Factors Responsible for the Growth of Small Businesses

J A Döckel and A A Ligthelm
Bureau for Market Research, University of South Africa

Abstract

Entrepreneurial conduct holds the key to economic growth. Thus those businesses that show growth and development are considered entrepreneurial, implying that SMME policy initiatives should focus on businesses with growth potential, and not the small business sector as a whole. The success of a small business seems to depend on the intentions of the owner, together with factors associated with the ability of, and opportunity for, the specific business to grow. The aim of this article is to make use of a multiple linear regression model to determine the variables that impact positively on business growth. In addition to demand factors, it was established that smaller and younger businesses are the ones that grow faster. A successful business also shows a positive correlation between business management skills and entrepreneurial conduct.

JEL C21; M13, 14

1 Introduction

Considerable emphasis is placed on the contribution that the SMME sector can make towards relieving the high levels of unemployment in South Africa. The policy framework to provide an enabling environment for small business growth is outlined in a 1995 White Paper (RSA, 1995). Since then, renewed emphasis has been placed on measures to assist the development of this sector. The contribution of small business to employment creation or the impact and efficacy of the various policy initiatives are not, however, the subject of this study.

The point of departure of this study is based on evidence that initiatives to promote small business need to be focused (Glancey, 1998). Policy makers are becoming aware of the economic and social limitations of policy initiatives that rely too heavily on the small business sector as a whole. These initiatives should instead be aimed at businesses and sectors with growth potential. It is maintained that most of the additional jobs created are derived from a relatively small number of small businesses. To target such firms and sectors, the factors that are likely to influence their behaviour need to be identified.

The data used to analyse small business growth are sourced from a survey conducted in the Greater Johannesburg Metropolitan Area (Tustin, 2001). This article focuses on ways in which the factors that significantly contribute towards the growth of small businesses can be identified and quantified. The results indicate which factors are important for the growth of businesses and also whether policy measures can be targeted at specific sub-sectors and at businesses that reflect specific growth characteristics.

2 Why do small businesses grow?

The success of small businesses has been the subject of a great deal of analysis (Everett & Watson, 1998, Lussier & Pfeifer, 2001). Success can be measured on the basis of different variables, including turnover, profit and employment growth. Only one element, namely growth in the employment levels of the firm, will be investigated here. Such growth has been associated with many factors, including the effect of policy measures directed at the small business sector, macro-economic factors, industry factors and firm-specific factors (Döckel & Ligthelm, 2002). However, it has to be admitted that economic theory has been of little help in providing a basis for the linkage between the theory of the firm and the reality of business formation, growth and decline (Wennekers & Thurik, 1999), resulting in general agreement with the assessment that the internal dynamics of the growth of the business has remained something of a 'black box' (Freel, 2000: 321).

Some of the analyses of business growth are of a descriptive nature, while others are more quantitatively oriented. Most of the quantitative studies relate to the identification of the characteristics responsible for the growth of small businesses that can in turn be used to predict such growth. Rather than survey this literature, the synthesis provided by Morrison, Breen and Shameen (2003) was used. On the basis of their analysis, a framework for the identification of growth factors and their characteristics was proposed. The human factor is considered to be the overwhelming force that determines whether or not a business prospers. It is proposed that small business growth is based on clear, positively motivated business intentions and actions on the part of the owner-manager, to achieve the desired outcome. The success of a small business is therefore guided by the integration of the *intentions* of the owner-manager, assisted by factors associated with the *ability* of the specific business to grow and its *opportunity* for growth.

These factors are classified into three broad categories that include the following (Morrison *et al.*, 2003: 418):

- **Intentions:** shaped by demographic variables, and the personal characteristics, values and beliefs of the entrepreneur
- **Ability:** relating to factors internal to the business such as educational level, business management skills, learning through social and informal networks, the legal format of the business, the growth potential of the product or service provided by the business, and its assets and premises and
- **Opportunities:** determined by growth factors outside the business such as market conditions, access to finance, public sector regulations and labour market conditions.

On the basis of available information, this study identifies the factors related to the intention, ability and opportunity categories, and quantifies the extent to which they have a significant effect on small business growth. For this purpose, survey data obtained for the year 1999 are used. Freel (2000) criticises the approach due to the static nature that is implicitly assumed by the use of data obtained from such large-scale cross-sectional surveys. According to him, the models based on such data cannot fully reflect that the growth of businesses is a process and not a static state. Such surveys provide an aggregate depiction of the growth of businesses. However, it is not essential that any specific business should precisely match these characteristics. An individual business's growth may be the result of only some or, in the extreme case, none of the identified characteristics.

According to Freel (2002), research which seeks only to enumerate frequencies and which is only capable of asking 'what' and 'how many' questions and neglect the 'why' and 'how' questions, offers less rich explanations of the processes driving growth. This criticism is echoed in an overview of the research on small businesses in South Africa (Berry *et al*, 2002). In their view, studies tend to focus more on the constraints of growth, based on the subjective perceptions of the entrepreneur, rather than on an objective evaluation of growth factors.

Longitudinal research can overcome this specific point of criticism, but in turn it may also prove to be difficult to project the results of such a specific study to the more general situation. Although the limitations of cross-sectional surveys are acknowledged, this study is based on a more refined cross-sectional survey. It does not ask only 'what' and 'how many' questions, but also how businesses have reacted over a specified short time-span (Tustin, 2001: 143-72). Since alternative empirical approaches are either not available or suffer from their own limitations, the refined cross-sectional method of analysis used here seems appropriate. Obviously, every business has a unique history, but the purpose of this study is to determine whether there are common growth drivers that are valid regardless of the uniqueness of the situation of each individual small business.

3
Data used in the analysis

The data used in this study were sourced from a survey commissioned by the World Bank and conducted by the Bureau of Market Research of the University of South Africa (Tustin, 2001). The results of the study are discussed thoroughly and consist mainly of cross-tabulations of various characteristics (Chandra, Moorty, Nganou, Rajaratnam & Schaefer, 2001; Tustin, 2001). The reports emanating from the survey do not attempt to quantify the growth factors of small businesses. The survey was conducted among 792 formal SMMEs operating across eight different sectors in the Greater Johannesburg Metropolitan Area as listed in Table 1. Formal SMMEs are defined as businesses employing 50 or fewer people that are registered for the purposes of value-added tax (VAT). The analysis in this article is therefore based on a fairly sophisticated component of small businesses. It excludes informal businesses classified as such, since they are not licensed or registered for VAT purposes. Informal businesses are the largest component of the SMME sector. They consist of survivalist businesses and micro-enterprises that usually involve the owner. There is often also some family involvement and one, or at the most two, paid employees.

Table 1
Businesses classified by sector and number of full-time employees

Sector		Percentage in employment group		
	Nº of businesses	1-5 employees	6-20 employees	21-49 employees
Clothing and garments	98	21.4	40.8	37.8
Metals and metal products	93	28.0	50.5	21.5
Furniture	92	15.2	51.1	33.7
Food and beverages	115	15.7	62.6	21.7
Tourism	92	26.1	56.5	17.4
Construction	92	27.1	48.9	29.3
Retail	116	40.5	39.7	19.8
Information technology	91	35.2	48.4	16.5
Other	3			
Total	**792**	**25.5**	**49.9**	**24.6**

Source: Tustin (2000: 34)

Almost half the sampled businesses fall into the group employing between six and 20 employees, with the rest of the observations spread evenly across the other two size groups. As is common with surveys of small businesses in South Africa, this survey probably does not reflect the population composition of small businesses because the demographic characteristics of the SMME population are not accurately known.

The survey relates to the individual business characteristics in 1999, but some data on previous years were also obtained, including employment statistics for 1997 and 1998. The data were used to determine the extent to which businesses experienced growth over the period 1997 to 1999. Since small businesses are vulnerable in terms of survival, especially in the early stages after establishment, not all the businesses in the survey existed in 1997.

Of the total of 792 businesses surveyed only 582 existed in 1997. Of these businesses, 27 per cent decreased employment, 41 per cent increased employment and 32 per cent indicated no change in employment. Between 1997 and 1999, the total employment of these businesses declined by seven per cent. In aggregate terms, three sectors, the tourism, retail and IT sectors, indicated positive growth. All the other sectors showed a decline in employment (Chandra *et al*, 2001: 14).

4 Methodology

The analysis makes use of a multiple linear regression model. The dependent variable is measured as a growth index, which is calculated as the 1999 employment level minus the 1997 employment level divided by the average of the two employment levels. The 14 independent variables used as explanatory variables of the growth experience of businesses are listed in Table 2.

Table 2
List and description of independent variables used to quantify the growth experience of businesses

Sector	Eight sectors listed in Table 1 represented by dummy variables. The clothing and garments sector is the omitted variable
Legal status	Five categories, namely sole proprietorship, partnership, family business, closed corporation and other, represented by dummy variables. Sole proprietorship is the omitted variable
Profitability	Three levels of profitability, namely increased, decreased and unchanged, represented by dummy variables. Increased profitability is the omitted variable
Access to credit	Use of bank loans or other forms of formal credit. Yes=1 and No=0
Age of business	Number of years in business
Size of business	Number of employees in 1997
Skills availability	Differentiating between businesses that found it difficult to find skilled employees and those that did not
Business experience	Differentiating between businesses with owners who had business experience and businesses whose owners had no experience
Government contracts	Differentiating between businesses that received contracts and those that did not
Crime	Differentiating between businesses experiencing crime and those that do not
Expectations	Differentiating between businesses that planned expansion over the next two to three years and those not planning expansion
Location	Differentiating between businesses satisfied with their present location and those that are not
Motivation for establishing a business	Six categories identified, namely owners who seized an opportunity, were retrenched from a formal sector job, were retrenched from an informal sector job, unavailability of formal sector job, family business, similar experience in foreign country. Opportunity is the omitted variable

The characteristics considered above fall into the categories *intention, ability* and *opportunity*, as listed by Morrison *et al* (2003). Intention factors related to the personality characteristics of the owner are difficult to quantify on the basis of the available information. Factors that may fall into this category are the initial motivation of the owner to establish the business and, to some extent, whether the individual is from a previously disadvantaged background.

The ability variables are captured in the business experience factor. The growth potential of the business's product(s) is to some extent measured by the sector classification and the business's profitability. The legal status of the business, and satisfaction with present location, age and size variables, are additional ability factors that could be quantified.

Opportunity factors are the ones on which policy makers usually focus. These factors include market conditions, access to finance, public sector regulation and the labour market. Market expectations are considered a proxy for market conditions, but cannot capture all the market factors such as the macro-economic environment and the degree of competitiveness in a specific sector. The role that access to credit plays could be obtained directly from the survey. The degree to which government regulation inhibits growth cannot be measured. Only the role of government contracts as a demand-boosting method is quantified. Although a substantial amount of information on the experience of small businesses regarding the impact of labour regulations was contained in the survey, the only quantifiable variable of this factor is whether businesses have found it difficult to obtain skilled workers. The omission is not considered to be critical, since the conclusion reached by Chandra *et al* (2000) is that the new labour legislation has very little effect on small businesses.

The variables listed in Table 2 do not exhaust all the potential influences on the growth of businesses. Notable factors excluded are those related to management aspects, innovation and technology. Unfortunately information on these factors cannot be quantified since they were not included in the survey.

5 Results and interpretation

The regression coefficients obtained by estimating the full model are presented in Table 3. Given that a total of 354 observations were used, the fairly large number of variables listed can be included in the regression to determine which ones are significant in determining the growth index. The variables included explain 41 per cent of the variation in the dependent variable, which is very good for regression analysis based on cross-sectional data (Kennedy, 1979: 25). However, it does mean that a large component of the variation in the dependent variable is due to individual behavioural characteristics, and macro-economic and sociological factors not explicitly included in this regression.

Table 3
Regression coefficients indicating which factors are significant contributors to the growth experience of the business

Variables	Regression coefficients	Standard error	Standard regression coefficients	T-values	Significance[1]
Constant	0.247	0.124			0.048**
1. **Sector**					
Sector 2	0.001	0.097	0.000	0.005	0.996
Sector 3	0.152	0.095	0.085	1.600	0.111
Sector 4	0.210	0.099	0.112	2.119	0.035**

Sector 5	0.222	0.102	0.120	2.167	0.031**
Sector 6	0.023	0.092	0.014	0.248	0.804
Sector 7	0.083	0.098	0.046	0.848	0.397
Sector 8	0.246	0.099	0.143	2.482	0.014**
2. **Legal status**					
Legal status 2	0.218	0.117	0.086	1.864	0.063*
Legal status 3	0.143	0.186	0.034	0.765	0.445
Legal status 4	0.131	0.071	0.111	1.847	0.066*
Legal status 5	0.126	0.077	0.100	1.647	0.100
3. **Motivation for starting business**					
Retrenched from formal sector job	0.016	0.152	0.005	0.108	0.914
Retrenched from informal sector job	0.488	0.231	0.088	2.117	0.035**
Unavailability of formal sector job	–0.013	0.181	–0.003	–0.074	0.941
Joined family business	0.023	0.085	0.012	0.268	0.789
Similar experience in another country	–0.280	0.133	–0.090	–2.108	0.036**
4. **Owner previously disadvantaged**	0.050	0.067	0.033	0.750	0.454
5. **Age of business**	–0.025	0.011	–0.109	–2.198	0.029**
6. **Profitability**					
Decreased	–0.242	0.064	–0.193	–3.804	0.000***
Same	–0.165	0.069	–0.107	–2.407	0.017**
7. **Access to credit**	0.090	0.052	0.077	1.746	0.082*
8. **Size of business**	–0.010	0.001	–0.430	–9.549	0.000***
9. **Skills availability**	0.059	0.052	0.051	1.144	0.253
10. **Business experience**	–0.010	0.054	–0.008	–0.178	0.858
11. **Govt contracts**	–0.043	0.107	–0.017	–0.399	0.690
12. **Crime**	–0.056	0.052	–0.046	–1.073	0.284
13. **Market expectations**	0.117	0.056	0.099	2.066	0.040**
14. **Location**	–0.101	0.052	–0.084	–1.923	0.055*
R square 0.462 Adjusted R-square 0.416 Std error of estimate 0.04463					

[1)] Where ***. ** and * denote the 1, 5 and 10 per cent levels of significance respectively.

According to the results in Table 3, five variables (i.e. crime, government contracts, previous business experience, availability of skills and previously disadvantaged status) do not affect the growth index significantly due to their relatively high significance levels. Several other factors fall between the five and ten per cent levels of significance. These factors (i.e. the two aspects related to legal status of the business, location and access to credit) can therefore be considered as of marginal significance.

The factors that are prominent at the one and five per cent levels of significance are discussed further. Their contribution is systematised in Table 4, which shows the standardised regression coefficients. The standardised regression coefficients represent the comparable effect on the dependent variable. The larger the standardised coefficient the greater the relative effect on the dependent variable. For instance, if the standardised coefficient of the independent variable is 0.4, then a change of one standard deviation in the value of the independent variable will cause a change of 0.4 in the dependent variable.

Table 4
Ranked standardised regression coefficients (level of significance of <5 per cent)

Variable	Standardised regression coefficients
1. Size	–0.430
2. Profitability	
Decreased	–0.193
Unchanged	–0.107
3. Sector	
IT	0.143
Tourism	0.120
Food and beverages	0.112
4. Age of business	–0.109
5. Market expectations	0.099
6. Motivation	
Similar experience in another country	–0.090
Retrenched from informal sector job	0.088

The most significant impact on growth proved to be the size of the business, which has a negative effect on growth, meaning that smaller businesses have a greater employment growth rate than larger businesses. These findings confirm evidence elsewhere (Storey, 1994) and may be an indication that new businesses start out small and that there is a need for businesses to achieve a minimum efficient size quickly. In other words, business employment is initially conservative to test the market demand and expands rapidly as market demand is established. As such, size is directly related to the age of the business, which, according to the results above is the fourth largest factor affecting growth. It also has a negative effect, implying that younger businesses grow faster than older businesses.

The profitability of businesses is a more comprehensive variable, in the sense that it involves both demand or supply factors that impact on the business. The results show a decrease in profitability over the previous year, resulting in a substantial reduction in growth. Similarly, a negative effect is registered even in the case where profitability remains unchanged. This indicates a rational approach, in that cost-cutting measures are implemented as declining or even unchanged profitability is experienced.

Higher growth rates were observed in three sectors. The IT, tourism and food and beverages sectors performed better, most probably as the result of favourable demand factors in these sectors. As expected, businesses where the owner has a positive view on future market conditions, favour growth.

The last significant factor relates to the motivation of owners or entrepreneurs. Those that were retrenched from informal sector jobs fared far better than others. This is most probably due to their previous direct, practical involvement in all aspects of running a small business and their exposure to the kinds of risk taking that are more likely to occur in an informal setting. The other significant motivational factor, namely similar experience elsewhere, had a negative effect on growth. This is contrary to expectations, since it is usually found that such businesses perform better than the rest (Rogerson, 2000).

In summary, the study shows that business size and age are important negative influences on growth. Market factors reflected by sector, profitability and future market expectations appear to be dominant, while the motivation of the owner is also a significant positive factor. This conclusion supports a scenario that presents the policy maker with a dilemma. While small, young businesses grow the fastest, they are also the most vulnerable in terms of survival. The best policies to help employment growth in the small business sector will probably be to see that market conditions are as favourable as possible by ensuring a stable, growing macro-economy. This is not a dramatic new conclusion, but taken together with the factors that have not proved to be such dominant factors, it indicates what the priorities ought to be. Factors such as credit availability, crime prevention, business experience and government contracts cannot be dismissed, but they play a secondary role.

6 Implications for the management of SMMEs

As indicated in the introduction, there is a growing realisation that policy measures that merely provide a favourable climate for a small business are not effective. More specific and targeted policies that focus on prioritised growth factors and sub-sectors of the SMME sector are required. Management is one of the crucial factors in determining business growth. Although it was not possible to quantify management directly in this study, the role of management in the growth of businesses can be measured by factors directly under the control of the individual business. From the list of variables identified in Table 2, such direct factors are considered to be motivational factors, location, past profitability of business, choice of sector, legal status of business and business experience of owner. From the list of significant factors in Table 4, it would appear that only three of these factors are relevant, namely the historic profitability of the business, the choice of sub-sector in which the business operates and the motivation of the owner. The relative importance of these factors is second and third and sixth respectively. This must be contrasted with significant factors less directly influenced by management, such as the size of the business, the age of the business and market conditions, which ranked first, fourth and fifth respectively. The results therefore provide an indication of the order of magnitude of management factors influencing the growth of businesses.

Generally, it seems that management acumen is indispensable for running successful SMMEs. Interpreting market conditions and other macro-economic and environmental factors should form the basis for business investment and growth. Understanding business and macro-economic dynamics requires management skills that can be enhanced by appropriate training and experience. Management thus appears to be a very important factor, but is not the only relevant factor for business success.

7 Conclusions

The study makes a contribution in the sense that it quantifies some of the important factors responsible for growth in small businesses. Apart from demand factors, which are important, it has been found that smaller and younger businesses are the ones that grow faster. They are also the most vulnerable. Closer attention will have to be paid to these businesses to assist their survival. As can be expected, small businesses in the growth sectors reveal higher rates of employment growth. At the time of this survey, the IT and tourism sectors were both growth sectors. Growth sectors will change to reflect the shifts in market demand patterns. It would be necessary to identify such sectors in advance and target assistance to enterprises in these sectors.

Successful businesses show a positive correlation between business management skills and entrepreneurial conduct. This is clearly manifested in the growth-oriented businesses where decisions of owners or managers show, inter alia, the following common characteristics: conservatism at the establishment phase, business expansion as demand increases, lowering of costs with declining profitability and employment expansion linked to positive future market expectations. This result emphasises that entrepreneurial spirit is the key to job creation, improving competitiveness and economic growth. Creating an enabling environment with favourable market conditions combined with some support to young dynamic entrepreneurs would be a catalyst for employment creation and economic growth.

References

1 BERRY, A.; VON BLOTTNITZ, M.; CASSIM, R.; KESPER, A., RAJARATNAM, B. & VAN SEVENTER, D.E. (2002) *The Economics of SMMES in South Africa*, Trade and Industrial Policy Strategies: Johannesburg.

2 CHANDRA, V.; MOORTY, L.; NGANOU, J.P.; RAJARATNAM, B. & SCHAEFER, K. (2001) "Constraints to growth and employment in South Africa: Evidence from the SMME firm survey", *Informal Discussion Paper*, 15(2) World Bank: Washington DC.

3 DÖCKEL, J.A. & LIGTHELM, A.A. (2002) "Factors that contribute to small business survival", *Southern African Business Review*, 6: 1-7.

4 EVERETT, J. & WATSON, J. (1998) "Small business failure and external risk factors", *Small Business Economics*, 11: 371-90.

5 FREEL, M.S. (2000) "Towards an evolutionary theory of small firm growth", *Journal of Enterprising Culture*, 8(4): 321-42.

6 GLANCEY, K. (1998) "Determinants of growth and profitability in small entrepreneurial firms", *International Journal of Entrepreneurial Behaviour and Research*, 4(1): 18-27.

7 KENNEDY, P. (1979) *A Guide to Econometrics*, Martin Robertson: Oxford.

8 LUSSIER, R.N. & PFEIFER, S. (2001) "A cross-national prediction model for young firms", *Journal of Small Business Management*, 39: 228-39.

9 MORRISON, L.; BREEN, J. & SHAMEEN, A. (2003) "Small business growth: Intention, ability and opportunity", *Journal of Small Business Management*, 41(4): 417-25.

10 ROGERSON, C.M. (2000) "Successful SMMEs in South Africa: The case of clothing producers in the Witwatersrand", *Development Southern Africa*, 17(5).

11 SOUTH AFRICA (1995) "National strategy for the development and promotion of small businesses in South Africa", White Paper of the Department of Trade and Industry: Pretoria.

12 STOREY, D. (1994) *Understanding the Small Business Sector*, Routledge: New York.

13 TUSTIN, D.H. (2001) "Economic prospects for SMME's in the Greater Johannesburg Metropolitan Area", *Research Report,* 284, Unisa, Bureau of Market Research: Pretoria.

14 WENNEKERS, S. & THURIK, R. (1999) "Linking entrepreneurship and economic growth", *Small Business Economics*, 13: 27-55.