs to fill. Deliberately forging ahead despite known weaknesses can result, all too often, in catastrophe.

Frequently, when a business organization is having internal problems, management looks longingly outside its company hierarchy for a quick, simple solution. If only we could arrange for another $10-million long-term loan, we could expand our plant and bring our per-unit cost down. If only we could hire an engineering vice president away from some other organization, all our production problems would be a thing of the past. If only we had more effective sales coverage in the Midwest, we could soon produce enough volume to turn our operating loss into a profit.

These simple recipes for success generally are wishful thinking. The very fact that general management has permitted weaknesses to develop within the organizational structure is evidence that there is something wrong with the management team—something that must be dealt with courageously without subjecting the company to the strain of major expansion.

Here are ten common situations in which major expansion or acquisition programs are often proposed as a way out but are seldom justified.

Substandard product quality

The product line does not match its competition in quality. Every effort should be made to redesign the product and improve its competitive position while the corporate organization is unencumbered with the many problems that develop during an expansion program. To neglect to correct this situation while management is devoting its efforts to diversification or expansion may undermine the basic structure of the business.

For example, a company in the electrical products field was working hard to hold its own, even though competition from larger and more efficiently run corporations was very severe. Its product line was not comparable in quality or price, but the company managed to keep its sales volume up by

Companies that cannot control their present operations should never embark on new ventures.

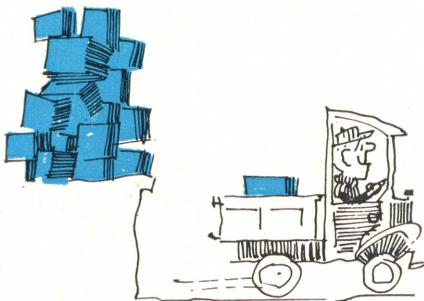
. . . management looks longingly outside its hierarchy for a quick solution

a high-pressure marketing approach. By this means it was able—but barely—to break even. Then, in a burst of ambition, management decided to acquire a company in an unrelated field and in a different geographical location. Within two years after this acquisition the company had to be reorganized under the terms of the Federal Bankruptcy Act.

Excessive costs — When production costs move out of line on the basis of the company's own past experience as well as the cost patterns of its competitors, the underlying problems should be brought to the surface and solved. Appropriate study may lead to one of two end results:

1. The areas of excessive costs are isolated, and corrective action is immediately taken.
2. The areas of excessive costs are identified, but the causes prove to be beyond the control of management. In this instance, the only solution is to adjust sales prices accordingly—or face up to the fact that it is economically impractical to continue making the same product in the same way.

Poor product distribution system —A company whose distribution setup is inefficient, outmoded, or otherwise inadequate is not prepared to carry through a successful expansion program. Various alternative methods of handling the distribution of the product line should be explored; and, on this basis, either corrective action should be taken or a wholly new distribution system should be adopted.



Vacant executive posts — If the present organizational structure does not have an adequate supply of manpower and the limited talent available is already spread thin, the No. 1 priority should be to alleviate the shortage by setting up any new executive positions that may be needed and filling all vacancies.

Although one occasionally hears that this or that acquisition is being made primarily to gain valuable manpower, as a general rule this is a risky way to round out a management team. Of course, it is entirely possible—and sometimes quite desirable—to obtain scientific and technical capability by acquisition. Technical research people work independently for the most part and can produce equally well under any corporate umbrella. Executive management personnel, however, must work as part of a team. This requires interdependent relationships, personality adjustments, and a comfortable give and take in getting things done on a day-to-day basis.

Executive relationships grow slowly and must be nurtured.

Inadequate working capital— Any business organization soundly conceived and managed should be able to make arrangements that will ensure an adequate supply of working capital. The financial community is made up of many institutions, including commercial bankers, investment bankers, factors, and the like, who are eager to assist in supplying needed working capital. No firm should attempt a big league move with a weakness in this area.

Shortage of long-term capital— In a small or medium-size business, one of the major drains on executives' time that commonly must be endured results from the misguided effort to satisfy long-term financial needs through short-term financing arrangements. Why not free executive management time by negotiating appropriate long-term debt? Investment bankers can help here.

The president of X Corporation, for example, needed assistance in developing an acquisition program. Discussion of the matter with financial men eventually turned to the general availability of executive management time to be devoted to the effort. At this point the president said, "We have excellent, dynamic officers, and I know they will enjoy the challenge of expanding our business through acquisition. Right now, however, and for the past several years, my executive vice president and I have been spending almost half of our time constantly negotiating with seven different banks for short-term loans. Actually, we need some long-term financing, and we thought perhaps the acquisition of a company that was loaded with cash might solve our problem."

In looking over the company's financial statements and making further inquiries, it became apparent that what these executives were doing was juggling short-term commercial bank loans among seven banks to meet a shortage of long-term working capital. When the president was asked what effort he had made to consolidate all those short-term loans into one long-term debt, his answer was, "Frankly, we've been so busy we haven't had a chance to find out what kind of long-term financing might be available to us."

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A company producing an inferior product line asks for trouble by branching out into an unrelated field.

Obviously, before giving any thought to a possible acquisition, this firm should have taken immediate steps to investigate the available sources of long-term debt and negotiate a loan promptly. This would have had the double advantage of improving the company's financial position and freeing top executives' time so that they could then devote their energies single-mindedly to exploring opportunities for expansion.

Volume and profits at a plateau —When the charts portraying the company's performance begin to show a "plateau" effect, this is a warning that the executive hierarchy may be suffering from a lack of vitality and may need renewing. How, then, to put greater vigor into the executive suite? (On the other hand, if investigation reveals that the leveling off of profits is the result of conditions within the industry, diversification, expansion, or both may be warranted.)

"Grasshopper"-type management —Frequently, in a growing field, especially if top management is technically oriented and full of ideas, a company may find itself with a wide and diverse line of products. It is just impossible to give any one item or line adequate attention; management jumps from one to another, depending upon the current whim of the chief executive. This is "grasshopper" management, and it is a common ailment among some of the more ambitious entrepreneurs who have established their own companies in fast-moving technological fields.

One company, founded and operated by scientists, has accumulated this varied list of products: salt-water-activated batteries, barometers, semi-automatic control systems, photographic materials, diagnostic instruments for the medical profession, stretchable cable, and so on and on. The total annual sale of all these products for each of the past three years has averaged about $500,000. Clearly, this company should not, simply because the price of its stock has risen to more than 200 times earnings, consider making acquisitions with this inflated paper.

Inadequate second-tier management — This deficiency is closely related to the problem of vacant executive posts. However, it represents an aspect of the executive manpower shortage which has different dimensions.

The concept of a major expansion program implies building an organization for a long life. This means that there must be upcoming executives ready to take over the reins when current management begins to falter and productivity tapers off. Planning, patience, and careful guidance are required here. It is never too soon to begin developing a second tier of management, whether expansion and diversification are in the offing or not.

Poor control setup — An adequate control system is basic to effective management, yet it is surprising how frequently controls are lacking. In a small but going business, continuing at its own modest pace, the absence of controls may be compensated for by the informal relationships that develop over the years among executives. During expansion, however, it is often necessary to move management people around and to break up these traditional relationships. When this occurs, the absence of a control system may create difficult problems for top executives as they attempt to direct new and complex operations.

When to expand

A business organization may begin thinking seriously about a major expansion move when it has certain characteristics:

High executive morale — Morale among key executives must be high. They must be dedicated to the conviction that major expansion is desirable and necessary. They should have such concern about the welfare of the organization that its success and growth are the focus of their daily activity. They

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must have that deep-down feeling that expansion will bring greater and quicker success to the enterprise for whose future well-being they are responsible.

Good communication — Communication within the organization should be well developed and effective. It should be the kind of communication that permits objective feedback. Only by this means can appropriate rapport be developed and maintained so as to assure timely decisions.

In one large, unusually successful growth company, the two top executives used to meet each Sunday morning for a two-to-three-hour walk during which the important developments of the past week were reviewed. This was a somewhat unconventional device for maintaining regular internal communication, but it worked. The Sunday morning walks continued for some fifteen years. They stopped only when one of the officials withdrew from the company to accept a government post.

Clearly defined mission — There must be a deep-rooted understanding of the company's mission, its *raison d'etre* and philosophy. This understanding should be stated in terms of where the company is going, not from whence it has come. It should be a looking forward, not a looking backward. In this respect it resembles the attitude of the driver of an automobile who keeps his eyes straight ahead toward his destination yet frequently glances at the rear-view mirror to satisfy himself that no unexpected problems are developing behind him.

A company that is ready to begin thinking about a major expansion should not waste time preening itself over past successes, however glorious. Its resources of time and thought should be applied to the problems of where it is to go from here. To grow and to take its place in the dynamic society of the future, management must concentrate on today's achievements and on plans for tomorrow.

Creative environment—The business organization must be truly conductive to creativity and innovation. It must be people-oriented, not equipment- or product-oriented. The individual with ideas should feel comfortable here.

The mind is one of the most viable elements of the human system. It grows or degenerates, depending upon the demands made upon it and upon the environment in which it is placed. If a person with a good, creative mind is placed in an environment that constantly stifles and rejects ideas—the lifeblood of any dynamic organization—his mind will soon begin to atrophy. Such atrophy is contagious, and once it attacks one mind it will spread to others within the organization. Management personnel will begin to play it safe and be suspicious of originality.

No major expansion program should be undertaken when the minds of potentially creative executives are blocked. Successful expansion programs require flexible thinking and imaginative solution.

Executive manpower program—Inasmuch as people are the key to any organizaiton, it is essential that a business corporation have an effective program for recruiting and training executive manpower. A pipeline should exist for bringing new, capable "comers" into the executive hierarchy. Self-motivated, well educated, trained executives are always in short supply, and when a major expansion or diversification program is undertaken, this shortage becomes even more pronounced.

Once a competent young executive has been attracted to the organization, a carefully designed program for coaching and developing him should be available. In addition, to ensure at least a reasonable chance to attract and hold the kind of man who can make decisions based on firm facts and sound judgment, a tried and proved executive compensation program should be operative.

No one-man show can grow and thrive for very long. Although many businesses are started and built by autocratic rule, for long-term efficiency an executive hierarchy must be developed. Henry Ford built an empire dominated by one man. He had the vision to apply assembly-line techniques to the

A company whose distribution system is outmoded or inadequate is not prepared to carry through a successful expansion plan.

production of automobiles and the imagination to strive toward making every worker an automobile owner. But eventually the once-successful Ford Motor Company almost found itself a victim of autocratic management; it was saved by the courage and determination of old Henry's heirs, who brought in and developed an effective management team.

Then there is the story of the DuPont Company. Most of the heirs of the dynamic founder were ready to sell out because E. I. DuPont had not built an effective management team. The determination of two young cousins to take hold of this great, unbalanced, headless industrial complex and fit an executive team to it preserved the enterprise and made possible even further expansion and success.

Major expansion or diversification moves naturally play a dual role so far as young executive talent is concerned. Not only do they create the need for additional talent, but they also should provide "protected" yet satisfying assignments in which young executives can be developed for more important management posts.

Internal flexibility — An organization must have internal flexibility so that it can cope with the many unforeseen problems that arise during a major expansion program. The older an organization is the more rigid are the departmental lines of authority. Sometimes an executive devotes as much effort to protecting his authority as he does to executing the function that justifies that authority.

A basic trait of human nature is the need to feel important. Too often, executives assert this natural self-importance by assuming jealous custody over their departments. Soon vested interests develop. Sales managers refuse to permit production executives to look through their sales catalogs. Production executives frown upon a marketing vice president who wants to inspect a plant and see how the products he sells are being made. Accounting executives are deaf to suggestions from production managers concerning the redesign of internal information forms.

These fences created and maintained between departments can have depressing effects on the smooth, efficient functioning of a business organization. When a major diversification program is under way, the results can be enervating and perhaps destructive.

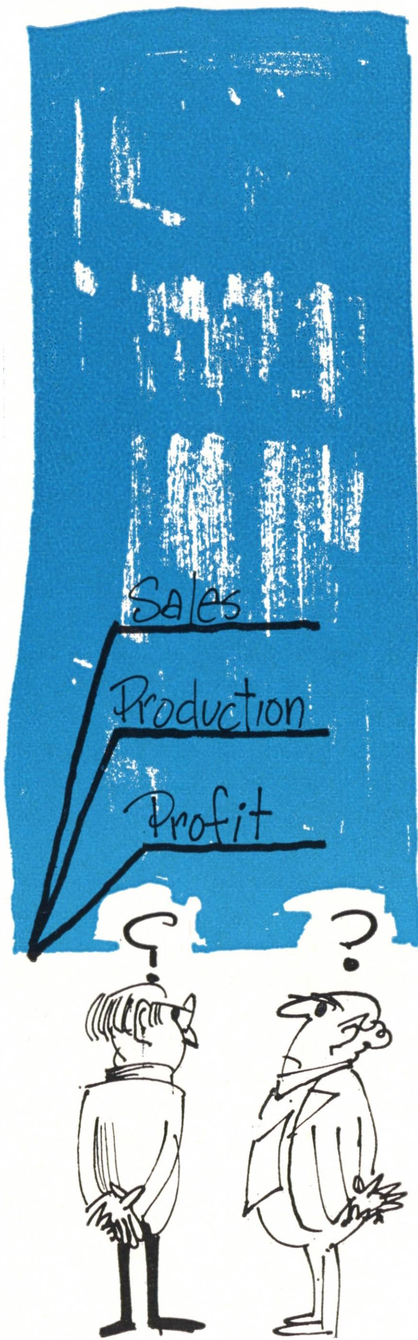
Receptivity to objective self-criticism — During expansion problems come up almost daily. A corporate organization should be able to confront them objectively, and to do this it must make conscious provision for self-analysis.

Good ideas are not the sole province of the particular executive who happens to be in charge of a program. His way of doing things or his solution to a problem is not necessarily best—in fact, it may not even be correct. An effective organizational structure permits and encourages subordinates to express themselves and to present their ideas for consideration without fear.

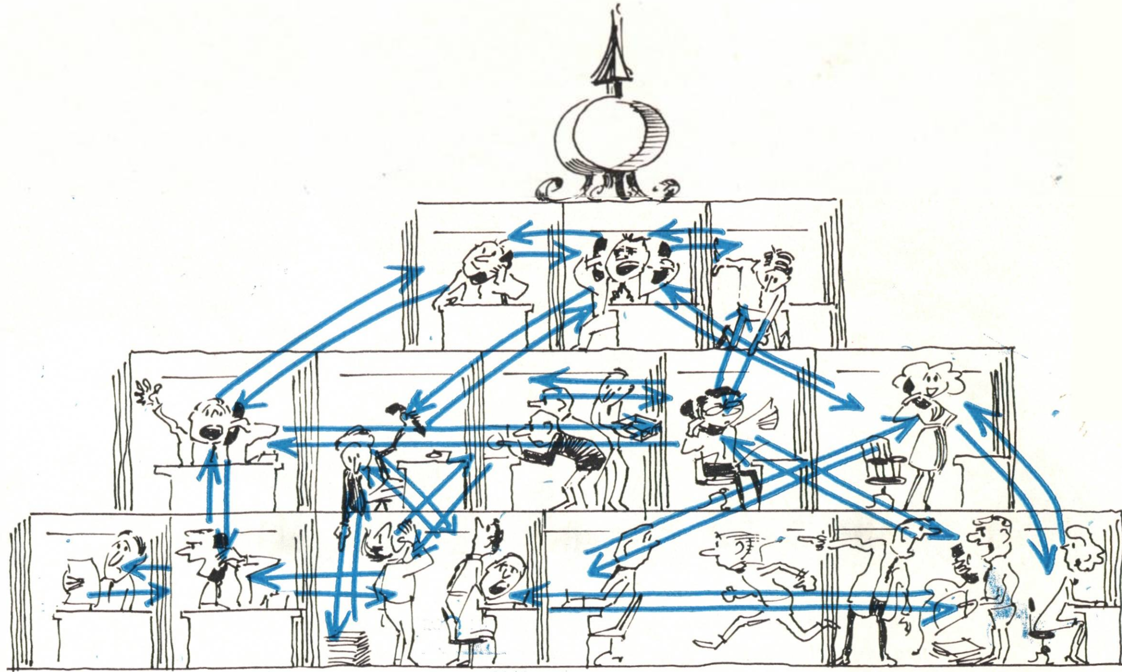
The older an organization gets and the longer an executive has been in his slot the more likely it is that rigid procedures will be interfering with efficiency. Precedence frequently dominates to such an extent that perceptive suggestions for getting a job done are effectively squelched.

In many old-line public utility and quasi-public utility corporations the executives fit into their positions as they would into comfortable old shoes. Even a minor change in long-standing procedures tends to cause loud and vengeful repercussions. Unwittingly, these executives have become manacled to methods for methods' sake even though some of these methods lost their usefulness decades ago.

Major expansion requires creativity, vitality, and dynamism. If a company has cobwebs in the form of outmoded rules and procedures, management should get rid of them before entertaining any dreams of extensive growth.



When charts portraying the company's performance begin to show a "plateau" effect, it is often a warning that the executive suite may be suffering a lack of vitality.



Communication within an organization should be of the sort that permits effective feedback.

Today's business environment is dominated by growth. Some observers of the economic scene have gone so far as to suggest that, over and beyond the making of profits, two prime objectives of most companies are constant growth and the creation of new challenges for their own sake. Increased volume seems to dominate the thoughts of numerous top executives.

In many instances, the urge to expand is something of a fad—everybody seems to be doing it. So, if management wants to appear progressive—and who doesn't?—it begins seeking out expansion or diversification opportunities. Yet most of the business moves that are made merely to keep up with the expanding Joneses rather than as a result of careful thought wind up as disasters.

Planned growth by expansion or diversification can be an effective means of achieving a business organization's stated objectives. We assume, of course, that every business organization has objectives. But too many organizations, even nowadays, drift along in a rudderless fashion, without leadership, buffeted by the winds of economic ups and downs. When such companies undertake an acquisition program, anything can happen—and it usually does.

Thus Step No. 1 in planning for growth is to define one's objectives: the long-range objectives of the business and those to be achieved by a particular program at a particular time. This definition requires substantial soul searching and introspection on the part of management. What business are we in? What business do we want to be in ten years from now? Are we competitive? Can our management structure tackle this program we have in mind?

Here are some objectives that might well be considered:

1. ***Increase in number of products***—The aim is to broaden the product line so that the needs of present customers and potential new customers are satisfied.

2. ***Broadened market area***—This objective is especially relevant for those organizations that have grown up in a particular region and have tended to concentrate all their distribution in a specific geographical area.

3. ***Diversification***—The objective here is to get the company involved in other fields for any number of reasons: to balance a seasonal operation, to move from a decaying industry into a growing industry, to continue growing larger yet not incur the wrath of the Department of Justice.

4. ***Vertical expansion of the business***—The manufacturer may seek to expand in the direction of acquiring retail outlets that distribute his manufactured products to the ultimate consumer. This vertical integration is fully accomplished when the company begins with a basic commodity like iron ore and ends up with completed widgets for sale to the public.

5. ***Growth for the sake of size*** — Some entrepreneurs have a growth objective that is essentially financial expansion. This is especially true of most financial entrepreneurs. Anything that appears to be available at a bargain price or anything that can be acquired with a minimum cash outlay even at an unrealistically high price interests them. As untraditional as this objective may be, it must be

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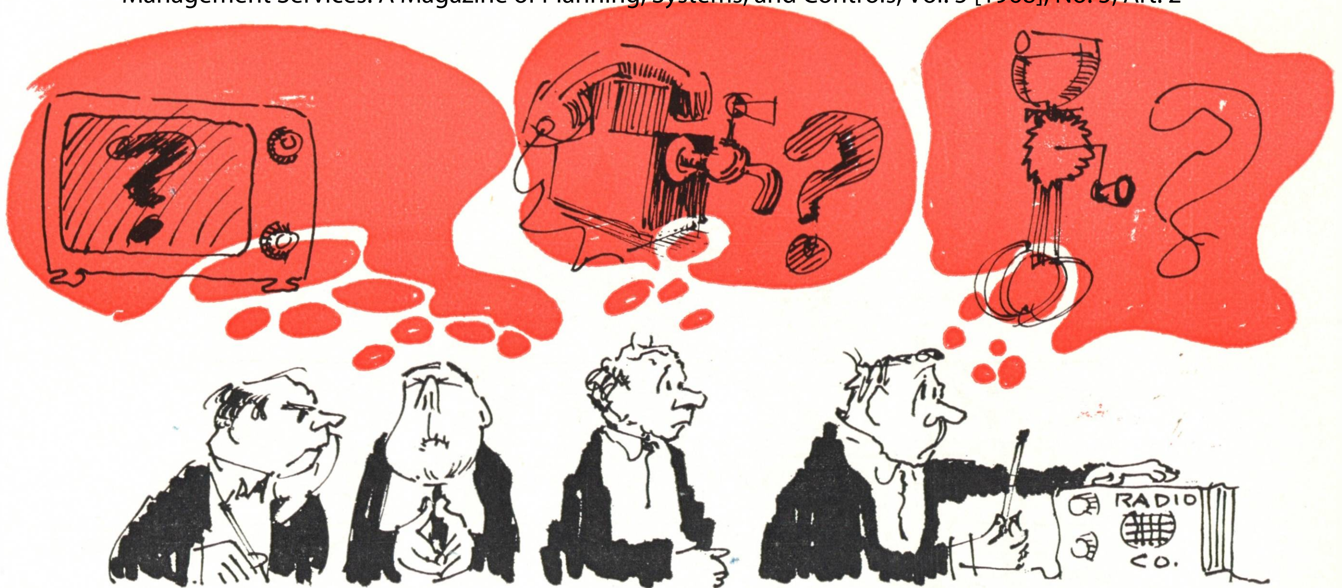


A common objective of a well-thought-out expansion plan is to broaden the company's range of products so that the needs of present customers and potential new customers are satisfied.

recognized as a fact of business life.

6. *Use of idle capacity* – Idle capacity may take the form of plant equipment, executive personnel, capital, or even unexploited mineral resources.

Regardless of what the company's objectives may be, it is important that they be clearly defined. They should, in fact, be set forth in writing and formally approved by the board of directors for the guidance of all those charged with the responsibility of helping the company grow. The form of the statement is not important in itself—it may be simple or elaborate—but it must be couched in clear, unambiguous terms.

The definition of objectives has distinct advantages. It forces the company's policy makers to think about the future, to engage in objective self-appraisal, and to give sober and unhurried thought to where the company wants to be by a given date and how it expects to get there.

Only after the objectives have been defined can management begin planning how best to go about achieving them.

Ironically, top management often devotes much time and money to investigating and evaluating manpower programs, research and development programs, and marketing studies. Somehow, though, the same management will plunge into a major expansion (especially through acquisition) with very little, if any, depth investigation of objectives, products, markets, and personnel.

No major expansion move should be undertaken without a full and complete investigation of the facts of the case. This investigation, moreover, should include adequate self-examination. Only when both management team and operations can be shown to be functioning effectively should a company attempt planned, deliberate expansion.

Effective management is evidence that the organization has the needed vitality and motivation to try the acquisition route.

The myths of acquisitions . . .

Any management considering an expansion program should be alert to the dangers of the following widely held myths about acquisition:

1. ***If it can be bought cheaply enough, you can't lose.*** This is not true. Any business executive who has had to live with the discomfort of operating a division or a company that is constantly losing money can testify to the devastating drain such an operation can be. If the means of quickly converting losses to profits are not readily apparent, any price paid for the business entity is too high. Physical assets waste away when operating losses cannot be stemmed. A small leak can sink a big ship.

2. ***There have to be hard assets to back up the price paid.*** Again, it's simply not so. Business today is dominated by change. A valuable hard asset in yesterday's technology may be valueless scrap tomorrow. What counts is the earning capacity, the management team, the research facilities, and the know-how.

3. ***Combining administrative functions, purchasing functions,***

and distribution organizations will save overhead costs. This observation appears to be good logic, but it hardly ever agrees with the actual experience of business combinations. When a much larger company acquires a small operation, some saving in overhead may result; however, when both companies are of relatively good size, any saving made by consolidating lower-echelon personnel is often more than offset by an increased central-office superstructure.

4. ***New management policies will reduce inventories and receivables.*** This may happen, but management should be prepared to suffer the consequences of reduced product lines and shorter credit periods. Sales can drop off drastically. Besides, the mores of some industries make curtailed lines and credit periods impossible.

5. ***Weak executive personnel in an acquired company can be strengthened by backing them up with strong home-office supervision.*** The record of past acquisitions does not justify this assertion.

6. ***Increase the gross business, and net profits will rise.*** No operating executive will accept this statement without qualification. Increasing the volume of a product unknowingly being sold at a loss (a condition that exists more frequently than most executives like to admit) means lowering net profits.

7. ***Control over spread-out operations can be established by appropriate reports.*** In time, this may be possible. However, until the acquired company has been effectively integrated, control of its operations requires a major effort.

8. ***Management should quickly determine what divisions of a business are not contributing their share of profits, then improve operations or cut them off.*** This is easier said than done. One of the most difficult tasks in evaluating business operations is to try to determine the profitability of a particular division. Many costs overlap. Service functions are shared with other divisions. Loss products are required to round out a line. Frequently, archaic internal information systems cannot furnish creditable figures.

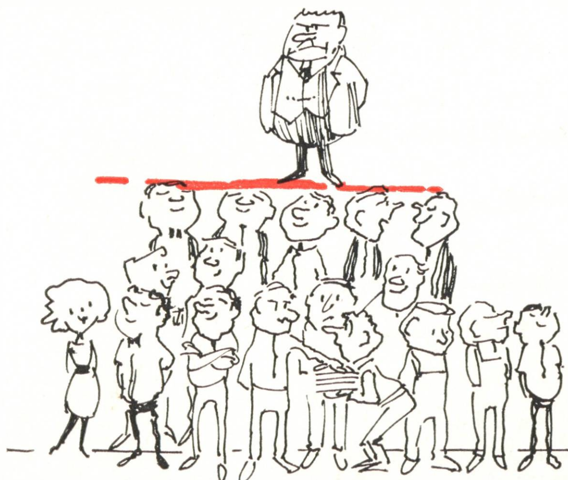
9. ***The first job is to dismiss the executives who opposed the acquisition and replace them with new, cooperative men.*** Good executives are a scarce commodity in business today. Competent replacements are painfully unavailable. The executive who has the courage and intellectual independence to express his convictions may be the best man in the company. No effort should be spared to try to mold him into a cooperative team member.

10. ***A good board of directors can set a proper policy for any type of business.*** Some apostles of the conglomerate merger preach this philosophy—to their later chagrin. Executives of successful conglomerates concentrate their boards' attention in the areas of financing, furnishing technical and professional advisers, and dealing with new acquisitions. They leave operating policy to the components' own boards of directors.

. . . the warnings against acquisitions

Here are a few warnings that should be kept in mind during all acquisition negotiations:

1. ***Don't believe everything you are told by the seller.*** He is not necessarily trying to mislead you consciously. But his impressions of his own business are obviously biased, and he is impelled to tell you all the good things about it. Full and effective communication between two people is always dif-



An executive hierarchy must be developed if the company is to perpetuate itself; the company dominated by one man is all too apt to disintegrate when anything happens to the man.

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ficult. The same words too often have different meanings to different people.

2. ***Don't be rushed into a decision before all the facts are in.*** All facets of a business operation must be examined. The function ignored may be your Nemesis. The seller always makes sure that you don't overlook his good points. Better to miss out on a closing than rue the day.

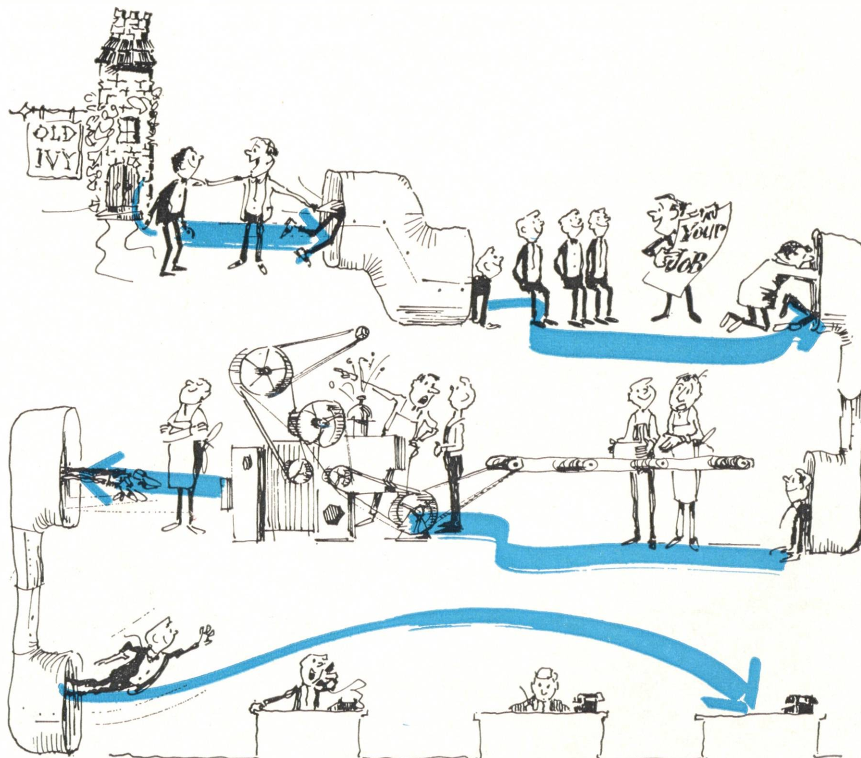
3. ***Don't let personality likes or dislikes get in the way of acquisition.*** Objectivity is always important in business decisions. If necessary, switch to negotiators with different personality types to keep the evaluation process and its findings impersonal.

4. ***Don't be dazzled by the physical facilities of a company.*** Acquisition of a business entity is undertaken for the purpose of increasing profits and growing. A physical plant that is beautifully designed but engineered for inefficient production must be rated accordingly.

5. ***Don't think an acquisition can be negotiated and integrated by executives in their spare time.*** Acquisition is a full-time task requiring all the abilities and concentration a man can give it. It is a distinct function of business and should be staffed accordingly.

6. ***Don't think the job of acquisition is over when the legal papers are signed.*** The real job is just beginning. You want to help the company grow. Very well, then. Growth is possible when the acquired operation becomes an integral part of its new environment.

7. ***Don't expect all your plans for integration to work smoothly.*** They never do. Be prepared for some disappointments, and the solutions to your problems will come more readily.



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