Tourism Management 32 (2011) 667–674

Contents lists available at ScienceDirect

Tourism Management

journal homepage: www.elsevier.com/locate/tourman

Growth-focused or profit-focused firms: Transitions toward profitable growth

SooCheong (Shawn) Jang*

Department of Hospitality and Tourism Management, Purdue University, West Lafayette, IN 47907-0327, USA

ARTICLE INFO

Article history:
Received 24 February 2010
Accepted 28 May 2010

Keywords:
Growth
Profit
Profitable growth
State transition
Liquidity constraint
Free cash flow
Firm size

ABSTRACT

Profitable growth is the most desirable state tourism and hospitality firm managers can hope to achieve. In reality, however, it is not easy for a tourism and hospitality firm to consistently grow and accumulate profits. In order to achieve profitable growth, some firms focus on sales growth while victimizing profits, while others concentrate on profits and hold off on growth. To better understand these strategies, this study investigated the growth state, profit state and transitions of restaurant firms. The findings of this study supported that profit-focused firms are more likely to achieve profitable growth than growth-focused firms. In addition, growth-focused firms with low liquidity had a higher likelihood of transitioning to a state of low growth and low profit in the short-term, and this liquidity effect was more serious for small firms in terms of long-term performance. Further, when profit-focused firms had few growth opportunities, large free cash flows increased the likelihood of transitioning to a state of low growth and low profit in the short-term. More detailed results are provided in this paper.

1. Introduction

Growth and profit are important goals in managing firms. In general, tourism and hospitality firm managers hope to pursue both growth and profit, but it is a difficult task to simultaneously achieve these two objectives in the real business world. Hence, companies often follow either growth-focused or profit-focused tracks in order to ultimately achieve profitable growth. However, which track is more advantageous in terms of moving toward profitable growth remains equivocal.

For business managers, sales growth has been considered one of the most important goals (Brush, Bromiley, & Hendrickx, 2000; Davidsson, Steffens, & Fitzsimmons, 2009; Jekanowski, 1999). Hubbard and Bromiley (1994) claimed that sales growth is the most common business objective for managers. In academia, it is commonly accepted that growth draws the profit cart. According to theories such as scale economies (Besanko, Dranove, & Shanley, 2004; Gupta, 1981) and first-mover-advantage (Lieberman & Montgomery, 1988), growth can lead to future profits due to reduced costs and a more advantageous market position.

However, recent studies have revealed that growth is not the antecedent of profitability (Chathoth & Olsen, 2007; Markman & Gartner, 2002). Further, Aaker and Day (1986) and Gartner (1997) stated that rapid growth could seriously inhibit firms' profit generation. Davidsson et al. (2009) recently claimed that firms with high growth and low profit (i.e., HG-LP, growth-focused firms, or GROWTH) are more likely to reach a state of low growth and low profit (i.e., LG-LP, or POOR) when compared to low growth, high profit firms (i.e., LG-HP, profit-focused firms, or PROFIT). In addition, they stated that profit-focused firms are more likely than growth-focused firms to transition to a state of high growth and high profit (i.e., HG-HP, or STAR). Davidsson et al. (2009) claimed that profit-focused firms are in a better position to reach profitable growth in the future than growth-focused firms.

Despite their valuable exploration, Davidsson et al. (2009) used limited samples in their study, such as small and medium-sized firms. Thus, their results lack generalizability in terms of firm size. Furthermore, they failed to investigate what drives firms' transitions from one state to another, which is very important information for firm management. In order to better understand firm strategies for growth and profit, as well as to better comprehend the transitions between firm states, it is necessary to investigate what factors drive these transitions.

In addition, even though there is a need for research on firm growth and profit in the academic field of tourism and hospitality, few studies have been conducted thus far. Lack of research is not an indication that the subject is not important in the tourism and hospitality industry but instead signals how little attention has been paid to the subject in academia. Past tourism and hospitality studies have dealt with firm growth and internationalization (e.g., Park & Jang, 2010; Singh, Upneja, & Dalbor, 2003) and with mergers and acquisitions (e.g., Park & Jang, in press), but firm growth has not

* Tel.: +1 765 496 3610.
E-mail address: jang12@purdue.edu

0261-5177/$ – see front matter © 2010 Elsevier Ltd. All rights reserved.
doi:10.1016/j.tourman.2010.05.023

yet been examined in association with profit. In order to fill this research niche, this study investigated growth-focused and profit-focused firms, their state of transitions, and drivers of the transitions. Consequently, this study is unique in the sense that it is comprehensive enough to reveal how a firm can achieve a profitable growth state in an efficient way.

Based on a review of the literature, this study incorporated two hypotheses that currently help guide the field's understanding of transitions between firm states: the liquidity constraint hypothesis and the free cash flow hypothesis. The finance theory of growth (Carpenter & Petersen, 2002) suggests that low liquidity prevents persistent firm growth (Fazzari, Hubbard, Petersen, Blinder, & Poterba, 1988; Wagenvoort, 2003) and this constraint is more serious for small firms (Carpenter & Petersen, 2002; Oliveira & Fortunato, 2006). Even when low-liquidity firms have growth opportunities, their ability to invest is constrained by the deficit of internal financial resources, which in turn prevents persistent firm growth. Thus, the liquidity constraint hypothesis is appropriate to explain growth-focused firms because these firms might be more likely to experience liquidity problems than profit-focused firms.

On the other hand, agency theory (Jensen, 1986; Jensen & Meckling, 1976) indicates that internally generated cash flow in excess of positive net present value (NPV) projects (free cash flow) allows managers to pursue personal interests, which are not aligned with shareholders' interests. A free cash flow surplus could be used for negative NPV projects, which in turn damages firm performance. Thus, the free cash flow hypothesis explains profit-focused firms that have few growth opportunities because these firms are more likely to have excessive cash flows.

Overall, the main purpose of this study was to investigate the transitions of growth-focused and profit-focused firms and to determine what drives these transitions. This study used U.S. restaurant firms for its sample. Thus, the more specific objectives of this study were: 1) to investigate whether growth-focused restaurant firms are more likely to reach a state of low growth and low profit as compared to profit-focused restaurant firms; 2) to examine whether profit-focused restaurant firms are more likely to reach a state of high growth and high profit when compared with growth-focused restaurant firms; 3) to determine if the liquidity constraint hypothesis significantly explains the transition of growth-focused firms; and 4) to test whether the free cash flow hypothesis is valid in accounting for the transition of profit-focused firms.

2. Literature review

2.1. Growth draws the profit cart or profit draws the growth cart?

As noted, some theories suggest that sales growth drives profitability through cost reduction or stronger market positions (Besanko et al., 2004; Gupta, 1981; Lieberman & Montgomery, 1988). However, empirical studies have not consistently found that growth has a positive impact on profitability. Capon, Farley, and Hoenig (1990) reported that growth is consistently related to higher financial performance. Also, Chandler and Jansen (1992) and Mendelson (2000) discovered significant positive correlations between sales growth and return on sales (ROS). On the other hand, Markman and Gartner (2002) found no significant relationship between growth and profitability and even Reid (1995) reported that growth has a negative effect on profitability. Further, Gartner (1997) proved that rapid growth inhibits profit generation due to the serious organizational challenges such growth entails. Aaker and Day (1986) argued that growth is not an essential indicator of sustainable success in business, instead competitive advantage is more important. Chathoth and Olsen (2007) also claimed that growth strategies do not guarantee a significant sustainable performance in the restaurant industry. Consequently, the proposition that growth draws the profit cart is supported by some relevant theories but is still empirically ambiguous.

If a firm shows high profitability but low growth, the firm is creating a product or service that has considerable value above cost and the firm has a competitive advantage in the market (Alvarez & Barney, 2004; Amit & Zott, 2001). As explained earlier, Davidsson et al. (2009) argued from a resource-based view that firms with low growth and high profits (LG-HP) are in a better position to achieve profitable growth in the future than firms with high growth and low profits (HG-LP). First, since firms with LG-HP have a competitive advantage in the market, if the market potential is not exhausted there is an opportunity to grow profitably. However, firms with HG-LP could lose this growth potential due to low competitive advantage, which might result in a state of low growth and low profitability. Second, as the pecking-order theory suggests, firms with LG-HP might retain more internal cash flows than firms with HG-LP, which suggests that profit-focused firms are better situated than growth-focused firms in terms of the cost of capital.

Thus, following Davidsson et al. (2009), this study hypothesized that restaurant firms with HG-LP are more likely to reach a state of low growth and low profit (LG-LP) than restaurant firms with LG-HP (Fig. 1). On the other hand, restaurant firms with LG-HP are more likely to reach a state of high growth and high profit (HG-HP) than restaurant firms with HG-LP.

Hypothesis 1. The likelihood of transitioning to a state of high growth and high profit (STAR) is higher for restaurant firms with low growth and high profit (profit-focused firms) than restaurant firms with high growth and low profit (growth-focused firms).

Hypothesis 2. The likelihood of transitioning to a state of low growth and low profit (POOR) is higher for restaurant firms with high growth and low profit (growth-focused firms) than restaurant firms with low growth and high profit (profit-focused firms).

2.2. Liquidity constraint hypothesis for growth-focused firms

The internal finance theory of growth (Carpenter & Petersen, 2002) argues that low liquidity could be a serious obstacle to firm growth. Myers and Majluf (1984) partially supported this notion by stating that firms whose values are largely determined by growth opportunities face more severe financing constraints due to asymmetric information. According to pecking-order

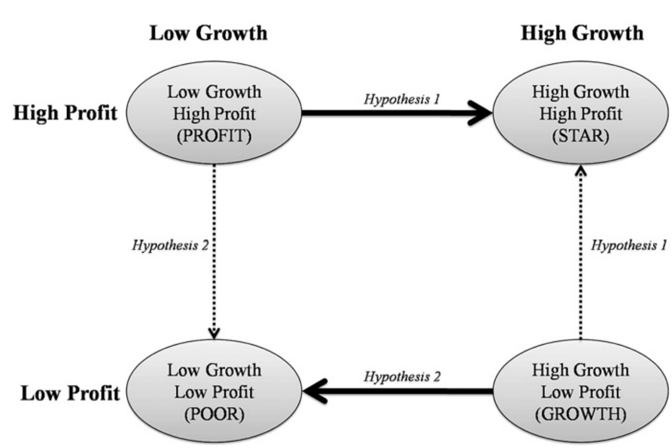

Fig. 1. Diagram for Hypotheses 1 and 2.