FIRM GROWTH, CAPABILITIES, AND PERFORMANCE

A Case Study and System Dynamics based Exploration of the Boom, Bust and Turnaround of an Australian Restaurant Chain
Acknowledgments

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Abstract
This study extends the theoretical knowledge on the dynamic relationships of firm growth, organizational capabilities, and performance. The findings of this study are drawn from a case study and an associated system dynamics model explaining the growth and performance history of an Australian restaurant chain. This study highlights that failure to develop adequate organizational capabilities for managing growth and administrate the enlarged operation is one explanation for why surges of growth are often followed by periods of stagnation or growth reversal among small and new firms. Rebuilding necessary organizational capabilities is a lengthy and costly process that requires substantial investment of financial and human resources and impedes simultaneous growth. The results from the system dynamics model suggest that growing at moderate rates is one strategy to prevent self-induced performance erosion and dilution of growth potential.
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<th>Abbreviation</th>
<th>Full Form</th>
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<tbody>
<tr>
<td>boh</td>
<td>back-of-house</td>
</tr>
<tr>
<td>CBD</td>
<td>Central business district</td>
</tr>
<tr>
<td>CEO</td>
<td>Chief executive officer</td>
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<tr>
<td>cf.</td>
<td>Confer - compare</td>
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<tr>
<td>CFO</td>
<td>Chief financial officer</td>
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<tr>
<td>COO</td>
<td>Chief operation officer</td>
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<tr>
<td>EBITDA</td>
<td>Earnings before interest, taxes, depreciation, and amortization</td>
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<tr>
<td>e.g.</td>
<td>Exempli gratia – for example</td>
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<tr>
<td>et al.</td>
<td>et alii – and others</td>
</tr>
<tr>
<td>etc.</td>
<td>Et cetera – and other things</td>
</tr>
<tr>
<td>foh</td>
<td>front-of-house</td>
</tr>
<tr>
<td>FY</td>
<td>Financial year</td>
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<tr>
<td>i.e.</td>
<td>Id est – that is</td>
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<tr>
<td>IT</td>
<td>Information technology</td>
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<tr>
<td>TV</td>
<td>Television</td>
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<td>vs.</td>
<td>versus – compared with</td>
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1. Introduction

Firm growth constitutes a topic of high interest amongst practitioners, policy makers and scholars within the research fields of entrepreneurship, management and organization theory (McKelvie & Wiklund, 2010; Shane & Venkataraman, 2000). While the benefit of growth for business owners is the opportunity of increased returns on investment, policy makers have an interest in the topic because of the importance of small and new businesses for employment creation and economic growth (Amini, 2004; Dobbs & Hamilton, 2007; Gibb, 2000; Hill, Nancarrow, & Len Tiu, 2002; Mulhern, 1995; Robbins, Pantuosco, Parker, & Fuller, 2000).

Despite the strong interest in the topic, which has spurred a growing number of studies, many questions remain about the phenomenon of firm growth (Delmar, Davidsson, & Gartner, 2003; McKelvie & Wiklund, 2010; Shepherd & Wiklund, 2009). As Wiklund and Shepard (2003) point out, there is a perceived lack of well-founded knowledge about the causes, effects, and process of growth.

The general notion is that growth is a good thing and many blindly believe in growth as the ultimate sign of business success (Davidsson, 1991). However, often neglected by practitioners and academics is that not all growth is good, or in other words growth does not inevitably lead to better firm performance and higher profits (Davidsson, Steffens, & Fitzsimmons, 2009). Instead of improving a firm’s economic position, growth can threaten the very existence of a business (Sharlit & McConnell, 1989). There are many examples across various industries where fast growth was followed by business decline and even bankruptcy (boom and bust) (Gary, Kunc, Morecroft, & Rockart, 2008; Paich & Sterman, 1993). A range of studies on firm growth find that growth is difficult to achieve and even more difficult to sustain (Dobbs & Hamilton, 2007; Garnsey, Stam, & Heffernan, 2006; Hess, 2010;
Kirchhoff, 1994; Storey, 1994; Wiggins & Ruefli, 2002). Prior research on small and new firm growth patterns observe that periods of growth are often followed by stagnation or reversal (e.g. Garnsey & Heffernan, 2005). However, the extant literature on firm growth falls short of theoretically explaining why many companies struggle to sustain continuous growth rates.

While the reasons for failure are manifold comprising both internal and external factors, the internal view for explaining why firms’ growth paths are characterized by discontinuities (Garnsey & Heffernan, 2005) has yet received scant attention in prior research. One explanation that research points at is that many firms struggle or fail to develop the firm internally during the growth process leading to subsequent performance decline. There is evidence in the literature that, growth, in particular fast growth, entails a number of challenges and poses a very difficult managerial task (Hambrick & Crozier, 1985; Hanks, Watson, Jansen, & Chandler, 1993; Hess, 2010). The associated challenges arise because growth adds complexity to the organization and creates a gap in the appropriateness and efficiency of prior configurations of organizational resources, capabilities, and processes requiring organizational change and development (Flamholtz & Randle, 2012; Fombrun & Wally, 1989; Phelps, Adams, & Bessant, 2007). Especially rapid growth strains a company’s culture, people, and resources, posing a difficult managerial challenge to successfully coordinate the growth process with the required internal organizational developments. While some companies successfully overcome the challenges associated with growth, many “stumble” (Hambrick & Crozier, 1985, p. 32). The literature suggests that inappropriate growth strategies and mismanagement of the growth process can overstretch organizational capabilities and result in growth setbacks or even business decline,
and bankruptcy (Garnsey & Heffernan, 2005; Garnsey et al., 2006; Hess, 2010). Yet, detailed studies and theoretical work on this are scarce.

This study aims to provide insights about the complex dynamic process of firm growth and also aims to spur theory building for explaining why firms struggle to sustain high growth rates based on the dynamic resource-based view of the firm (Gary et al., 2008; Morecroft, 2007; Morecroft, Sanchez, & Heene, 2002). The resource-based view is deeply connected with the topics of firm growth and firm performance (Davidsson et al., 2009). The link of the resource-based view of the firm and growth originates from Penrose’s seminal work “The Theory of the Growth of the Firm” (Penrose, 1959, 1995). So far, the dynamic resource-based view of the firm is primarily used in strategy and management theory for explaining performance development of established firms over time based on firm’s development paths of resources and capabilities (Gary et al., 2008). But the integration of the interlinked concepts of resources and capabilities is also an emerging approach in the literature on small and new firm growth (Wiklund, Patzelt, & Shepherd, 2009).

This study presents the results of in-depth fieldwork with an Australian restaurant chain that suffered a drastic performance decline after an early period of rapid growth, leading almost to the company’s bankruptcy six years after formation. It required increased management attention and considerable investment to build the organizational capabilities and achieve a turnaround of the business. In a detailed case study supported by a system dynamics model, this study identifies and explains the causal relationships for the observed boom, bust, and turnaround growth pattern of the studied firm and its internal developments over a period of nine years. The case study approach was used to deal with and capture the complexity inherent to the phenomenon of firm growth. Detailed longitudinal qualitative and quantitative data
was analyzed for building the case study. The system dynamics model was developed adjunct to the case study as another means to increase the understanding of the dynamic relationship of firm growth, capabilities, and business performance.

The study contributes to the extant literature on firm growth in three ways: (a) by providing a detailed case description capturing the process of firm growth based on rich, longitudinal quantitative and qualitative data; (b) by providing an analysis of the dynamic causal relationships of organizational capabilities and firm performance during the process of growth; and (c) by advancing the integration of the concept of capabilities to the literature on firm growth.

The contents of the study are organized as follows: in chapter two, I provide an overview of the extant literature on firm growth and discuss approaches prior research has adopted to investigate growth. The focus is placed on small and new firm growth. Further, I review the literature on firm growth patterns and paths, the link between growth and performance, and research findings on the challenges of growth. In this chapter I also provide the theoretical foundations and define the concept of capabilities in the context of firm growth and its use in this study.

In chapter three, I describe the data that I have used for the in-depth case study and explain the methods used to analyze the data, including the system dynamics approach as another way to analyze the case material.

The results from the case study and the system dynamics model are presented in chapter four and five respectively.

In the last chapter, I discuss the results of the case study and the model simulation inferring theoretical and practical implications, but also hint at limitations of the present study. Lastly, I point out paths for future research and make concluding remarks.
2. Theoretical background

2.1 Approaches to firm growth

The body of firm growth studies has grown in scope and there is now considerable knowledge about the phenomenon (Davidsson, Achtenhagen, & Naldi, 2005). Nevertheless, recent literature reviews of the field suggest that many questions remain about firm growth (Davidsson & Wiklund, 2006; Dobbs & Hamilton, 2007; Wiklund et al., 2009).

Especially the internal dynamics of organizational growth remain opaque and many questions about what happens before, during, and after the growth phase are left unanswered (Freel, 2000; Garnsey et al., 2006). This also includes a lack of insights into the management process of firm growth (Whetten, 1987).

Scholars acknowledge that firm growth is a “multi-dimensional, heterogeneous, and complex phenomenon” (Leitch, Hill, & Neergaard, 2010, p. 250). The complexity and heterogeneity inherent to the topic has led to the development of different theoretical perspectives and methodological approaches. This has caused high fragmentation in the literature, which impedes the development of accumulated knowledge in the field (Davidsson & Wiklund, 2006; McKelvie & Wiklund, 2010; Wiklund et al., 2009). Attempts to classify the literature into coherent streams have been difficult, as shown for example by the works of Coad (2007), Macpherson and Holt (2007) as well as McKelvie and Wiklund (2010). McKelvie and Wiklund (2010) and also Davidsson et al. (2005) have applied a similar approach to organize the literature and identified three rather broad categories of firm growth studies. I chose to follow the broad categorization offered by McKelvie and Wiklund (2010) to briefly discuss the different approaches to firm growth because their study represents one of the most recent and comprehensive literature reviews. I advise the reader to see the original
paper of McKelvie and Wiklund (2010) and also the works of Davidsson et al. (2005), Wiklund et al. (2009), and Dobbs and Hamilton (2007) for exhaustive reviews, for this is outside the scope of this study.

**Growth as an outcome.** The first category treats growth as an outcome. Studies of this stream try to identify the determinants that facilitate or hinder growth mostly using cross-sectional data and multivariate analysis (Achtenhagen, Naldi, & Melin, 2010). This line of research intends to develop a prescriptive model of firm growth and represents the dominant approach in the literature (Dobbs & Hamilton, 2007; Leitch et al., 2010).

Although these studies have an important contribution to make (Garnsey et al., 2006), studies of this category are focused on how much firms grow and have only been able to provide partial explanations of firm growth rates (Dobbs & Hamilton, 2007). Further, Storey (1994) reviewed the most common variables used to predict differences in growth rates and concluded that few, if any, variables have a similar influence on growth across various studies he reviewed. Studies that treat growth as an outcome have also been criticized for their inability to “capture the growth paths of new firms or represent the surges, interruptions and reversals which are to be expected from the operation of dynamic processes” (Garnsey et al., 2006, p. 9).

Moreover, most studies that treat growth as an outcome have a one-dimensional view on growth. The majority of studies of this stream define growth solely as a change in amount and use revenues and/or employee numbers as measures for growth (Davidsson et al., 2005; Delmar, 2006). The firm’s internal developments and other aspects of growth remain largely concealed in this stream of growth studies.
The outcomes of growth. The second category of growth studies is concerned with the outcomes of growth, “and examines the changes that result within the organization as a consequence of growth, with a particular focus on the challenges associated with managing an increasingly larger organization” (McKelvie & Wiklund, 2010, p. 269). This approach to firm growth encompasses an array of stages of development models (e.g. Greiner, 1998; Lewis & Churchill, 1983; Scott & Bruce, 1987), which are often also referred to as stages models or life cycle models (McKelvie & Wiklund, 2010). The focus of these models is not what causes growth but rather how a business adapts during the process of growth.

There is also a body of literature on growth, which does not apply the stages or life cycle view per se (e.g. Arbaugh & Camp, 2000; Fombrun & Wally, 1989; Hambrick & Crozier, 1985; Hofer & Charan, 1984). Yet, these works refer to the stages of development models in identifying managerial problems associated with growth.

The paradigm in these studies is that growth puts the firm’s configuration of resources, structure and systems out of balance (Short, Payne, & Ketchen Jr, 2008), and leads to organizational problems that need to be resolved as the firm reaches different stages (cf. Fombrun & Wally, 1989; Phelps et al., 2007). Thus, as a firm grows, the organizational configuration becomes inappropriate and the firm needs to transform. After the transformation, the firm enters the next configuration and growth stage, where the process is repeated (e.g. Greiner, 1998; Lewis & Churchill, 1983). Different problems must be addressed during different stages of growth, resulting in the need for different management skills, priorities, and structural configurations over the development of the firm (McKelvie & Wiklund, 2010; Van De Ven & Poole, 1995).
The stages of development models have considerable intuitive appeal and are widely popular within practitioner oriented entrepreneurship literature, but also among academics (Levie & Lichtenstein, 2010). However, this approach to firm growth has been increasingly criticized for the lack of theoretical grounding about the firm, the lack of evidence for the number of stages, and the rigidity of the development process as growth is seen as linear, sequential, deterministic, and invariant (Fombrun & Wally, 1989; Levy & Lichtenstein, 2010; Phelps et al., 2007; Stubbart & Smalley, 1999). This view does not correspond with the discontinuities of firm growth paths observed in reality.

In their extensive study about stages models of growth Levy and Lichtenstein (2010) conclude that, “stages models and life-cycle theories of business and entrepreneurial growth […] do not accurately represent the growth and development of entrepreneurial firms. As such, stages models are similar to clear but misleading roadmaps that create an illusion of certainty about the path ahead” (p. 336). The authors then propose an alternative dynamic states approach, which assumes that as an organization grows, it is likely to do so by growing in a series of configurations that can occur in any number and any sequence (Levie & Lichtenstein, 2010). Applying a dynamic perspective of firm growth and associated organizational change seems a promising approach for building theoretical frameworks that are able to explain the non-linearities of growth trajectories and organizational transition observed in real organizations (cf. Levy & Lichtenstein, 2010; Lichtenstein, 2000).

Regardless of the fact that stages models have been criticized for their conceptual foundations, stage approaches do have the merit of making observations at the firm level. Without observations at the firm level, the mechanisms and processes of growth remain obscure (Mohr, 1982). Further, mostly drawn from case studies, the
stages frameworks have a value in making business leaders aware of the challenges of organizational growth and how to resolve related problems (Phelps et al., 2007). Stages models address the occurring management issues in a growing firm and give advice for their resolution and effective management.

**Growth as a process.** The previously discussed literature streams view growth either as a dependent (growth as an outcome of firm attributes) or an independent variable (focusing on the outcomes of growth). Studies concerned with the process of growth fill the gap between the latter two categories, although many overlaps exist between them (Davidsson et al., 2005; McKelvie & Wiklund, 2010). The process approach is less strongly represented in the extant firm growth literature (McKelvie & Wiklund, 2010) because it requires detailed longitudinal firm data on various dimensions, which is not easily available (Lichtenstein, 2000).

Studies in this stream presume that firm growth is a dynamic process and view the firm as a complex system of resources and people utilizing these resources in response to changing external and internal conditions. Studies of this category also recognize the idiosyncratic nature of firm growth paths (Dobbs & Hamilton, 2007). The view focused on growth as a process draws from several theoretical perspectives on organizational learning (Aldrich, 1999; Macpherson & Holt, 2007) and the resource-based view of the firm (C. Brush, 2001; Garnsey et al., 2006; Penrose, 1995).

The process perspective of growth is majorly influenced by Penrose’s theory of firm growth (1995), which she derived from case studies of established manufacturing firms. Penrose’s work constitutes the most comprehensive theory on firm growth until today (Lockett, Wiklund, Davidsson, & Girma, 2011). Although Penrose developed her theory around the established firm, her work finds much appreciation in the
context of small business growth among entrepreneurship scholars (Garnsey, 1998; Orser, Hogarth-Scott, & Riding, 2000).

Penrose (1995) defined growth as “a process of development […] in which an interacting series of internal changes leads to increases in size accompanied by changes in the characteristics of the growing object” (p. 1). Referring to firm growth, Penrose viewed growth as a dynamic process in which members of an organization accumulate knowledge and competence. In her theory the firm is an administrative unit made up of potentially valuable resources. “The function of managers is to decide what resources to deploy and what activities to carry out. Within this context, Penrose identifies two types of firm-specific capabilities: entrepreneurial and managerial capabilities. Entrepreneurial capabilities are a function of imagination, and are necessary for a company to utilize its resources in new ways” (McKelvie & Wiklund, 2010, p. 272). According to Penrose (1995), entrepreneurial capabilities act as an engine for growth. However, in order to administrate the growing organization and keep a sustainable growth trajectory, managerial capabilities are needed. In Penrose’s firm growth theory managerial capabilities refer to the firm’s ability to efficiently manage the growth process and the enlarged business operation. Managerial capabilities, which the organization attains through an evolutionary process of learning and investment, can be a major limit to growth in two ways. First, a firm’s rate of growth is limited by the rate at which knowledge can be accumulated. Second, a firm’s size is limited by the extent of the firm’s ability to sustain effective business administration of the firm’s expanding borders (Penrose, 1995). The process of acquiring and accumulating sufficient levels of managerial knowledge and expertise constraints the rate at which a firm can grow, which is known as the “Penrose Effect”
(Slater, 1980, p. 521) or referred to as the managerial capacity problem by Barringer and Jones (2004).

The key insights from Penrose’s theory of growth are that growth is a dynamic process that is enabled through and needs to be accompanied by the development of firm’s internal capabilities. A firm’s growth path depends on the resources and knowledge base accumulated in an evolutionary process and its ability to restructure its resources and administrate the tasks of the running operation of the business (Penrose, 1995).

In coherence with the growth theory developed by Penrose, but also often discussed in relation to stages of development models, there is a substantial amount of studies that particularly address the importance of organizational knowledge accumulation as an enabler or preventer of growth (Goffee & Scase, 1995; Macpherson & Holt, 2007). Studies focused on growth find that firms accumulate knowledge often in response to critical events (Boussouara & Deakins, 2000). Business evolution and growth depends “on the satisfactory resolution of the crisis of ‘knowing’” (Macpherson, 2005, p. 1138), so that firms’ growth paths will mirror to some extent the process of learning within the business (Deakins & Freel, 1998; Dobbs & Hamilton, 2007).

### 2.2 Firm growth patterns

Growth is one of the most common objectives for business managers of established firms as well as entrepreneurs of new ventures (T. H. Brush, Bromiley, & Hendrickx, 2000; Davidsson et al., 2009; Hubbard & Bromiley, 1994; Sexton, 2000). Albeit many strive for growth, studies show that very few companies achieve sustained, continuous growth. Reviewing six large-scale studies on firm growth Hess (2010) states, “that smooth continuous growth is rare over even modest periods of time” (p.
38). Garnsey et al. (2006) find that particularly the growth paths of new businesses are characterized by unsteadiness, interruptions and reversals. Although young and small companies tend to grow at higher rates than established firms (Evans, 1987), a study by (Garnsey & Heffernan, 2005) on growth set-backs of new businesses (that have survived at least a period of 10 years after formation) revealed that “over half of the [93 sample] firms with the best survival record experienced growth interruptions and a third of these survivors did not subsequently recover to their earlier size” (p. 638). The prevalent finding of studies on firm growth patterns is that growth is very difficult to achieve and even more difficult to sustain, and poses a very difficult task for most firms (Audtresch, 1995; Garnsey & Heffernan, 2005; Kirchhoff, 1994; Storey, 1994; Wiggins & Ruefli, 2002).

Growth interruptions and reversals can be the result of both internal and external dynamics and factors. The investigation of internal causes for growth setbacks has yet received limited attention in the literature. The internal dynamics “have so far remained something of a ‘black box’ for most growth studies” (Freel, 2000, p. 321). The few studies addressing internal organizational causes include the study by Garnsey and Heffernan (2005) in which the authors explicitly discuss internal dynamics and management problems as a cause for growth stagnation or even reversal. Specifically, the authors suggest that growth induced resource shortages and synchronization problems of resources, people and processes might be a common cause for growth setbacks.

### 2.3 Growth and profitability

The great majority of growth studies is solely concerned with one-dimensional growth measures, most often sales growth or growth in number of employees (Delmar, 2006). Whereas, “the simultaneous pattern of growth and profit perfor-
mance evolution of small and/or young firms has received relatively little empirical attention” (Davidsson et al., 2009, p. 1).

Different theoretical perspectives suggest different outcomes for the relationship between growth and a firm’s financial performance. One perspective suggests that growth should be positively associated with profitability\(^1\). This is brought forward in literature streams relating to economies of scale (Besanko, Dranove, Shanley, & Schaefer, 2009), experience effects (Stalk & Stern, 1998), first-mover-advantages (Lieberman & Montgomery, 1988) and network externalities (Katz & Shapiro, 1985). “These theories suggest that growth drives profitability due to reduced costs or by establishing a better market position” (Davidsson et al., 2009, p. 390) and “that in the presence of such positive feedbacks, firms should pursue an aggressive strategy in which they seek to grow as rapidly as possible” (Oliva, Sterman, & Giese, 2003, p. 84) in order to ensure high firm performance in competitive markets.

The other perspective is that growth engenders great organizational challenges as addressed by Garnsey and Heffernan (2005) and discussed in detail in a study by Hambrick and Crozier (1985). Based on this argument, other scholars contend that rapid growth inhibits profitability (Gartner, 1997). Meeting the resource needs of growth, coping with increased managerial complexity and establishing new organizational capabilities and processes, may lead to an upsurge in costs, which decreases profitability. Growth may also dilute performance if the organization is not able to effectively transform and develop the required organizational capabilities to accommodate the growth process (Slevin & Covin, 1997). Thus, growth and profitability

\[^1\] Note: In this study the terms profitability and performance are used interchangeably.
may be negatively related not only temporarily but also potentially endangering the continued profitable operation of the business.

The results of empirical studies do not support a straightforward relationship between growth and profitability but rather suggest that the relationship is just as idiosyncratic as any firm’s growth process. Some studies report positive correlations between growth and profitability (e.g. G. N. Chandler & Jansen, 1992; Cox, Camp, & Ensley, 2002; Mendelson, 2000). While for example Reid (1995) shows that growth has a negative effect on profitability. The prevalent opinion in the literature is, there is no distinguishable relationship between growth and profitability as shown by the works of Capon, Farley, and Hoenig (1990) and Coad and Hoelzl (2010).

The complex relationship between growth and profitability, suggests that simplistic growth measures of size, such as sales and employee numbers, should not be taken per se as signs for business success (i.e. the firm’s ability to sustainably generate profits). However, the number of empirical studies that take a more differentiated view on growth, as opposed to the majority of one-dimensional growth studies, is very limited. One important exception is a study by Davidsson et al. (2009) in which the authors show that firms with high growth and low profit (i.e. growth-focused firms) are more likely to reach a state of low growth and low profit in comparison to low growth, high profit firms (i.e. profit-focused firms). In addition, the authors find that profit-focused firms are more likely than growth-focused firms to transition to a state of high growth and high profit. The findings by Davidsson et al. (2009) suggest that profit-focused firms are in a better position to reach profitable growth in the future than growth-focused firms, and low-profit firms are unlikely to have higher profitability after growth. Supporting the findings of Davidsson et al. (2009), Sexton, Pricer, and Nenide (2000) find that firm profitability is related with sustainable
growth, suggesting that firms that can finance growth through internally generated funding are more profitable than firms with uncontrolled growth. Commenting on their findings Davidsson et al. (2009) state:

“[…] growth is not direct evidence of effective value creation and appropriation […]. [However,] growth is often portrayed as evidence of business success. This tendency is particularly pronounced in the entrepreneurship research literature. Our findings are a strong reason for practitioners and researchers alike to question a universal and uncritical growth ideology” (pp. 390-402).

2.4 Challenges of growth

The notion that growth entails potential risks and engenders great organizational challenges is not new. The hazardous effects of growth and associated common managerial problems find addressing in the stages of development models (Greiner, 1998; Hill et al., 2002; Kazanjian, 1988; Lewis & Churchill, 1983; Schuman & Seeger, 1986) and are also investigated in growth related literature on organizational transitions and management of growth (Arbaugh & Camp, 2000; Barringer & Jones, 2004; Fombrun & Wally, 1989; Hambrick & Crozier, 1985; Hess, 2010; Hofer & Charan, 1984). The research findings suggest that, growth, particularly fast growth, adds and creates managerial complexity and requires organizational adaption (Nicholls-Nixon, 2005). Successfully accomplishing the required internal development of the organization, relating to the build-up and coordination of capabilities, resources, and processes, presents a dynamic and complex managerial task. Many firms struggle during this process (Hambrick & Crozier, 1985).

In a study drawing from extensive field-work and interviews with Chief Executive Officers (CEO) of both public and private companies Hess (2010) identified predominant risks that are associated with growth: “growth can outstrip the capabili-
ties and competencies of a company and its management team; growth can stress quality and financial controls and destroy or dilute a firm’s culture; growth can dilute the customer value proposition; and growth can take management’s focus off operational excellence, weakening existing business” (pp. 4-5).

Hess’s (2010) study further reveals that many managers fail to anticipate the risks and effects of growth and are overwhelmed with the complexity growth suddenly engenders. His study gives evidence that firms may suffer substantial financial losses and/or operational performance decline due to managers’ lack of foresight and an inability to effectively manage the process of growth.

Focusing on the management of rapid growth Hambrick and Crozier (1985) identified four fundamental, primarily people-related, challenges that managers of fast growing businesses need to solve. The four challenges are: instant size, which produces dissatisfaction and disorientation among employees and gaps in the adequate skills and systems required to manage growth; a sense of infallibility, which makes entrepreneurs less willing to change their strategies and behavior even if circumstances require different actions; internal turmoil refers to problems associated with quickly integrating new people into the organization and getting everyone in the bigger organization to fulfill their tasks effectively; lastly, the need for extraordinary resources often puts the growing organization under great financial pressure, which can endanger the existence of the business and cause stress among employees affecting morale levels in the company.

In addition to the problems associated with changes in the human dynamics as a consequence of growth, the literature on new firm growth emphasizes the necessity for young companies to adapt a professional management style as the company evolves (Flamholtz & Randle, 2012; Gibb & Davies, 1990). The findings of Davila,
Foster, and Jia (2010) suggest that the management style needs to change from an informal entrepreneurial style to a professional management style at a company size between 50 and 100 employees. The founder of a company may not be the right person to also steer the advancing organization (McKenna & Orit, 1981) and often times needs to be replaced by a professional CEO (Boeker & Wiltbank, 2005; Davila & Foster, 2005). When the entrepreneur is unable to apply a more formal management style and create an enhanced management infrastructure, companies are likely to experience serious problems in retaining control of the growing organization. Stages models refer to this as a leadership crisis (Greiner, 1998; Steinmetz, 1969).

In order to make a successful transition from entrepreneurial to professional management it requires the delegation of responsibility, development of managerial skills, and the introduction of formal control systems (Davila et al., 2010; Roberts, 1987; Tse & Elwood, 1990). However, a study by Garengo and Bernardi (2007) suggests that management frequently struggles to simultaneously enhance their processes and capabilities – qualitative development – to the firm’s growth in size – quantitative development. Firms invest in capability development and systems in response to managerial crisis rather than taking a proactive approach. Companies that do not accomplish the required enhancement of management capabilities and processes to meet the administrative demands of growth risk to be driven into the “chaos zone” (p.526) (i.e., into a state where the problems are greater than the organizational capabilities to manage them) “[…], and although a lack of organizational capability is initially absorbed through voluntary and over-extension of capacity, it eventually becomes a cause of organizational crisis” (p. 528).

Also, Covin and Slevin (2000) stress that rapidly growing companies have a reinforced need to timely achieve the required enhancement of managerial practices.
They argue that the inadequacy of organizational systems and management processes threatens the viability of the growing organization. If the gap between the required configuration of organizational components and its present condition is too big, the business might run out of control and suffer performance decline eventually leading to growth reversal.

**Overcoming the challenges of growth.** In coherence with the perspective that knowledge accumulation puts a limit to the rate at which a company can sustainably grow (Penrose, 1995), the findings by Hess (2010) suggest, managers need to know how to pace growth in order not to overstretch a company’s capabilities and let people and processes catch up with the organizational changes during the growth process.

In conjunction with the four fundamental growth challenges identified by Hambrick and Crozier (1985), the authors observed the following set of themes distinguishing firms that successfully overcome or avoid the challenges of rapid growth from those that do not: “the chief executive is able to envision and anticipate the firm as a larger entity; the team needed for tomorrow is hired and developed today; the original core vision of the firm is constantly and zealously reinforced; new ‘big-company’ processes are introduced gradually as supplements to, rather than replacements for, existing approaches; hierarchy is minimized; employees hold a financial stake in the firm” (p. 32).

Commenting on their findings Gareongo and Bernardi (2007) stress that growing firms “[…] need to understand the importance of managerial investment in order to increase their added value rather than only their turnover. They have to invest more in qualitative development than in business growth as a way of moving beyond the ‘chaos zone’ and solving managerial problems” (p. 528). Their study highlights that
many companies focused on growth neglect organizational and managerial development.

The described findings convey that the development of organizational capabilities, particularly the enhancement of managerial capabilities, is of crucial importance for the successful management of the growth process and meeting the requirements of a more complex firm.

2.5 Capabilities
Although the literature suggests that the development of capabilities is crucial in the process of growth, few studies focusing on firm growth directly address organizational capabilities (Barbero, Casillas, & Feldman, 2011; Garengo & Bernardi, 2007). In this section, I amplify the capabilities concept, based on the perspectives developed in strategy and management research, where capabilities are dominantly discussed. Subsequently, I review the concept in the context of managing firm growth and conceptualize managerial and operational capabilities for the further discourse of this study.

**Concept of capabilities.** Capabilities have emerged as a central concept in organizational and strategy research (Mahoney, 1995; Teece, 2009). The resource-based view of the firm hosts capabilities as essential to sustain a company’s competitive advantage. It thus explains capabilities to act as an engine for firm growth (A. D. Chandler, 1990; Morecroft et al., 2002). Capabilities are a somewhat elusive concept, which has led to different definitions. The understanding of capabilities in this study accords with the definition of Morecroft et al. (2002) who describe capabilities “[…] as an organization’s repeatable patterns of action in the use of resources, usually in the context of activities that the organization undertakes in pursuit of its goals” (p. 5). This definition is applied because it covers the general understanding of the term
offered by other authors. Further, according to Morecroft et al. (2002), “[…] organizational capabilities result from the coordinated application of the knowledge and skills of individuals in person-to-person interactions and in the interactions of people with non-human tangible assets” (p. 5). Learning, experience, resources, and routines are inputs to capabilities. Conversely, capabilities themselves are associated with putting organizational resources into action (Dosi, Nelson, & Winter, 2000; Eisenhardt & Martin, 2000; Winter, 2003).

Research distinguishes between two basic types of capabilities (Eisenhardt & Martin, 2000; Teece, 2009). The first type is operational or ordinary-level capabilities that permit a firm to “make a living in the short term” (Winter, 2003, p. 991). Operational capabilities for example entail a firm’s abilities to manage and operate the production of goods or services, procurement, and customer service. The second type is called dynamic or higher-level capabilities. These capabilities “[…] operate to extend, modify or create ordinary capabilities” (p. 991). In the strategic management literature dynamic capability, involves the capacity of an organization to purposefully alter a firm’s resource base and its capability stock in order to enhance its current products or service offerings (Helfat et al., 2007; Winter, 2003). The view that dynamic capabilities operate on other capabilities indicates that capabilities evolve within a hierarchy (Collis, 2006; Winter, 2003).

Dierickx and Cool (1989) conceptualize capabilities as the outcome of accumulation and depletion processes inferring that capabilities cannot be directly acquired, but require investment of organizational resources, such as money, labor, and technology, for their development. This conceptualization entails that capabilities cannot be developed instantaneously but accumulate over time. Managers can only influence the levels of capability by controlling their rate of change (Rahmandad, 2012).
Thus, for example, managers cannot immediately transform poorly trained employees into a high performing workforce. Instead, they must invest in training, and, operational performance will improve over time. Conversely, if managers suddenly begin to neglect training and employee development, operational performance does not immediately decline; employee turnover and forgetting will yield a poorly skilled workforce with time (Repenning & Henderson, 2010).

**Capability perspective in this study.** Drawing upon the general conceptualization of capabilities in the strategy and management literature described above, I specify the capability perspective used in the case study and the system dynamics model.

In this study organizational capabilities comprise a firm’s overall set of capabilities, consisting of managerial and operational capabilities. Following Helfat et al. (2007) and Winter (2003), managerial capabilities represent higher-level capabilities acting on operational capabilities in a hierarchy. Following the conceptualization of Dierickx and Cool (1989) both the development of managerial and operational capabilities happen in an accumulation process over time and require investment of financial and human resources. Operational capabilities represent the firm’s ability to efficiently use tangible and intangible resources within the immediate business operation as the crucial determinant for high business performance. Operational capability is used as an overarching term comprising more specific capabilities, which fundamentally result from employees’ skill levels and the application of accumulated knowledge (Morecroft et al., 2002).

While the strategy literature offers a comprehensive description of the general concept of capabilities, it addresses managerial capabilities with a special emphasize on managers’ abilities to make strategic choices based on their understanding of a firm’s competitive environment (Gary & Wood, 2011). The strategy literature is
concerned with managerial capabilities as an enabler to develop future growth opportunities in competitive environments. However, this study is focused on capabilities in the context of managing the organization’s internal process of growth. Therefore, I apply a definition of managerial capabilities based on the developed perspectives in the literature on firm growth, that specifically view managerial capabilities as an essential factor to efficiently manage the growing organization.

However, my literature review revealed that there is no universal definition for managerial capabilities and what they comprise. The literature discusses the term in different contexts, which leads to varying definitions and level of detail of these definitions. Because no single definition is complete I conceptualize managerial capabilities combining the different aspects of the most relevant definitions for the further use in this study.

Penrose (1995) conceptualized “managerial services” (p. 51) as the capacity of managerial knowledge within the organization needed to successfully plan, execute and manage the operations of a business.

Covin and Slevin (2000) describe managerial capabilities as “an ability to build the organization internally or strengthen the organizational system such that unnecessary tensions or incompatibilities among the organization's components are minimized and new, contextually-appropriate behavioral patterns and processes are adopted" (p. 109).

In a more specific approach Barbero et al. (2011) define managerial capabilities in four functional groups: human resources (referring to personnel selection, establishment of incentives based on performance, and training of personnel), organizational (referring to the establishment of professionalized management systems), mar-
marketing (referring to the need for being client oriented), and financial capabilities (referring and stressing the importance of financial planning).

Similar to Barbero et al. (2011), Garengo and Bernardi (2005) divide managerial capabilities along three managerial macro-processes: (a) management macro-processes, i.e. management and economic-financial planning; (b) support macro-processes, i.e. management of information technologies and personnel management; and (c) operational macro-processes, i.e. product development, marketing, production and purchasing.

Based on the given definitions I define managerial capabilities as managements’ ability to successfully plan, build, and manage the business operation requiring sufficient managerial capacity (i.e. human resources and knowledge) as well as appropriate management processes and systems, spanning across the dimensions of human resources, financial planning, and operations.

**Summary of findings from the literature review.** In order to advance in the field of firm growth, research is needed that embraces the complex, dynamic and idiosyncratic nature of growth and views growth as dynamic process (Dobbs & Hamilton, 2007; Garnsey & Heffernan, 2005; Leitch et al., 2010). Prior research shows that firm growth patterns are characterized by interruptions, stagnation, and reversal (Garnsey et al., 2006; Storey, 1994). The least firms achieve smooth continuous growth over sustained periods. Particularly rapid growth is hard to sustain (Baldwin & Gorecki, 1998; Kirchhoff, 1994; Parker, Storey, & Van Witteloostuijn, 2010; Storey, 1996). However, the literature falls short on theoretically explaining why many firms struggle to grow continuously. It is known that growth bears risks and that managing the process of growth and meeting the requirements of a more complex firm poses a great managerial challenge (Hess, 2010). Especially fast
growth reinforces managerial complexity (Hambrick & Crozier, 1985; Nicholls-Nixon, 2005). In order to cope with increased complexity within the growing organization and to facilitate the growth process, firms need to invest and develop appropriate organizational capabilities, particularly managerial capabilities (Barbero et al., 2011; Davila et al., 2010). The literature suggests, that many firms develop managerial capacity, processes, and systems reactively rather than proactively building needed capabilities in advance (Covin & Slevin, 2000; Davila et al., 2010; Slevin & Covin, 1997). This study shows how this can lead to sustained periods of poor business performance and growth disruption in a detailed case study and an associated system dynamics model.

3. Method

3.1 Case study approach

This study applies the case study method because it enables the rich description of complex business situations and the detailed study of firm internal processes. The literature on firm growth suggests that case study based research is needed to make valuable contributions in this field and generate insights about growth as a process (Garnsey et al., 2006). Research on firm growth has “largely ignored the importance that entrepreneurs and managers attribute to growth as a process and as internal development” (Achtenhagen et al., 2010, p. 307). There is a notable need for longitudinal research aiming to explore the dynamic firm internal processes underlying firm growth based on in-depth firm level data (Achtenhagen et al., 2010; G. N. Chandler & Lyon, 2001; Davidsson & Wiklund, 2006).

In reference to the central research objective of the present study Garnsey et al. (2006) have explicitly called for case study research:
“We suggest that failure to sustain growth may not simply be the result of resource constraints (Kirchhoff, 1994), but of growth at a rate too rapid to be sustained in relation to the resources available to the firm. Confirmation requires more detailed data like case study evidence that shows how this can occur” (p.16).

The value of case study research “lies in its capacity to provide insights, rich detail, and thick description” (Freel, 2000, p. 330) and provides a suitable method that requires detailed comprehension “of the rules underpinning organizational and individual action and interaction, which impact upon the processes under consideration […]” (Freel, 2000, p. 330). Thus, the case study allows for building a comprehensive picture of the phenomenon of interest by using detailed and multi-dimensional data. Scholars have recommended the use of case studies as a means to capture the dynamic, unique process of organizational emergence (Eisenhardt, 1989).

**Research theme.** The present case study is based on in-depth fieldwork with an Australian restaurant chain. The selection of the company for this study was phenomenon driven. The firm’s growth path and performance development showed an interesting pattern that was suitable for theoretical investigation. The case study is based on the extensive analysis of interviews with the company’s CEO as well as extensive time series data capturing the company’s operational and financial performance from the creation of the company in May 2002 to June 2011.

In accordance with the grounded theory research approach (Glaser, 1992; Glaser & Strauss, 1967), I did not set any ex-ante research hypotheses and allowed the findings to emerge from the case analysis. However, the interviews with the firm’s CEO raised the suggestion that the company’s early rapid growth undermined the organizational capabilities leading to a drastic performance decline and subsequent growth
reversal, threatening the company’s existence six years after formation. Only through an intense focus and substantial investments in managerial and operational capabilities, did management achieve a turnaround and stabilization of the business. The company managed to survive and save the more than 400 jobs it had created and was able to start a new growth phase at the beginning of 2012.

The focus of the case study is to explore the causes of the company’s performance decline and growth reversal as well as the underlying dynamic structure of causal relationships explaining the boom, bust, and turnaround in the company’s development (see appendix A).

**Data and analysis.** The data used for this study was collected from the studied company in 2011. The firm provided full access to the firm’s archives of documents including: (a) quantitative time series data, comprising full financial records from the company’s formation in May 2002 to June 2011 for each sales period\(^2\) and operating performance indicators; (b) extensive qualitative data including e-mails between the members of the executive team, internal management presentations, and investor presentations.

In addition, three semi-structured interviews were conducted with the CEO of the company in 2009 and 2010. The interviews with the company’s CEO were structured as an open-ended conversation with a semi-structured setup. All the interviews were tape recorded and subsequently transcribed. The transcriptions contained more

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\(^2\) Note: The studied company reports financials, as is common in the hospitality and retail industries, using periods instead of months. This way every period can start on a Monday and end on a Sunday and each week is comparable to another. Monthly reports cause problems because some months have more days than others and some months may have more Fridays or other days of the week than other months. Therefore, Alpha is managed on a weekly basis and reports financials in periods instead of months. The financial year has 13 periods.
than six hours of audio material from the three interviews. Also, notes that were taken during the interviews were included in the analysis.

The collected data also includes one interview with the founder of the company from a public source, stemming from 2007.

In an initial step, the profit and loss statements for the entire period were pulled together in one complete data file. This revealed the development of the company’s sales growth (through opening new stores), versus the business’s decline in profitability (see figure 1). The profit and loss statements also provided measures for the firm’s operational performance and capability development. This included information about the quality of cost management, quality of labor management, intensity of staff training, and investment in managerial capability development. In addition, management used detailed data to assess and control the operations efficiency, which provided more operational performance measures and an assessment of the capability levels in the firm. This data comprised measures for: guest count, average bill per guest, a service excellence score evaluating the capabilities of service personnel to sell extra items to guests, evaluation of service quality and the capability of restaurant managers to achieve efficient cost control.

In another step, I combined the financial data with the data on operational performance. I analyzed the consolidated quantitative data through graphical analysis, in order to get a complete picture of the company’s development and study the relationship between growth, capability levels and operating profitability.

Simultaneously to the quantitative analysis, I carefully examined the firm’s internal documents and the interviews, which provided information about causal relationships within the operation, necessary to make sense and derive conclusions from the quantitative data. The qualitative data analysis involved the evaluation of the
research interviews as well as the thorough review of the firm’s internal documents. The examination of the qualitative material was concerned with capturing critical events in the company’s history and the firm’s process of organizational development, including the development of managerial capabilities, control systems, introduction of new decision policies, employee satisfaction, and building operational capabilities.

3.2 System dynamics approach

In conjunction with the case study a system dynamics model was developed (Forrester, 1995). This allowed building a deeper understanding of the dynamic causal relationships explaining the studied firm’s growth and performance pattern.

During the last two decades system dynamics and simulation modeling have increasingly gained importance in the advancement of organization and strategy theory as well as management education (cf. Perlow, Okhuysen, & Repenning, 2002; Repenning, 2002; Repenning & Sterman, 2002; Sastry, 1997).

System dynamics modeling constitutes a suitable method to represent complex systems, such as a firm or a whole industry, and analyze the dynamic behavior of the system’s interrelated parts over time (Repenning & Sterman, 2002; Sterman, 2001).

In organization and strategy theory, system dynamics modeling is increasingly applied to study the dynamic behavior of firm performance and connecting performance outcomes to the underlying structure of interdependent factors influenced by managerial decision-making (Gary et al., 2008; Gary & Wood, 2011). The system dynamics modeling approach has already been used in a number of studies analyzing boom and bust performance patterns relating to the complex, dynamic phenomenon of firm growth (e.g. Graham, Morecroft, Senge, & Sterman, 1992; Hall, 1976; Oliva et al., 2003; Paich & Sterman, 1993).
The method has a number of benefits that make it particularly suitable for this study. First, system dynamics enables researchers to capture the relationships of interdependent variables and model the mutual modes of operation of interrelated parts. Second, system dynamics distinguishes between state variables, such as the number of employees or quality of organizational systems, and rates, which represent the speed and direction of change affecting the state variables (Sastry, 1997). The hiring rate for example is the speed at which the number of employees is growing or declining. The distinction of state variables and rates is important because state variables represent a firm’s features that have been accumulated over time and cannot be altered instantaneously (Sastry, 1997). Another beneficial property of system dynamics is its ability to represent intangible or ‘soft’ variables, such as staff morale or customer satisfaction (Morecroft, 2007). Intangible variables are often hard to account for in management decisions because they are less easily quantifiable than for example financial measures. Often there is no data available to assess the state of such variables, which complicates managerial control and recognition of these factors (Morecroft, 2007). Notwithstanding, ‘soft’ factors often have great influence in an organizational system (Larsen, van Ackere, & Warren, 1997). Lastly, system dynamics models capture the dynamic behavior of simultaneously ongoing processes that influence each other and thus constitutes a method “to explore the effects of time lags likely to be at work in organizational settings” (Sastry, 1997, p. 240).

Central concepts of system dynamics. This sub-section briefly discusses the central concepts of systems and their dynamic behavior referring to the definitions of Morecroft et al. (2002). I follow the definitions of Morecroft et al. (2002) because the authors offer a concise introduction to this field, basing their definitions on the pertinent literature on systems and system dynamics. For a more complete introduc-
tion to system dynamics I advise the reader to see the works of Morecroft and Sterman (2000), Forrester (2007), and Sterman (2000).

A system is a collection of interacting elements. The elements of a system can be animate or inanimate, tangible or intangible and interact with each other in the way that a change in one system element results in a change in one or more other system elements. The current state of any given system element thus depends on the state of one or more other elements in the system. This interdependence of system elements constitutes the basic characteristic of a system. The dynamic behavior of the whole system depends on the nature, speed, and intensity with which the interdependent elements interact.

System dynamics highlights circular causal relationships or feedback loops in which variables influence and, in turn, respond to each other (Richardson). These feedback loops exist if the interrelationship between the system’s elements (minimum two) allows that a change in one element evokes a further change in the same element through the reaction of other system elements to the first element’s initial change.

The interaction between system elements can be of two types. When an increase or decrease in one system element causes a corresponding increase or decrease in another system element the first element has a reinforcing, positive, feedback effect on the other element. Vice versa, the link between one element to another has a balancing or negative feedback effect if a change in the first element leads to an opposite change in the second element. If a circular chain of interconnected elements has an overall reinforcing effect (starting at one element and closing the loop at the same element) the loop is called a reinforcing or positive loop. If the overall effect in the circular chain of linked elements is balancing the loop is a balancing or negative
feedback loop. Reinforcing loops tend to quickly destabilize a system by producing increasingly fast growth or decline in system elements eventually leading to the system’s collapse if not controlled by one or more balancing feedback loops.

Another characteristic of feedback loops is that changes between system elements are usually subject to time delays. The change in one element may cause an increase or decrease in another element only after a considerable time period. For example, the time between hiring an employee and the time for the employee to become effective in the job may be considerable. The time delays between system elements increase the difficulty for decision-makers to comprehend the causal relationships of elements in complex systems and to take effective measures in order to achieve desired outcomes (Barnett & Hansen, 1996; Levinthal & March, 1981; Masuch, 1985; Sastry, 1997; Sterman, 1989; Sterman, Repenning, & Kofman, 1997).

**Modeling process.** The system dynamics model was developed in conjunction with the thorough analysis of the case study. The developed model was built using the software Vensim (see Eberlein & Peterson, 1992 for an introduction to Vensim). This software constitutes a practical tool for academics and practitioners to build and formalize system dynamics models.

The modeling process starts with capturing and illustrating the fundamental feedback structure observed in the real system. A common method for that is causal loop diagramming (Sterman, 2000; Weick, 1979). The causal loops are used to identify the causal relationships (especially feedback loops) that generate the dynamic behavior observed in the real system (Larsen et al., 1997). I used this method to map the causal relationships of factors that the data indicated played a major role in the performance development of the studied firm.
The mapping process generally begins with the selection of the central longitudinal patterns from the initial data analysis. I started by diagramming the early business expansion driven by managements’ aspiration to achieve a certain growth target, which drove growth in number of stores and sales. The process then continues with the iterative development and integration of more detail. This encompassed adding other variables and closing the causal loops that were identified in the case analysis. The essential source for identifying the relevant links between variables and building the reinforcing and balancing loops were the research interviews. The CEO had prior system dynamics modeling experience. Central causal relationships that are implemented in the model were developed during the interviews. The CEO’s deep understanding of the business and his personal experience in managing the company guided the modeling process.

In order to run simulations with the developed model, another crucial part in addition to conceptualizing the feedback structure is to formalize the effects between related system elements. In this process, the quantitative and qualitative information from the case analysis is converted into mathematical formulations that define the direction, intensity, and speed of effects between linked parts of the system. As part of this process each system element is specified with quantitative data. The formulation of the model is a highly iterative process. The model’s simulation results have to be tested against the original data. For many of the variables, I had very detailed time series data that supported the process of determining rigorous formulations between the interrelated system elements (e.g. profitability margin, number of stores, revenues). For capturing the dynamic behavior of ‘soft’ variables (e.g. staff skill, staff morale, service quality, pressure in the business, effort to develop organizational capabilities) I conducted a detailed analysis of the executive management team’s
assertions expressed in the interviews as well as the thorough analysis of the extensive firm’s internal documents. These ‘soft’ variables are generally harder to quantify, as often no reference data for these variables exist. Yet, these variables find representation in the model by setting a scale and specifying a reference value that represents a normal level for each variable.

During the modeling process I often returned to the case data to check for and resolve any anomalies or contradictions. Following the method of Repenning and Sterman (2002), I also reviewed the links in the causal maps to assess whether the relationships were supported by existing studies. This method helped to ensure that the developed model is grounded in the field data as well as consistent with the literature on organization theory. The result is a system dynamics model with a number of feedback processes capable of generating the studied company’s performance pattern that can be used for simulation experiments. The simulation experiments aim to provide insights about how the application of different policies change the dynamic behavior of the system and lead to different outcomes (Barlas, 2007).

4. Case study results

The central research theme is derived from the company’s performance development shown in figure 1. The bars show absolute sales in million dollars\(^3\). The line shows Operating EBITDA\(^4\) as percent of sales. The Operating EBITDA margin is used as the central measure for operational performance by the firm. The course of the line indicates the business’s boom phase (FY03-FY05)\(^5\), the bust phase (FY06-FY08),

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\(^3\) Note: The currency is Australian Dollar in this figure and all other figures, tables and the remaining text

\(^4\) Note: Earnings before interest, taxes, depreciation, and amortization abbreviated EBITDA

\(^5\) Note: Financial year abbreviated FY; ‘03’ refers to the year 2003, ‘04’ to the year 2004, and so on; Alpha’s financial year starts in June and ends in July
and the turnaround phase (FY09-FY11). As evident from the data, operating performance declined drastically after the company had grown in size during the period of rapid expansion (FY04 - FY06). Also, the build-up of organizational capabilities to improve profitability and turn the business around took substantial time.

The company and all people involved wish to remain anonymous. Henceforward, the case company will be called Alpha, and the protagonists will be given fictitious names.

**Business overview**

Alpha is one of Australia’s leading exponents of fast-casual dining. Restaurants in this sector are broadly defined as having an average spend of 15 to 30 dollars. Fast-casual dining has emerged as a subset of casual dining and combines the key disciplines of a fast food restaurant, speed and efficiency, with the quality and freshness of food and the superior dining environment of a full service restaurant. There are only few branded ‘chain’ competitors in the domestic market in this sector, although there are many single site restaurants. Alpha’s target customer group are the both time-starved and health conscious consumers.

The business was started as a franchise based on the concept of a successful European restaurant chain that has opened more than 100 restaurant sites worldwide. The Australian operation follows the European model with a few minor exceptions due to differences between the markets. These minor differences include menu changes to make the food more relevant to the Australian consumer. Also, the high cost of labor in Australia forced a change to the operational structure and the rosters, with a reduction in the number of service team members on duty at any time vis-a-vis a European Alpha restaurant.
**Boom phase: Entrepreneurial launch and rapid expansion**

Paul, a young Australian entrepreneur, initially approached Alpha Europe in 2001 to get the franchising license for opening Alpha’s restaurants in Australia. Prior to his new venture Paul had started a successful Burger King franchising business with the support of a small group of private investors. He persuaded the same investors that the Alpha concept would be a success in the Australian market. With initial funds of $2 million Alpha Australia was launched in May 2002 with the first restaurant location opening in Sydney.

During the entrepreneurial launch phase, the team focused on bedding down the concept, working out adaptations from the European menu, and getting the new team of employees trained. Paul had ambitious aspirations for Alpha Australia and planned to grow the number of stores (the company’s internal term for its restaurant locations) rapidly once the concept had demonstrated success.

The first store performed well and over the first twelve months of operations achieved $2.5 million revenues and earned $274,000 of Operating EBITDA. A second store was opened in Sydney about 14 months after the first store opened. Once again, the new store performed well and over the first twelve months of operations reached $1.6 million revenues and $222,000 Operating EBITDA.

The success of the first two stores emboldened the entrepreneur to rapidly expand the business and gave him the credibility to secure further funding from the initial investors and also bank loans.

Store number three opened in February 2004 in Sydney, followed by eight more store openings over the next 24 months (see Appendix B for a list of Alpha Australia’s series of store openings). By the beginning of 2006 Paul had built a chain of 11
restaurants across four Australian states with yearly turnover just under $14 million and almost 400 employees in less than four years.

The rapid expansion was driven by the ambition to build a considerable business and accelerate profits in order to realize a quick exit for the founder and the initial group of investors. Based on a market analysis the early management team assumed that the Australian market could sustain at least 35 Alpha stores. The business plan suggested an upper limit of even 70 stores when the concept reached maturity. Based on the market analysis early management envisaged opening 26 stores by 2009.

**Bust phase: Threats to company survival**

The fast growth of the business appeared like an amazing success but the relentless, rapid growth caused problems in the business. In Paul’s mind each new store would add approximately $200,000 of Operating EBITDA at a margin of 12% on store revenues given a normal level of customer throughput per store. However, most of the stores opened during the rapid expansion phase traded well below expectations and the company’s overall Operating EBITDA margin decreased sharply (see figure 1).

**Initial troubles during the rapid growth phase.** Trying to grow the business as quickly as possible overstretched the managerial capabilities of the early management team and engendered the subsequent erosion of operational capabilities needed for the immediate and continuous profitable operation of the business. Specifically, the early management team lacked the capacity, knowledge, experience, and adequate processes to carefully manage the selection of restaurant locations as well as the recruitment and training of new staff. Although crucial for success, both issues received only limited attention in the rush for growth.

Selecting high quality restaurant locations is essential to ensure each restaurant attracts enough customers to be profitable. The Alpha restaurant concept is very la-
bor intensive and thus requires a large throughput of customers to generate profits. Each restaurant needs to attract approximately 1,800 guests per week, with a split across both lunch and dinner hours. To attract enough customers, site selection is essential because the customer numbers strongly depend on the quality of the restaurant location.

Driven by enormous confidence in the Alpha concept, Paul initially believed customers would fill the restaurants regardless of location. The early store opening policy was, “if you build it, they will come.” Because Paul wanted to open as many stores as possible with minimal investment and because of the lack of a strategic process for selecting store locations, the new stores were opened:

“[…] anywhere the landlord was willing to give a really good deal. The landlord gave deals, minimizing the cash outlay upfront and good rental deals ongoing as well. Assuming certain levels of revenue were maintained, these locations would deliver good profitability. But then, it was such a bad location, the revenues just did not come anywhere close to covering the costs. Some stores were opened only because the landlord gave a good deal. Neither of those were good locations at all. The quality of locations was sacrificed to hit a certain target number of stores.”

In order to attract guests in the numbers needed and ensure restaurant profitability, it is also crucially important to develop and maintain a high level of operational capabilities within the restaurant teams – the servers, chefs, and restaurant managers. Therefore, staff recruitment and training is crucial for the business to succeed.

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6 Source: Interview with Alpha Australia founder (2007), public source
7 Source: Research Interview with Alpha Australia CEO (2009)
In order to satisfy guests and make them come again it also needs a skilled and functioning team of servers and chefs who can deliver excellent service and great food. In order to ensure restaurant profitability it needs capable restaurant managers who carefully manage labor costs. The cost of labor in the restaurants accounts for 30-35% of sales. Managing the relationship between sales and labor is crucial for both the short and long term success of the restaurants. If a lunch or dinner shift has too many servers and/or cooks given the number of guests, then the labor costs will wipe out all of the profit for that shift. On the other hand, if the ratio of servers and/or cooks to guests is too low, customers will be dissatisfied because of delays in taking meal orders, preparing food, getting served, and/or paying the bill. Customer dissatisfaction hurts the business in the long term. Therefore, restaurant managers’ capability to manage the rosters in an efficient manner is very important.

The other major operating cost item in Alpha’s business is direct cost of sales. This includes the costs for food, drinks, and incurred wastage. These costs account for 20-25% of sales. Efforts to reduce the cost of sales directly affect the bottom line significantly, while untrained staff and a lack of attention by restaurant managers causes a direct decrease of profitability.

In the course of the rapid expansion, little time and money was spent to recruit and train newly hired restaurant staff. The new teams did receive little training up-front, instead management attempted to train the new back-of-house staff (boh), chefs and restaurant managers, on the job by sending them to the existing restaurants. Also, experienced store managers and chefs were sent to the new stores to train the rookie restaurant teams. However, the store openings during the early business expansion happened in such quick succession and from such a small base of experience in the team, that the quality of the training was poor. Such rapid growth made it dif-
ficult to spend adequate time and effort on training the new boh staff. Achieving ef-
effective training was even more complicated as the company opened restaurants in
different Australian states. In addition to the poor performance of the newly opened
stores, inserting inexperienced staff into the established stores and taking experi-
enced staff out of these stores negatively impacted the performance of the established
stores as well.

The lack of managerial capabilities and attention to carefully manage the re-
cruitment and training of staff subsequently left Alpha with low skilled, badly trained
restaurant teams that did not deliver great food and service. Poor management of the
rosters, and increased wastage significantly impacted restaurant’s profitability. As a
result of poor operational performance, overall Operating EBITDA margin was de-
clining sharply. Also, the rapid growth of the company from one restaurant in 2002
to 11 restaurants in 2006 added a great amount of managerial complexity further
straining managements’ capabilities to manage the growing operation.

Enhancing managerial capabilities. As financial and operational performance
problems appeared, the shareholders realized Alpha’s corporate structures and lead-
ership capabilities needed to be enhanced.

The company expanded the management team by adding the positions for CEO
and Chief Operational Officer (COO) and launched a fully resourced support office
(head office) with corporate functions for accounting, marketing, operations and
store development.

In March 2006 Eric joined Alpha Australia as CEO. Eric had been a manage-
ment consultant for ten years and had also spent over three years with a large Aus-
tralian retail business. Paul stayed in a business development role as Chief Executive
Director of Alpha Australia, with accountability for store design and development,
while handing over full operational and financial responsibility to the new CEO and COO. In his introduction e-mail to the Alpha team Eric wrote:

“I am here because Paul wanted to improve the strength of the leadership within Alpha. I will be responsible for the Australian Business. What I hope to accomplish with your help is: 1) to fix the Australian business to ensure it is operating to its potential and set a foundation for future growth (improve the customer experience; improve operational performance results; develop people); 2) grow the Australian business (improve the financial performance of existing stores, grow the store base in Australia, look for opportunities to expand the brand). I am very excited about the opportunities this business has ahead but also aware that there are some very important and fundamental things that we need to focus on in the short term that will allow us to realize these future opportunities. We have a tough 3-6 months ahead as we try to fix the business, however, this will set us up for many fantastic opportunities in the future.”

The new CEO was expected to, and believed, that he could quickly solve the operational issues in the poor performing stores, and then continue the growth of the company. In August 2006 (beginning of FY07), $6.2 million in new funds were raised from existing shareholders and a group of new investors to complete the restructuring of the company. A large component of this funding, $2 million, was used to pay back part of the bank debt because Alpha’s bank had threatened to withdraw their line of credit due to decreasing profitability and emerging cash flow problems.

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8 Source: Internal e-mail from Alpha Australia CEO to executive management team (April, 2006)
9 Note: The case firm’s financial year starts in July and ends in June
The balance of $4.2 million was injected to finance the further growth of the business.

*Learning about issues in the business.* To learn about the issues that need addressing in the business, one of the first things Eric did was to bring all of the restaurant management teams together to meet. Eric wanted to find out what problems needed to be resolved in order to improve profitability in the restaurants.

The discussion revealed a wide range of operational issues that needed to be fixed, but perhaps more importantly, the session brought to light a number of people related issues within Alpha Australia that needed to be improved and had emerged as a consequence of the fast growth. However, most of the issues had received little attention or remained undetected in the relentless pursuit of growth.

Employees were not enjoying their jobs at Alpha due to long hours, little pay, lack of support, and a lot of pressure in the company. The employee turnover rate within the restaurants was high, reinforcing the problem of having very few experienced people in the restaurants. The business did not have a positive and supportive culture and employees did not enjoy working for Alpha, which also negatively affected operational performance (see table 1 for a detailed list of issues raised by the restaurant managers).

In addition to the internal business analysis, Eric also approached the European parent company to assist in a review of the Australian operation. The European parent company’s Human Resource Director, Marketing Director, International Operations Manager and CEO visited Alpha Australia, and offered their help over a period of two months. The external review of the business identified several primary reasons for Alpha Australia’s poor operational performance and low customer and employee satisfaction. These included: lack of training and development at the store
level; poor management at the store level; and stretching the store teams too much given their lack of experience.

**Investing in the development of organizational capabilities.** As a result of the internal and external business review, the ‘fix-it’ program was launched in February 2007. The ‘fix-it’ program included investment in training and development of the team, recruitment to fill vacant store manager positions, investment in store equipment, fixing broken equipment in the stores, buying missing equipment, and implementing new IT systems in the restaurants in order to manage labor cost and cost of sales efficiently. In addition, the corporate support office team of Alpha Australia grew by adding the positions of Chief Financial Officer (CFO), Development Chef (head chef), and Marketing Manager. Also, a new Operations Manager was sent from Alpha Europe to replace the former COO who had just joined Alpha a few months earlier, but had not been suitable for the job.

**Fixing and growing the business at the same time.** The newly formed management team focused on improving performance of the business immediately and also started trying to change the team culture of Alpha Australia for sustainable success in the future. Notwithstanding this, management was also busy opening new stores during financial year 2007. Commitments to open three new Alpha stores had already been made during financial year 2006, and between July 2006 and March 2007 these three new stores were opened. Additionally, one store was relocated because it had performed poorly since the opening in October 2004. The store’s operating margin over 24 months was -3%. This location was outside of the Melbourne Central Business District (CBD) and suffered from low dinner traffic. Management decided to close the location and relocate the store within the CBD where both lunch and dinner traffic was expected to be strong. Management also decided to close one
poor performing store located in a shopping center outside of Sydney. Over a period of 28 months this store had been continuously losing cash at an operating margin of -7%.

After the two store closures, there were still more unprofitable locations where management was confronted with decreasing weekly sales and profits. However, closing additional stores was not an easy decision. The prevailing growth expectations by Paul (still a member of the Board of Directors) and the other shareholders delayed the decision to close more of the unprofitable stores. Closing additional restaurants would have undermined the achievement of the growth targets for increasing the total number of stores and revenue year on year. It was not feasible to hit the growth targets in store numbers by replacing all of the unprofitable stores with new locations. Replacing all of the unprofitable stores would require roughly $1 million investment per new store opening (including fit out costs, recruitment, and training), and the new store locations would need substantial time to ramp up sales. In addition, the business faced high exit costs for terminating the long-term leases of the existing locations. The business did not have the money to fund all of the relocations. Also, Alpha Australia had already invested about $1 million to open each of the existing stores. Management felt that closing these stores would throw away this investment. Instead, management tried to improve the performance of these stores by increased staff development and marketing activities.

Moderation of growth plans and consolidating the business. Despite slight improvements in higher comparative sales in most of the stores in the first half of 2007 the situation of the business was not significantly better one year after Eric had joined Alpha Australia as CEO. Significant improvements in per store sales and profitability seemed elusive and were a long way off.
Under increasing pressure from shareholders, at the beginning of financial year 2008 (June 2007), management changed the strategy to focus exclusively on improving financial performance. It was clear that growth could not be the priority in the near future, as management needed to first address more fundamental operational issues. Management identified the following initiatives to improve performance\textsuperscript{10}:

- Need to tighten overall financial and operational control
- Need to work with Alpha Europe and to invest in training to achieve high operational standards
- Need to build team morale and create a cohesive performance culture
- Need to deal with various compliance issues, particularly those relating to employees on skilled migrant visas
- Need to re-finance our bank loan
- Need to deal quickly with some poorly located unprofitable restaurants that are a distraction to management and sapping financial resources.

It was decided that no new stores would be opened until the end of 2007. Instead of growing the business at the same time as fixing it, the focus shifted to building a consolidated portfolio of profitable stores and getting everything right in these stores. Once these basic fundamental issues were addressed, management would continue to grow the business.

A review of the existing stores showed that stores with less than $30,000 average sales per week were not profitable. Figure 2 shows the relationship between sales and profit of the existing store portfolio for financial year 2007. Six stores were below $30,000 in average sales per week. Of these, four stores were delivering negative operating EBITDA and two stores were just above negative territory. Four of the five

\textsuperscript{10} Source: Alpha Australia shareholder presentation (March, 2009); review of situation in financial year 2007
stores that were delivering healthy operating profits were above $42,000 in average weekly sales.

As a result of this review, three more stores were closed in the course of 2007 and 2008. Management had tried to stimulate sales in these locations over many months and also made sure that trained employees were running the stores. However, sales never reached levels where these restaurants could be profitable. The stores had been reporting negative Operating EBITDA margins in some periods in excess of -30% of sales. Keeping the stores in the portfolio had cost the company a lot of money by the end of 2008. In addition to the operational losses, management had spent a lot of attention and additional money trying to turn each of the stores around.

Introduction of a new store opening policy. Learning from the mistakes made during the rapid expansion of the business, management introduced a new store opening policy to ensure future store openings would be a success.

The first lesson management had learned through the unprofitable restaurants was:

“if you are rolling out a retail business, you must very carefully focus on what makes your business work from a location point of view and hold very true to that.”

The new store opening process for Alpha restaurants included assessment of the local population demographics and analysis of natural traffic drivers in the area (e.g. cinemas, pubs, stores and offices). To help guide new location decisions in a more rigorous, analytical way, management introduced an overall location score calculated by weighting a range of different location attributes. Examining the attributes of Alpha Australia’s profitable stores identified these attributes and weights.

11 Source: Interview with Alpha Australia founder (2007), public source
The second lesson learned from the mistakes made during the rapid expansion phase in 2004 and 2005 was:

“if you are going to open a restaurant, do it properly or don’t do it at all”\(^{12}\).

This included taking the time to build and train the new restaurant team upfront, as well as making sure the new store opening did not negatively affect the performance of the established stores. The new store opening policy included expenses for nine weeks of team training prior to the store opening:

“[…] so that when the store opens the teams are ready and can actually take ownership of the store and not be reliant on assistance from elsewhere.”\(^{13}\)

Management realized that service levels declined during the rapid expansion because too many new staff required training in the restaurants at the same time. The new store opening process mandated that store openings would be staggered over time to ensure high quality training and consistent service levels. New staff would also be sent to different cities for training in order to mitigate against increasing the rookie factor in any single location.

**The costs of fixing and consolidating the business.** During the period of consolidating the business, management completed the ‘fix-it’ program with investments to enhance training, development, and recruiting management processes, repairs and maintenance of store equipment and the implementation of new technology for better management capabilities of the corporate support office as well as the restaurants. By

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\(^{12}\) Source: Research Interview with Alpha Australia CEO (2009)

\(^{13}\) Source: Alpha Australia management presentation (May, 2007)
the end of 2008 the business had gone through a major transition that included the following:\(^\text{14}\)

- Five store closures in poor locations or with poor trading prospects
- Investment in new IT systems to improve operational and financial controls
- Investment in management team and staff through better recruitment, training and implementing consistent human resource policies and procedures
- Investment in commercial equipment and important maintenance projects to bring every restaurant up to a high standard
- Re-financing of loans with a financial services company, that has a division focused on financing for the hospitality industry

The great effort to develop adequate management processes and direct investment in restaurant team capabilities led to a much improved team morale and competency to deliver good service. The improvement of the ability to deliver good service showed in much increased mystery dining scores due to increased investments in staff training (see figure 3). The mystery dining visits were conducted on a monthly basis as a measure for restaurant service quality and included a range of questions covering different aspects of the dining experience. A mystery diner would show up at a restaurant and secretly rate the service along a number of dimensions, including the speed of service, the friendliness and helpfulness of staff, the quality of the food, the cleanliness of the restaurant.

Despite these positive results, Alpha’s financial results continued to come in below expectations. Store Operating EBITDA was taking longer to improve than anticipated and was not adequate to sustain the support office costs, capital expenditure needs, and other funding obligations of the business. Figure 4 illustrates the increasing investment in Alpha Australia’s support office against the business’s profitabilit-

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\(^{14}\) Source: Alpha Australia shareholder presentation (March, 2009)
ity. The investment in support office mainly encompassed the salaries of Alpha’s executive team. Not included are capital expenditures for new store openings and store closings or financing expenses. The company’s operating net cash flow in financial year 2007 was -$1.5 million and -$1.0 million still in financial year 2008. The initial $2 million and further $4.2 million invested by the shareholders in August 2006 had been spent. Instead for opening 15 new stores, the money had been used for funding the build-up of the management team, the ‘fix-it’ program, debt repayments to the bank, and the business’s ongoing losses.

**Turnaround phase: Leveraging on capability development**

The company’s shareholders had growing concerns about the poor performance of their business. Over the six years since the launch of Alpha Australia, the shareholders had not seen the operation return one single dollar. The board of directors discussed three choices:

1) Sell the business for $0 and the investors lose their investment
2) Slash the costs of the support office by $1 million
3) Open more stores to increase the store EBITDA

The decision was made to trim some of the support office costs; open two new stores; ensure the consolidated restaurant portfolio meets the budget and earn minimum $2 million Operating EBITDA to recover the cost for the support office. The board made this decision because they still had confidence that management could turn the business around and make it a success. The Operating EBITDA contribution from a ‘great’ new Alpha store was estimated to be $250,000 per year, and therefore opening good stores would increase the Operating EBITDA (but increase capital

\[\text{Source: Alpha Australia management presentation (September, 2008)}\]
expenditure in the short term). Management agreed that the support office costs could be trimmed without a long-term detrimental effect on managerial capabilities and store operational performance.

With these decisions endorsed by shareholders, management secured another equity injection to finance the operations of the business and the opening of the two new stores. However, the company had reached a critical point and the pressure for achieving the turnaround of the business increased dramatically. The shareholders unambiguous message was that the Alpha management team from there on had to deliver results to budget. Management needed to prove that the investments in building the organization’s capabilities and fixing the business were worth the investment.

*Leveraging on the investments in capability development.* To save the company, it was crucial to quickly improve profitability leveraging on the continuous effort to improve operational capabilities of the restaurant teams:

“[…] we need to increase our efforts to get sales through great promotions, local store efforts and up-selling and also manage costs better in the restaurants. In addition we need to watch the support office costs. The future of Alpha depends on this.”

During the first half of 2009 management had a determined focus on marketing initiatives, improving operational standards, and the implementation of profit maximization initiatives and restaurant profit controls (see table 2 for a list of management’s actions to spur sales and bring costs down at the store level and the support office).

16 Source: E-Mail from Alpha Australia CEO to executive management team (October, 2008)
It proved that the development of better management processes, implementation of performance controls, investment in the ‘fix-it’ program, efforts to increase the restaurant team’s capabilities, and the store closures had laid the foundation to reverse Alpha Australia profitability development. The sales initiatives led to an average increase of 13% of monthly sales across all on a month-to-month comparison with the prior year (see figure 5). The increase in store sales was driven by a 5% price increase; by increasing marketing efforts; and by increasing average spending per guest, which was driven by focusing on selling additional items (e.g., side dishes, bottled water, juices, etc.) to guests. Although the average weekly number of guests across all stores was decreasing in financial year 2009 over financial year 2008, average spending per guest increased from $21.3 at the end of financial year 2008 to $24.5 by the end of financial year 2009. The improved sales were an especially strong result given that an economic recession negatively affected consumer spending in 2009 affecting the decrease in guest numbers. In addition to the sales driving initiatives, management’s decision to close the remaining unprofitable stores (one store during FY08 and two stores during FY09) also contributed to the increase in average sales per store.

The introduction of labor and profit principles helped managing the rosters more effectively resulting in significant labor cost savings (see figure 6). The labor principle ensured restaurant managers delivered better than budgeted profit when sales exceeded expectations and reduced costs to minimize the loss of profits when sales fell below budget. Also, management achieved a tremendous decrease in cost of sales through supplier renegotiations and the launch of cost of sales principles that restaurant General Managers were incentivized to meet (see figure 7).
The profit maximization initiatives significantly increased the financial performance of the business during financial year 2009. The average store Operating EBITDA margin increased from 2% at the beginning to 10% at the end of financial year 2009. Cost reductions in the support office also helped turn the business around, adding another 4% increase to the company’s profitability. As a result of these efforts Group EBITDA improved from -8% to 4%. Figure 8 shows the increase of the company’s Operating EBITDA margin and Group EBITDA margin during financial year 2009. After the severe bust phase for more than two years with massive losses Alpha Australia generated positive operating cash flows by the end of financial year 2009.

Stabilizing the operation. After successfully implementing the systems and processes to control labor costs and costs of sales, management next focused on achieving operational excellence. The business needed to continue to improve in order to generate sufficient profits to fund future investments in the business and to deliver returns to shareholders. The executive team agreed to change the vision of the company:

“Alpha’s vision until the end of 2010 is to be cash flow positive every period from now on, whilst maintaining our operational standards and save money every period to allow us to open our own restaurant without help from our shareholders or the bank.”

During this phase of continued focus on improving operational performance, management continued to reduce the cost of sales, to below 22%, through supplier

\[\text{Note: Operating EBITDA – Support Office costs}\]
\[\text{Source: E-Mail from Alpha Australia CEO to executive management team (June, 2009)}\]
negotiations. Also, restaurant managers completed an internal six-month coaching program to further improve their capabilities. Full employee retention of the main operational restaurant teams led to strong profit and loss management and operational execution. Additional cost savings were realized by restructuring the support office. In July 2009, as part of this restructure, Eric stepped back from the CEO position but maintained his involvement in the business as a member of the board of directors. The new CEO, replacing Eric, had been with the business since 2007 first as a restaurant manager and later as Operations Manager.

In spite of decreasing sales due to decreasing consumer spending in 2009 and 2010, Eric’s successor was able to continue Alpha Australia’s performance improvement. By the end of financial year 2011, all Alpha stores were delivering positive operating profits (see figure 9). In part, this was driven by continued improvements in average spending per customer, which increased from $24.5 at the beginning of financial year 2010 to $28.7 by the end of financial year 2011.

Alpha Australia also consistently achieved strong mystery dining results and positive audits of operational performance from the European parent company. The CEO and director of International Licensing of Alpha Europe visited the Australian operation in financial year 2010 and communicated that Alpha Australia was their best international franchise based on operational performance.

Management had successfully stabilized the business in difficult economic conditions and achieved the goal of opening two new Alpha stores by the end of 2011 using retained earnings from operations.

**Concluding remarks**

Alpha Australia’s, aggressive, rapid growth undermined the organization’s capabilities, which caused sustained periods of poor performance, leading to growth reversal
and very nearly resulted in bankruptcy. Building the organizational capabilities to support the firm’s growth had received limited attention in the rush for growth. The required organizational capabilities to operate the growing business were developed in response to the emergence of operational problems, which resulted from a lack of managerial capabilities during the rapid growth phase. It took a great amount of learning and investment to build the managerial and operational capabilities needed to stabilize the operation and achieve a turnaround. In reflecting about the lessons from Alpha Australia’s growth trajectory, Eric commented:

“One of the things in my mind, in the story about Alpha, is it would have been so much cheaper to not have to make all the mistakes in the restaurants and then have to spend so much money on support office to help the restaurants and then to cut back on the support office. Instead it would have been so much easier to slowly build the capability in the restaurants […] But what happened was the number of restaurants grew too quickly. The support office was non-existent, so it couldn’t help with the restaurants when the number of restaurants grew too quickly. Then, we had to invest heavily in support office, which is expensive because it’s straight to the bottom line and no revenue related to it. Then gradually, over time, build up the capability of the restaurants again to be able to then cut back on the support office. It’s just a very expensive way of doing it.”

The business has finally emerged from the turnaround and started once again growing the number of stores. Alpha Australia’s management and board of directors have learned indelible lessons from the boom and bust growth history of the business. With well-developed organizational capabilities including richer understanding

19 Source: Research Interview with Alpha Australia CEO (2009)
about the causal relationships within the operation and policies to sustainably lead
and grow the business, the odds of continued success seem high.

**5. System dynamics modeling results**

**5.1 Model description**

The model was developed to extract and build a deeper understanding of the dynamic
forces and causal relationships explaining the boom, bust and turnaround performance pattern of the case study firm. The model condenses the dynamic feedback structure in the real firm, which is already verbally embedded in the detailed case study description. As described in the method section, I use casual loop diagrams to illustrate the dynamic feedback structure implemented in the system dynamics model. The causal diagrams are a simplification of the much more complex system dynamics model (see appendix C).

**Management driven store expansion.** Figure 10 illustrates the feedback loop capturing the early store expansion driven by managements’ ambitious growth targets. Management’s goal to open 26 stores is captured in Target Number of Stores. The difference between Target Number of Stores and Total Number of Stores (indicating current number of stores) creates the Gap in Number of Stores, representing management’s desire to open more stores. The New Store Opening Rate connects to Total Number of Stores and closes feedback loop B1 (Management Driven Store Expansion). Feedback loop B1 represents a simple balancing or goal seeking feedback structure, which is a fundamental building block in representing organizational goal setting situations in system dynamic models (Sterman, 2000).

**Insufficient managerial capabilities causing performance decline.** The case study firm’s operating profit margin quickly fell below the expected level of 12% once management drove the rapid store expansion because of two reasons. First,
many of the new stores did not achieve the required customer levels needed to amortize the high labor costs. Second, the newly hired restaurant teams (servers, chefs, and restaurant managers) did not have the skills and experience to perform their jobs effectively. Both problems arose because the firm’s managerial capabilities were inappropriate for dealing with the rapid expansion of the business.

Figure 11 exemplifies the dynamic feedback structure underlying the performance decline, due to the selection of poor store locations. The New Store Opening Rate links negatively to Managerial Capabilities, because managing the business expansion and the growing store portfolio takes up managerial capacity and requires the advancement of managerial processes and systems. This link also denotes the dilution of location quality through rushing for growth and minimizing the required store opening investments in order to open more stores. Managerial Capabilities connect positively to Average Location Quality, as an increase in the former variable represents an improvement of the site selection process. However, the initial site selection policy was unprofessional and short-sighted. Management was focused on finding cheap sites in the rush for growth and lacked a structured approach for new site selection. This resulted in picking several poor locations where insufficient customer throughput caused immediate profitability issues. This is denoted in the positive link from Average Location Quality to Achieved Operating Margin through Customer Levels per Store, which drives Sales per Store. These connections capture that high numbers of customers are needed in order to offset labor costs in the stores. Due to declining Average Location Quality, Achieved Operating Margin falls below the Desired Operating Margin (of 12%), which engenders a gap between desired and actually achieved performance leading to pressure in the business. This is denoted in the variable Performance Pressure. This variable implies two things: (a) the literal
pressure management feels to achieve desired results, and (b) the availability of financial resources. As the performance gap increased management perceived growing pressure to improve the operation. Also, investors became concerned, which increased the pressure on management to improve performance. Sustained periods of decreasing profits also led to cash flow problems and eventually spoiled investor’s willingness to support the unprofitable growth of the business.

Therefore, cumulative performance pressure impedes further growth (i.e. slow down new store openings and also closing stores). This is captured in the negative link between Performance Pressure and New Store Opening Rate, which closes the balancing feedback loop B2 (Eroding Location Quality). However, this happens with a significant time delay, as it takes time for management and investors to perceive the performance gap and also correctly understand the causes for the poor performance of the operation. Until cumulative performance pressure leads to corrective actions feedback loop B2 drives the erosion of Average Location Quality, which in turn leads to decreasing profitability.

In figure 12 the balancing feedback loops B3a and B3b (Eroding Operational Capabilities) are added to the model structure. Feedback loop B3a represents the decrease in Average Staff Skills resulting from hiring many new staff – waiters, chefs, and restaurant managers – in response to the rapid succession of store openings. New staff is less skilled than experienced members of the organization, which is why Hiring Rate is negatively linked to Average Staff Skills. Also, management lacked managerial capabilities to thoroughly manage the hiring process and training of new staff. This is captured in feedback loop B3b, which links Managerial Capabilities to Average Staff Skills, and Operational Capabilities (Store In-Role Performance), which in turn is linked to Achieved Operating Margin. Without proper hir-
ing processes and human resource policies in place Operational Capabilities (Store-In-Role-Performance) of the restaurant teams decrease due to low Average Staff Skills. This matches the experience of the real firm, as servers were not sales oriented, chefs were cooking the food incorrectly and incurred a lot of wastage. Moreover, the restaurant managers did not manage the labor costs appropriately. All mentioned factors attributed to the fast and continuous erosion of operating profitability.

Similar to the balancing feedback loop B2, the feedback loops B3a and B3b drive the erosion of Operational Capabilities (Store In-Role Performance), leading to the fast decline in overall profitability of the operation, until financial pressure and increasing pressure from shareholders induce the moderation of growth and compel investment to raise staff skills and develop adequate organizational capabilities to effectively manage staff recruitment and training.

**Staff dissatisfaction reinforcing capability erosion and performance decline.**

In figure 13 the model structure is extended by the identified causal relationships reinforcing operational capability erosion and performance decline.

The qualitative case material gave evidence for the negative link between Performance Pressure and Staff Morale. As store profits were falling behind expectations, management pushed restaurant teams to their limits. Also staff grew dissatisfied due to the lack of a positive culture in the business and little pay (see table 1). Staff Morale is positively linked to Operational Capabilities (Store In-Role Performance), constituting that a decrease of Staff Morale adversely affects the quality of job execution, as staff gets less motivated and increasingly frustrated. Hence, this relationship creates the reinforcing feedback loop R1 (Staff Morale Spiral).

Continuously low levels of Staff Morale also increase the turnover rate. The negative link between Staff Morale and Staff Turnover denotes this effect. The con-
nection of Staff Turnover with Average Staff Skills completes the reinforcing feedback loop R2 (Staff Turnover Spiral). As dissatisfied staff members leave the company, it is even harder to build experience in the restaurant teams. Leaving staff members have to be replaced with new hires that need to be trained again and take substantial time to become effective in their roles. This leads to the further erosion of Average Staff Skills, which in turn contributes to the dilution Operational Capabilities (Store In-Role Performance) reinforcing the decline of operating profitability.

Another reinforcing feedback loop is added by linking Operational Capabilities (Store In-Role Performance) to Service Quality, which affects Customer Levels per Store. Poorly trained, inexperienced restaurant teams are not able to deliver great service to guests. Strong support for this was provided in the data by the initially low mystery dining scores. The results from the mystery dining visits implied that restaurant team’s ability to meet operational standards and deliver great service was poor until substantial investment in training lifted restaurant teams’ ability to meet operational standards and provide good service to guests (see figure 3). The positive link between Operational Capabilities and Service Quality denotes this relationship. However, poor Service Quality adversely impacts Customer Levels (i.e. prior customers get dissatisfied with the service or new customers come once but never want to come again). The reinforcing feedback loop R3 (Poor Service Quality Spiral) captures this causal relationship.

The causal relationships constituted in the feedback loops R1 and R2 are concerned with changes in the human dynamics resulting from growth and increasing pressure in the organization. These effects are also commonly discussed in the growth literature (Hambrick & Crozier, 1985; Hess, 2010; Slatter, 1992) as challenges and risks of growth. Also the underlying causal relationship of feedback loop R3
has been observed in previous studies about initially fast growing companies that experienced a subsequent downfall due to declining service quality (e.g. Morecroft, 2007; Oliva et al., 2003).

**Performance pressure leading to development of capabilities.** Accumulating performance pressure induces the build-up of managerial and operational capabilities. This crucial effect of performance pressure is illustrated by the link from the variable Performance Pressure to Effort to Develop Organizational Capabilities in figure 14. The effect that accumulating pressure leads to strategic and organizational changes aiming to achieve desired outcomes has been theoretically studied by Tushman and Romanelli (1985) and is also formalized in a simulation model by Sastry (1997). The model also captures the effect that a growing gap between actual and desired outcomes leads to increasing efforts to achieve performance improvements. The principal issue for the case study firm was to enhance its managerial capabilities in order to be able to administrate the business operation with more than 400 employees and to fix the evolving operational problems. The specific things that were gradually implemented requiring substantial financial and human capital included: build-up and extension of the executive management team and management processes, development of corporate structures including corporate functions for human resource, marketing and accounting; careful organization and planning of staff training; investment in technology based control systems both on the corporate and store level; development of performance measures and performance standards; implementation of employee development activities; development of corporate values and ensuring compliance; and implementation of a rigorous site selection and store opening process. The described measures generated the basis to regain control over the organization, raise staff skills and operational capabilities of the restaurant teams.
This causal relationship is represented by the positive connection between Effort to Develop Organizational Capabilities and Managerial Capabilities. This link creates the balancing feedback loop B4 (Build-up of Organizational Capabilities), which acts to support the balancing effects of feedback loops B2, B3a, and B3b. For simplification the link from Effort to Develop Organizational Capabilities to Managerial Capabilities to Average Staff Skills also denotes the positive effect of investment in staff training on Average Staff Skills.

**Accumulated performance pressure causing moderation of growth and store closures.** As the business was continuously loosing cash, investors increased the pressure on management to work on profitability. Investors decided not to further fund unprofitable store openings, and stressed that management had to put rigorous focus on improving the business. Eventually, this also drove the decision to close the poorly performing stores. The unprofitable stores had been a great distraction to management and had incurred great financial losses. The decision to slow down the growth process and even close the (unprofitable) stores is already embedded in the presented feedback structure, captured by the negative link from Performance Pressure to New Store Opening Rate (see figure 14)\(^\text{20}\). Stopping store expansion and closing stores drives the balancing effects of the feedback loops B2 and B3.

Halting new store openings and closing the poorly performing stores enabled management to fully concentrate on a smaller number of stores giving more managerial capacity to focus on the ongoing business improvements. Closing the poor store locations denotes an improvement of Average Location Quality, which causes Achieved Operating Margin to increase. The number of stores that could not attract

\(^\text{20}\) Note: Store closures and new store openings are separated in the full system dynamics model (see appendix C); for the purpose of simplifying the causal loop diagrams the reader should assume that New Store Opening Rate can be negative, which expresses net store closures.
enough customers to guarantee profitability had dragged down the profitability of the overall portfolio. Closing the worst performing stores was necessary to build and maintain a reduced portfolio of profitable stores (compare figures 2 and 9).

5.2 Model simulation

This section presents the simulation results of the full model and highlights the results from three simulation experiments. The model does not aim to achieve exact numerical reproduction and statistical fit with the historical data. The model’s primary purpose is to capture the qualitative patterns and dynamic behavior observed in the real system. On the one hand, this serves to augment one’s understanding of the causal relationships explaining the dynamic behavior of the real system; on the other hand, this provides the basis to run simulation experiments that can test whether and how different policies lead to changes in the dynamic behavior and outcomes.

**Base run.** In the base run, the parameters of the model variables are set to replicate the dynamic behavior observed in the real business. Figure 15 presents the simulated development of sales and Operating EBITDA margin. The boom and bust phases are stronger accentuated in the simulation model compared with the actual historical data (see figure 1 for the pattern of sales versus operating profit margin development of the real firm, and appendix A for the exact numbers). In the simulation sales grow faster, because the model starts with five store openings per year and stays at this level until 2007, as opposed to less store openings in the real firm (see appendix A). This explains why sales grow quicker in the simulation compared with the historical data. Also, the simulated decrease of the operating profit margin is stronger than observed in the real data. In the simulation model the Operating EBITDA margin increases to above 15% during the early boom phase, which is slightly higher than the values in the historical data and falls to approximate 3% ver-
sus 7% percent in the real firm. Operating EBITDA margin recovers by the end of the simulation to approximately 12%, which is consistent with the historical data. In the simulation the Operating EBITDA margin begins to recover one year earlier than observed in the real case. In the model, this is line with the simulated development of sales, which also peak one year earlier than in the historical data. Despite these numerical deviations, the simulated base run and the real system show the same growth pattern of rapid growth followed by a reversal of sales growth and the recovery of operating profitability.

Figure 16 illustrates the driving forces for the performance erosion and recovery in the simulated base run. At the beginning Managerial Capabilities (line 1) are greater than the threshold of one. One was set to be the reference ratio of required and actual managerial capabilities for achieving normal business performance (operating profit margin of 12%). At the beginning of the simulation the firm has one store. The reference value for normal location quality (i.e. that attracts sufficient customers to achieve expected operating profitability) is 70 on a scale from 0 to 100. The first store is slightly above the average location quality, denoted by Location Quality (line 2) starting at 75. Similarly, the reference value for Average Staff Skills (line 3) required to achieve normal performance was set to be 70 on the same scale from 0 to 100. The team in the first store starts at a level of 60, because the team is still inexperienced. Managerial Capabilities are better than sufficient to manage the first store and also the first few store openings (Average Location Quality and Average Staff Skills rise). However, the adequacy of Managerial Capabilities falls quickly below the reference value resulting from increasing demand of managerial capacity and needed processes driven by consecutive store openings. The demands of the fast business expansion overstretch managerial capabilities, line 1 falls below the refer-
ence value of one. This implies the selection of poor locations and poorly skilled new hires, which in turn causes Average Location Quality (line 2) and Average Staff Skills (line 3) to drop below the reference value of 70. This in turn leads to decreasing customer levels and poor operational capabilities in the restaurant teams, which cause the rapid decline of operational profitability (line 2 in figure 15). Lines 2 and 3 start to increase due to the moderation of growth (i.e. stopping new store openings and building a consolidated store portfolio) and investment in rebuilding organizational capabilities.

Figure 17 illustrates the dynamic behavior leading to the decline in sales and the recovery of lines 1, 2, and 3 in the previous diagram (figure 16). Increasing Performance Pressure (line 1) stops New Store Openings (line 4) by 2007 and also prompts Store Closures (line 3), which acts to improve Average Location Quality leading to improving profitability. The increase in Performance Pressure engenders an increase in Effort to Develop Organizational Capabilities (line 2). This comprises both the investment in building Managerial Capabilities by expanding the management team and implementation of managerial processes across different functional areas and improving Average Staff Skills through investment in training. These investments yield the improvement of Operational Capabilities (Store In-Role Performance) causing profitability to recover.

**Simulation experiment 1: Adequate managerial capabilities.** Figure 18 presents the results of the first simulation experiment, in which a constant adequate level of managerial capabilities is assumed. For that purpose the model variable Managerial Capabilities was set to be one for the entire simulation period (line 3). In this ideal scenario the business continuously grows at the initial rate of the base run and achieves to open the targeted 26 stores by 2009, yielding a turnover of $50 million
(line 1). Assuming that the firm always has sufficient managerial capabilities to cope with the growth process and retain control over the enlarged operation, the firm is also able to slowly ramp up profitability (line 2) as operational capabilities improve over time through steady learning and improvements in the operation (line 4).

This scenario highlights, that having adequate managerial capabilities yields much better performance outcomes in comparison with the base case, in which organizational capabilities are insufficient to control the growing organization and have to be rebuild.

**Simulation experiment 2: Moderate growth.** The second simulation experiment assumes a moderate growth strategy, which suggests that the business grows by adding one store per year. This is achieved by setting the New Store Opening Rate at a constant value of one. As depicted in figure 19, the firm’s Managerial Capabilities (line 4) stay above the value of one for the entire simulation horizon. This is because the model assumes that management starts with more than adequate Managerial Capabilities appropriate to manage a number of stores. Also, managerial capabilities increase in each year by a standard rate. This represents a steady improvement of capabilities due to learning effects and a normal level of continuous investment into increasing management capacity and processes. Therefore management is able to manage the slowly growing portfolio of stores. The moderate growth allows management the time and resources to pick excellent sites (i.e. Average Location Quality is greater than reference value of 70), which guarantee high customer throughput, yielding excellent profitability of the stores. Adding one store at a time also facilitates hiring new staff and appropriate training of the restaurant teams without negatively affecting profitability of the running operation. These two factors drive high profitability of the slowly growing store portfolio. By the end of this simulation the
firm achieves even higher turnover by 2011 as in the base run, and also operates at much better operational profitability.

**Simulation experiment 3: Acting promptly.** The third simulation experiment tests whether perceiving and reacting faster to occurring performance pressure leads to different outcomes. This experiment assumes that management immediately reacts to a performance decline of 1% below the expected level of 12% operating profit margin by halting store expansion and developing organizational capabilities earlier as compared to the base run.

Figure 20 illustrates the firm’s sales development of this scenario compared with the base run. As evident from the graph the firm grows at the same speed initially but the business expansion is stopped earlier as in the base run. Sales in this simulation experiment remain at the same level until 2008 and then a new phase of store openings drives further sales growth (line 2) versus sales reversal and stagnation in the base run (line 1).

Figure 21 presents the same comparison of this simulation with the base run for the development of operating performance. The Operating EBITDA margin also declines after the initial boom in this simulation experiment due to the rapid store expansion, which overstretches Managerial Capabilities leading to the erosion of Average Location Quality and Operational Capabilities (Store In-Role Performance). However, the performance decline is much less severe. Also, the operating profitability remains at the expected level during the next growth phase.

Figure 22 illustrates what causes the difference in sales and performance development of this simulation experiment compared with the base run. Reacting to occurring management and operational problems earlier by stopping further growth more promptly (line 3 versus line 4) halts the erosion of Managerial Capabilities. In the
base run managerial capabilities dwindle further due to additional store openings (line 2 versus line 1). In contrast to the base run, this allows the firm the time and resources to achieve the improvement of organizational capabilities much faster than in the base run, in which additional store openings between 2005 and 2007 yield unprofitable growth and exacerbation of managerial and operational problems within the business. Recovering profitability requires much greater effort in the base run. Rebuilding poor organizational capabilities impedes new store openings until the end of the simulation (line 4 stays at zero from 2007 onwards). In the simulation experiment managerial capabilities improve quicker during the stagnation phase between 2005 and 2008 as the damage to the organizational system is not as severe. Because the operating margin does not fall as dramatically as in the base run, implying less financial strain and less worried investors, the firm is able to start a new growth phase by 2008. With adequate managerial capabilities in place the firm is able to increasingly grow the number of stores and achieve the expected level of operating profitability during the renewed growth phase.

6. Discussion

6.1 Implications of the study

This study contributes to remedy the perceived lack of knowledge in the firm growth literature about the dynamic process of growth and extends the integration of the concept of capabilities into the research on firm growth. Prior research suggests that the development of adequate organizational capabilities is crucial for achieving sustainable growth. However, detailed investigation of how firms build capabilities for growth and the effects of overstretching organizational capabilities due to fast growth is scarce. By providing insights about the dynamic relationships of firm growth, capabilities, and performance this study provides a firm internal explanation
for why in many cases growth surges are followed by periods of stagnation and/or reversal. The findings of this study have important implications for research and practice.

**Theoretical implications.** The present case study and system dynamics model explain how growth can undermine organizational capabilities leading to performance erosion, which in turn can result in growth reversal. This has been suggested by prior research as being one common reason for why many firms fail to achieve continuous growth over time (Garnsey & Heffernan, 2005). The results of this study imply that: (a) continuous growth without adequate development of managerial capabilities to manage the process of growth and the larger organization, can lead to the erosion of operational capabilities, which in turn can dilute overall firm growth rates or even drive the growing organization into severe crisis of financial performance decline leading to growth setbacks; (b) failure to develop required organizational capabilities results from constraints on the process of learning and how fast organizational capabilities can be developed; and (c) rebuilding the organizational capabilities can take several years even in a relatively small firm, and requires extensive investment of financial as well as human resources.

The results of the present study challenge the universal notion of growth as an ultimate measure of business success and being inherently positive. Growth can be good and be conducive to further growth as long as the firm is able to cope with building the organizational capabilities that an increasingly larger firm requires. This has been proposed in a study of Garnsey et al. (2006) and is reassured by the findings of this study. After the successful opening of the first few stores the company was able to secure more capital from private investors and also bank loans to fund further growth of the business. However, the lack of managerial capabilities, insufficient to
adequately cope with the rapid growth of the firm, led to the erosion of operational capabilities, which in turn caused profitability to decline. Continuously declining profitability stressed the limited financial resources of the growing business and complicated further fundraising, needed to fund further growth.

Further, the findings of the present study highlight that a relentless growth focus can limit business potential and lead to poor performance outcomes. Especially rapid growth poses the threat that negative effects may go undetected initially, but unfold over time (Garnsey & Heffernan, 2005; Hess, 2010). Therefore, a central problem of growth, and particularly rapid growth, is that difficulties may escalate before they are addressed (Garnsey & Heffernan, 2005). The results from the case study underpin these issues, addressed in the literature. For example the management of the case study firm expected that new stores needed considerable time to ramp up sales. Only after almost two years the first store was closed because management realized that customer numbers were never going to be sufficient due to the poor location of the store. However, during that time management had opened stores in similar locations, but these location concepts just were not attracting enough customers to offset the costs of the store operations.

Following up on this, another finding from the case study and the system dynamics model is that it takes substantial time to develop organizational capabilities. Building an effective management team, managerial experience, organizational structures, policies and systems happen in an evolutionary process over time. Also the integration and training of new staff takes time. There is a limit to the speed of these processes, which also puts a limit to the rate at which a firm can grow without overstretching the organizational system. The moderate growth simulation experiment implies that more modest growth strategies allow businesses the time and re-
sources to invest in building sufficient organizational capabilities needed for the profitable operation of the business in the long term. Growing at moderate rates allows the simulated company to achieve the required organizational changes to sustain profitable growth. Therefore, this study suggests that the rate at which a firm can profitably grow is limited by the ability to build and accumulate sufficient organizational capabilities in a continuous process of investment and accumulation of knowledge. This is consistent with Penrose’s growth theory and studies on organizational learning.

However, this study has additional implications, as this study is concerned with a case in which managerial capabilities are overstretched by growing too rapidly. The results from the case study and the system dynamics model illustrate how this can lead to operational problems and performance decline. Furthermore, the results show that the process of rebuilding organizational capabilities can be a lengthy and costly process for a firm, impeding the firm’s growth process for several years. This has important implications for research investigating the process of rebuilding resource and capability levels.

The results from the third simulation experiment show that stopping additional growth when the organizational system is already strained contains increasing damage to the organization. This implies that reacting to occurring problems within the operation quickly and pacing growth before things get too bad may be crucial to whether the firm is able to recover more easily and continue growing when adequate organizational capabilities are in place or enters a period of severe crisis, which may spoil long-term investor support. The importance of knowing how to pace growth is also stressed by Hess (2010) and Hambrick and Crozier (1985) in the literature. The results from the system dynamics model support this view.
Yet, the question remains why firms fail to sustain and develop adequate organizational capabilities before they are needed? This leads to another point that finds addressing in the extant growth literature and has also evolved from the findings of this study. Organizational learning and the development of capabilities, particularly managerial capabilities, happen in an evolutionary process of trial and error (Phelps et al., 2007). It seems that the development of required organizational capabilities is in many cases triggered by the occurrence and happens in response to crisis (Deakins & Freel, 1998; Garengo & Bernardi, 2007; Slevin & Covin, 1997). This is one explanation why many firms, fail to develop adequate organizational capabilities before their insufficiency leads to noticeable problems within the operation. A difficult to solve problem seems to be that crisis need to occur in order to spur learning about what organizational capabilities are required, leading to investment in building these capabilities. The first simulation experiment shows that having adequate managerial capabilities (to cope with the challenges of growth and sustain high operational performance) in place at all times enables the firm to sustain high growth rates and profitability. However, in accordance with the previously discussed point, this scenario hardly represents how capabilities, particularly managerial capabilities, are developed in real firms. This observation also questions whether the implication of the second simulation experiment that growing at moderate rates prevents straining of organizational capabilities is actually transferrable to the growth process of real firms. It could be that some sort of managerial or operational crisis always has to precede for inducing subsequent development of adequate organizational capabilities.

The findings in the present study extend the understanding of the consequences of overstretching organizational capabilities by growing the firm too rapidly. How to
facilitate the development of capabilities and solve the issue that required capabilities are developed with considerable delay due to the evolutionary process of managerial learning is left for future research to answer.

**Practical implications.** The results of this study stress the importance for business leaders and investors of understanding that growth connotes increasing managerial complexity, which demands the enhancement of managerial capabilities. The managerial capacity and processes needed in an organization with 50 employees will certainly be inappropriate when the organization doubles or triples in size. When growth requires hiring many new employees, business leaders need to be careful not to underestimate the management challenges associated with changes in the firm’s human dynamics (feedback effects of intangible factors including pressure in the business, skill of the workforce, employee morale, firm culture, etc.). Especially, the recruitment, integration, and training of new employees require investment of organizational resources and adequate managerial capabilities. If these capabilities are not in place, fast growth is likely to lead to managerial and operational challenges that can be costly to fix and disrupt the growth process for substantial periods of time.

### 6.2 Limitations of the study

The principal caveat of case study research is that the small sample size employed by case study methodologies limits the degree of generalization of such studies to populations of firms. This is also the case with this study, particularly so, because the analysis was confined to the idiosyncratic data of one single firm. However, using rich case data also has advantages for theory building (Eisenhardt, 1989; Freel, 2000; Yin, 2008). Connecting data from the specific growth case with constructs and relationships from the literature helped to enrich our understanding about the link between firm growth, managerial and operational capabilities, and firm performance.
The case study and the associated system dynamics model are based on a particular firm in the hospitality industry. Therefore, the findings might be more easily transferred to other companies of comparable industries. The specific variables and causal relationships certainly take a different form in other companies and other industries (e.g. technology-based companies), but the danger that rapid growth will overstretch managerial capabilities and undermine operational capabilities is applicable to virtually any organization. Future work could test the generalizability of the findings through either more longitudinal case study research or large sample studies.

Another common limitation of the case study approach, although it constitutes a suitable method for capturing the complexity and dynamism of the studied phenomenon, is that it leaves the results in a descriptive form. Building a system dynamics model facilitated converting the descriptive case data in a formal mathematical model.

Yet, system dynamics modeling, like any method has limitations as well. Every model is a simplification of the complexity inherent in the real system (Sterman, 2000). The challenge of building system dynamics models is to choose a “level of conception and system boundaries that include the smallest number of components capable of appropriately describing the real […] system” (Hall, 1976, p. 187). The purpose of the model in this study was to capture the central causal relationships underlying the studied firm’s performance and growth pattern. The detail of the developed model was sufficient to serve this purpose, however the chosen level of detail was insufficient to reproduce an exact numerical fit with the historical data.

Also needs to be addressed that the model placed special emphasize on managerial capabilities driving firm growth. The first simulation experiment suggests that with adequate managerial capabilities in place the case study firm could have grown
to 26 stores within six years by opening 5 stores a year. Although both the total number of stores and the store-opening rate is reasonably achievable, the model omits that growth rates and the firm’s potential for growth are not solely controlled by managerial capabilities, but are also bounded by external factors (e.g. availability of store sites, customer acceptance, increasing competition).

The model was limited to the investigation of the firm’s essential internal feedback loops and therefore omitted the downturn in customer numbers due to the effects of the economic recession in 2009 and 2010, which were offset by a price increase and upselling of additional items to guests. This was not captured in the model. Also omitted in the case study as well as the system dynamics model were factors relating to the competitive environment. Although the data suggested that the firm’s performance development was solely in management’s hands, it cannot be ruled out that developments in the competitive environment affected the studied firm’s growth rates and profitability.

6.3 Future research and concluding remarks

While this study focused on one particular firm, future research could take the path of empirically enumerating how often failure to develop and sustain appropriate organizational capabilities is responsible for the dilution or reversal of growth rates. Also, future studies could delve into the topic why companies fail to develop appropriate organizational capabilities during the growth process. This study has analyzed a case in which the erosion of organizational capabilities was induced by the ambition to grow as quickly as possible and a failure to recognize the effects of growth on firm internal dynamics. Interesting questions for future research to answer also include: Do firms that are pursuing less aggressive growth strategies still struggle to
simultaneously develop needed capabilities? What facilitates the development of organizational capabilities?

In order to advance research on firm growth, future studies need to be designed to and apply methods that are able to cope with and embrace the dynamism and complexity inherent to the phenomenon of growth. This calls for more longitudinal studies on the firm level and requires multi-dimensional study approaches that aim to integrate various theoretical perspectives from research on organizational learning, organizational transitions, entrepreneurship and management theory.

The combination of the case study and the system dynamics model used in this study explain how rapid growth can undermine organizational capabilities leading to sustained periods of performance erosion. The findings highlight the importance of developing adequate managerial capabilities, needed to cope with the challenges of growth and to sustain sufficient levels of operational capabilities necessary for achieving profitable growth. Growing too rapidly to sustain sufficient organizational capabilities is one explanation for why firms fail to stay on a continuous growth trajectory and also one cause for commonly observed periods of growth stagnation and/or reversal. These findings yield important implications for how rapidly firms should grow, and for future research into the dynamics of capability development.
References


Weick, K.E. (1979). The social psychology of organizing (Topics in social psychology series).


### Tables and figures

**Table 1: Employee feedback about issues in the business in FY06**

<table>
<thead>
<tr>
<th>Training</th>
<th>Marketing</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Lack of training – we need training at the start or we pick up bad habits, make mistakes, cause waste etc.</td>
<td>• We give away too much free food</td>
</tr>
<tr>
<td>• We have staff/management that are not even 50% competent because no training was given – and then blaming them</td>
<td>• We run to many promotions, I think this cheapens the brand</td>
</tr>
<tr>
<td>• Managers not properly trained so they cannot train the team</td>
<td>• No store specific marketing ideas</td>
</tr>
<tr>
<td></td>
<td>• Marketing seems to only be focused on 2 for 1 voucher – is this really marketing?</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Basics</th>
<th>Accountability</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Fix the basics before we can move forward</td>
<td>• There is unwillingness in the business to deal with the difficult problems</td>
</tr>
<tr>
<td>• Basic issues not dealt with in the business</td>
<td>• Lack of accountability in the business</td>
</tr>
<tr>
<td>• Marketing is detrimental when we cannot get the basics right</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Suppliers</th>
<th>Customers</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Our suppliers deny us product/service because they have not been payed</td>
<td>• Inconsistent customer experience</td>
</tr>
<tr>
<td>• Poor supplier relationships</td>
<td>• Negative word of mouth</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Culture</th>
<th>Communication</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Lack of pride in this company</td>
<td>• Lack of communication at all levels</td>
</tr>
<tr>
<td>• Too reactive</td>
<td>• Stores not in Sydney are out the loop</td>
</tr>
<tr>
<td>• A culture of negativity</td>
<td>• Not enough communication between the stores</td>
</tr>
<tr>
<td>• Too many band aid solutions</td>
<td>• Need more communication between support office and stores before changing or implementing anything</td>
</tr>
<tr>
<td>• Lack of recognition for the job I do with the resources I have</td>
<td>• Inability to effectively communicate with back of house staff with poor English skills</td>
</tr>
<tr>
<td>• Issue with general managers not understanding they are responsible for back of house and front of house staff</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Leadership</th>
<th>Team Satisfaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>• High level expectations without any specific direction</td>
<td>• Expectations on work hours of restaurant managers to high</td>
</tr>
<tr>
<td>• Need for achievable timeline and plan to change things</td>
<td>• Working too many hours with low pay</td>
</tr>
<tr>
<td>• Lack of leadership from above</td>
<td>• Need to get paid bonuses</td>
</tr>
<tr>
<td>• No process thought out</td>
<td>• No work life balance</td>
</tr>
<tr>
<td>• Thrust into a million different directions at once</td>
<td>• No performance or pay review for 12 months</td>
</tr>
<tr>
<td>• Starting too many things e.g. catering and specials when we cannot even handle the basics</td>
<td>• Current rate of pay for team members is too low</td>
</tr>
<tr>
<td>• No learning from mistakes to stop it happening again</td>
<td>• Staff turnover is too high leading to more work, more pressure, slides in performance</td>
</tr>
<tr>
<td></td>
<td>• Need to create a hospitality career path for people</td>
</tr>
<tr>
<td></td>
<td>• We hire too many students and travellers – not enough industry focused people</td>
</tr>
</tbody>
</table>

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Source: Adapted from Alpha Australia internal management presentation (May, 2006)
Table 2: Sales driving and cost reduction initiatives to improve profitability

<table>
<thead>
<tr>
<th>Restaurant cost reduction</th>
<th>Support office cost reduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Cost of sales management and supplier negotiation and sourcing</td>
<td>• Restructure of the marketing department and salary reduction of the marketing manager</td>
</tr>
<tr>
<td>• Labour management through strong accountability process</td>
<td>• Salary reduction of the CEO</td>
</tr>
<tr>
<td>• Focus on the reduction of consumables costs: e.g. elimination of wet towels, advertising revenue from suppliers</td>
<td>• Elimination of development costs paid to Paul as a result of us not opening any further restaurants in the near future</td>
</tr>
<tr>
<td>• Charging for Credit card usage through a surcharge</td>
<td>• Reduction in travel</td>
</tr>
<tr>
<td>• Introduction of team meal cards</td>
<td>• Elimination of bonuses</td>
</tr>
<tr>
<td>• Focus on reducing chemical usage</td>
<td>• Pay freeze</td>
</tr>
<tr>
<td>• Renegotiation of utility contracts</td>
<td>• Restructure of the operations team</td>
</tr>
<tr>
<td>• Bonus reduction</td>
<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Sales driving initiatives</th>
<th>Sales initiatives</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Price rise – increasing prices by main suppliers put pressure on cost of sales; to improve cost of sales management and drive top line sales implementing a price rise by 5%.</td>
<td>• TV advertising – advertising on TV in Perth and Sydney; also trialling TV advertising in Brisbane</td>
</tr>
<tr>
<td>• Focus on increasing the spending per guest; improving up-selling capabilities of service staff</td>
<td>• Radio advertising – advertising on the radio to raise brand awareness and drive traffic to the restaurants</td>
</tr>
<tr>
<td></td>
<td>• Sales initiatives to support two newest stores</td>
</tr>
</tbody>
</table>

22 Source: Adapted from internal Alpha Australia shareholder presentation (March, 2009)
Figure 1: Sales and operating performance development\textsuperscript{23}

\textsuperscript{23} Source: Alpha Australia internal financial reports
Figure 2: Store portfolio sales and profit relationship FY07\textsuperscript{24}

\textsuperscript{24} Source: Alpha Australia internal financial reports
Figure 3: Investment in staff training and improvement of service standards

25 Source: Alpha Australia Mystery Dining reports and internal financial reports
Figure 4: Investment in support office and development of profit margins²⁶

²⁶ Source: Alpha Australia internal financial reports
Figure 5: Average store sales per period for FY08 vs. FY09$^{27}$

Note: Alpha reports financials, as is common in the hospitality and retail industries, using periods instead of months. This way every period can start on a Monday and end on a Sunday and each week is comparable to another. Monthly reports cause problems because some months have more days than others and some months may have more Fridays or other days of the week than other months. Therefore, Alpha is managed on a weekly basis and reports financials in periods instead of months. The financial year has 13 periods.

$^{27}$ Source: Alpha Australia internal financial reports
Figure 6: Labor cost improvements FY08 vs. FY09²⁸

²⁸ Source: Alpha Australia internal financial reports
Figure 7: Improved cost of sales management FY08 vs. FY09

Source: Alpha Australia internal financial reports

29 Source: Alpha Australia internal financial reports
Figure 8: Improving profit margins in FY09\textsuperscript{30}

\textsuperscript{30} Source: Alpha Australia internal financial reports
Figure 9: Store portfolio sales and profit relationship FY11

Source: Alpha Australia internal financial reports
Figure 10: Balancing feedback loop B1

Note: Arrows indicate the direction of causality. The pluses and minuses indicate the polarity of relationships: “+” denotes that an increase in the independent variable causes the dependent variable to increase, while a decrease causes a decrease. Similarly, a “−” indicates that an increase in the independent variable causes the dependent variable to decrease, while a decrease causes an increase (Sterman, 2000). Loops are marked with circular arrow; a “B” indicates a balancing loop, “R” stands for reinforcing. Each loop is given a unique number code for identification.
Figure 11: Balancing feedback loop B2
Figure 12: Balancing feedback loops B3a and B3b
Figure 13: Reinforcing feedback loops R1, R2, R3
Figure 14: Balancing feedback loop B4
Figure 15: Base run: Simulated sales and operating performance development
Figure 16: Base run: Development of capabilities, staff skills, location quality
Figure 17: Base run: Effects of performance pressure
Figure 18: Simulation experiment 1: Adequate managerial capabilities
Figure 19: Simulation experiment 2: Moderate growth
Figure 20: Simulation experiment 3: Development of sales
Figure 21: Simulation experiment 3: Development of operating profitability
Figure 22: Simulation experiment 3: Store openings and managerial capabilities
Appendices

Appendix A: Alpha Australia historical performance in numbers

<table>
<thead>
<tr>
<th></th>
<th>The Boom</th>
<th>The Bust</th>
<th>The Turnaround</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>FY03</td>
<td>FY04</td>
<td>FY05</td>
</tr>
<tr>
<td>Nr. of Stores</td>
<td>#</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>Store Openings</td>
<td>#</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Store Closings</td>
<td>#</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Sales</td>
<td>$'000</td>
<td>2,894</td>
<td>4,529</td>
</tr>
<tr>
<td>Sales Growth</td>
<td>%</td>
<td>57%</td>
<td>107%</td>
</tr>
<tr>
<td>EBITDA</td>
<td>$'000</td>
<td>322</td>
<td>664</td>
</tr>
<tr>
<td>% of Sales</td>
<td>%</td>
<td>11.1%</td>
<td>14.7%</td>
</tr>
<tr>
<td>Support Office</td>
<td>$'000</td>
<td>0</td>
<td>123</td>
</tr>
<tr>
<td>% of Sales</td>
<td>%</td>
<td>0.0%</td>
<td>2.7%</td>
</tr>
<tr>
<td>Group EBITDA</td>
<td>$'000</td>
<td>322</td>
<td>541</td>
</tr>
<tr>
<td>% of Sales</td>
<td>%</td>
<td>11.1%</td>
<td>11.9%</td>
</tr>
</tbody>
</table>

Source: Alpha Australia internal business report
### Appendix B: Alpha Australia store openings and closures FY02 – FY11

<table>
<thead>
<tr>
<th>Year</th>
<th>Date</th>
<th>Event Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY02</td>
<td>Dec, 2001</td>
<td>License agreement signed between Alpha Europe and founder</td>
</tr>
<tr>
<td></td>
<td>May, 2002</td>
<td>Store opening (#1), flagship location in Sydney, New South Wales</td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>FY03</strong> – Jun, 2003</td>
</tr>
<tr>
<td></td>
<td>Jul, 2003</td>
<td>Store opening (#2) in Sydney, New South Wales</td>
</tr>
<tr>
<td></td>
<td>Feb, 2004</td>
<td>Store opening (#3) in Sydney, New South Wales</td>
</tr>
<tr>
<td></td>
<td></td>
<td>FY04 – Jun, 2004</td>
</tr>
<tr>
<td></td>
<td>Oct, 2004</td>
<td>First store opening (#5) in Melbourne, Victoria</td>
</tr>
<tr>
<td></td>
<td>Dec, 2004</td>
<td>Store opening (#6) on the central coast (first regional operation)</td>
</tr>
<tr>
<td></td>
<td>Feb, 2005</td>
<td>Store opening (#7) in Sydney, New South Wales</td>
</tr>
<tr>
<td></td>
<td>Mar, 2005</td>
<td>First store opening (#8) in Brisbane, Queensland</td>
</tr>
<tr>
<td></td>
<td>Nov, 2005</td>
<td>Store opening (#9) in Sydney, New South Wales</td>
</tr>
<tr>
<td></td>
<td>Dec, 2005</td>
<td>Store opening (#10) in Melbourne, Victoria</td>
</tr>
<tr>
<td></td>
<td>Feb, 2006</td>
<td>First store opening (#11) in Perth, Western Australia</td>
</tr>
<tr>
<td></td>
<td>Aug, 2006</td>
<td>First store closure (store #5) and relocation (#12)</td>
</tr>
<tr>
<td></td>
<td>Nov, 2006</td>
<td>Store opening (#13) in Brisbane, Queensland</td>
</tr>
<tr>
<td></td>
<td>Dec, 2006</td>
<td>Store opening (#14) in Canberra, New South Wales</td>
</tr>
<tr>
<td></td>
<td>Jan, 2007</td>
<td>Second store closure (store #6)</td>
</tr>
<tr>
<td></td>
<td>Mar, 2007</td>
<td>Store opening (#15) in Brisbane, Queensland</td>
</tr>
<tr>
<td></td>
<td>Nov, 2007</td>
<td>Third store closure (#7)</td>
</tr>
<tr>
<td></td>
<td>Sep, 2008</td>
<td>Fourth store closure (#3), fifth store closure (#12)</td>
</tr>
<tr>
<td></td>
<td>Oct, 2008</td>
<td>Store opening (#16) in Chadstone, Victoria; store opening (#17) in Fremantle, WA</td>
</tr>
<tr>
<td></td>
<td></td>
<td>FY10 – Jun, 2009</td>
</tr>
<tr>
<td></td>
<td></td>
<td>FY11 – Jun, 2010</td>
</tr>
</tbody>
</table>

Note: Alpha Australia’s financial year starts in July and ends in June

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33 Source: Alpha Australia internal business report
Ehrenwörtliche Erklärung

Ich erkläre hiermit ehrenwörtlich, dass ich die vorliegende Arbeit selbständig angefertigt habe. Die aus fremden Quellen direkt und indirekt übernommenen Gedanken sind als solche kenntlich gemacht.


Die Arbeit wurde weder einer anderen Prüfungsbehörde vorgelegt noch veröffentlicht.

Sydney, 11. März 2013

____________________________________
(Unterschrift des Verfassers)