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Department of Mechanical, Materials and Manufacturing Engineering

The private enterprise

What we will talk about today:

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The private enterprise

- *The private enterprise is the functional unit of management*
- *The business as a framework for the flow of money*
- *The business as a set of activities*
- *The business as a legal form*
- *The business as an organization of people*
- *The objectives of the business*
- *The objectives of owners*

What is a private enterprise?

Definitions and structure

Definitions:

- Just a fancy word for “a business”
- Business is normally a means to create wealth
  - Whether this is the only responsibility (or not) is debated
- Often helpful to distinguish between:
  - Manufacturing industries
  - Service industries

→ But this is not always possible!

- Generally seen as a process to add value

Milton Friedman
1912 – 2006

Broadly, we can distinguish between two different categories ("ideal types")

- **Manufacturing** - i.e. brings in materials, adds value and sells physical goods at profit

- **Service** - e.g. taxi, hairdresser, bank - provides an service for which it is paid

→ It's not always possible to distinguish clearly (e.g. Rolls Royce)

"No, I'm not angry at you, sir.
I'm angry at the random act of fate
that directed your call to my extension."

Businesses have a 'Business Model':

Defined as "a plan for the successful operation of a business, identifying sources of revenue, the intended customer base, products [or services] and details of finance."

We need more basic definitions:

- Sales revenue (or just 'Sales') = financial inflow due to sales
- Cost of Goods Sold (COGS) = input cost + process cost

  → Where input cost is the cost of raw materials , e.g. steel, and the process cost reflects the cost of converting the input, for example energy costs
- Gross profit = sales revenue - COGS
- Added value = sales revenue - input cost
- Operating profit = gross profit - operating costs

An absolutely fundamental point in business:

PRICE $\neq$ COST

- **Cost** is how much is paid or incurred for a product or service
  → Measures how much money needs to be given up to obtain something

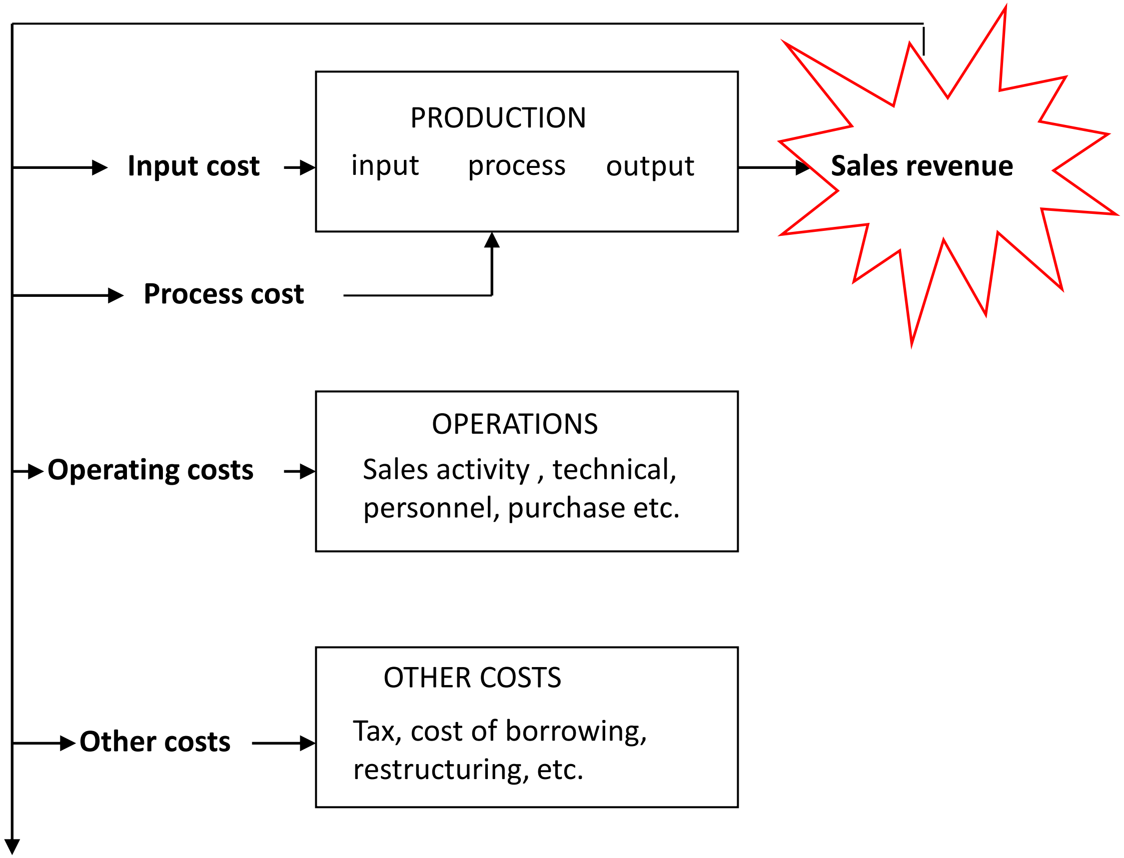
- **Price** is the amount that the market is prepared to pay for it
  → Determined by interaction between a buyer and a seller

- Sometimes price and cost are entirely unrelated

- Price is not always greater than cost!

How money flows in a business:

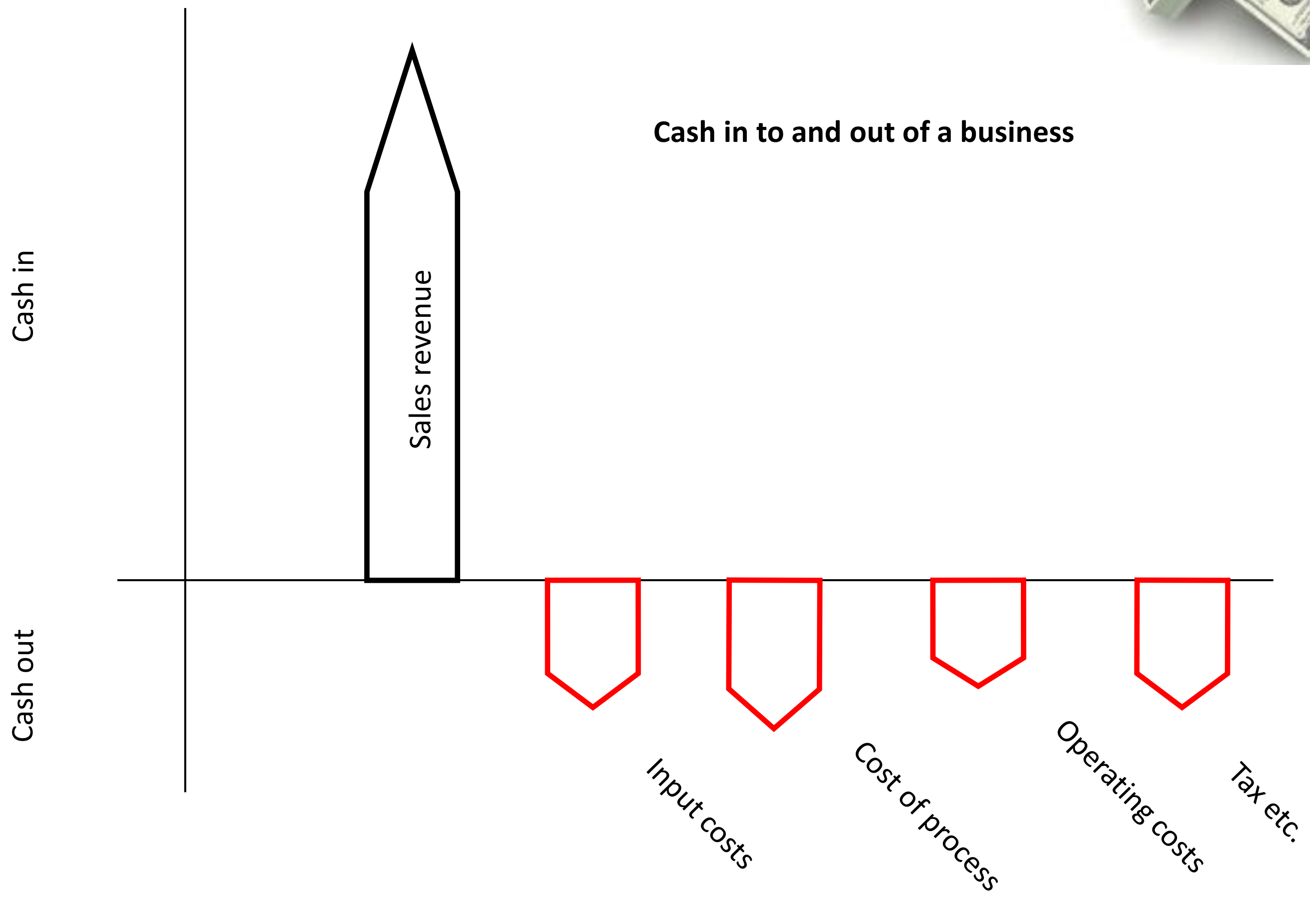
An introduction to the financial structure of a business:



Net Profit
(or loss)

Note that the Sales revenue is the ONLY financial input to the company.

Cash inflows and cash outflows



Ordering cash inflows and cash outflows to show profit

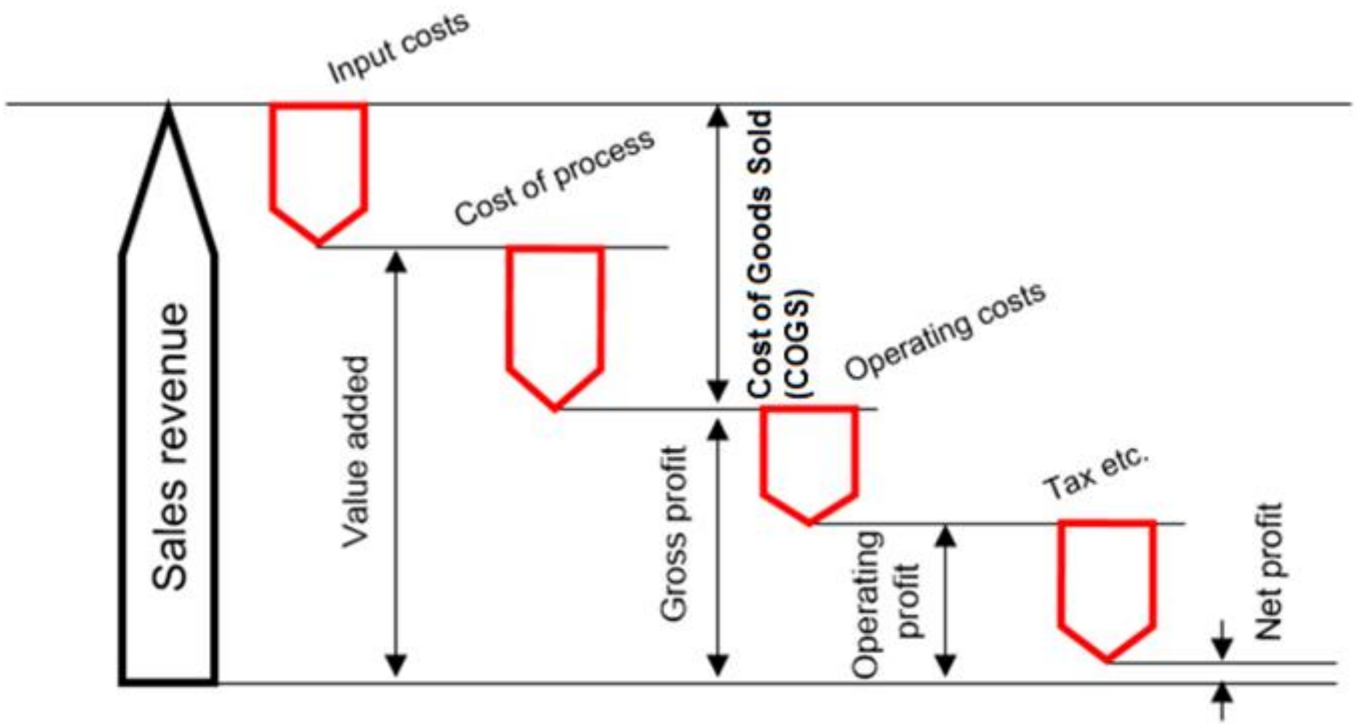
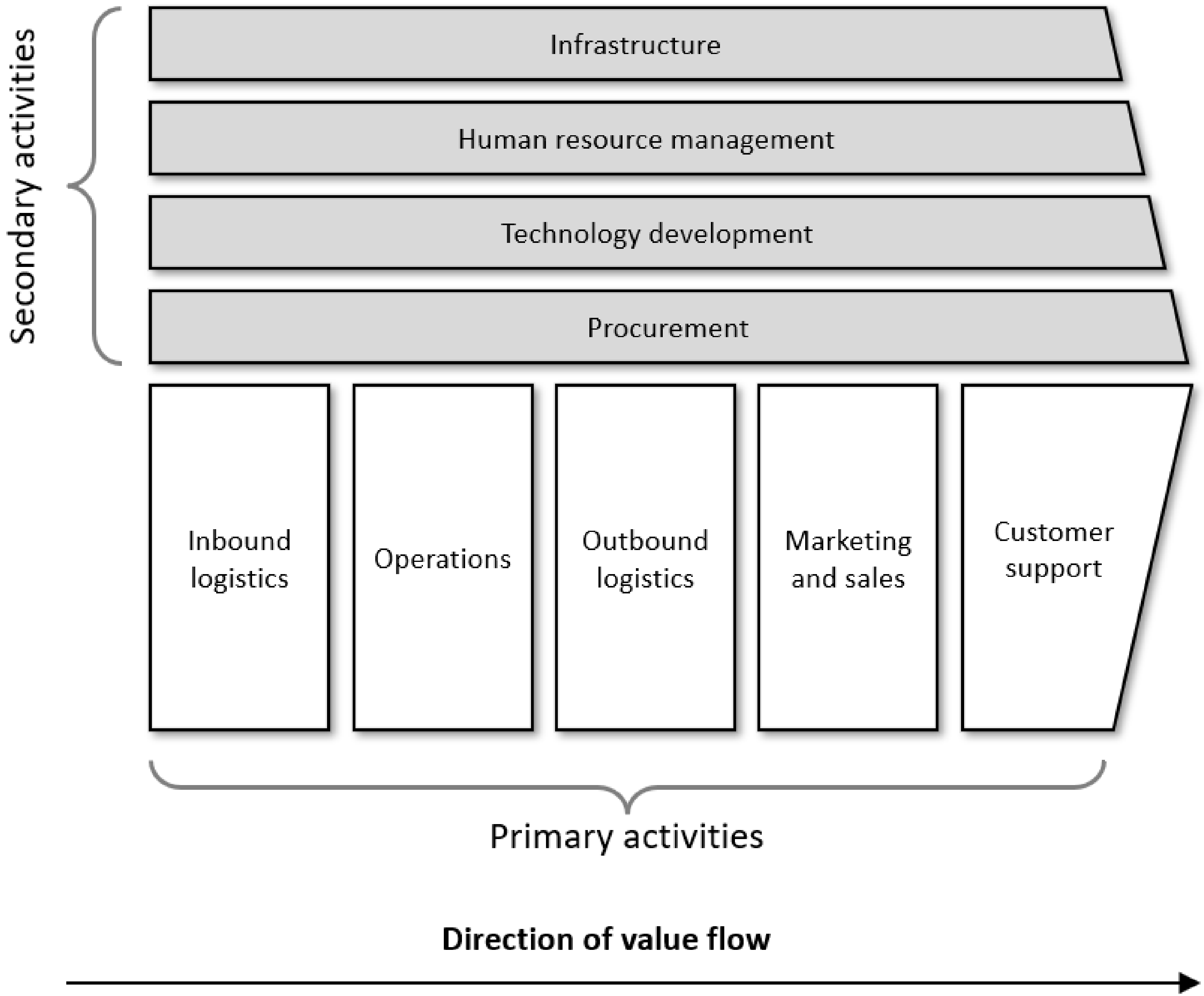


Illustration of cash, costs and profit within a company

The value chain

Developed by management scholar Michael Porter in the 1980s the concept of a value chain is very influential in thinking about businesses.

"A value chain is the set of activities that a business performs with the objective of delivering a valuable product, which can be a good, a service or both, to its customers."


Secondary activities
Infrastructure
Human resource management
Technology development
Procurement
Inbound logistics
Operations
Outbound logistics
Marketing and sales
Customer support
Primary activities
Direction of value flow

Businesses have a legal form

Every business must select a legal structure to follow, referred to as the legal form of ownership

- Decision is made by the founders before the business begins to operate, but businesses can change their legal form later on

- Determines how resources are structured, management roles are administered, taxes are paid and financial information is reported

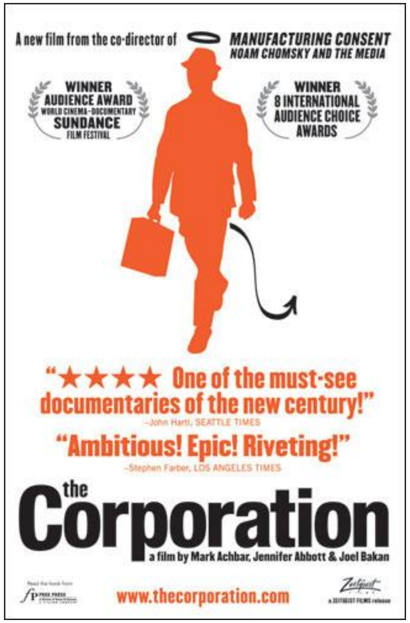
- Legal forms vary from country to country

Company ownership types

- Sole Trader
- Partnership
- Limited Company
    - Private Limited Company
    - Public Limited Company
- This list is not exclusive…

- Day to day management is separated from ownership
- Liability is limited to the money the owners put in

→ Shareholders are not liable for company debt



Shares

Limited companies must have at least one owner who owns a fraction of the company called a share. Collectively, shares are also known as equity

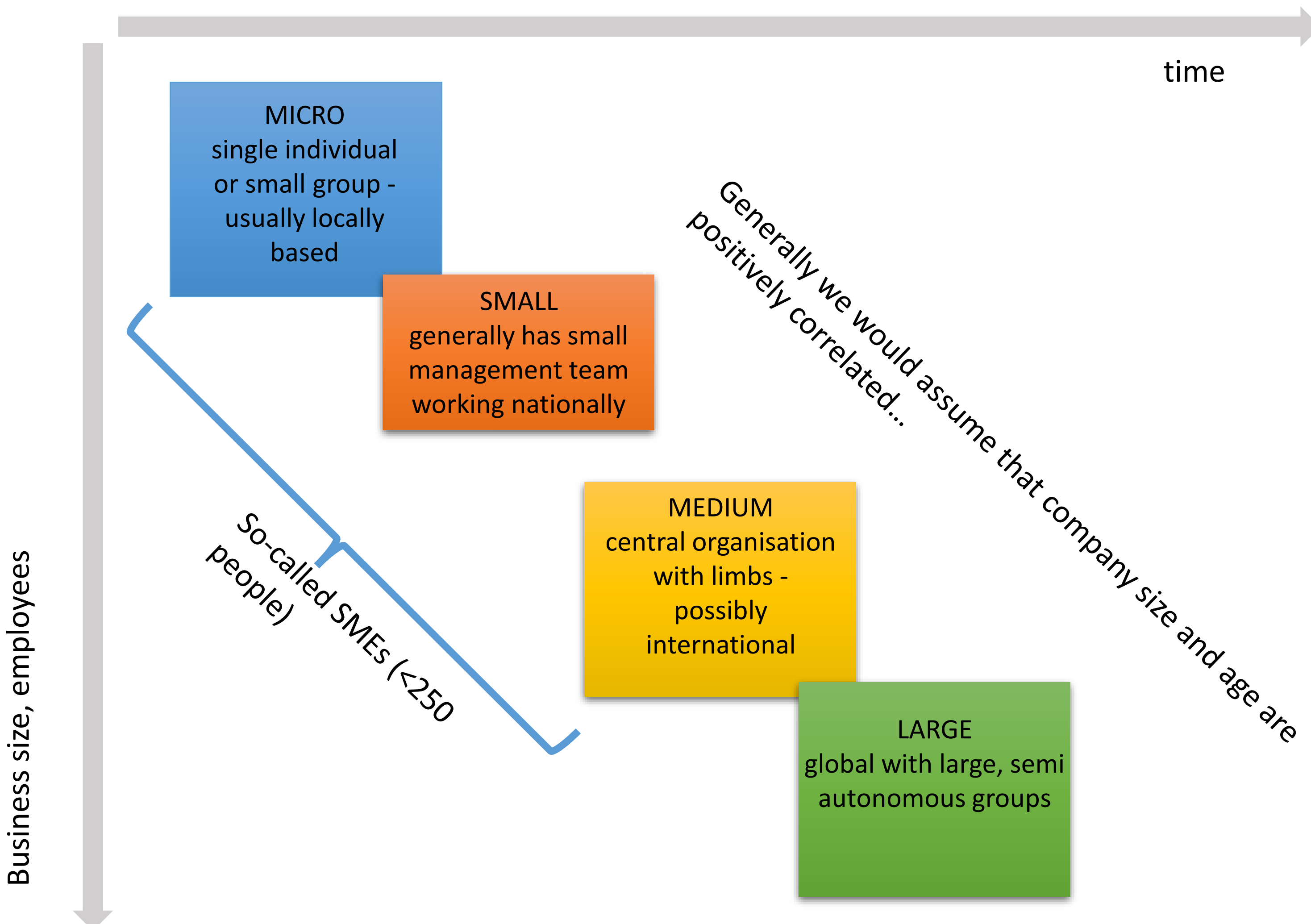
- Confers ownership
- Normally gives shareholders the ability to vote on important decisions affecting the business

Businesses are organisations of people

Every business is also an organisation comprising people to achieve a collective goal

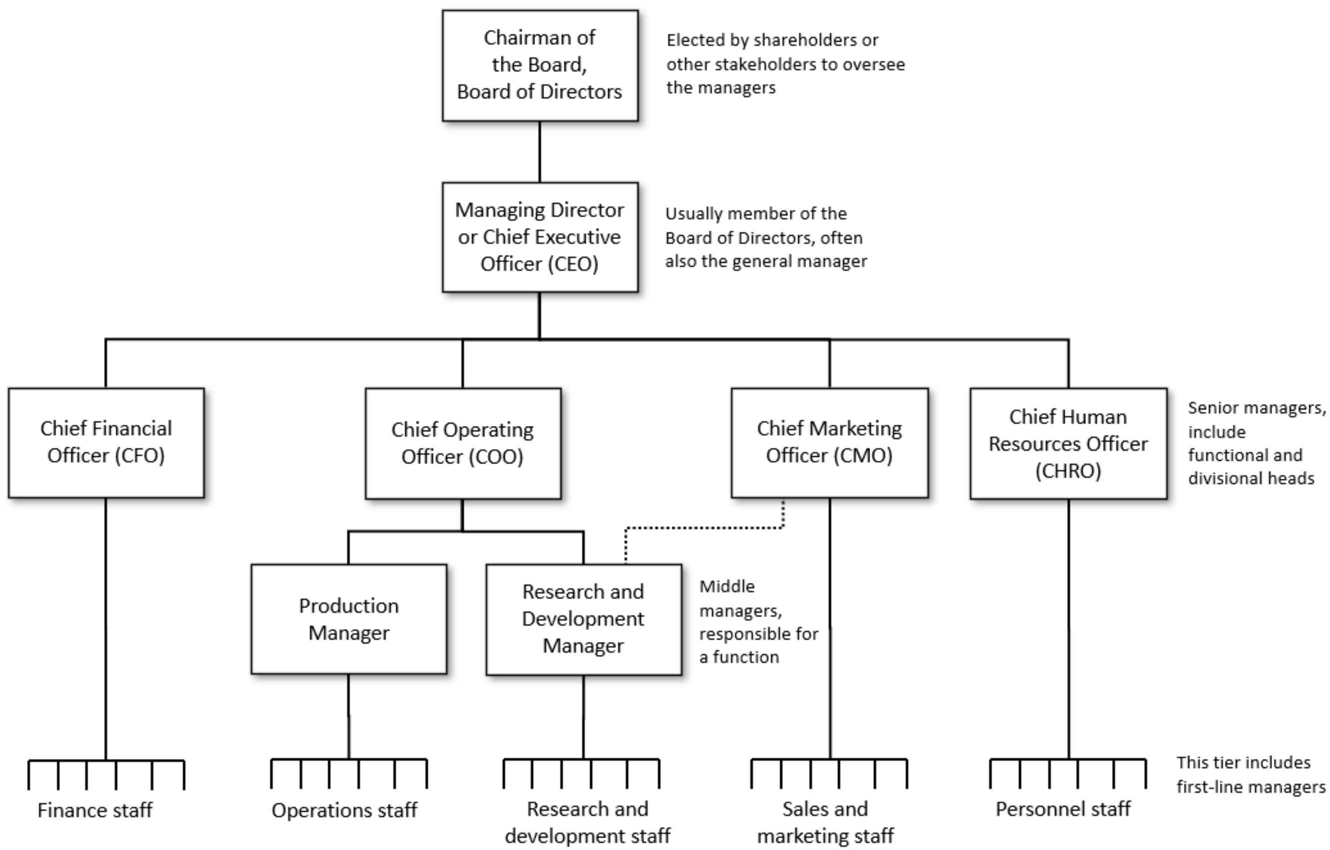
- This perspective deals with who is in the organisation and who isn’t
- Also deals with who has power or authority

Generally, there's a relationship between the size and age of a business



Lines of reporting

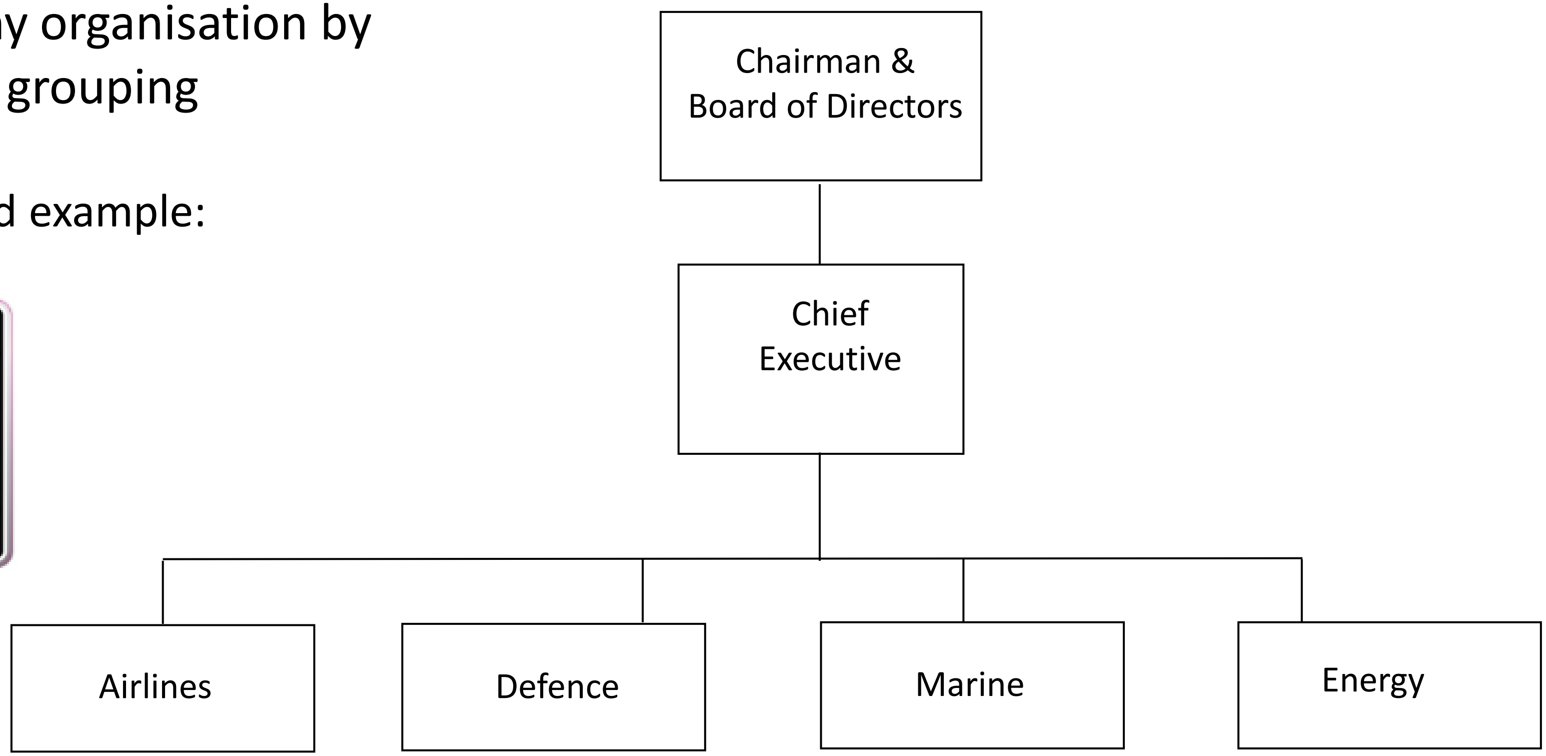
The organisation's structure and who reports to whom in a business is normally shown in organisational charts

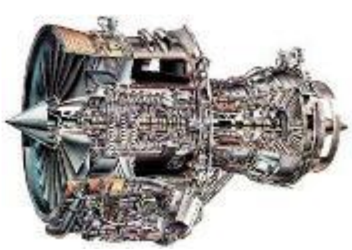


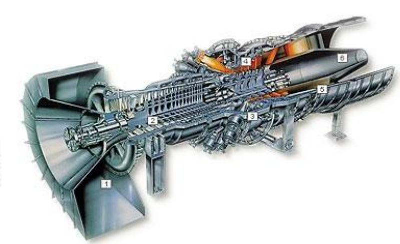
Companies may also be organised by product divisions

Company organisation by product grouping

Simplified example:





What managers in a business do

A business has structure and can set and achieve objectives by:

- Setting targets that the business is committed to meet
- Managing its resources to enable the objectives to be achieved

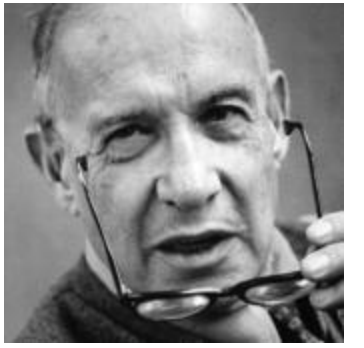
So we need two types of managers
with objectives on different levels…

- "Strategists" who set the objectives and define overall strategy

- "Doers" who manage the resources to achieve the objectives and implement the strategy

A more structured view of business objectives

“Management By Objectives” (MBO) is a strategic model in which managers and employees agree to a set of objectives



Peter Drucker
1909 – 2005

- **Peter Drucker proposed eight criteria:**
  1. Market standing
  2. Innovation
  3. Productivity
  4. Physical and financial reserves
  5. Profitability
  6. Worker performance and attitude
  7. Manager performance and growth
  8. Public responsibility

Some general objectives

Before we can go into detail, it is generally held that a successful company should:

- Continue to grow (may require aggressive or acquisitive approach)
- Show profit
- Gain market share
- Show a dividend for the shareholders

Drucker's concept of “Management by Objectives” (MBO) is about systematically measuring this…

1. Market Standing

- Basic measure: “market share” (share of all revenues in the market)

- Examples of threats that can be identified:

  - Price competitions squeeze small companies out

  - Small companies win in niches that larger companies overlook - e.g. Microsoft

- Large companies also have problems.
  → Consider many steel and "bricks and mortar" retail businesses
- Restrictive legislation
- Become complacent and attract outside competition (e.g. British textile industry)
- Inability to react to technology changes BlackBerry/RIM.
- Vulnerability to disruption

2. Innovation

Alphabet

- To innovate or not to innovate?
- How do product or service innovation? Doesn’t have to be technical → marketing innovation has often led to greater market share
- Focussed innovation? Rolls-Royce or 3M?
- Cost of innovation - Risk of market acceptance (e.g. mobile phones)
- R&D - temptation to make short term cuts versus long term product competitiveness

NOKIA

3. Productivity

- All assets must contribute to productivity
- Measures of productivity:
  - Labour sales productivity = Sales revenue / number of employees
  - Labour profit productivity = Operating profit / number of employees

4. Physical and financial reserves

Possession of the necessary resources to meet its objectives in terms of:

- Employee numbers
- Employee skills
- Capital assets (buildings, machinery etc.)
- Technology and IP (“Intellectual Property”)
- Finance (access to funding to progress towards the objectives)

Additional finance can be raised by:

- Spending company retained profits or other reserves
- Loans from a bank
- Venture capital
- Sale of shares to the public

5. Profitability

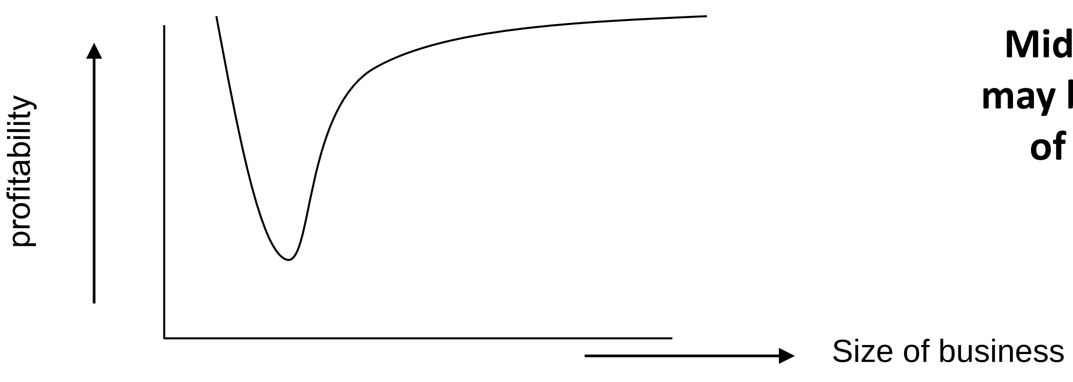
Common metrics for profitability include:

Return on sales	Net profit / sales revenue
Return on assets	Net profit / asset value
Return on capital employed (ROCE)	Net profit / capital employed

More on profitability

Healthy profits allow the company to:

- Maintain and grow physical assets
- Progress research and development, build competitive advantage
- Reward owners - especially in the case on a public limited company

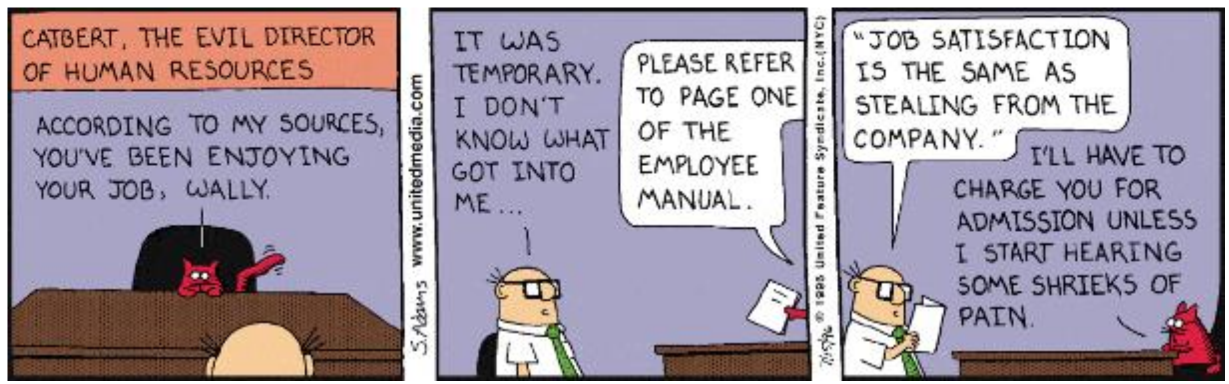


Middle sized companies may be at the greatest risk of low profitability….

6. Worker performance and attitudes

- Drucker recognised that what workers think and feel is important

- Dilbert - "Job satisfaction is the same as stealing from the company!"



- How do we define "workforce" and "management"?
  - Traditionally, managers direct work and implement the strategy of the company
  - With worker empowerment, the differences are becoming blurred…

7. Manager performance

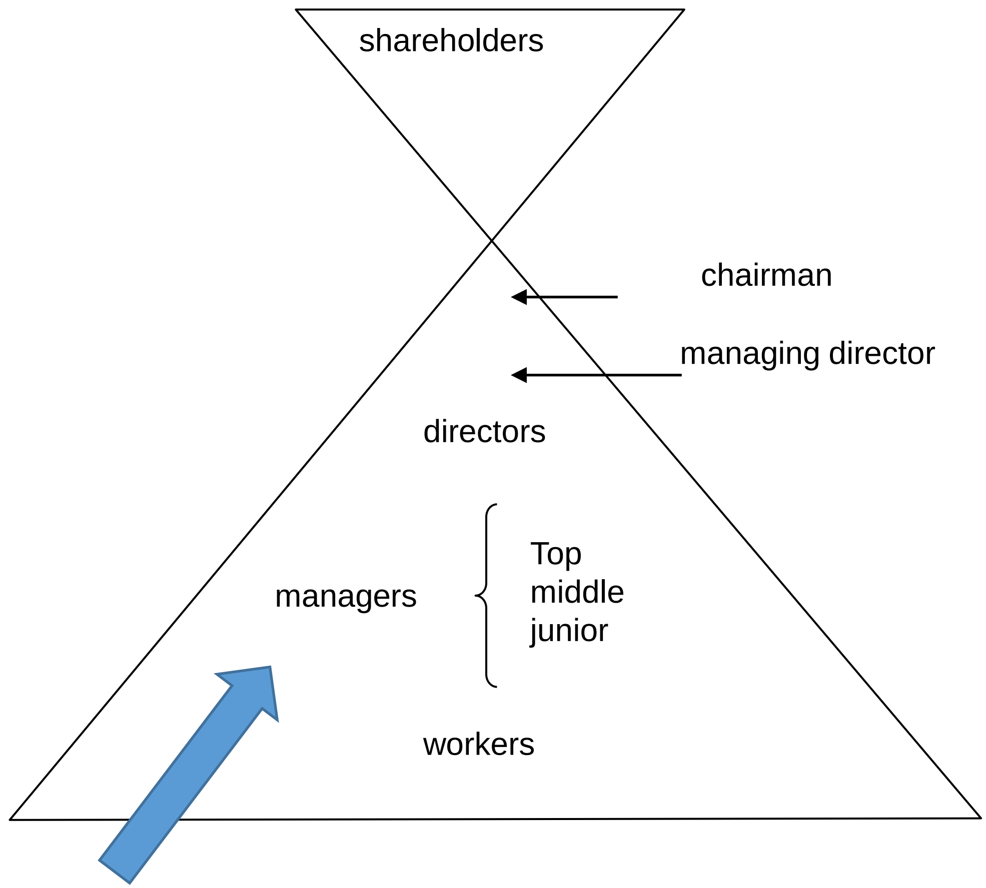
- The performance of a management team can be seen relatively easily

- A measure of management effectiveness is the ability of managers to make the most of the available resources and to maximise:
  - market share
  - profit (in the short and long run)

- An effective management team must have the skills to:
  - plan
  - organise
  - control
  - lead

Management skills requirement and performance

Skills employed	responsibility	Time horizon
general	high	long
specialist	low	short



Note that managers at different levels have different requirements

8. Public responsibility

- Drucker realised that companies have a social responsibility beyond making profits (compare Friedman!).

- Depending on size and structure, companies may prioritise different things, besides profit, e.g.:

    - Education.
    - Support for professional bodies and public institutions.
    - Participation in legislation.

- This is the topic of “Corporate Social Responsibility” (CSR)

The objectives of owners

In unincorporated businesses, the managers and the owners are, in the vast majority of cases, the same people. This implies that there is no difference between the owners' and the managers' objectives

- This is often different for incorporated businesses, especially if they are large
- This can cause the problem of misalignment of the interests between managers and owners
- But managers have lots of autonomy and may decide to serve their own interests → *"principal-agent problem"*

Objectives can also differ between different types of shareholders

"Genuine" investors

- Interested in the long-term success of the business
- Seek to profit from the long-term ownership of shares through capital gains, dividends or through interest payments
- Objectives are normally aligned with those of managers

Speculators

- The characteristics of the business are irrelevant, only attempting to profit from short-term fluctuations in value
- Objectives are not aligned with those of managers and may even oppose them

“Long” and “short” positions

Speculators who attempt to benefit from increases in the share price or the payment of dividends by buying shares are said to have a long position

- Speculators may take the opposite stance and adopt a short position in a process known as short selling

- The goal of short selling is to benefit from decreases in the value of shares

- While this may sound obscure or immoral this is a routine process in the investment community and there are many financial “products” based on short selling

A brief summary of short selling

The principle of ***"short selling"***

The idea of short selling is to exploit decreases in asset values. "Short" products are available as tradeable securities aiming for an inverse reflection of the underlying asset price. It generally works as follows:

1. Obtain temporary ownership of an asset (i.e. share) by renting it for a fee
2. Sell this asset in the market
3. Wait until the value of the asset drops
4. Buy back the asset at a lower price
5. Return it to its permanent owner

The interests of outsiders: takeovers

A further situation in which the objectives of shareholders and managers can deviate strongly is when a hostile takeover of a business is attempted

- The aim of a hostile takeover is to allow an outside bidder to acquire ownership of a business whose managers are unwilling to agree to the acquisition

Tender offer	A tender offer is a public takeover bid in which existing shareholders are invited to sell their shares to an acquirer. This bid is normally significantly above market value and conditional on enough shareholders accepting.
Creeping tender offer	A creeping tender offer is executed by secretly buying shares over a period of time. The acquirer thereby attempts to secure sufficient voting rights to replace the management with one that will approve the takeover.
Proxy fight	In a proxy fight, an acquirer will attempt to persuade other shareholders to use their voting rights to install new managers who will approve of the proposed sale of the business.

Lecture summary in three points

- Introduced the private enterprise by looking at businesses form four perspectives: flows of money, distinct activities, legal form and organisation of people
- Know the different objectives of management (Drucker's eight criteria)
- Understanding that the objectives of owners may be different

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Thank you!