

## When businessmen fear growth

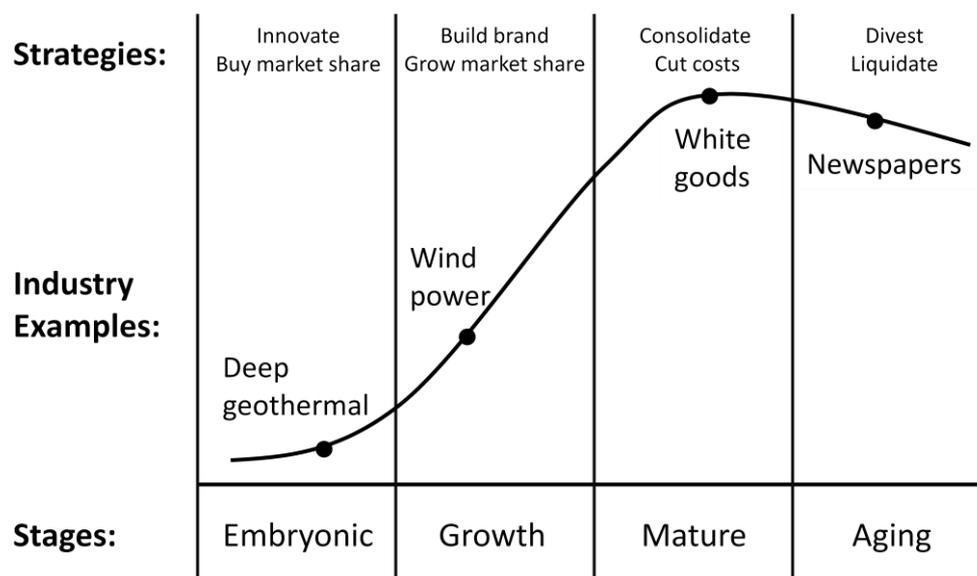
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*Summary: The political focus on promoting expansionist GDP growth causes developed economies to incur significant opportunity costs as well as directly destroying wealth by risky investments. The industry life-cycle model, widely used by business strategists, shows how these negative effects of expansion (which are independent of GDP's shortcomings in reflecting social and environmental costs) can damage economies in the same way that the inappropriate pursuit of top-line revenue growth damages unwary businesses.*

The mainstream political parties pursue economic expansion because they believe that it reduces deficits and creates jobs. Paradoxically, experienced chief executives of large companies are not so enthusiastic. They worry about their companies expanding too much. This is not because they are concerned about the environment, but for a much more basic reason: they know that trying to grow their company can be a sure way to wipe out the value of their share options.

There is a science to it: bosses must detect the market signals that indicate when the time for growth in a particular business is over. Wealth-creating companies can be seen as mini-economies, and politicians can learn from them. Most important is to understand the reasons why inappropriate pursuit of growth has caused companies to crash and burn just as the booming developed economies did in 2008. National policymakers should understand why the slowest-growing companies generally pay the biggest and most reliable dividends to shareholders. Companies can't pay dividends at all unless they are creating wealth, so what is the secret of zero-growth wealth creation? Management strategists find the answer in the concept of the 'industry life cycle' and in the S-shaped curve which illustrates many of the characteristics of that cycle.



**The industry life cycle**

Industry life cycles are predictable and determine the destiny of each 'business unit' – normally a combination of product and market. In the life cycle model, businesses pass

through embryonic, growth, mature, and aging stages. The S-shaped curve empirically describes many different characteristics which evolve through time when they are plotted on the vertical axis. Top-line revenue, capital requirements, cost of capital, market size, product diversity and quality, number of competitors, profitability: all tend to follow this curve from slow expansion through to slow decline. By analysing past industry data, it is in theory possible to locate a business on the life-cycle curve and determine its appropriate strategy. A business that shows signs of moving into maturity should stop trying to grow organically (through increasing market share, for example), and should instead consolidate through mergers with competitors, pay higher dividends, and plough back a smaller proportion of its profits into projects which improve efficiency rather than boosting sales. Variations of the life-cycle model are used by many strategic management consultants including Arthur D. Little, Michel E. Porter, McKinsey & Co., and BCG.<sup>1</sup>

It is the transition from growth to the mature stage which offers the best lesson for the more developed national economies about the dangers of inappropriate growth. A business strategy textbook defines a 'mature' industry as follows:

A 'mature' industry, for instance, is characterized by slow or negligible rates of growth; little or no further growth potential; few changes in breadth of product line; stable or declining numbers of competitors; stable market share positions; established buying patterns; high barriers to entry; and process and materials innovations in technology.<sup>2</sup>

Many of the horror stories from industry about inappropriate growth relate to businesses which were suddenly deregulated, with no competitive life cycle history to guide them, being run by people who mistakenly thought that the industry was in the growth stage. This was arguably the case recently with retail banking, a mature business if ever there was one. Other over-grown businesses such as McDonalds and the clothing retailer Gap were on such a roll with their new approach to the market that they did not question the simple growth strategy that had worked for them so far. Gap's growth-hungry chief executive was quoted as saying before his fall that he wanted his company to become 'as ubiquitous as Coke'. With hindsight this may seem a naïve basis for strategy but chief executives, despite their high salaries, put their pants on one leg at a time just like the rest of us and if they start an innovative new business they will make mistakes. Simple extrapolation from past experience, hype, and overconfidence bred by early success are a common cause of problems in business and politics.

Businesses which make a successful transition to maturity create wealth for their shareholders after growth stops by using shareholders' capital (i.e. profits retained instead of being paid out as dividends) to continuously improve their performance and hence their profits. They compete mildly with each other (retail banking being a good example) and therefore have to pass some of this improvement on to customers. Utility companies (household water and energy) are seen as the most obvious success stories among the mature industries. Their markets, in the developed economies, are pretty much saturated but they can still produce wealth for shareholders who want a low-risk, low-return investment in their portfolio. Their shares are cheap compared to the size of the dividends (i.e. price to earnings ratio is low) because mature utilities are not likely to make a breakthrough that will increase the value of the business, so dividends are all that can be expected. Investors who can accept

more risk will get lower dividends (a higher share price to earnings ratio) from a growth stage company but can also hope for an increase in the value of its shares if revenues grow as planned. Businesses which are still in the growth stage can make less risky non-growth investments but the important lesson of the life cycle model is that such improvements offer less competitive advantage at that stage. It's not a good idea to invest in producing the perfect product at lowest cost in a growth industry in which your competitor is hoovering up market share with a ramshackle operation that barely breaks even. Risk/reward is therefore a factor when choosing a growth share over a dividend share, and many investors diversify their growth investments to reduce risk. There is a possibility of changing the risk profile of the economy at a general election but unfortunately the main UK parties are offering the same undiversified high-risk, high-reward investment strategy.

When maturity overtakes a business, it does not necessarily mean firing staff; continual performance improvement can be gradual and just as labour-intensive as growth. Dramatic layoffs and instructions to office staff to write on both sides of the paper and use their pencils until they are only an inch long (corporate equivalents of an austerity programme) are not normal signs of a successful transition to maturity. They are more likely to be demonstrations by management that they have taken control. In politics, slash-and-burn austerity is often presented and accepted as the only way to generate savings, revealing ignorance of the way zero-growth industries create wealth.

Are the developed national economies reaching something like maturity? Those who are familiar with the S-shaped curves of Worldwatch and the UN Human Development Report<sup>3</sup>, which show that variables like life expectancy and happiness tend to stop increasing when GDP per capita passes a certain level, may detect a resemblance to the industry life cycle curve. More important, though, there is a degree of maturity because the infrastructure of a developed country like the UK is so huge and of such varied vintage that there are plenty of employment-intensive and wealth-creating opportunities to reduce costs instead of expanding. The wealth created is just as useful for paying off deficits – it cannot be emphasised enough that GDP is a measure of *value added* in the economy, equivalent to 'profit' in a business rather than 'sales'. This means that expanding production is not the only way to increase GDP. 'Decoupling' (reducing material usage) and other process improvements will also cause GDP to grow. The problem is that GDP, as currently calculated, gives undue weight to expansion by adding in capital expenditure in the year it occurs rather than waiting for the profits that it might generate. Since the 1990s there have been continuous attempts to improve the GDP calculation, but it struggles to keep up with the changing nature of mature economies which are investing in intangible assets which are not included in the GDP calculation merely because they are hard to measure.<sup>4</sup> Policies which try to maximise 'calculated GDP' rather than the real thing therefore focus too much on expansion rather than on the decoupling and process improvement which mature economies need. This 'calculated GDP'-focussed approach afflicts mainly public spending because the private sector, understanding the industry life cycle, gives more weight to improvement and intangible asset investment.

The validity of the life-cycle model as a description of national economies is enhanced by the fact that less developed economies still show healthy top-line growth. An important inference can be drawn from the life cycle model's revelation that revenue growth is a

reasonable target and measure of business performance in the growth stage, but nobody would use it as a target in a mature industry. It may be the same with economies: GDP growth rates (as GDP is currently defined) may roughly signal economic health in developing economies but be incapable of recording the economic wealth being created (or destroyed!) in mature ones. This shortcoming is independent of the inadequacy of GDP for taking account of the environmental or social aspects of progress, and may explain why the Governor of the Bank of England finds the recent fall in unemployment hard to reconcile with the weak growth in GDP.<sup>5</sup> It is probable that, deprived of expansion opportunities, enterprises are turning to lucrative efficiency projects which are not given their due weight by the current calculation of GDP.<sup>6</sup>

So ingrained is the habit of expansionary growth that many UK policymakers assume that it is the only way to increase GDP and employment. Experience gained in the boiler-rooms of industry is becoming ever rarer among politicians. A typical example from a recent House of Commons debate illustrates this:

Rather than more empty promises we need the Government to take real action now and to tackle the housing crisis and boost our flatlining economy. That is why they should back Labour's call to use the windfall from the 4G auction to build 100,000 more affordable homes and create hundreds of thousands of jobs ...<sup>7</sup>

This example also shows how the tendency of GDP to undervalue a mature economy is causing influential voices to 'talk down' the UK business climate. Parliamentarians used the pejorative 'flatlining' to denigrate the British economy at least 50 times in 2012 during House of Commons debates. If there is one lesson to be learned from the industry life-cycle model it is that zero-growth businesses are accustomed to creating wealth and employment and are prized as investment opportunities in the private sector. Quite apart from the financial risks and losses associated with attempts to increase 'calculated GDP' by expanding production, and whether or not the current UK slowdown is permanent, opportunity costs are being incurred by focussing exclusively on top-line growth and leaving on the table the money available from other economic activity. 'Opportunity costs' are financial benefits which are foregone. Successive UK governments are incurring these costs by focusing only on expansion, as if the UK were a developing economy, and the dysfunction is not self-correcting as it is in the private sector.

UK political vision doesn't seem to extend much beyond the next construction boom, or more correctly bubble, as in the parliamentary quote above. This recipe is still popular despite its contribution to the last financial crisis after the Labour government in March 2000 issued Planning Policy Guidance Note PPG3. This rescinded existing planning regulations which preserved the housing density of a neighbourhood, and instructed local planning authorities to allow only developments with greater than 30 dwellings per hectare. The most immediately promising sites were expensive suburbs with 4 houses per hectare and big gardens suitable for infilling. The sudden change in the regulations caused much strife between neighbours and created a building and lending boom which helped Labour to be re-elected in 2005. The Coalition cancelled Labour's 'infilling' policy and in its place has announced plans to allow large extensions to home and business premises without planning permission, for a three-year period only. The coalition also proposes to lend up to £10bn for 'new housing'. The three-

year deadline is evidently designed to artificially speed up investment and fits well with the election timetable.

Not only in housing but in other areas of construction, the political focus on capital expenditure on new projects leads the government to take risks with taxpayers' money and incur opportunity costs too. 'HS2', a proposed new railway link between London and the UK's second-largest city Birmingham costing at least £33bn, is a prime example. Both main parties support it. The fact that it is a 'big bang' project independent of the current infrastructure speeds up the investment and boosts GDP in the short term, even if the investment never pays off, but makes it impossible to modify the plans in the light of experience. There are alternative low-risk projects for improving the efficiency of the current rail transport links, but they have never been evaluated by successive governments of both main parties who support HS2. The opportunity costs of not going ahead with these improvements have simply been ignored.

Growth has many other risks which are not discussed in this paper, including most obviously the destruction of natural resources. This paper only explores what governments can learn from the mini-economy of a business, where 'peak oil', 'peak minerals' and other natural resource limits to growth may not yet be affecting the decision-making. But businesses have another limitation to worry about which causes them to seek out opportunities that politicians remain oblivious to. The limit that has led to the discovery of zero-growth wealth creation is 'peak shareholder equity'; the shareholders simply won't fund inappropriate expansion, and the banks will only lend when they can see that shareholders are putting equity at risk.

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1. Lancaster, G. and Lester Massingham, *Essentials of Marketing Management*, Routledge NY 2010. See Chapter 15, *Strategic Marketing Planning Tools*, pp 456-483 for a description of the industry life cycle planning approach and its variants.

2. *op. cit.* p. 460.

3. Worldwatch and UN Human Development Reports: see Jackson, T., *Prosperity without Growth*, Earthscan, 2009

4. Richard T. Froyen in *January 2000 Survey of Current Business*, Bureau of Economic Analysis; Simon Field and Mark Franklin, *Results from the Second Survey of Investment in Intangible Assets*, Office of National Statistics, 16 November 2012

5. Sir Mervyn King, 14 November 2012 reported at <http://www.bbc.co.uk/news/business-20323096>

6. See this author: *Resolving the Productivity Puzzle* (forthcoming)

7. Jack Dromey, Labour's Shadow Housing Minister, 22 November 2012