



business environment specialists

# alert

## Growing Small Firms, Growing Employment

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Experts on business development have coined the term “gazelles” to describe high-growth companies. The gazelle encapsulates characteristics such as speed, energy and dexterity, and provides an apt description for successful, expanding firms. The gazelle, however, is not an animal given to domestication. Studying it requires a process of patient observation. Similarly, understanding what differentiates the small business that scrapes by year to year with no real prospects of growth, from the firm that achieves gazelle status and expands employment, requires careful and considered analysis, over a period of time.

“Growing” small business is near-universally seen as a positive to which societies should aspire. Yet for all the enthusiasm that supporting small businesses generates, there is little clarity about how best this should be achieved. Empirical research on the drivers of small firm growth is scarce. This is not a uniquely South African challenge: researchers worldwide find that coherent information regarding the defining characteristics of successful small businesses is difficult to divine.

SBP is committed to producing high-quality research and analysis that bridges the gap between theory, observation and practice. Our ground-breaking new **SME Growth Index** will, for the first time, provide South African policy makers and business owners with an understanding of what separates gazelles from the rest of the herd.

The SME Growth Index will monitor the characteristics, performance, and resilience of a representative sample of 500 *growth-oriented* small firms, over a period of years, in order to identify the internal characteristics and external factors associated with successful businesses growth. It takes as its starting point that business gazelles – like their counterparts in the wild – change over time. Moment in time data is of limited utility. Longitudinal monitoring - revisiting the same firms over a period of time will provide us with a dynamic picture that captures the subtle impacts of changing market conditions, regulatory frameworks and innovation, and allow us to understand how business decisions have played out.

Our cohort will consist of well established small firms, employing 10 to 49 people. Our focus is on sectors offering growth potential for small businesses, specifically the business services sector, and manufacturing. The SME Growth Index will be the first of its kind in South Africa, and indeed one of very few such indices worldwide.

## Gazelles and employment creation

Little attracts more attention in South Africa today than unemployment. Across the fractured political landscape, the imperative of generating job-creating economic growth unites virtually all parties and commentators. A failure to deal with this issue properly will not only condemn millions to an unproductive life in poverty, but will provide an ongoing source of instability which impacts on the prosperity of the country as a whole. A failure to deal with the issue *prudently* could produce outcomes that merely compound the problem. Efforts to deal with the problem are necessarily multi-faceted and complex. However, SBP would argue that small businesses are a critical component of the solution. And while an environment conducive to entrepreneurial activities and new business start ups is certainly crucially important, we believe that to generate real growth job creation potential, efforts must focus on supporting the growth and expansion of *established* small businesses, moving them along the continuum toward medium-sized employers.

International experience has shown that the small business sector is the key creator of jobs. In this they outperform larger enterprises – owing in part to the latter's ability to employ capital intensive methods. This is acknowledged globally by scholars and policy makers and is for the most part common cause in South Africa. National Treasury's 2011 *Budget Review* puts it clearly: "Small businesses create jobs. Firms with fewer than 50 workers account for about 68 per cent of private employment and 77 per cent of all hiring that takes place."

Small business growth tends, furthermore, to be organic – that is, small businesses tend to grow through actual expansion of the business and creation of new staff positions, rather than through acquisitions. A study in Sweden in the 1990s found this trend to be quite dramatic, especially as it relates to employment. Smaller firms were found to produce notably larger organic employment growth than larger firms. Over the ten years covered by the study, organic employment growth in firms with 20 to 49 staff comprised 98 percent of total employment growth. Among firms employing over 2500 people, organic employment growth was actually negative – firm growth was based on acquisitions and mergers and firms' original staff complement tended to decrease. Research in Ireland, Scotland and France showed similar, though less dramatic, patterns.<sup>1</sup>

Owning a successful small business is a form of independent wealth creation open to a broad and diverse spectrum of the population. This is of considerable importance for a country's democratic stability. Recent commentary on Africa – including Moeletsi Mbeki's *Architects of Poverty* – has argued that too much of the continent's wealth-holding is merely rent seeking, and not the sort of confident, assertive enterprise that is associated with demands for firm and clear goals for clean and democratic governance.

So if employment creating small business growth is an issue of profound importance to South Africa's present stability and future prosperity, how do we go about achieving it?

## Getting to grips with growth

Growth is not a natural business phenomenon, but one which emerges out of conscious decisions and actions. To grow is a choice, and one which a business owner may reject for a variety of reasons. The large majority of small firms do not grow significantly over the course of their lifespan.

Growth is by definition a multifaceted phenomenon and can be measured in a number of ways. Possible indicators include sales, employment, assets, physical output, market share and profits. Growth in sales often precedes other areas of growth, including growth in staff numbers, and is thus often a vital component of measuring growth, even where other indicators are of interest.<sup>2</sup>

What makes businesses grow? A wealth of research and commentary on issues relating to small business success can be found in academic, policy and popular publications. Very little of the literature however directly addresses the question of what makes small businesses grow in such a way as to produce jobs. There is considerable debate as to the relative weight of internal versus external variables influencing growth. This is further complicated by the fact that internal and external factors are not always easily distinguishable.

The SME Growth Index recognises the dynamic nature of growth – that it happens over time and interacts with a range of factors. It seeks to differentiate as far as possible between internal firm characteristics with an impact on growth potential, and external conditions which influence growth prospects.

## External factors: where the gazelle grazes

A firm does not exist or develop in isolation. There is little debate about the fact that factors external to individual businesses play a role in their performance. Gazelles are likely to be more adept at managing these external influences to best advantage. International research suggests that even in difficult environments, high-growth firms are able to meet their growth goals. The prospects of non-gazelles, in contrast, tend to ebb and flow in line with changes in the economy and operating environment. However, the research indicates that even gazelles are more likely to expand as a result of acquisition, rather than organic growth, during tough economic times – suggesting that their edge may be their ability to survive external economic shocks better than their competitors.<sup>3</sup>

The range of external factors that may impact on firm growth is of course broad and diverse. Different environments, and external changes, impact differently on different types of businesses, making it difficult to draw generalized conclusions. The SME Growth Index will assess the impacts associated with key indicators such as market conditions, the regulatory environment, labour issues and the availability of appropriate skills, and external shocks.

### *Market conditions*

Market conditions – the demand for a firm’s products or services, levels of competition and market saturation, access to external markets through export, and the overarching market structure – are a key factor influencing firms’ behaviour and opportunities. Recently, finance minister Pravin Gordhan has complained that “oligarchies” dominate the South African economy and are impeding the success of small businesses.<sup>4</sup>

The SME Growth Index will explore factors such as barriers and opportunities for expansion linked to competition issues and export opportunities, the operation of value chains and linkages, and product differentiation.

### *Regulatory environment*

The regulatory environment can ease or complicate the conduct of business. In South Africa, the regulatory burden is high – SBP’s 2005 *Counting the cost of Red Tape* study put the cost of compliance for South African businesses at R79 billion, equivalent to 6.5 percent of GDP. Regulatory burdens have a disproportionate impact on smaller enterprises. In the US, for example, official estimates put the cost of compliance for a small firm at \$10,585 per employee - 36 percent higher than the cost compliance for a large firm.<sup>5</sup> There is increasing recognition among policy makers worldwide that minimising unproductive regulation is necessary to encourage small business growth.

Pravin Gordhan has acknowledged that South Africa’s regulatory environment for small business needs improvement: “We need to do a lot better to drop the red tape ... we’ve been too slow at removing constraints on small businesses, and we’ve been pathetic in terms of helping small businesses to become more dynamic within our own context as well.”<sup>6</sup>

The SME Growth Index will assess the impacts of key aspects of the regulatory framework, and the efficiency of administration and enforcement of regulatory requirements.

### *Labour issues and skills availability*

Labour market factors are among the most hotly contested of all influences on small business, particularly in relation to prospects for employment growth. This is true internationally, but has particular resonance in South Africa, where the country is currently in the throws of debating the meaning of “decent work,” and contentious new legislative proposals are aimed at tightening the country’s labour laws.

The case is frequently made that small business cannot deal with the cost and administrative burdens imposed by rigid labour regimes. It is certainly the case that their voices are typically excluded from the debate, as large business, big labour and government negotiate deals.

The SME Growth Index will seek to understand the extent to which small firms perceive specific aspects of the labour legislation framework as a disincentive to expansion, and the extent to which the types of employees required by small businesses are available and accessible to them.

### *External shocks*

Small businesses are often required to manage their cash flows on a knife edge. In such circumstances, the promptness of customer payments, for example, is a critical external factor impacting on business viability. During 2010, many South African businesses experienced crushing external shocks, as a result of late payment by government departments. Firms over-extended themselves in filling government orders, and were left critically exposed when payments were tardy. Says economist Iraj Abedian: "Small businesses create jobs, but the government fails them by not paying them on time. That is what destroyed more than 40 percent of the one million jobs we lost in the recession."<sup>7</sup> Big business also has a tendency to be tardy in paying small suppliers, as acknowledged by a recent BUSA appeal for their members to pay small businesses within 30 days.

The SME Growth Index will explore the types of external shocks experienced by small businesses, and how these have impacted in terms of firm viability and growth prospects. The internal working of the firm, in terms of how it responds to and manages such shocks, is also of course a critical focus for analysis.

### **Internal factors: the mind and sinews of the gazelle**

The Global Entrepreneurship Monitor reports that entrepreneurship flourishes best in a society which values and accords status to entrepreneurs and the values that they embody. The SME Growth Index endeavours to get under the skin of small business owners, to understand what drives them, how they make decisions about their businesses, and how their different styles and approaches make a difference to firms' growth potential.

### *Leadership and aspirations for growth*

Establishing a firm is a conscious decision. *Somebody* needs to commit time, energy and resources to the project in the hope of some reward. For a firm to succeed and grow, effective leadership and entrepreneurialism is imperative. The business owner, and the manner in which he leads and manages his firm, are a key focus of the SME Growth Index.

Conceptually, an important distinction exists between entrepreneurship and self-employment. Entrepreneurship assumes a drive and commitment to the enterprise, and a desire to grow. Self-employment, in contrast, may often be driven by necessity, and is frequently survivalist rather than growth-oriented. Research by Stats SA, for example, shows that over two thirds of owners of non-VAT registered businesses had started their businesses because they were unemployed and lacked other alternatives.<sup>8</sup> Businesses such as these are very unlikely to become vehicles for significant job creation, no matter what support might be provided to them.

Studies of entrepreneurial characteristics highlight the motivation for starting the business, as well as the entrepreneur's education and experience in the business or occupation, as key determinants of success. Where a business venture is conceived because of strong pull factors - where the founder has a particular vision or dream and is passionate about his concept - survival and success are far more likely than when a business is started as a result of push factors such as unemployment.

These findings tally with a study of mainly informal small businesses in Soweto between 2007 and 2009.<sup>9</sup> The particular context was the growth of shopping malls in the area, which were introducing significant competition to established township commercial patterns. The findings suggested that the "human factor", notably an entrepreneurial disposition and business management skills, was the most important element determining a firm's ability to adapt and survive.

The SME Growth Index will delve into the mind-set of small business owners, exploring factors such as education and previous experience, management styles and decision making approaches, and attitudes to risk.

### *Innovation*

While definitions of entrepreneurs and entrepreneurship abound, vision and innovation are recurring themes. An entrepreneur strives to bring to market something that did not exist before, or indeed to create a new market for his offering. His ability to do that effectively is probably the most important internal determinant of a firm's success. Research in the UK has highlighted 'judicious use of innovation' as one of the defining characteristics of high growth firms.

The SME Growth Index will assess levels of product and process innovation in South Africa's small firms, and business owners' attitudes toward and prioritisation of innovation and differentiation of offerings.

### *How firms spend their money*

Finance (in the form of equity capital or debt) is a very important factor in promoting the growth of existing small firms. This does not imply, however, that simply increasing access to finance for small firms will lead to growth in this sector. Indeed, research indicates that it is "naïve to conceive of the economy as populated by small firms that are all full of willingness and potential to grow if only the financial means were available."<sup>10</sup> If a business owner does not prioritise growth (and many business owners do not), or if the market for a firm's product is limited, provision of external capital will make little difference.

There is a great deal of research on the issue of small businesses' access to finance, most notably, in the South African context, the body of work conducted by the Finmark Trust, as well as internal research conducted by South Africa's major banks and other financial institutions.

The SME Growth Index does not seek to reinvent the wheel. Our focus will be on understanding how firms direct the money they have, and how this translates in terms of productivity, input and output ratios, and investments in the company.

## Where to from here?

International research demonstrates that a small number of rapidly growing firms are responsible for a disproportionately large share of new employment creation.

The extent to which this is mirrored in South Africa is limited. The 2010 Global Entrepreneurship Monitor indicates that while entrepreneurs are generally positively perceived in South Africa, our levels of entrepreneurship are low in comparison to mid-level "efficiency-driven" economies. Worryingly, our rate of established business ownership – those businesses demonstrating the capacity to survive a length of time and potentially become significant job-creators – is, along with Romania, the lowest of the 24 countries in our group.

South Africa at present lacks a coherent understanding of the characteristics associated with high-growth small businesses, and what it takes to become such a business. While global research and experience provides some interesting insights, there can be no substitute for hands-on, real time enquiry.

SBP's SME Growth Index hones in on what is arguably the most economically and socially important strata of the small business community - small, established, high-growth, employment-generating companies. It will play a critical role in enhancing South Africa's capacity to nurture and breed gazelles, as an essential component of South Africa's job creation drive.

### Endnotes

- 1 Davidsson, P., Achtenhagen, L., Naldi, L. Research on small-firm growth: A review Paper presented at the 35th EISB Conference, Barcelona, September 2005
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- 4 Moorad Z, "Small business shut out", iAfrica, 8 March 2011
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- 8 Stats SA, "Survey of employers and the self-employed", Statistical Release P0276, 19 October 2010
- 9 Ligthelm AA, "Entrepreneurship and small business sustainability", *Southern African Business Review*, Vol 14, No 3, 2010, pp. 131-153
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SBP is a not for profit company specialising in improving the environment for doing business. We have worked in Africa and internationally since 1998 providing innovative solutions for policy formulation, better regulation and development in emerging markets. We have a special interest in small business as vehicles for growth and job creation.

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