

**ENTREPRENEURSHIP AND SMALL FIRMS - 4<sup>th</sup> Edition**  
*DEAKINS AND FREEL*

**CHAPTER 8: ENTREPRENEURIAL AND GROWTH FIRMS**

**CASE STUDY: NICHOL- MCKAY LTD**

The following information provides detailed information on the case study, Nichol McKay, that has been referred to in the main text in Chapter 8. A suggested assignment, based on this case was given in Chapter 8. The case is presented in two parts; part A and part B. Lecturers can obtain further information on this case and tutor notes in the Lecturer's Manual.

A reminder of the suggested assignment is given below:

## ***Suggested Assignments***

### **Resources:**

The following assignment is based on the Nichol McKay case study provided in the additional student on-line learning resources material. Further information on this case and teaching notes are also available in the Lecturer's Manual.

### **Required:**

Prepare a written report or for a classroom discussion to answer the following:

1. Consider the Nichol McKay case in light of Storey's tripartite model. How closely does Nichol McKay fit the criteria suggested in the model?
2. Where possible, can the direction/nature of cause and effect be determined?
3. At start-up would we have predicted Nichol McKay's subsequent growth and success?

## **Nichol McKay Ltd-Part A**

The firm started in 1977 with little ambition for growth, yet by 1991 Nichol McKay had developed its service from simple steel stockholding to value-added first stage manufacturing. During this time turnover had risen from £132,000 to in excess of £4,000,000, with employment levels enjoying a proportional rise. Resources were available for expansion. In addition, Raymond Nichol was now in a position to give free rein to his growth ambitions.

### **Part A -Background and Early Development**

Driven by dissatisfaction with his current employment and the conviction that there existed an untapped opportunity in a related market, Raymond Nichol, in partnership with a close business contact, Bert McKay, decided that exploitation of the opportunity could be best achieved independently. Thus, Raymond Nichol and Bert McKay resigned from their posts as, respectively, Works Director with a small-medium sized light engineering subcontractor and Value Analyst Manager with a national engineering company.

The opportunity - steel stockholding - had been identified as a consequence of market research undertaken by Raymond Nichol, over a period of 6 months, in his previous employment. Although there existed similar concerns in the region, it was the *a priori* belief of the partners that the absence of a steel stockholder in the locality offered considerable scope for business development. The market research, however, met with mixed response. Many of the companies and industry contacts whose views were canvassed, felt there was little need for such additional provision. Yet, Raymond Nichol and Bert McKay remained convinced of the proposal's viability, believing that, though the market research evidence was inconsistent, a gap remained. Perhaps, significantly, their experience within the industry brought a

belief, 'within themselves', of its prudence. Thus, with a personal investment of £2,500 per director *Nichol McKay Steel Services* began trading in January 1977.

In 1977 the investment of £5,000 was considerable. In addition, the partners "...were fortunate to acquire premises at a reasonable rental" and, as a result of their standing within the local industry, to secure good credit facilities. Consequently, Raymond Nichol and Bert McKay were able to avoid the common use of overdraft funding to finance start-up (note; an overdraft was ultimately required and obtained after 3 months trading to provide operating capital).

Operations during these early stages were typically *ad hoc*. The invested capital was used to purchase materials that the partners felt may be required by local engineering companies and a process of 'phoning around' was initiated. At 32 years old, Raymond Nichol had 17 years industry experience and considerable first hand knowledge of many of the actors. Accordingly, he drew up lists of potential clients from which he and Bert McKay would 'cold call'.

It is interesting to note the growth aspirations of the company (as a proxy for the partners) at this time and the importance of historical context in defining these. In the late 70s, trade unions were arguably at the height of their power. However, from the perspective of the small business manager, whose concerns were primarily with cost minimisation and efficiency, powerful unions constituted a powerful threat. Both Raymond Nichol and Bert McKay had occupied management positions within companies employing in excess of 100 individuals and had first hand experience of the effects of labour disputes on cost and efficiency levels. As a result, their initial inclination towards growth was restrained. The determination was to own and manage a small firm employing no more than 5-6 people. However, irrespective of

this lack of growth ambition, turnover within the first year reached an impressive £132,000 (1978).

### **Product / Service Development**

This relative success had been achieved solely through steel stockholding. *Nichol McKay* held crude steel, of various dimensions, for use within the engineering industry. In essence, the company was a 'middle-man' - simply purchasing, storing and selling the material. In this way, no work was carried out on the steel and no value was added.

Although the partners' ambitions for expansion were conservative, this does not equate with a comprehensive unwillingness to grow. The realisation that a broader product or service base may provide greater security and the natural inclination to pursue an identified market opportunity saw *Nichol McKay* expand into limited first stage manufacturing. Raymond Nichol and Bert McKay recognised that there existed a market, where potential customers required 'worked' steel (the provision of tooled parts), in which the company would be able to achieve greater added value from its services.

Such a fundamental shift in the organisation's scope inevitably required a degree of investment to bridge gaps in competence and capital. Machinery and skills were necessary which, though relatively crude by today's standards, were sufficiently more sophisticated than those previously employed. However, the investment strategy adopted was circumspect, reflecting both resource constraints and the partners' caution. The initial step towards first stage manufacturing was taken after the company had been trading for approximately one year and involved the purchase of a second-hand metal cutting saw. Thereafter, numerous other pieces of second

hand equipment were bought to further expand the level of work which could be carried out on the steel and, hence, increase the amount of value added. The first new machine purchased was for profiling - cutting heavy steel - and cost £14,000 (paid through a hire purchase agreement). The level of capital investment at this time remained essentially modest.

With regards to staffing; *Nichol McKay* pursued a policy of employing 'good' semi-skilled individuals and training them in the necessary skills in-house. Raymond Nichol's own background and competencies placed him in a position to adequately develop the organisation's employees in the appropriate direction and to the appropriate level. This strategy had the further advantage of ensuring that all staff had immediately applicable proficiencies. In addition, the company's relatively small size, at this time, allowed such a policy to be followed fruitfully and kept extraneous expenses to a minimum.

A further illustration of the conservative nature of the partners' investment strategy and operations, during these early stages, lay in their use of a local haulier for distribution and deliveries. The haulier's driver worked almost exclusively for *Nichol McKay* as demand for their services grew. Yet, since resources were not available to purchase a suitable vehicle, the relationship remained a subcontract one in the short term. After three years, when the company were in a position to purchase a second hand truck, this activity was brought in-house and the original driver became an employee of *Nichol McKay*.

## Further Product Development

The consequences of this change in or addition to scope, with regards to growth were considerable. Over the three years immediately following the diversification decision, this shift towards first stage manufacturing started to pay off. After six years turnover had reached in excess of £1,500,000 (1985) and the number of employees had risen to 21. The company, having developed into first stage manufacturing (profiling), had, following a similarly modest investment strategy, further diversified into precision cutting (plasma). These areas were differentiated by the density of metal worked and the precision of cut required. By this stage the company was characterised by the three distinct operating departments which would form the basis of consolidation and future growth:

- Steel Stockholding
- Profiling (Heavy Engineering)
- Plasma (Precision Cutting)

At this point technology presented the company with the opportunity of gaining a competitive advantage within the area of precision cutting. Raymond Nichol and Bert McKay realised the need, and recognised a demand, for improved precision in worked steel. Through trade magazines they were able to identify a 'state-of-the-art' cutting machine which would allow them to capture this technological edge. However, the machine, manufactured by the German company *Trumpf*, would cost *Nichol McKay* £500,000. The company's previous highest spend on a single machine had been between £15,000-£20,000.

Having used *Trumpf* machines in his previous employment, though smaller and less technologically sophisticated, Raymond Nichol was confident of their reliability and quality. However, the capital required to finance this purchase was not available internally and external finance would have to be sought for the first time.

Hire purchase was dismissed, as a means of funding the proposed investment, since the initial deposit required was too large. However, with the assistance of *Coopers & Lybrand*, the company's accountants, *Nichol McKay* were able to identify and secure a £90,000 grant and a £200,000 loan from the *European Coal and Steel Council* (ECSC). With the cost for the machine amounting, ultimately, to £445,000 this left a balance of £155,000. The bank, having been identified as the most appropriate source of financial assistance, required that a business plan be developed justifying this scale of expenditure. Subsequently a term loan was agreed for the appropriate amount. The loans on this machine were paid over seven and eight years respectively, with a moratorium granted for the first year and interest only paid for the first four years. The rationale behind this arrangement was to get the machine working and generating income prior to commencing payments, thus allowing it, in some measure, to pay for itself.

The lengthy process of sourcing funding and the requirement to formulate a detailed business plan, to finally secure the grant and loans, lasted approximately a year. As a result, the new *Trumpf* machine was not installed until January 1987. However, in addition to the gains offered, in terms of precision and turnaround time, a primary advantage of the *Trumpf* machine lay in its ability to work 'around the clock'. Hence, for the two years immediately following initial installation, the machine was run, treble shifting, seven days a week.

The effect of the new machine on costs, precision, quality and, consequently, sales was such that within two years turnover had risen to £2,600,000. Again, the decision was taken on further investment. On the basis of the level of turnover and turnover rise, *Nichol McKay* sought funding for a further two, similar model, *Trumpf* machines. As a result of the company's performance track record, *Nichol McKay* had little difficulty in sourcing the necessary finance for this additional expansion. Both machines were purchased simultaneously at a cost of £900,000 - one through hire purchase, the deposit for which the company was now in a position to post, the other by means of a term loan from the bank. The following year's turnover reached £3,800,000 whilst the number of employees had risen to 37.

A niche market had been identified in first stage manufacturing (flatpacks) and the exploitation of this market begun. In addition, parallel investment was made in machinery to take greater advantage of the related heavy engineering market (profiling). Although the investment in this area was modest by comparison, circa £40,000 at this time, it reflected a determination to maintain the company's three primary operating areas and to avoid abandoning the core and over specialising in the more dynamic plasma technology. Raymond Nichol and Bert McKay remained confident in the belief that there existed an enduring market for all three functions. Increases in turnover and employment were not solely attributable to the purchase of the *Trumpf* machines and the remaining two divisions within the company contributed, if comparatively modestly, to *Nichol McKay's* overall growth.

As the company gained its competitive advantage and increased in size relative to its competitors, it targeted high capital expenditure investment in the latest technology as a means of further development. The technology available increased efficiency and, consequently, reduced turn-around times and costs; the more that could be

done to steel at this stage, the greater the added value, and; immediate rivals were not in a position to keep pace with this investment.

## **Comment**

Whilst it is a simple matter to record the effect of this period of intensive investment on the company's growth in terms of employment and turnover, without the relevant accounting data it is more difficult to gauge the effect on standard financial variables such as gearing, liquidity and profit margins (as a result of the company's unincorporated status there was no requirement to maintain historical accounting data - no such data exists). Such information would allow a more accurate evaluation of the risk involved in pursuing this investment strategy. However, the information available would suggest a high degree of risk, more so in light of the company's borrowing history prior to 1985.

## **Premises**

As previously mentioned, *Nichol McKay* had been fortunate, at start-up, to secure adequate premises at reasonable rates. The company occupied part of a, British Airport Authority (BAA) owned, 12½ acre site, adjacent to a major regional airport. However, *Nichol McKay* were only one of a number of, lease holding, tenant companies - albeit the largest. In total there were seven organisations occupying this site.

In 1990 the insecurity and uncertainty associated with this arrangement was identified as an area of potential vulnerability. In addition, the company had grown considerably beyond initial projections and were continuing to do so. Physical scope was required to accommodate current and future expansion. As a result,

negotiations were opened with the appropriate BAA representatives with a view to purchasing the site, in its entirety. The negotiations, described as “...quite straightforward”, concluded with an agreement to purchase the site at a cost of £350,000. Again, relatively smoothly, a £300,000 term loan was obtained from the bank, with the balance met by internally generated funds. *Nichol McKay* changed from tenant to landlord.

Although the gains in assurance, anticipated through this acquisition, were achieved immediately, the desired increases in physical capacity were subject to a longer-term, gradual realisation. The other tenant firms held legally binding leases and it would be a number of years before *Nichol McKay* became sole occupant.

## **Organisational Structure**

Whilst the pace of growth had been admirable, the internal structure of the company, now fourteen years old, had developed slowly and along functional lines (Figure 10.1).

### **Take in Figure 10.1**

In essence, only one layer of management existed between Raymond Nichol, Bert McKay and the shop floor. This layer consisted of four managers based upon the organisation's three distinct operating divisions and the administrative function. These management positions enjoyed notionally equal responsibility and authority, with actual parity of salary. Accordingly, since the areas for which the individual managers were accountable varied in size, there existed discrepancies between the managers' rewards system and their responsibilities. However, more importantly, there was no single executive with sufficient scope of authority to fully deputise for the directors during enforced absences.

This structure, having evolved in line with company development, had seemed appropriate for earlier developments. However, by 1990 Raymond Nichol had begun to identify this feature of the firm as a potential area of weakness for future developments. In the absence of a director to undertake executive decisions it was clear that operational problems may have arisen.

## **PART B - TEAM CHANGE**

The acquisition of its own premises was the culmination of a period of concentrated investment and corresponding growth. Measured in number of employees, the company had grown from 21 (1985) to 47 (1990). This growth is particularly remarkable given that the company's original growth projections envisaged employing 5-6 individuals at most. Although Bert McKay had been equally enthusiastic about the purchase of the first *Trumpf* machine, by the time of the purchase of the second and third machines his enthusiasm had begun to wane. The drive for continuing growth was the ambition of the younger Raymond Nichol. Having achieved, by 1990, turnover approaching £4,000,000 and employing 47 individuals, Bert McKay was justly satisfied with the company's accomplishments. At the age of 55, nine years Raymond Nichol's senior, Bert McKay began to consider retirement.

The company's equity was split on a fifty-fifty basis between Raymond Nichol and Bert McKay. The decision to retire provided Raymond with the opportunity to purchase Bert's shares and assume a 100% equity holding in the company. However, such finance was not available to Raymond Nichol from his private means and, as a result, the company, utilising loan finance, purchased back Bert's equity stake. The consequence of this restructuring of ownership was to allow full rein to the ambitions of Raymond Nichol. Although it is often taken as axiomatic in the entrepreneurship/small firms literature that 'a team grows a business while an individual makes a living', Bert McKay's desire to consolidate rather than grow was at odds with the appetite for growth Raymond Nichol exhibited.

## **Richard Gedge**

As previously mentioned, company employment had risen to 47 by 1990. The management skills required by this expansion were necessarily distinct from those practised during the company's formative years. Yet, Raymond Nichol brought with him considerable experience of managing in a similar environment. The problems which the company's growth created were not directly associated with an absence of competence on the part of the remaining entrepreneur. Rather, they were associated with an inability to maintain effective control of all aspects of the business and the lack of formal processes for the delegation of responsibility (see discussion of organisational structure in part A).

Raymond Nichol recognised the need to recruit an individual who could assist with the operation and control of an expanding administrative function and who would be capable of assuming responsibility for human resource management and development issues. To this end, Richard Gedge eventually joined the organisation.

Immediately prior to joining *Nichol McKay* Richard Gedge had been employed as a management consultant for *Marks & Spencers*. With *M&S* his most recent assignment had been a two year posting in Jersey overseeing the re-organisation of a franchisee. In this role he had primary responsibility for the organisational restructuring, and the related human resource issues, of a company, employing 120 individuals, with a turnover of approximately £20,000,000.

At this point, it is interesting to note the informality of the recruitment, or 'team-building', process. Richard Gedge and Raymond Nichol knew each other socially. Consequently, during conversations about their respective business interests it became apparent to Raymond Nichol that the role Richard Gedge was serving for

*M&S* was similar to that which he had identified as a requisite for *Nichol McKay* - namely, an organisational structure appraisal and the subsequent management of change (if warranted). Hence, after explaining the circumstances within *Nichol McKay*, Raymond Nichol outlined a proposition which would involve Richard Gedge joining the firm - initially on a short-term, task specific consultancy contract, latterly in the role of Company Secretary (a role which, out of necessity, had been previously filled, nominally, by the company's lawyer).

### **Organisational Restructuring**

Richard Gedge's initial role prescription, in joining *Nichol McKay*, was to analyse and report on the prevailing structure of the organisation (figure 10.1 - part A), offering recommendations where appropriate. Although the prevailing structure had been initially appropriate, changes in the size of the firm, its products and services, operating practices and personnel had undermined this legitimacy.

Following analysis, Richard Gedge highlighted the shallow and horizontal nature of this structure as a potential area of weakness. Further insulation between Raymond Nichol and shop floor staff was required to allow greater scope for delegation. In addition, management remuneration should better reflect responsibility and authority, while it was necessary to highlight the appropriate individual(s) who could deputise for the Managing Director.

Richard Gedge formulated a template structure which he believed would more appropriately meet the present and future needs of the company (figure 10.2). This proposal attempted to offer a more vertical structure with greater scope for delegation and clarity of responsibility.

The shift required, to take the company from the situation represented by figure 10.1 and the structure proposed by figure 7.2 was considerable. It was clearly impossible to implement the suggested changes instantaneously. As such, the process employed as a means to achieving the recommended structure would be incremental. A series of continuous small steps, involving the continual reviewing of the management team in light of skills and scope for future development, was deemed the most appropriate method through which an appropriate structure could evolve.

The first of these steps sought to address those issues upon which the structural analysis had placed greatest emphasis - namely, the inability of the prevailing structure to appropriately differentiate the responsibilities of the four managers and the lack of scope for delegation. This phase saw the Trumpf Manager and the Sales and Administration Manager promoted above their colleagues on the basis of responsibility and an assessment of their abilities - with a corresponding change in the wage rates and authority system. In this intermediate structure, which was three tiered with senior management and junior management levels, both senior managers had sufficient authority to deputise fully for Raymond Nichol. This initial change, which had the immediate effect of strengthening the management team, was indicative of future structural developments which were initiated and complemented by ongoing personnel and process monitoring.

## Future Developments

As part A of the case details, the period 1985-1991 saw *Nichol McKay* grow considerably beyond initial aspirations and projections. Employment had risen to 48 and turnover to £4,417,736, with an operating profit of £341,504 (retained profits £253,899). The company had grown through expansion of its initial geographic market, to encompass the whole of the region, and through diversification into related, value added, first stage manufacturing. From the original investment of £5,000, firm growth was such that total fixed assets were in excess of £1,805,000. In addition, the ambition, management team, organisational structure, personnel and capital were available to facilitate further developments. Yet, there existed external barriers to organic growth within the company's current product and service portfolio.

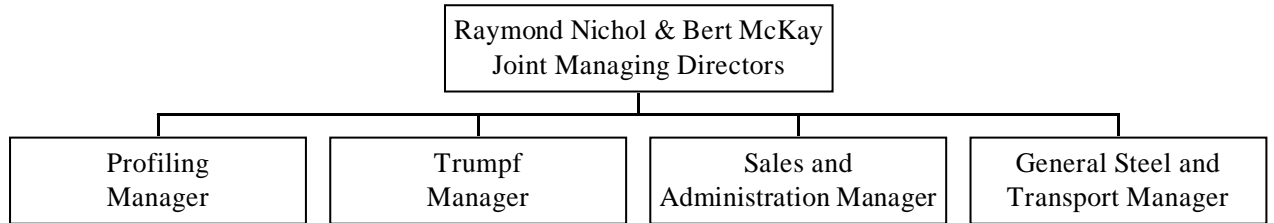
Growth along these lines would have required the company to enter new geographic markets with its existing product(s). The obvious avenue for such expansion was offered within the UK, which would initially avoid the regulatory complications that accompany exporting. However, *Nichol McKay* had been attempting to break into the other regions (such as the Midlands) with little or no success, for two years. The attitude of potential clients was, understandably, "why should we purchase from (the North) when the product/service is available locally?".

Despite this constraint, Raymond Nichol remained determined to grow and began to investigate alternative avenues for expanding his company.

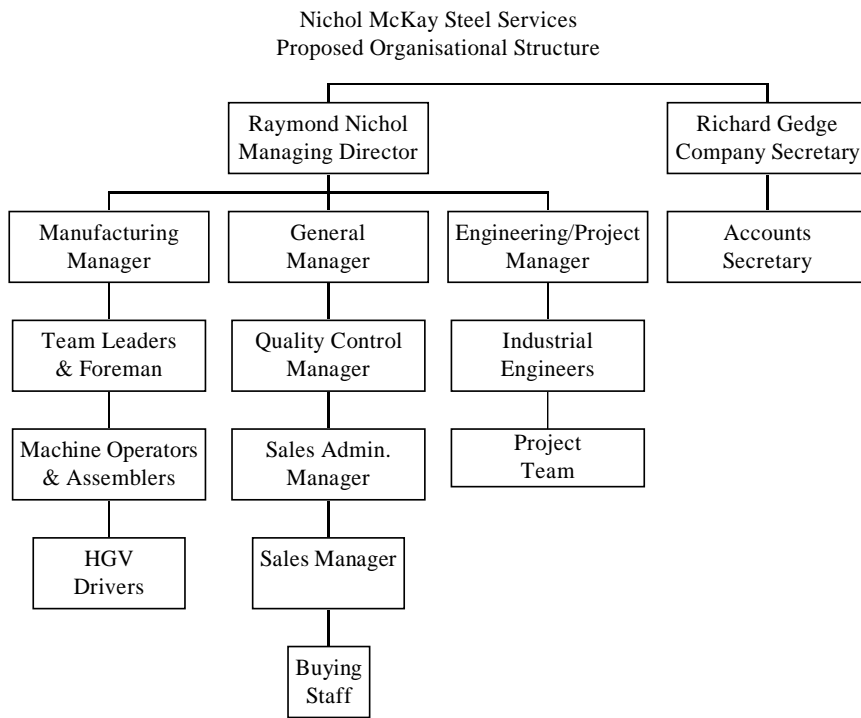
[take in financial accounts for 1990]

**Figure 10.1**

Nichol McKay Steel Services  
Organisational Structure - 1990



**Figure 10.2**



**Financial accounts for 1990**  
**Profit and loss account**  
**for the year ended 31 December 1990**

	<b>1990</b> <b>£</b>	<b>1989</b> <b>£</b>
<b>Turnover</b>	<b>4,417,736</b>	3,808,145
Cost of sales	<u>3,214,121</u>	<u>2,609,317</u>
<b>Gross profit</b>	<b>1,203,615</b>	1,198,828
Net operating expenses	<u>862,111</u>	<u>752,546</u>
<b>Operating profit</b>	<b>341,504</b>	446,282
Interest payable and similar charges	<u>210,038</u>	<u>106,597</u>
<b>Profit before exceptional item</b>	<b>131,466</b>	339,685
Exceptional item	<u>59,500</u>	<u>-</u>
<b>Profit on ordinary activities before taxation</b>	<b>71,966</b>	339,685
Tax on profit on ordinary activities	<u>44,776</u>	<u>108,598</u>
Retained profit for the year	<u><u>27,190</u></u>	<u><u>231,087</u></u>
<b>Statement of retained profits</b>		
Profit at 1 January	<b>418,384</b>	484,297
Redemption of share capital	<b>(191,675)</b>	-
Profit for year	<b>27,190</b>	231,087
Less transfers from reserves	<u>-</u>	<u>(297,000)</u>
<b>Retained profits at 31 December</b>	<u><u>253,899</u></u>	<u><u>418,384</u></u>

## Balance Sheet - 31 December 1990

	1990		1989	
	£	£	£	£
<b>Fixed assets</b>				
Tangible Assets		<u>1,805,914</u>		<u>1,808,081</u>
<b>Current Assets</b>				
Stocks	718,885		389,807	
Debtors	775,270		876,555	
Cash at bank and in hand	144		325	
	<u>1,494,299</u>		<u>1,266,687</u>	
<b>Creditors:</b>				
Amounts falling due within one year	<u>1,940,039</u>		<u>1,642,519</u>	
<b>Net current liabilities</b>		<u>(445,740)</u>		<u>(375,832)</u>
Total assets less current liabilities		1,360,174		1,432,249
<b>Creditors:</b>				
Amounts falling due after one year	659,501		575,192	
<b>Provision for liabilities and charges</b>				
Deferred taxation	106,774		66,423	
Accruals and deferred income	<u>40,000</u>		<u>72,250</u>	
		<u>806,275</u>		<u>713,865</u>
		<u>553,899</u>		<u>718,384</u>
<b>Capital and reserves</b>				
Called up share capital		250,000		300,000
Capital redemption reserve		50,000		-
Profit and loss account		<u>253,899</u>		<u>418,384</u>
		<u>553,899</u>		<u>718,384</u>

<b>Nichol McKay Steel Services - Financial Ratios</b>	<b>1989</b>	<b>1990</b>
Gross Profit Margin	31.48%	27.25%
Operating Profit Margin	11.72%	7.73%
Expenses as % of Sales	19.76%	19.51%
Return on Capital Employed	31.16%	25.1%
<sup>1</sup> Current/Liquidity Ratio	0.77	0.77

<sup>1</sup>Capital Employed taken as; Fixed Assets plus Current Assets less Current Liabilities