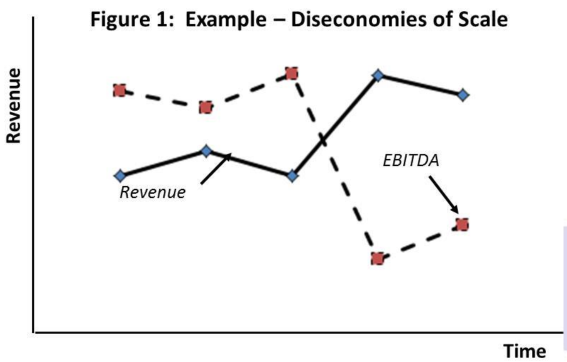
The Fallacy of Size – Achieving Economies of Scale as you Grow

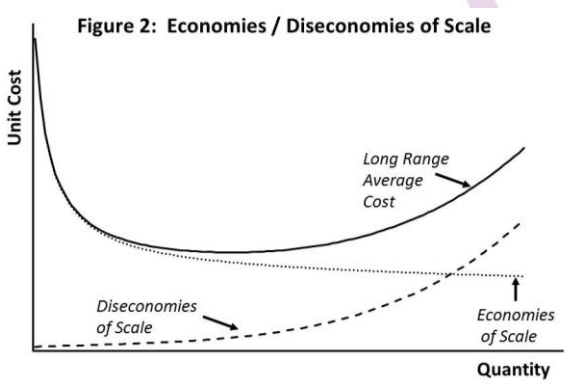
"Size can be a two-edged sword, either improving or eroding a cost position."

Are you failing to see anticipated increases in operating margin as you grow? Have merger synergies been slow to hit the bottom line?

Frequently, corporate leaders equate size with economies of scale. Often, scale is a primary justification for an acquisition or growth plan. One company had increased sales by 50% but saw EBITDA cut in half. In fact, the additional business had generated no incremental margin (Figure 1).



Recall that larger organizations can achieve "economies of scale" and a cost advantage through better utilization of capital, facilities, supply chain, energy and people. **However, size also can create diseconomies** like more organizational layers, slow decision making, and reduced operational flexibility. Size can be a two-edged sword, either improving or eroding a cost position (Figure 2).



Additional Challenge: Frequently, executives point to economies of scale to justify growth, both internally and through acquisition. It may be straightforward to identify and calculate scale benefits in manufacturing plants, but quantifying scale in service organizations is problematic. In fact, services can just as easily experience diseconomies of scale as the complexity of a larger workforce more than offsets the expected savings.

Solution: Companies can still achieve economies of scale but they need to be deliberate in identifying and capturing them.

1. Choose Your Company Structure: Too many companies seek both P&L accountability and economies of scale, with difficult-to-manage matrix organizations. Instead,companies should decide whether they should be a "Holding Company" that will drive performance in each business unit, or an "Integrated Organization" where economies of scale are achieved across the combined company.
2. Seek Economies of Scale: No supplier or internal function willingly volunteers volume discounts or cost reductions. To fully capture economies of scale the organization must identify specific opportunities and pursue each one relentlessly.
3. Eliminate Diseconomies: Diseconomies are those unintended consequences of growth such as decision interia, organizational layers and risk aversion. To successfully grow, the company must quickly identify the diseconomies and implement countermeasures.

To achieve profitable growth, companies must set specific objectives to fully capture economies of scale and avoid diseconomies that erode margins.

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