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SUCCESS FACTORS IN GROWING SMBs: A STUDY OF TWO INDUSTRIES AT TWO STAGES OF DEVELOPMENT

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ABSTRACT

The study attempts to identify factors for growing SMBs. An evolutionary phase approach has been used. The study also aims to find out if there are common and different denominators for newer and older firms that can affect their profitability. The study selects a sampling frame that isolates two groups of firms in two industries at two stages of development. A variety of organizational and structural data was collected and analyzed. Amongst the conclusions that may be drawn from the study are that it is not easy to find a common definition of success, it is important to stratify SMBs when studying them, an evolutionary stage approach helps to compare firms with roughly the same external and internal dynamics and each industry has its own set of success variables.

The study has identified three success variables for older firms that reflect contemporary strategic thinking such as crafting a good strategy and changing it only incrementally, building core competencies and outsourcing the rest, and keeping up with innovation and honing competitive skills.

INTRODUCTION

This paper addresses the never ending question: What makes some SMBs more successful than others? The ideal is, of course, to find a recipe for success and apply it. Needless to say, there are too many external and internal variables interacting with the operation of a firm to be able to present a formula.

Ongoing research into the subject, added to earlier findings might, over time, possibly establish some rough denominators for seemingly successful firms—and those that are not so successful. Literature reviews suggest that common denominators are difficult to find, however, and any ambitions in this respect should be modest.

Nevertheless, the present study attempts to do exactly that. Two industries (manufacturing and trading firms) in Norway have been studied over two time spans in an attempt to identify success variables and change.

Comments on Earlier Research on Entrepreneurs

Literature that evaluates research on entrepreneurship is rather critical of previous work within the field. Churchill and Lewis (1986) found that more than 50% of the articles published in journals between 1981 and 1984 were "journalistic" (vignette or reportage) or "armchair" (observational and contemplative theory building). Aldrich (1992) used the same classification of articles from 1985 to 1990 and found that a shift in research towards other classifications (surveys, public data, ethnography or computer simulation) had not taken place. 57% of the articles were still in the journalistic or armchair category. The need for change is supported by Wortman (1986), who argues that we need fewer case studies and more studies targeted to a specific population or sample that "utilize appropriate statistical techniques that would lead to the external validity of the studies."

It can further be observed that it seems as if much of what has been published mainly attempts to identify the attributes of the entrepreneur. The research has often been carried out by postal surveys with weak common denominators; and the results can therefore not be applied to other groups of entrepreneurs. It may be argued that this reflects the wide variety of typologies found among entrepreneurs. On the other hand, if common denominators can be found, they could be of help in establishing a platform for further entrepreneurial research.

Aldrich (1992) further claims that in many studies the methods that have been used are inadequate, in respect to sampling procedures and statistical analyses of the material. An attempt is made to explain this by the fact that research on young firms is still a new field, which has not yet found its form.

Aldrich (1992) recommends a more distinct selection of groups and sub-groups, which should be homogenous (for example in items of industries or firm size), and emphasizes the importance of continued theoretical development.

As an illustration, Aldrich (1992) states that at the 1989 Babson Entrepreneurship Conference in the United States, only 17% of the material presented satisfied the above criteria.

However, there has clearly been some improvement in these respects in recent years. By looking at more recently published research reports it seems as if the use of medium-level statistical techniques, such as multivariate analyses, are now common, clearly pointing in the direction of more empirical studies in this area.

Longitudal studies of entrepreneurs moving through development stages into an established environment are even more unusual.

OVERVIEW OF THE STUDY

This study is based on selecting a sampling frame that isolates two groups of firms in two industries at two stages of development. A variety of organizational and structural data were collected. When the data are subsequently statistically analyzed, some inherent success factors emerge. By analyzing the same categories of firms at a later stage, evolution regarding success factors can potentially be identified. The research project was constructed with this in mind, and therefore satisfies some of the desired criteria for entrepreneurial research:

- Two industries were studied. The sampling frame eliminates firms with low growth aspirations or extreme growth characteristics.
- Two stages of development were studied.
- Multivariate statistical methods were applied in addition to cross tabulations.

A Comparison of Newer with Older Firms

Most big firms were once small. The seeds of success may very well have been planted in the initial phases after establishment. Vision, company culture, and professional direction set at an early stage may be the source of success (Collins and Porras, 1994).

The motives, qualifications and thoroughness of founders of new firms that are created every year vary greatly, but entrepreneurs are all convinced that they shall succeed. Unfortunately, this is not so. About half disappear within the first five years after creation (The European Observatory for SMEs, 1996). Fortunately, entrepreneurs have more enthusiasm than statistical inclination, or else the creation of new enterprises would be greatly reduced.

Evolutionary Stages for a Start-Up

For the purpose of this study, it is necessary to segment the firms in evolutionary stages for comparison. As early as in 1972, L. E. Greiner published a direction setting article in the Harvard Business Review suggesting five phases of organizational growth: (1) creativity, (2) direction, (3) delegation, (4) coordination and (5) collaboration. (The article was reprinted in 1998 as a HBR Classic.)

A simplified model with three stages is applied in the present study. By reducing the number to three stages, it is easier to separate them for classification purposes.

In the first stage, lasting perhaps five years, *survival* is paramount. This is the period of product and market matrix adaptation. The first thing many entrepreneurs discover is that

their product is not exactly what the market wanted, after all. Often, extensive product or delivery modifications are needed, requiring unanticipated investments, not to mention the loss of revenue while doing it. The second observation is that the customers they thought would knock on their doors are just moderately interested and reluctant to switch from their present suppliers.

Those who survive this traumatic phase have a fair chance to enter into the second stage: *growth and pain*, lasting perhaps another five years. During this period, the initial organizational learning in the business environment is rewarded and the firm grows. However, the ways of organizing activities, which were successful initially, do not necessarily work any more. Very long working hours and interpersonal stress in the organization are symptoms. A transformation must take place.

If the firm has growth and profit potential, the stakeholders try to solve the problems encountered in stage two and can move on to the third stage. This stage could be called *institutionalization*. Present investors increase their investments and new investors are often invited. Change of management is often initiated, and the organization chart is redrawn to reflect present and future requirements. Functional specialists (in marketing, finance, procurement, personnel, etc.) are appointed to substitute the original generalists. The latter often feel that their position is threatened or unfairly diminished and quit, sometimes to start a new, competing firm.

Selection of Firms to be Studied

The present study addresses two groups of firms at different evolutionary stages. One group that has passed the *survival* stage, and has evolved into the next. They are winners, since they have survived. In other words, one part the study focuses on the clever entrepreneurs before they receive too much non-entrepreneurial influence. In this study these are firms that are a minimum of five, and a maximum of ten years old.

The second group represents the same industries as the first, but here the firms are 15 to 20 years old, and represent a well established group that most likely has reached the *institutional* stage.

WHAT IS SUCCESS?

Quite a few studies have been made concerning success factors for SMBs. In 1983 the Confederation of Norwegian Business and Industry (NHO) carried out a study: "What are the best doing better?" In that survey, net profit after tax of 10% on sales was used as a separating criterion between the "best" and the rest. Storey (1994) uses employment growth as a criterion. Vatne (1995) points out that research suggests that there is, not unexpectedly,

a correlation between sales growth and employment growth. A study by Dunkelberg et al. (1987) uses sales growth and change in number of employees as success criteria.
Success may, of course, be measured by other variables than profits and growth alone. Foley and Green (1989) mention personal satisfaction such as "being their own boss", independence, and realizing creativity and innovative potential as measures of success. It may be suggested that, paradoxically, if a venture is successful in terms of growth, some of those personal success factors may erode.

Definition of Success in Present Study

As indicated above, many viewpoints have been expressed of what success really is. In this study it is assumed that the purpose of private enterprise is profit maximization. Profitability is the basis for growth, which again is one expression of success. Society's economic growth is sustained by a number of smaller enterprises growing larger, complementing or substituting incumbent companies that reach maturity and, in many cases, lose their competitive strength and consequently disappear.

The criterion chosen for measuring success in the present study is net profit after regular depreciation, but excluding capital costs and before year-end adjustments and taxes.

It may be argued that varying accounting principles may distort the real profitability figures to the extent that they are not reliable for research purposes. Modern accounting rules are rather strict. By choosing a defined measure of profits only modest variations should be expected, considering transparency of the rather small firms chosen for the study. (Even at the level of year-end adjustments, the opportunity for manipulation is limited; the auditors closely oversee adherence to the legal framework.) On the other hand, there is an inclination for firms showing very low net profits or actual losses to have somewhat inferior actual results, whereas firms with high, declared profits tend to understate profitability to avoid income tax (Dunkelberg et al., 1987). Foster (1986) suggests that "management can deliberately misrepresent the timing, amount, or intent of transactions or events in the financial statements" for the purpose of "smoothing" net income figures. The author mentions backdating (or postponing) invoices; or recording, for example, advertising prepayments as expenses for the period in which the payment was made, both of which affect the net profit level before year-end adjustments.

After looking at the profit and loss statements of a number of the respondents, 8% net profit, as defined above, was chosen as the cut-off point. The group with more than 8% profit was defined as successful. The tendency to overstate and understate profits, depending on actual results, lends support to the use of the comparatively low cut-off level of 8%. This percentage roughly reflects a bank savings interest rate and thus also reflects capital opportunity cost.

RESEARCH DESIGN

SELECTION OF INDUSTRIES TO BE STUDIED

Two industries were selected for study that should ideally represent two different modes of operation. One industry was defined as trading firms by Compass Norway, the source of sampling frames. They included wholesalers, sales organizations, importers/exporters, agents, but not retailers.

The other group was manufacturers. This group comprises as the name denotes, makers of diverse, physical products.

Sampling Frames

To select sampling frames, an evolutionary stage (see above) approach has been chosen. It has the advantage that the firms selected for study have a degree of homogeneity. The younger group in that they have survived and proven themselves as viable. The chosen sampling units for that group were firms registered between 1984 and 1989. They were, in other words, between 5 and 10 years old at the time of data collection in late 1995. The companies of the second group, had been established 15–20 year before data collection in 2000, have most likely arrived in the truly institutionalized phase.

The following additional characteristics were required for inclusion:

Trading firms should have at least five employees and a maximum of 100. The purpose of the lower limit is to eliminate "husband and wife" enterprises primarily established to create employment for the owner(s), but with no ambition to grow. Firms that were still very small were thus not included. The maximum limit was set to eliminate firms that are in extreme growth industries, or that are spin-offs from larger companies that have given them a flying start. In addition, this would eliminate firms that have expanded rapidly by mergers and acquisitions, which could lead to a completely different modus for conducting business.

Manufacturers have a minimum number of 11 employees. This number is chosen to eliminate the more crafts-oriented enterprises, which were assumed to have different growth ambitions than mainstream manufacturing companies. A limit of 100 employees was set as a maximum in this group as well.

In addition, both groups should have sales of at least NOK 4 million. Thereby a minimum level of activity is assured, further eliminating enterprises with unusual structures.

The restrictions on the sampling frames were established to make the survey sample represent the majority of incrementally growing businesses that are the bedrock of economic activity.
All firms in Norway that were registered within the specified time frame and size constraints, were extracted. This approach assures a good basis for data analysis, as it includes the complete universe. For the younger group, 639 trading firms and 423 manufacturing firms that satisfied the selection criteria were found, totaling 1062. For the older group, the corresponding figures were 447 and 338 totaling 785 firms. The comparatively low number of sampling units reflects the large number of very small enterprises that were eliminated in the selection process.

Data Collection

Due to the rather large number of sampling units, a mail survey was chosen for data collection. The questionnaire was comprehensive, covering a number of areas such as profile of the managing director, profile of employees, ownership structure, composition of the Board of Directors, markets and marketing, suppliers, planning systems, use of IT, vision and strategic planning, financial matters, etc.

Considering the multitude of information that could be collected in the survey, it was tempting to consider several measurements of success. Personal motives and satisfaction with present situation could add to the understanding of the feeling of personal success among the entrepreneurs. Feelings are subjective and a postal survey may be less suited to measure them with regard to validity and reliability. It was therefore decided that, in this survey, only directly measurable variables should be included.

The questionnaire was pilot tested by convenience sampling on ten individuals with approximately the same function as the anticipated respondents, i.e., managing directors of SMBs. Adjustments were subsequently made to improve the validity of the responses.

A prepaid envelope was included, and a reminder was sent to those that had not returned the questionnaire within the set time limit.

Because of the rather extensive questionnaire a reply rate of 15% was anticipated. The actual response rate was 26.5% for both surveys**,** which is satisfactory. N = 281 for the newer firms and n = 208 for the older firms. There was little difference in response rate between the two industries investigated for the newer group, whereas the response was 30.5% for the manufacturing firms and 23.3% for the trading firms in the older group.

Analytical Approach

Based on the hypothesis that there are common denominators for successful firms, the present research project was designed to test this assumption. A wide variety of data on organizational, structural and operational characteristics were collected. The sampling units were dichotomized by a profitability measure and used as a success criterion.
Each variable should be tested against the dependent variable "successful" or "not successful". As the purpose of the analysis was to extract variables that affect the success criterion, discriminant analysis was selected as a tool. Cross tabulations were used for supplementary analyses when the discriminating variables had been identified.

First, however, frequency analyses were run to identify variables with very skewed distributions, which should be omitted from the analysis. Colinearity was furthermore detected between several variables. A systematic, skewed distribution and colinearity can indicate flaws in the measuring instrument (questionnaire). Based on these analyses and visual scrutinization (identifying apparent misinterpretations by the respondents) of the returned questionnaires, many of the variables were eliminated.

The two industries were analyzed separately to assure that industry peculiarities should not interfere with the results. Only variables with significance level $p < .05$ (unless indicated otherwise) are commented on.

FINDINGS

The analyses indicate that there are in fact some common denominators. Some of them are confirmations of what perhaps is common knowledge being taught in business schools. That is in itself comforting. Some variables were, however, unexpected and required innovative interpretations.

General Observations

Frequency analyses presented in Table 1 revealed that some evolution from a new firm (5–10 years old) to a well established firm (15–20 years old) could be observed.

TABLE 1
PROFILE OF FIRMS

	Newer firms	Older firms	Comments
Subsidiary of larger firm	41%	43%	Structure in population did not change
Successful	27%	33%	Older firms more profitable
Main customers abroad	23%	27%	Market expansion
Own industry evaluation: Expanding	76%	56%	Suggests maturing industries

Static	21%	32%	
Shrinking	3%	9%	
Sales			
Mean	€3.66 mill	€4.51 mill	Modest growth: 25% increase
Median	€2.76 mill	€3.36 mill	over 10 years

SIGNIFICANT VARIABLES FOR BOTH NEWER AND OLDER FIRMS

Tenure of Managing Director (CEO*)*

For the younger group of firms, the best results were found when the manager had tenure of two to five years. The managers in the group of older firms seemed to be most successful when they have had tenure between six and ten years. Short (one year) and long tenure (more than ten years) seem to have negative effect on financial results. It is interesting to note that tenure thus seems to follow a life cycle pattern.

Age of Managing Director (CEO)

For older firms, the success rate is greatest when the CEO is between forty and fifty years of age. This is also supported by analysis of younger firms, with lower statistical significance, however.

The industries that were studied are both mature industries. Experienced managers appear to have the most successful profile for value creation at this age interval. The best of the younger candidates are perhaps not attracted to these industries.

Personal motivation or ability to continuously adapt may fall over time. This could be taken as an indication that management change may be beneficial and that different types of managers are needed in the different stages of evolution. Awareness of this can be valuable information for managers and investors alike.

The second observation is that if a firm's managing director stays on through several stages, i.e. too long, the profitability also seems to diminish. The CEOs seem to be most effective when they have gained some experience, but still have the drive needed to create competitive advantage.

Active Suppliers

The question asked is whether the suppliers support or take active part in, for example, marketing activities. The analyses show, surprisingly, that respondents in both younger and older trading firms with active suppliers actually are *less successful* than those with less active suppliers!

Considering the industry, one can assume that the respondents are resellers. Further analyses suggested that respondents with active suppliers sell brand names, and also are inclined to offer more favourable conditions to customers (retailers). It is therefore a likely explanation that strong suppliers exert pressure on their resellers to maintain or increase market share. The reseller must therefore, perhaps under threat of losing the brand, make special efforts to keep it. Discounting and heavy promotion reduce profitability.
Two observations can be made from the analysis. One is that for trading firms the selection of suppliers seems to be of importance, and the bargaining power of a strong and active supplier with a known brand name reduces the profit potential of the reseller.

SIGNIFICANT VARIABLES FOR NEWER FIRMS

An established and Communicated Business Idea (Vision)

In the questionnaire, the respondents were asked to write their business idea. Several did not qualify for inclusion due to their content and were eliminated. Analysis of the remainder suggest that formulation of a clear business idea indicates a professional approach to the business venture, resulting in a higher success rate.

Use of Variable Pay for The CEO

Incentive pay is becoming increasingly common. It is also likely that start-ups will use it as a way to align the manager's and owners' interests in profitable growth. The variable was not significant for the older firms, suggesting that it is not as important once a firm (and its management) have reached a mature stage.

The lesson to be learned from the findings is that a clear and communicated vision combined with personal incentives for the CEO seem, as perhaps could be expected, to be success factors for younger firms.

An Approved Plan for Information Technology

Surprisingly, this variable correlated with *lower* profitability for manufacturing firms. Intuitively, a firm with planned use of IT should be in a better position to control the business and also use it as a tool for improved competitiveness.

Two alternative explanations for the associated lower profitability may be suggested:

The firm has blindly accepted a plan developed by a consultant or IT vendor and invested accordingly, regardless of return on investment.

The firm has, according to a plan, made substantial basic investments in IT infrastructure, hardware, software and training in anticipation of later growth. For a manufacturing firm, IT systems are rather complicated compared to a trading firm's needs, and can therefore lead to substantially higher total cost in an initial phase before real benefits accrue.

Since the variable did not have a negative impact for the older firms, it seems as if point two is the most likely explanation.

SIGNIFICANT VARIABLES FOR OLDER FIRMS

Number of Strategy Changes

It is interesting to note that the number of business strategy changes (major redirection of products and markets) impact profitability. Firms with one strategic change or none at all, show a higher success rate than those with several changes. Statistically, the observation is at the ten per cent level, however. The finding ties in with the growing attitude that a well crafted business strategy should be kept for a long enough period to prove itself viable. Porter's (1996) view that "Consistency ensures that the competitive advantages of activities cumulate…" further supports this tendency.

Outsourcing

The successful firms had a higher degree of outsourcing than the less successful firms. Among manufacturing firms, around more than 90% answered that they bought services outside the firm, with emphasis on technical assistance.

Considering the maximum size constraints of the sampling units, it is unlikely that the respondents should be proficient in all disciplines needed to run a business. Evidently, the successful firms realized this and secured assistance from outside sources.

Major Customers Abroad

19% of the trading firms and 35% of the manufacturing firms had major customers abroad. The trading firms were evidently to a higher degree either importers and having mainly customers in Norway.

Of the successful manufacturing firms, 53% had major customers abroad, vs. only 27% of the less successful ones. International customers are possibly more demanding and therefore a manufacturer that succeeds there is in a better competitive position which again is reflected in the success rate.

CONCLUSIONS

The study aimed at following two industries over a longer period of time to identify early and later success characteristics. It was possible to find some success variables for newer firms as well as for older ones, and some variables apply for both groups, supplemented with variables that indicated negative effects. The findings suggest that it is possible to carry out structured research on growing firms and make findings that are interesting for academics (for further research) and practitioners (what to look for) alike.

Finally, it is interesting to note that the three success variables for older firms reflect contemporary strategic thinking:

- Craft a good strategy and change it only incrementally.
- Build on core competencies and outsource the rest.
- Strive for demanding, international customers to keep up with innovation and hone competitive skills.

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