Thought Piece:

Size Matters

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Recent site visits to Shirebrook and Swords served as a reminder of the beauty of ultra-high-volume operations, seen running smoothly. Whether it is the seamless sorting, delivering and selling of 250 million sports apparel units annually or the low-cost transportation of 168 million humans around Europe, seeing both businesses in action highlights their unusual trait - they thrive as they grow. These businesses, by design, get better with increased size; their economic moats widen.

Few companies are engineered this way. Companies that truly operate what has become known as 'scale economics shared' business models are very scarce. Yet most external shareholders of businesses demand growth (preferably perpetual) on the not unreasonable assumption that growth is a primary factor determining returns and corporate value. (Whether all those shareholders really appreciate that a high growth business with a low return on capital destroys value is not always clear).

In fact, excessive growth in the wrong hands can at the extreme, kill a business. Lord Myners once alluded to this:

> *"When it comes to financial companies, growth is not necessarily good and when it comes quickly, it's time to ask questions."*

In his book, Small Giants, Bo Burlingham suggested it was no coincidence that only 4 of the 14 companies he profiled had shareholders who didn't work in the business. Burlingham's book makes the connection that those business owners who wanted to build great companies without chasing growth typically had to eschew external investment.

So there is always tension within companies in determining the appropriate level of growth. Bigger is often, but not always, better.

Growing Pains and Remedies

In the corporate world, growth does not come naturally, it needs to be nurtured, sometimes cajoled and always fed. That feeding often brings unwanted side effects for some companies.

> *"When you double the business, the complexities of your business are probably going to quadruple by that time"* - Joszef Varadi, CEO of WIZZ

In retrospect, a notable side effect of Covid-19 in the corporate world was growing pains. A raft of companies, buoyed by the sudden jump in product demand, added significant capacity within their online businesses. The demand step change ultimately proved temporary, but the side effects of the over build lingered. When the Covid tide receded, stock levels were readjusted, but it took longer to recognise or acknowledge degradation of corporate culture. The better businesses showed they were better tuned to recognise these less tangible and undesirable side effects.

"Our corporate organisation had grown very large, much more senior than in our history, and very expensive. Despite this much higher level of investment, we were not getting more done, but rather less. More senior people meant more people one had to meet with to coordinate plans and to negotiate what to do. This led to long strategy documents extolling plans for a given area, which then took time for others to read. This led to more meetings. This was a bad cycle. " - Niraj Shah, CEO of Wayfair

Niraj Shah's reference to a bad cycle of "more meetings" resonates it seems. Shopify's COO says that a meeting is a bug. To that end, at the start of 2024, Shopify sought to eliminate 12,000 (not a typo!) meetings for the year ahead. The company built an internal meeting invitation system which computes the implied dollar cost of each scheduled meeting in terms of executive time spent. One shared screenshot of a simple one-hour meeting scheduled with seven executives suggested that the computed cost of the meeting would be $2,115 if it went ahead!

Reality Checks

The above examples suggest that businesses need growth plans and organisational structures that are grounded in reality. Could the corporate world perhaps use other real-world disciplines to help design for growth?

For example, an anthropologist might suggest that since corporations are ultimately social entities, it is likely there could be natural limits to the sizing of effective human groups within a company. Diverse examples like Jeff Bezos's 2-pizza meetings, Neolithic tribe sizes or W.L. Gore & Associates 150-person divisional group size limits, all suggest this has some merit. The Gore business (of Gore-tex fame) is a renowned follower of Dunbar's Number, and it seems to be highly effective. Dunbar, himself an anthropologist, describes his rule of thumb informally as "the number of people you would not feel embarrassed about joining uninvited for a drink if you happened to bump into them in a bar." The fact that Gore has 12,000 employees is a reminder that this innovative organisational structure is not an impediment to growth, rather a highly effective way to design for it.

Nature too, might be a useful reference for growing our human-designed corporate systems. Trees don't grow to the sky. Nature, by design, insists on buffers, uses redundancy and is extremely patient. Nature is also subject to atrophy. Atrophy is very real in the corporate world (aka fading returns) and is a headwind that long-term organic growth forecasts perhaps too often ignore.

Perhaps base rates (i.e. studying history) can also provide a useful sense check. Michael Mauboussin undertook an extensive study of the median growth rates of companies in the Russell 3000 from 1984-2000 to derive a database of base rate levels of growth and profitability. The study found, unsurprisingly, that optimism and over-confidence are common in forecasts. As Mauboussin puts it: *"Executives and investors commonly rely on their own experience and information in making forecasts (the "inside view") and don't place sufficient weight on the rates of past occurrences (the "outside view")."*

Right Sizing

So is there a 'right size' for a company at any given time? Hard to say. Perhaps it is more useful to invert the question and to ask whether we can identify when a company is not right-sized. In such a case, it is either not taking advantage of growth opportunities (too small) or has not put the corporate structure in place to run the business at a larger scale and has grown too quickly (too large).

A primary responsibility of any CEO is capital allocation, which also means resource allocation and, correctly sizing the business. The corollary also means downsizing if growth has been too fast. A former Nike CEO was reported to have called the Apple CEO for advice after he became CEO of Nike. Steve Jobs' advice? "Just one thing: Nike makes some of the best products in the world. Products that you lust after. But you also make a lot of crap. Just get rid of the crappy stuff and focus on the good stuff." Jobs basically told Parker to right size the portfolio.

This can be a tricky task for CEOs to acknowledge considering that most executives are explicitly incentivised to find and realise growth. Simon Wolfson, CEO of Next, was candid recently on the dangers of setting explicit growth targets. *"The risk is that if targets are set, they will be met"* he told us. Wolfson's point is not that growth targets are easy to achieve. Rather, his point is that if growth is made a primary target (in the absence, say of return on capital or other constraints), the incentives are high to reach that target, possibly at the expense of other unintended consequences.

Constraint Breeds Productivity

Constraint breeds creativity. You see this in start-up organisations or in companies that have cut out the corporate bloat. Famously, WhatsApp had only 34 engineers serving its then 450m users when it was sold to Facebook for $1.9bn in 2015. Today, Telegram another huge social media business counts circa 900m users but has only 50 full-time employees (and no HR department!). Clearly these are the exceptions, the outlier beneficiaries of global, highly scalable platforms, but their efficiency is nonetheless a thought-provoking example of what can be achieved from small employee headcounts. AI might create (or indeed release) another raft of such small beauties.

Jim Simons of Renaissance Technologies once recounted his investment principles. Number one on his list of principles is to 'be guided by beauty'.

> "*Just as a great theorem can be very beautiful, a very very well-run company that's really working on all things very very efficiently, that can be beautiful.*"