2 Corporate Strategy: Growth Paths and Reasons for Downfall

The concept of firm growth is widely discussed in politics, corporate practice and in scientific research. When Jean-Claude Juncker is talking about his priorities as the new Commission President of the European Union in 2014 he is focusing on measures which create economic growth and jobs and which help companies to grow.[25] Martin Winterkorn, CEO of *Volkswagen*, as well as Elmar Degenhart, CEO of *Continental*, for example, call growth as a main element of their corporate strategies.[26] Further, management consultancies like *Bain & Company*, *McKinsey & Company* or *Boston Consulting Group* are offering to develop growth strategies for companies to become more successful and outperform their competitors.[27] Growth seems to be a high valued component of the entrepreneurial and managerial activity in today's globalized economy although it is not a primary objective for a company and not necessary for its survival in the short and medium term.[28] But why is firm growth still so important and how can it be measured?

2.1 Indicators of Growth

In business research firm growth is a frequently studied topic and has a long history. The understanding of the concept of growth is the expansion and thus the increase of the size of a company – the intention to become a large firm – mainly expressed by a growth indicator as an absolute number or as a growth rate to increase the comparability between firms.[29] The indicator itself can be based on various key figures of the company like, for example, total sales, the number of employees, value added or productivity. Each key figure enables its own interpretation. Therefore, a more comprehensive growth indicator would be helpful but often due to a limited access to corporate data only the collection of

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25 See Juncker (2014).
26 See Volkswagen AG (2012): p. 21 and Continental AG (2012): p. 5 et seqq.
27 See their concepts like the *Fundamentals of Growth*, the *Portfolio Approach to Growth Investments* and the *Granularity of Growth*. Further, see McKinsey & Company (2014a) for future trends of strategy and growth from the view of consultancies and scientists and McKinsey & Company (2014b) for research on family-owned businesses.
28 See Rall (2002): p. 4.
29 See among others Coad (2009): p. 2 and for a more precise textbook definition see Jünger (2008): p. 28 et seq. He distinguishes between three classifications of definitions of firm growth: 1. Definition by the use of synonyms; 2. Definition by a growth indicator and 3. Definition by the combination of metrics. For his analyses Jünger uses the development of total sales as the indicator for (internal) firm growth.

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single indicators is possible based on publicly available information.[30] Nevertheless, also these indicators can be informative to reflect the development of a company. But it should be considered that the time horizon of the measured growth is also of great importance. Already in 1942 Gutenberg noted in one of the first articles about firm growth that this concept is not a term of a short but instead of a long period of time due to short term variations in the economic conditions which distort the real business situation.[31] Albach also defines firm growth by the increase of a key performance indicator over a "*longer period of time*".[32] In favor of a long-term perspective Rall adds that companies which are not growing in the long term would be in trouble due to a lack of internal development and adaption to dynamic industries and markets. Further, these companies are unattractive for talented employees and they often do not fulfill the requirements of the capital markets among others due to a lower company value.[33] Therefore, investigating the growth process of companies the observation period has to be sufficiently long so that the long term trend can be detected and not only the situational business activity which is also determined by external factors like the economic cycle. But which other – internal or external – factors affect the firm growth? And what are the advantages or disadvantages of size for a company?

2.2 Determining Factors of Firm Growth

Even after 80 years of research on firm growth Gibrat's theory of a "law of proportionate effect" is still widely acknowledged. The concept states that expected growth rates are independent of firm size because growth shocks are randomly distributed.[34] Despite lots of empirical work on *Gibrat's law* this theory cannot be falsified until today. Nevertheless, there is also empirical evidence for several factors which are affecting firm growth. Further, theoretical considerations based on different approaches suggest a high number of factors, as well. But the intensities of these variables vary greatly in the studies. But which factors are considered to affect growth?

First of all, there are firm-specific factors like the relative performance of the company mostly measured by profits or productivity. Neoclassical theory emphasizes on the one hand that there is no relationship between financial per-

30 See Haberlandt (1970) for a comprehensive discussion about different indicators of firm growth.
31 See Gutenberg (1942): p. 149 and Brockhoff (2008): p. 226.
32 Albach (1965): p. 10.
33 See Rall (2002): p. 4.
34 See Gibrat (1931) for the primary source and Lotti et al. (2003) as well as Santarelli et al. (2006) for an overview of empirical tests based on Gibrat's law.

formance and firm growth while on the other hand among others evolutionary economists postulate a positive influence. Further, because productivity is strongly connected to profits an influence on growth might also be expected. But reviewing a great number of empirical studies regarding these relationships, Coad states that “productivity and profitability are not major determinants of firm growth”.[35] Besides these two factors empirical studies have investigated even more firm-specific factors like the age of the company, the competition between firms, the characteristics of the entrepreneur (like gender and human capital) as well as the company’s ownership structure, its legal status or innovations. Although significant influences can be measured in some cases none of all these possible factors enable a satisfactory explanation for the phenomenon of firm growth.[36] Therefore, the empirical models are extended with industry-specific factors like the industry structure which also might have an influence on the expansion process. But also including these external factors the models do not show valid improvements of the relationships with growth.[37] Further, the macroeconomic environment like the inflation, the business-cycle, country- and regional specific factors or growth rates of the Gross Domestic Product (GDP) might be affecting the firm’s growth and thus its amount. In principle, a positive effect can be detected for these components.[38]

Regarding the factor of a company’s size Gibrat postulates that there is no relationship between firm size and growth rate. These results can also be found in a cross-country study by Hart and Pearce from 1986 especially for German and Japanese organizations. Large and small firms do not have a difference in their growth rate.[39] Therefore, Coad summarizes:

> “It appears that smaller firms tend to grow faster than larger firms, although above a certain size threshold these differences fade out, such that expected growth rates are more or less independent of size.”[40]

Besides research on the influencing factors and on the amount of firm growth scientists have investigated the continuity of the growth process. Two different

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35 Coad (2009): p. 74.
36 For the influence of the age on the growth of family businesses see among others Lantelme (2014). Further, the factor of innovation has a positive and a negative influence on firm growth – a small positive influence on sales growth; product innovations seem to have a positive impact on employment growth, while process innovations might have no or a small negative influence on this type of growth.
37 See Coad (2009): p. 93 et seq.
38 See ibid. p.95 et seq.
39 See Hart, Pearce (1986). However, in the USA and the UK a slightly higher growth rate for small companies is found.
40 Coad (2009): p. 48.

streams can be identified. First, several early studies describe growth as a continuous process.[41] But observations of disruptions have increased the awareness of the second stream. Optimization models, simulation models as well as life cycle models try to explain these discontinuities within the expansion process.[42] Especially Albach describes the existence of thresholds and crises within the growth process of a company and therefore also contradicts a continuous progress.[43] Additionally, research on the direction of an organization's growth deals especially with the development of new international markets and which country might be the best for the next expansion step.[44] Further, the question of internal or external growth is often investigated. Over the last decades several waves of mergers and acquisition activities can be detected which indicate an attempt especially by large companies to grow externally during the upturns.[45]

The high number of different models which postulate to describe the expansion process of a company show the complexity of firm growth. Further, the various influencing factors – firm-specific, industry-specific and macroeconomic components – on this expansion process add even more complexity especially because they are dynamic and their effect might be different depending on the development stage of the company. Although there is – sometimes a stronger, sometimes a weaker – empirical evidence for the specific factors influencing the firm growth, the stochastic component of the growth process might still be predominant.[46] Can the theoretical work to date maybe help to shed more light on the complex phenomenon of firm growth?

41 See among others Baumol (1962) and Arrow (1958).

42 See among others Gutenberg (1942) and Ludwig (1978) for optimization models, Albach (1965) and Kieser (1970) for simulation models as well as Bleicher (1991) and Pümpin, Wunderlin (2005) for life cycle models.

43 See Albach (1976), Albach et al. (1984) and Albach et al. (1985).

44 See among others Johanson, Vahlne (1977) and their updated Uppsala internationalization model in Johanson, Vahlne (2009) as well as Maitland et al. (2005) for (un)clustered investments in international markets.

45 See Müller-Stewens (2012) for the trend of *M&A waves*.

46 See also Marsili (2001): p. 18 who states: "In short, the empirical evidence suggest that although there are systematic factors at the firm and industry levels that affect the process of firm growth, growth is mainly affected by purely stochastic shocks, especially in the short term and in the case of new firms. These shocks reflect idiosyncratic, and apparently non persistent, factors specific to a firm or to an industry, factors that are mainly unrelated to firm size."

2.3 Theoretical Perspectives of Growth

The early approaches of the neoclassical theory on firm growth are based on the idea of an *optimal size* of the company.[47] A firm aims to produce at the profit-maximizing level which is connected to its optimal firm size. The costs to manage the large company are compared to the economies of scale of its production. After reaching the optimal size the company has no more incentive to grow anymore. Growth serves as a means to reach the profit-maximizing production level. But this approach seems not very helpful and too easy to meet the high complexity of the growth process.[48] But this idea was the precursor of Penrose's contrary resource-based approach formulated in her famous monograph "The Theory of the Growth of the Firm" in 1959.[49] Firm size results just from to the company's development in the past and has basically no limits; nevertheless companies have different capacities of the needed resources. Further, firm growth is just limited by the managerial capacity and attention because the company's expansion is the outcome of required human resources for the management. Besides, the personal motives of the managers increase the potential growth opportunities. Additionally, managerial resources become vacant as managers become more and more experienced and develop routines for their administrative tasks because of efficiency gains – Penrose calls these newly created resources based on growth "economies of growth".[50] In addition, growth can act as a motivating element for the managers of a firm because it can be accompanied with a higher salary and bonuses but also with increased power and a potential promotion.[51] Further theoretical work tries to explain growth by evolutionary principles, among others. But can these theories help to understand firm growth? To some extent.

Although, the phenomenon of firm growth has been studied frequently based on theoretical approaches and empirical work Coad summarizes "that firm growth rates are remarkably idiosyncratic and that it is quite difficult to generalize across the growth experiences of firms".[52] Further, the idea of a representative firm as research object – still used in some of the empirical studies on firm growth – can be misleading. The homogeneity of companies even of the same industry is not given.[53] Firms and their growth process seem to be heterogene-

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47 See among others Viner (1932).
48 Coad calls the *optimal size* "a statement of faith" and suggests to "un-learn it quickly" (Coad (2009): p. 101).
49 See Penrose (1995) for a reprint of this classic book.
50 See ibid. chapter VI for a more detailed description.
51 See Marris (1964) for the basic ideas of the managerial enterprise.
52 Coad (2009): p. 143.
53 See Griliches, Mairesse (1995): p. 23.

ous and discontinuous. But this is not the end of research on firm growth. Even the opposite is true and Coad admits that more research can advance the understanding of this phenomenon.[54] Therefore, it might be helpful to investigate firm growth in a two-step process. First, the overall development of the sample categorized by certain characteristics should be the beginning of the research process. In a second step, the individual expansions of each firm should be considered to improve the understanding of the underlying idiosyncratic characteristics. Later, the results should be brought together to improve the validity of the totality. But also the previous and ongoing research on declining businesses can help to improve this understanding of the concept of growth. Therefore, what are the special characteristics of a declining business? What are reasons for the downfall of companies?

2.4 Declining Firms and Their Downfall

Investigating the development process of companies, besides the phenomenon of growth, it is also possible that the firm is declining over time – for example indicated by decreasing total sales or a smaller number of employees. This downward process can end in the firm's downfall and its market exit. But what does downfall mean? Based on a legal perspective a company can go into bankruptcy and – as one of the most obvious stages – file for insolvency. In addition, it can be liquidated or dissolved – the firm ceases to exist.[55] In Germany the number of corporate insolvencies has increased tremendously over the last 20 years with a peak of 32,687 in 2009 although this number does not completely reflect the market exits of firms – especially liquidations also occur frequently.[56] But besides these clear incidents a firm's downfall can also mean that the company loses its independence. This can happen for example due to a partial or an entire acquisition by another company or by an investor. Further, two or more companies can merge and form one new organization – *merger of equals*. But often one company has the lead in such a merger and dominates

54 See Coad (2009): p. 143.

55 Since the introduction of the German Insolvency Code (*Insolvenzordnung (InsO)*) in 1999 filing for insolvency does not necessarily mean that the company vanishes. It is still possible to maintain and restructure the company based on an insolvency plan (see § 1 InsO).

56 See Statistisches Bundesamt (2014c): p. 3. For a discussion about the reasons for this increase see Rindfleisch (2011): p. 2 et seqq. and for the number of liquidations as a major driver of a firm's market exit in Germany see Pinkwart, Kolb (2003).

the new founded firm which is then rather comparable to an acquisition.[57] But what are the reasons for the downfall of companies or the declining development process which can lead to a sale of the firm or the loss of its independence?

2.4.1 Exit Rates and Symptoms of Insolvency

Although Whetten states regarding the research on declining businesses and especially based on life cycle theory that “more effort needs to be focused on identifying the sets of problems unique to organizational decline and death”[58]. There are a few concepts trying to explain this downward process in general. An early historical perspective of firm growth and decline was that a large size was a prerequisite for security due to financial strength, economies of scale and the ability to generate innovations by research and development. Therefore, the accompanying understanding of the reason for the death of firms was their small size. The exit rate of smaller firms was assumed to be higher compared to the rates of larger firms. Small companies might be more often affected by a decline and in the end by a downfall than larger firms – thus, firm size as a reason for a declining development. Further, it is assumed that the rate of company downfalls is declining with an increasing time of the existence of the firm – with its age. In the first month after its foundation the risk for the firm’s death is growing. Later the rate is falling again. The so called concept of *liability of adolescence* based on the ideas of organizational ecology can be found in several studies on newly founded companies.[59] Therefore, the exit rate of established and more mature companies, for example also companies which belong to the largest ones in an economy, might be smaller compared to younger and smaller firms.[60] Recollecting the empirical studies of firm growth, however a significant difference of the growth rate between small and large organizations was not proven. But it has to be considered that within these studies failed companies are often not part of the research.[61]

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57 See for example the merger in 2004 between *Sanofi-Synthélabo* (France) and *Aventis* (France/ Germany), the successor company of *Farbwerke Hoechst AG* (see Müller-Stewens, Alscher (2006)).

58 Whetten (1980): p. 354.

59 See Fichman, Levinthal (1991) for the *liability of adolescence* and Freeman et al. (1983) for the concept of the *liability of newness.* Further, see Brüderl et al. (2009) for a study on the development of newly founded German companies.

60 See among others Evans (1987) and Audretsch, Acs (1994).

61 For a comprehensive overview of the literature on corporate decline see Trahms et al. (2013) and Mellahi, Wilkinson (2004) for a critique on the research approaches.

Research on insolvencies which is often based on a structural analysis of financial key figures is focusing on the symptoms of insolvencies and additionally a solid theoretical basis is often missing.[62] Further, filing for insolvency requires at least one of the following three matters of fact; actual or impending insolvency and/or over-indebtedness.[63] The reasons for insolvency which are more like the symptoms of the declining process are therefore legally defined. To better understand the true reasons, a business administrative perspective might be helpful. So what are the dynamic elements within a company triggering this declining process?

2.4.2 Corporate Crisis and Path Dependency

In business administration theory the concept of the company crisis is predominant. The origins of the decline and downfall of organizations are investigated although the definition of crisis is still under heavy discussion.[64] The main objective of this kind of research is to effectively avoid and overcome the crisis or the entrepreneurial negative development.[65] The insolvency can be understood as a subtopic of the corporate crisis and is less strictly defined compared to the legal definition. In business administration theory not only the matters of fact should be considered but also the previous processes and the underlying reasons of the existential crisis – the internal factors for the firm's crisis. As possible reasons the interactions of the top management team or policies were identified among others.[66] It is necessary that the performance-related causes of the strategies, structures and processes of the companies at risk are in the focus of the research.[67] Such research requires a lot of internal corporate data which is often difficult to collect due to the downfall of the company and the data's high sensitivity.[68] Therefore, limitations have to be expected. Nevertheless, it is necessary to work with them in the best possible way.

62 See especially Gemünden (2000) for the theory deficit and for an quantitative analysis see Verband der Vereine Creditreform e.V. (2011).

63 See §§ 17, 18 and 19 InsO.

64 For a comprehensive discussion of the current state of the business administrative research on insolvency and corporate crises see Rindfleisch (2011), especially part B II. She distinguishes between classical and newer organizational theory approaches with numerous sub-approaches.

65 See especially the practitioner research literature in the field of turnaround management like Faulhaber et al. (2009) and Lymbersky (2013).

66 See Trahms et al. (2013): p. 1289.

67 See Rindfleisch (2011): p. 40.

68 Denrell (2003): p. 227 states that "the available sample of organizations usually undersamples failure" and McKinley et al. (2014): p. 104 adds because "the former organizations usually expire and vanish from the radar screen of observers".

Dosi et al. describe companies as packages of specific capabilities as well as the source of organizational routines.[69] The firms' current activities are based on their past activities, capabilities and routines. Further, McKinley et al. investigate the feedback effects of organizational responses to corporate decline and their possible downward spirals.[70] These actions show the characteristics of path-dependency. The future developments of companies – either growth or decline – are restricted by the past processes and follow them due to this path-dependency. Path-dependency, as a process theory and a recent approach in organizational and strategy research, explains exemplarily the tendencies of a company to carry on as usual although there are possibilities for a misleading development. The ongoing development is predominantly explained by *increasing returns* partly due to economies of scale, learning curve effects and high switching costs but in the end with an inefficient result.[71] Based on this theoretical approach, the decline and downfall of a company can also be described as a path-dependent process with an inefficient result like the insolvency.[72] Changing the companies' routines takes a long time. The effects based on the (negative) entrepreneurial developments, organizational processes and these routines can often only be understood with a time lag. Firm growth or decline has to be seen as path-dependent and as a long-term process. Therefore, it is necessary to investigate the development of the companies based on a longer time period, as well.

As mentioned above, the strategies, structures and processes of the companies – the internal factors – have to be investigated to detect and then understand the underlying reasons of a recent corporate crisis to finally overcome it. But to answer the research question of this thesis in hand and focus on the historical perspective of the development processes of companies, in a first step it is necessary to describe the fundamental developments of the companies like their growth or decline trends over a longer period of time as well as their loss of independence or their downfall. Because of this historical perspective an identified company crisis is not able to be solved anymore. Nevertheless, it would be very helpful to discover the underlying reasons for the downfall or the loss of independence to derive strategic implications from these findings to prevent other companies from such a destiny or to ensure growth.

69 See Dosi et al. (2000).
70 See McKinley et al. (2014).
71 See among others Pierson (2000).
72 See Rindfleisch (2011) especially part B II 1.3. Further, it has to be mentioned that a path-dependent decline process is not random and therefore it does not support *Gibrat's law* although the empirical results on corporate growth support this concept.

2.4.3 External Effects for Corporate Decline

To get a better understanding of the decline and downfall of companies it is also necessary to include industry and general environmental factors – the external factors for the firm's crisis. Technological changes, market turbulences or market concentration, entry barriers, political frameworks and demographics as well as cultural changes can send a firm into organizational decline. This happens when the firm's "adaptation or alignment with its niche or domain deteriorates"[73]. Therefore, the firm has to adjust its strategy. Harrigan distinguishes between five possible strategies as a response to a declining environment: 1. Increasing the firm's investment; 2. Holding the firm's investment level until the uncertainties about the industry were resolved; 3. Decreasing the firm's investment posture selectively; 4. Harvesting the firm's investment to recover cash quickly; and 5. Divesting the business quickly.[74] But these strategies are restricted by the firm's available resources like managerial cognition and strategic leadership.[75] Thus, the uncertainties of the industry and general environment factors remain.

The number of growth determinants seems endless and the growth process itself idiosyncratic. Recent research has only shed some little light in this complex process. Although research on a firm's declining process and on the industrial as well as macroeconomic circumstances can help to understand the development of companies, even more research has to be conducted to get a more coherent picture. Overall, empirical studies which are investigating the factors of growth and of decline of companies are rare especially for Germany.[76] Further, the distinction between family and non-family businesses is often not made. But why might this be of importance? What are the specific characteristics of family businesses that make them worth to investigate? And which influencing factors might be affecting the growth or decline of large German family businesses?

73 Trahms et al. (2013): p. 1289.
74 See Harrigan (1980b): p. 27.
75 See Trahms et al. (2013): p. 1291.
76 See among the few Albach et al. (1985), Harhoff et al. (1998) and Woywode (2004).

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