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Five Stages of Growth in Small Business

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As a small business develops it moves through five growth stages, each with its own distinctive characteristics. Because the transition from one stage to the next requires change, it will be accompanied by some crisis or another. Crises tend to be disruptive and the problems of change can be minimized if managers are proactive rather than reactive. Prior knowledge of what generates crises and what to expect in each stage will smooth the process of change. This article proposes a model of small business growth to enable managers of small businesses to plan for future growth. The model has been successfully tested and used by the authors in analysing and solving the problem of growing small businesses. The model isolates the five growth stages, the sort of things that will precipitate crises and the major strategies that should be considered at each stage. Its main purpose is as a diagnostic tool in analysing the firm's present position and in planning what will be required as it progresses to the next stage of its development.

Introduction

All businesses pass through distinctive stages (each with its own characteristics) as they develop. This development process can be likened to the product lifecycle. Like products, businesses do not move through the cycle at the same speed but unlike most products businesses can stay in the same stage for a considerable period of time.

Whilst it is clear that each business is different our research has shown that there are sufficient similarities in the problems that they face to make a general growth model useful to the management of a small business. It is prior knowledge of what can be expected in the next stage of development that makes the growth model useful in planning the future of the business.

Because of the different characteristics of each stage the transition from one to the next is often accompanied by a crisis[1] which may be either external or internal to the firm. It follows that the small businessman has two major concerns in moving from one stage of development to the next. Firstly he will be concerned with handling the crisis itself. If he succeeds in this he is faced with the second problem of managing the 'new company'. This will clearly involve managing change and because the successful management of change is both difficult and often time consuming,[2] planning is crucial. This means that events likely to precipitate a crisis should be constantly monitored so that the manager can be proactive rather than reactive in moving from one stage of development to the next.

The use of the model lies in anticipating when a crisis is likely to arise and what will be necessary to successfully negotiate the next stage of growth.

Objective

Not all businesses that survive grow to be large businesses. This is due either to the nature of their industry or simply the personal desires or ambitions of the owner/manager. The objective of this article is to develop a model of small business growth to isolate the main factors which will be important in each stage of growth and the type of crises to be faced in moving from one to the next so that managers can more successfully plan the future of their businesses, i.e. to assist in formulating feasible strategies.

What is a Small Business?

Defining a small business is necessary to avoid misunderstanding of the term. Several attempts have been made at a definition.[3-6] For the purposes of this article that of the American Committee for Economic Development[7] has been adapted.

This is:

(i) Management is independent. Usually the managers are also owners.

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(ii) Capital is supplied and ownership is held by an individual or small group.

(iii) Area of operations is mainly local. Workers and owners are in one home community, *but markets need not be local.*

Selected Research

Several growth models were analysed and drawn on in the development of the model. These models can be broken down into the following categories:

☆ Industry Growth Models.
Wright,[8] Little[9] and Porter[10] used the product lifecycle concept to illustrate how industries develop and how businesses react to these pressures.

☆ Large Business Growth Models.
Channon[11] and Salter[12] showed the characteristic changes in businesses as they grow into large multidimensional units which become geographically decentralized.

☆ Small Business Growth Models.
Maher and Coddington,[13] Bruce,[14] Steinmetz,[4] Churchill and Lewis[15] and Barnes and Hershon[16] developed models for small businesses per the above definition.

☆ General Growth Models.
Scott,[17] Greiner[5] and Lippitt and Schmidt[18] developed models that can be applied to businesses of all sizes.

The methodology followed in developing the model is one of drawing on the work of previous researchers as well as that of the authors. The proposed model has drawn extensively on the work of Churchill and Lewis.[15] Their model, however, concentrates mainly on organization structure whereas the proposed model is much broader.

Because the authors believe that each stage of a business is preceded by a crisis the model developed by Greiner[5] (Figure 1) is important. As this model deals exclusively with small businesses the nature of the crises are somewhat different from those described by Greiner. Changes in both external and purely internal factors can precipitate these crises. As the external factors are usually beyond the manager's control, monitoring the key issues is

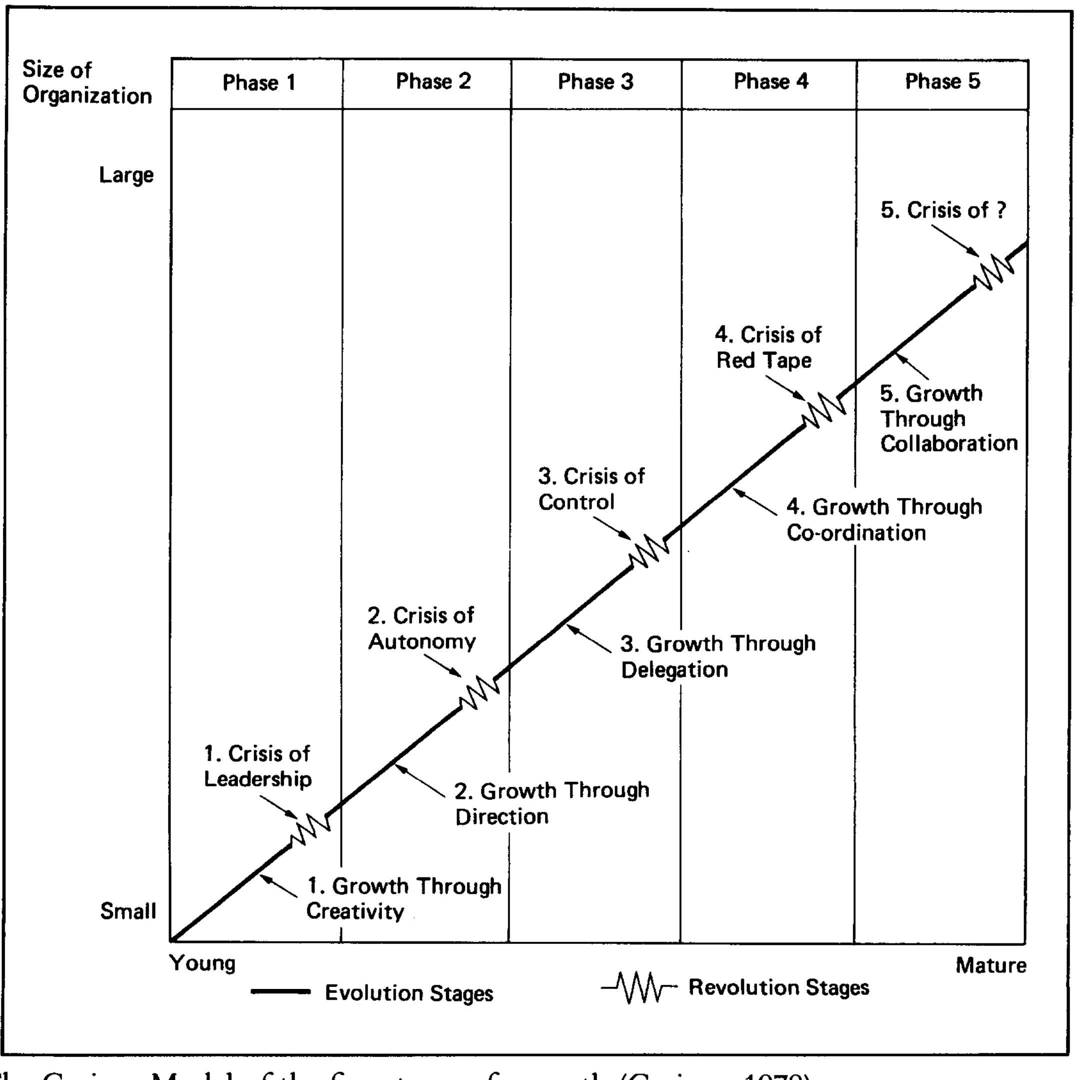

Figure 1. The Greiner Model of the five stages of growth (Greiner, 1978)

important so that he is prepared for possible change. It is being proactive rather than reactive that can spell success or failure in moving from one stage to the next. The transition will often involve relatively major change and the importance of being prepared cannot be overemphasized.

The Proposed Model

The model is developed in two stages. The first is in the form of the classic product lifecycle and is set out in Figure 2. It is important to remember that the shape of the curve and the speed at which the firm moves through each stage will vary from business to business. This part of the model does not attempt to act as a predictor as to when it will move from one stage to the next but rather to show the relationship between time, size of the firm and the stages of growth.

It must be emphasized, as is shown in the model, that although the business may fail at any time it is most likely to happen at one of the crisis points. These crises are extremely important to the entrepreneur in terms of both his business and personal life.

Table 1 sets out details of the proposed model. Expansion of and comments on the model follow.

The Question of Size

We use size to describe one of the axes in Figure 2 with some trepidation. It begs a definition in terms of something like sales, total assets or number of employees. It also hints that there is some finite level of, say, sales which launches a firm from one stage to the next. It is not any single measure that precipitates change but rather a combination of all of them accompanied by some external factor or another that forces a business into the next stage if it is to survive. The actual combination will vary from one business to the next depending on both internal factors (such as condition of the plant or the aspirations of management) and external factors (such as the entry of a new competitor into the market or a change in technology). Size is not dealt with in absolute terms but rather as something which is unique to each business. It is the concept that is important here.

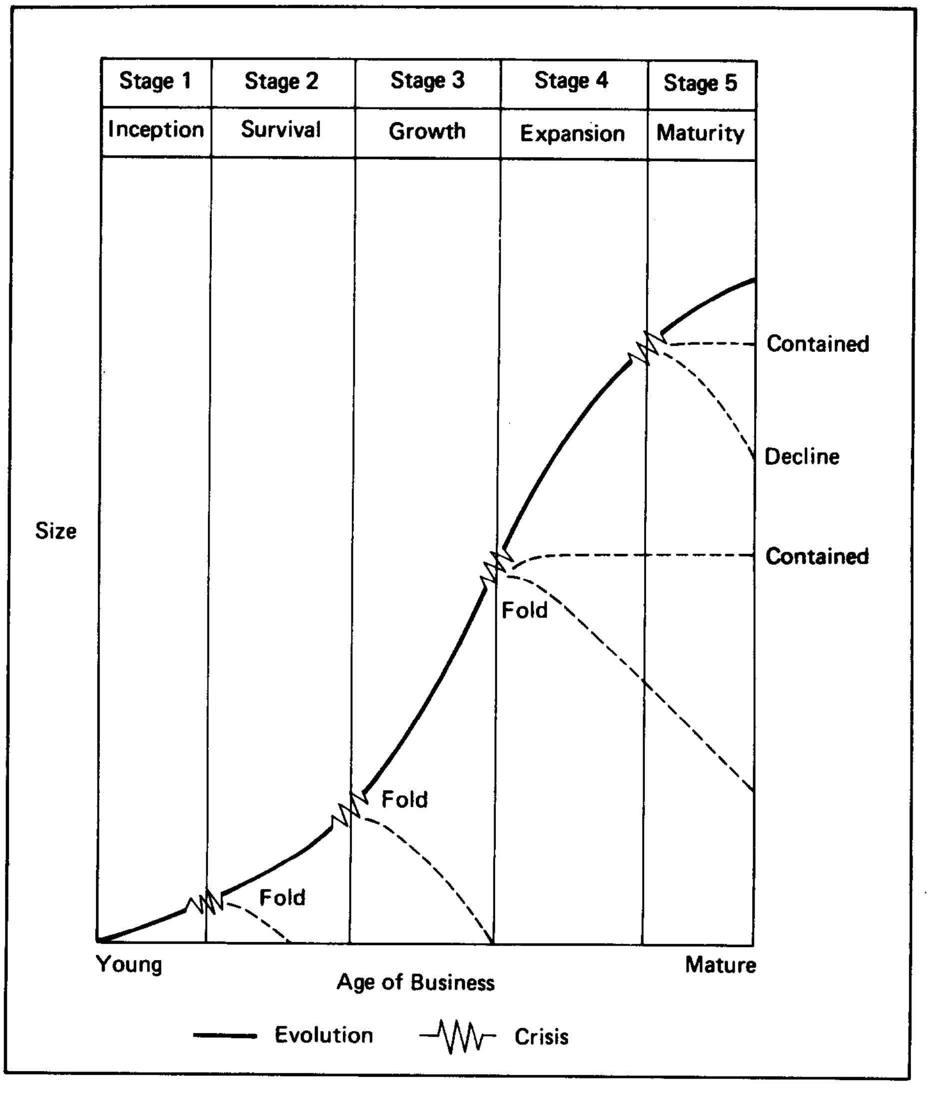

Figure 2

Table 1. A model for small business growth

	Stage 1. Inception	Stage 2. Survival	Stage 3. Growth	Stage 4. Expansion	Stage 5. Maturity
Stage of industry	Emerging, fragmented	Emerging, fragmented	Growth, some larger competitors, new entries	Growth, shakeout	Growth/shakeout or mature/declining
Key issues	Obtaining customers, economic production	Revenues and expenses	Managed growth, ensuring resources	Financing growth, maintaining control	Expense control, productivity, niche marketing if industry declining
Top management role	Direct supervision	Supervised supervision	Delegation, co-ordination	Decentralization	Decentralization
Management style	Entrepreneurial, individualistic	Entrepreneurial, administrative	Entrepreneurial, co-ordinate	Professional, administrative	Watchdog
Organization structure	Unstructured	Simple	Functional, centralized	Functional, decentralized	Decentralized functional/product
Product and market research	None	Little	Some new product development	New product innovation, market research	Production innovation
Systems and controls	Simple bookkeeping, eyeball control	Simple bookkeeping, personal control	Accounting systems, simple control reports	Budgeting systems, monthly sales and production reports, delegated control	Formal control systems, management by objectives
Major source of finance	Owners, friends and relatives, suppliers leasing	Owners, suppliers, banks	Banks, new partners, retained earnings	Retained earnings, new partners, secured long-term debt	Retained earnings, long-term debt
Cash generation	Negative	Negative/breakeven	Positive but reinvested	Positive with small dividend	Cash generator, higher dividend
Major investments	Plant and equipment	Working capital	Working capital, extended plant	New operating units	Maintenance of plant and market position
Product-market	Single line and limited channels and market	Single line and market but increasing scale and channels	Broadened but limited line, single market, multiple channels	Extended range, increased markets and channels	Contained lines, multiple markets and channels

Stage 1—Inception

The Basic Features

The reasons for starting the business will be varied but in all cases the main values driving the firm will be those of the founder(s). The basic skills of the founder also determine the functional emphasis (for example if he is an engineer we can expect the main concentration of effort to be on production rather than on sales), and management will be by direct supervision. The main efforts will hinge around developing a commercially acceptable product and establishing a place for it in the market-place. The difficulty of doing this will depend in part on the stage of the industry lifecycle.[10]

The result will normally be one operating unit operating in a single market with limited channels of distribution. Sources of funds will be haphazard and will place heavy demands on the founder, his partners (if any), and his 'friends and relatives'. With the high level of uncertainty the level of forward planning is low.

The Most Likely Crises

If owners can accept the demands that the business places on their finances, energy and time, they become stage 2 enterprises. If not the firm will fold because it can only spend a limited time in this stage.

(1) *The emphasis on profit.* The major focus switches from establishing itself and its product to profitability (or are least curbing losses). More important perhaps is the necessity for generating a positive cash flow in order to survive. This requires a different management attitude and concentration of effort on new and different aspects of the business. The firm will disappear if the manager is unaware of the new demands or chooses to ignore them.

(2) *Administrative demands.* With the push for profits and the increased business activity will come the need for some formalization of systems and record keeping. This is likely to create demands on the manager that he may not have the skills to handle or quite simply does not want to handle. The crisis arises when it is ignored in the forlorn hope that it will go away. It will not.

(3) *Increased activity and its demands on time.* It is likely that because of increased activity demands on the manager's time will become excessive. This along with the increased administrative load will call for a change in management style. He will have to delegate supervisory tasks. This may escape his attention causing backlogs, bottlenecks and confusion. The result is a crisis of management style and an organization structure requiring change (or at least adaptation) if the firm is to survive.

Stage 2—Survival

The Basic Features

If a company has reached this stage it is potentially a workable business entity. As the business expands the financing emphasis will swing to working capital and the need to finance increased inventories and receivables. The owner and his personal sources of financing continue to bear the brunt although more use may be made of creditor financing if the firm has established credibility with its suppliers. Bank overdrafts or short-term loans are common at this stage.

The level of competition is still uncertain but it is likely that if the business is doing well the industry will be attracting new entrants. If barriers to entry are low (which they often are at this stage) the entry of new businesses will be simplified, increasing competition and making success based purely on differentiation more difficult.

The product line is normally still single or at least limited with growth coming from market expansion. Expanded channels of distribution may well be needed to reach the expanded market.

The Most Likely Crises

Many firms remain in the survival stage for some time earning marginal returns but once they decide to grow of their own accord or because competition intensifies they must to move to the next stage.

(1) *Overtrading.* From this point onwards overtrading is an ever present threat. It is possibly wrong to include it here as a crisis as its occurrence will not necessarily push the firm into the next stage. On the other hand if it is not properly handled it will certainly lead to the demise of the business. Because uncontrolled growth is what overtrading is all about there are two possible remedies. The first is to curb that growth which will mean that the firm stays in the survival stage. Here it will not be a catalyst for change. The second is to continue to grow but to bring this growth under control. This will certainly need a move to stage 3 as more control systems are required. Some of the specific issues that will arise are dealt with below.

(2) *The increased complexity of expanded distribution channels.* As the drive for sales growth increases so the existing customer base will need to be expanded. If this requires operating in new geographic areas or selling to a different type of customer some major changes in the way business is done is likely. Operating in new geographic locations broadens spans of control so that 'supervised supervision' management style at present in place will be sorely tried. The result is a need to restructure the firm and with it the adaptation of management style to one with even more emphasis on delegation and co-ordination from a distance. Selling to a new type of customer will probably mean that the rules of the game are different. Norms vary from industry to industry and from market to market, forcing the firm to adapt its practices if it is to succeed. The existing resources will be sorely tried and the new

skills necessary will put pressure on 'the way things are done around here'. To succeed, management style will need to adapt accordingly. Again greater delegation is indicated.

(3) *Change in the basis of competition.* If new competitors enter the market and the firm wishes to maintain market shares and relative competitive strength, changes will be necessary. The increase in competition is likely to place greater emphasis on price at the expense of differentiation. If the firm chooses the price path economies of scale become necessary and with it plant modernization and expansion. Apart from further stretching spans of control, and the need for new skills, financing will be required. To maintain a sound equity base further capital will need to be issued. If, as is usually the case, the founder(s) is unable to raise the cash himself he will have to consider admitting new partners. All of this is likely to lead to new demands on the business and hence on management.

(4) *Pressures for information.* All of the above crises will put huge demands on the firm's information systems. Price competition will demand cost control which in turn requires formalized control systems. If they include a budgetary control system it is almost inevitable that financial expertize will have to be bought with, at the very least, a full-time book-keeper. This will bring a change in management style and threaten the existing power base.

Stage 3—Growth

The Basic Features

By the time the firm reaches this stage it should be profitable but is unlikely to generate cash for the owner. It will be ploughed back into the business to help finance the increased working capital demands. More time will have to be spent on co-ordinating the efforts of the functional managers. This will mean a more formal organization structure based on functional lines. Normal accounting systems will now be in place. Depending on the nature of the product the firm may have to embark on formal research and development to expand the product range. It is likely to be on a small scale, however, due to the lack of resources available to the firm. If management can adapt to the changing environment the firm can continue in this stage for quite some time. In some cases the owner may be able to sell the business prior to stage 4 at a substantial capital gain. If the growth gets out of hand and the firm falls into the trap of overtrading it could find its resouces overstretched. Liquidity can be a major problem and despite the acceptance of its products in the market-place the firm can fold. If sufficient opportunities are seen for new products and/or operating in different markets the enterprise will enter stage 4.

The Most Likely Crises

(1) *Entry of larger competitors.* As the industry moves through its lifecycle[10] and starts to consolidate or at least attract larger competitors the basis of competition will once again change. These larger firms often use economies of scale as a major competitive weapon. The result—pressure on price. Response can take one of two forms. The first is to respond in kind. The implications of this are dealt with in (2) below. The second is to forfeit market share and to compete on a differentiation basis exchanging volume for margin. To succeed this will require considerable investment of time and resources in product or service development. This strategy effectively means staying in stage 3.

(2) *The demands of expansion into new markets or products.* Hand-in-hand with the first response above is the strategy of expanding into new markets and/or new products. Both of these will stretch both managerial and financial resources. Key issues facing management will be financing the growth and maintaining control of operations. To cope with this the organization structure will need to change again and for the first time a professional rather than entrepreneurial approach may be necessary. Heavy emphasis will fall onto administrative issues to control and co-ordinate the expanded and more diverse operation. A degree of decentralization is probably necessary. This sort of change is probably the most demanding on management style and as such represents a major crossroads for the entrepreneur. He may well have to relinquish some of his power base if the firm is to grow further. This is easier said than done.

Stage 4—Expansion

The Basic Features

Budgetary control, regular management reports and decentralized authority accompanied by formalized accounting systems are the order of the day. The need to systemize most administrative functions will be a fundamental to survival through this stage.

As in the growth stage long-term funds will be necessary and if further equity partners were not introduced in that stage they will almost certainly have to be sought now. Retained earnings are still a major form of finance but dividends, especially to sweeten new investors, are by now virtually inevitable. The company's track record of successful operation will now allow it to seek long-term debt but it will have to provide security in the form of its assets.

It is during this stage that company politics are likely to become a major issue for the first time. To cope with the enlarged scope of the business and the formalized systems that have been introduced 'professional' managers will have been introduced. They will not have the commitment to the business that those who were with the business from the early stages had and are unlikely to be prepared to make the same sacrifices 'for the sake of the business'. This situation is potentially dangerous and can cause a crisis not indicated in Figure 2. This is essentially a crisis of culture.

The company may continue to operate successfully on this scale depending upon the competitive environment. If the industry is growing then there may well be opportunities to sell out and take what could be a substantial capital gain. If the firm is not well managed it may drop back to the growth stage or even disappear completely if growth has got out of control. Once again if there is the desire and opportunity for growth then the company may proceed to the next stage.

The Most Likely Crises

(1) *The distance of top management from the 'action'.* If growth is maintained decentralization will continue apace and the entrepreneur/founder will find himself getting further and further from the coal face and thrust more into the role of watchdog and planner. This is often completely against his nature—the nature that allowed him to set up the new business in the first place. The professional managers gather more power and hold greater sway in decision making further diluting the entrepreneur's traditional power base.

(2) *The need for external focus.* Up to this point many firms have been internally focused with the product dominant. As the industry matures and consolidates so competition for sales grows and product differentiation, although possible, becomes more and more difficult. To maintain a competitive advantage through a differentiated product requires greater focus on customer needs and adapting the product offering (including promotion) to meet those needs. The intensified competition often causes a more turbulent operating environment which in turn increases the need to be proactive and anticipatory. This again calls for greater external emphasis and an adaptation of management style.

Stage 5—Maturity

The Basic Features

It is important to realize that unlike the conventional lifecycle concept the company is still growing in the maturity phase. Most companies in this stage are on the verge of moving out of being small businesses in terms of the earlier definition.

The key issues facing management are expense control, productivity and finding growth opportunities. The lines of authority may continue along functional lines or be reorganized along product lines. Because of price competition productivity is fundamental to success and a major innovative thrust should be towards improving this.

Major investments are now into the marketing effort and plant upgrading and maintenance. Earnings are normally sufficient to handle this but sometimes further long-term debt (or at least bridging finance) may prove necessary. The firm may stay in this stage, shrink its operations or go on, normally after a flotation or acquisition, to becoming a large corporation.

Whatever happens the manager will come under pressure from 'shareholders' to ensure the future of the company. This hinges around succession. Whilst this is undoubtedly correct and sound business practice it is a move that will not come naturally to the entrepreneur. He founded and built up the business with a great deal of effort and often sacrifice. Now he is asked to give it away. As an unknown entrepreneur said, 'My banker has suggested that I bring along a potential successor. In effect he is asking me to supply the plank and then walk it.'[19]

Conclusion

The model developed isolated five stages through which a small business grows. It also identified four crisis points that precede the advance into the next stage of development. It is the anticipation of these crises and the successful management of the change that they cause that ensures the survival of the growing small business. Small businesses may not follow all of the paths suggested and may in fact appear to be a hybrid of two or more stages. This may be perfectly rational if that firm is in a stage of transition or if it has an operating environment peculiar to itself which indicates that such courses may be correct.

The model is not intended as a panacea for strategy formulation. It is rather a diagnostic tool to assist in analyzing a firm's present situation. It is also meant to be an indicator of what strategies appear suitable at various stages in an organization's growth. It is, however, only a tool and cannot make the decisions for management. They must rely on their judgement for that. Hopefully the model will add to their information and thus enable them to make better judgements.

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