ACE Research Vignette: Growing Profitable or Growing from Profits?

This series of research vignettes is aimed at sharing current and interesting research findings from our team of international Entrepreneurship researchers. In this vignette, Professor Per Davidsson considers some of the dynamics associated with firm growth.

**Background and Research Question**

Praise for rapidly growing firms – the ‘gazelles’ as they are sometimes called – abound in the media and sometimes also in political rhetoric. These fast-growing firms, we are told, create the bulk of new jobs and new wealth and are therefore the heroes of the economy. And surely sometimes they are.

Several academic theories also portray firm growth as a good thing. Economies of scale, Experience effects and First mover advantages are assumed to accrue to those firms that grow larger than their competitors. More recently phenomena like eBay and Facebook are clear examples of Network externalities; that the value of a product or service can increase with the number of users.

But is growth universally a good thing? We also hear horror stories about firms that grew to their own death by losing financial control and/or growth creating internal, organizational turmoil. And to achieve rapid volume growth all you need to do is buy high and sell low, and for sure customers will love you; grow in numbers, and buy more. Financially it would be sheer disaster. So when we are assessing the value of growth we also need to consider how sustainable it is, and what are its likely effects on profitability. This is what we tried to do in the research here. We asked the question:

**What firms are more likely to be able to combine high growth with high profitability? Do firms become more profitable as a result of their growth? Or is it the small, profitable firms that manage to scale up their businesses without losing their already high profitability?**
How we investigated this

To investigate this question we used two large multi-year data sets: the Australian Bureau of Statistics “Business Longitudinal Survey” which provided data on some 3,500 Australian Small and Medium-sized Enterprises (SMEs), and a customized data set from Statistics Sweden, providing information on another 2,500 SMEs’ development. We divided firms into those performing below or above the average of their industry in terms of growth and profitability. This gives 4 categories: Low growth/Low profit (POOR); Low growth/High profit (PROFIT); High growth/Low profit (GROWTH), and High growth/High profit (STAR). In order not to make small changes weigh too heavily in the results we created a ‘Middle’ category (see Figure 1). We then analysed how firms changed category over time; particularly ‘who become STARS’.

What we found

The results were very clear. ‘Star’ firms are much more likely to originate from the ‘Profit’ category than from the ‘Growth’ category. This corresponds to the thick and the thin green arrows in Figure 1. Instead of becoming ‘Stars’, the ‘Growth’ firms disturbingly often end up in the ‘Poor’ category, showing substandard performance on both dimensions. In the figure, this transition is denoted by the thick, red arrow. That is, in general SMEs do not ‘grow profitable’. Many of those who try can neither sustain their growth nor reach high profitability. Rather, it is firms who have already shown an ability to achieve high profitability at smaller scale that later embark on a trajectory of growth which allows them to sustain their relatively high level of profitability. These results hold up independently for Australian and Swedish firms as well as in a number of breakdown analyses by industry and size classes. We interpret this as suggesting that sound growth usually starts with a sound level of profitability. High profitability, in turn, is likely based on some unique advantage that appeals to a sufficiently large number of customers. This is what firms should focus on in the first place – developing an attractive market offer that allows them to be profitable. Once that is achieved, the firm can undertake sound growth financed to a large extent by the firm’s retained earnings (possibly further boosted by external finance). Firms who are too eager to grow without a unique enough offer will have to ‘buy’ market share by lowering the price or spending more on marketing, which would lower rather than increase the firm’s profits.

Business and Policy Advice

There may be situations when rapid growth is necessary for success. Our results suggest this is not usually the case. Rather than focusing simply on encouraging firms to grow, policy makers and investors could put more emphasis on focused development of the firms’ unique strengths through which they can achieve above-average profitability at a modest size. There is then a sound foundation on which to build sustainable and profitable growth. We should encourage owner-founders to focus on developing their specific unique strategic advantages that allow high profitability. Supported by this realisation more business owner-founders may be willing to realize the full potential of their creation by growing it larger. In all, our research is in line with Clayton Christensen’s motto “patience for growth; impatience for profits.”

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