The Business Model and Early Growth States of Small Businesses

Honghua Chen and Michael Jijin Zhang

***Abstract*—In this study, we drew on the business model research and the stage theory of business growth to develop a five states model of how small businesses grow in their early existence. The model suggests that a small business may progress through five states (seed, breakthrough, sprout, sapling and young tree) of early growth, depending on the extent to which the business addresses the four fundamental issues in its business model (for whom to create value, what value to create, how to create value, and how to capture value). We assessed the validity of our model with data from a questionnaire sent to 100 small and micro businesses operating in the City of Changsha in China. A preliminary analysis of the collected data generated some initial evidence in support of the five early growth states. Using the model, a small start-up firm can quickly identify where it stands in its early stage of existence and what critical problems it needs to resolve in order to move to a more advanced state and increase its viability.**

***Index Terms*—Small business, business growth, business model.**

I. Introduction

While the formation and development of small businesses are vital to innovation, job creation and regional economic development, small business failure rates remain high in both developed and developing countries. In the U.S. only half of the new businesses managed to survive during the first five years between 1994 and 2015, according to data released from the Bureau of labor Statistics in 2015 [1]. In China, it was estimated that 80% of China's new businesses would go bankrupt within three years of their formations [2]. It is widely accepted among researchers and practitioners that many small firms struggle to grow in their early years of existence, significantly lowering their likelihood of survival due to the liability of newness or smallness [3]-[5]. In an effort to help small businesses survive and grow, a distinct literature in entrepreneurship and management research has developed a stage theory where firms are viewed as evolving through a series of development stages, cycles or states [6]-[14]. By understanding its development stages and addressing the unique problems and issues in each stage, a small business is more likely to achieve faster growth and maintain long-term viability. While numerous models of how firms grow have been proposed in the stage theory research, we are still far away from reaching a consensus on what are the stages of business growth and what characteristics a firm exhibits in each stage [13], [15]. Furthermore, the extant literature has not paid sufficient attention to early business growth and its process [14], [16].

As an attempt to contribute to further investigations of how small businesses grow in their early existence, we developed in the current study a five states model based on the business model research in the management literature and argued that young firms may progress through five states (seed, breakthrough, sprout, sapling and young tree) of early growth, depending on the extent to which they address the four fundamental issues in business value (for whom to create value, what value to create, how to create value, and how to capture value). The research questions we sought to address in the study were: what are the different states a small business may evolve through in its early existence and how can we determine those growth states?

II. Literature Review

A. Stage Theory of Business Growth

Business growth or development has been studied for more than four decades. The stage theory is probably the most influential paradigm for explaining and predicting how and why businesses grow. In general, the stage approach to modeling business growth suggests that firms typically move through a series of distinctive stages, and each stage presents certain unique internal and external challenges that call for differing managerial and organizational skills, processes and actions. Over the years, various models of business growth stages have been advanced in the literature, reflecting different theoretical roots and statistical techniques employed. These growth models identify three to ten different stages through which a business would progress in its development. Among the different stage models, many are rooted in the organizational life cycle analogy, which views organizations as similar to a living thing (e.g., people and plants) that has a life cycle (conception, birth, growth, aging and death) [17], [18]. The life cycle models predict businesses grow in a linear manner (i.e., the sequence of the development stages is predetermined and movement from one stage to the next stage is inevitable) [6]-[9], [12]. For example, Miller and Friesen developed a summary life cycle model based on a synthesis of other life cycle models and the longitudinal data from 36 companies [7]. In this model, organizations would go through five common stages: birth, growth, maturity, revival and decline. Lester and Parnell studied the thirty-eight year history of a small, family owned business and identified a similar life cycle consisting of five stages:

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existence, survival, success, renewal and decline [19].

Among the various stage models in the literature, only a few offer details on how a business grows in its early age. Adizes, for example, suggested that a new business typically goes through four stages in its early development (courtship, infancy, go-go and adolescence) before reaching its prime [8]. At the courtship stage, the focus is on entrepreneurial dreams and possibilities. At the infancy stage, entrepreneurial dreams are turned into actions through officially forming a company and starting to operate. Yet the company lacks specific policies, rules, procedures and budgets. Businesses at the go-go stage start to really show their values by overcoming cash flow problems and generating higher sales. The adolescence stage is characterized by internal conflicts and turf wars between the old timers (founders) and the new hires. Excessive internal conflicts reduce time for serving customers and have short-term negative impact on the corporate vision.

Scholars who entertained the stage view of business growth noted that firms at different development stages differ in terms of some key organizational characteristics (e.g., age, size, extent of formal systems, growth rate, organizational structure, strategy and problems), although there is no general consensus on which of these characteristics represent the dominant dimensions that differentiate one development stage from another [13]. Another elusive issue in the stage theory is what drives the transition from one stage to another. While some authors view internal factors (e.g., changes in an organization's make-up, structure or pressing problems) as drivers of movements through the stages [6], [19], others posit that stage transition is sparked by environmental dynamics such as growing competition [10], [13]. In their recent review of the stage theory, Levie and Lichtenstein offered a dynamic states view where each state ('a condition or stage of being') in entrepreneurial business growth reflects a match between the organization's business model and the market potential [13]. The authors argued that organizations constantly shift from state to state to convert entrepreneurial opportunity into value creation and the enactment of the new opportunity is accomplished through continuous reshaping of an organization's business model. Scholars in the business model literature also maintain that the design of business model is central to entrepreneurship and its wealth creation [20]-[22] and business model innovation leads to future value creation and competitive advantage [23]. In view of the critical role of the business model in entrepreneurial business growth and success, we proposed a five states model of early growth of small businesses where a small business is said to grow through five different states as it evolves past five different development phases of its business model. The particular state a small business is in at a particular time is determined by how well its business model addresses four fundamental issues in business value.

B. The Business Model

The concept of the business model has become prevalent in the literatures of management and entrepreneurship since the mid-1990s. Afuah and Tucci view the business model as "a system of components, linkages between the components, and dynamics" [24]. The components of the business model are customer value, customer segments, scope of product and services, pricing, revenue sources, connected activities, implementation, capabilities, and sustainability. Zott and Amit define the business model as "the content, structure, and governance of transactions designed to create value through the exploitation of business opportunities" [20]. Based on a synthesis of the different views of the business model, Osterwalder, Pigneur and Tucci suggest that the business model is "a description of the value a company offers to one or several segments of customers and of the architecture of the firm and its network of partners for creating, marketing, and delivering this value and relationship capital, to generate profitable and sustainable revenue streams" [25].

The current conceptualization of the business model indicates that the business model is, in essence, about value creation and value capture or appropriation [26], [27]. Afuah and Tucci suggest that a business model must clearly indicate what value to provide to customers, which customers to provide value for, how to create value and how to maintain competitive advantage in value creation [24]. In a similar vein, Magretta maintains that the business model answers several age-old questions managers often ask: Who is the customer? What does the customer value? How to make money from the business? What is the underlying economic logic that explains how the customer value is delivered at a suitable cost? [28] Viewed from the value creation and capture perspectives, the fundamental issues in designing the business model can be summarized as: 1) for whom to create value, 2) what value to create, 3) how to create value, and 4) how to capture or appropriate value. From the business model perspective, we argue that the early development of small businesses may involve the evolution from value identification, value proposition, value creation to value capture as reflected in these four fundamental issues.

III. A Model of Early Growth States of Small Businesses Based on the Business Model

In keeping with the lifecycle approach to modeling business growth, we view the early development process of a small business as evolution through five growth states similar to those of a tree: seed, breakthrough, sprout, sapling and young tree. Unlike the previous lifecycle models of business growth, our model suggests that a young small business' progression from one growth state to another depends on the extent to which the business addresses the above four fundamental issues in business value creation and capture. The more issues the business addresses adequately, the more advanced state it grows to. Each of the five growth states is described below.

A. State 1: Seed

A new business is typically formed to pursue entrepreneurial dreams or take advantage of a business opportunity. In this initial state, the start-up business often lacks a thorough knowledge of the target customers and their needs, and product positioning is not well specified. In other words, the new business has not adequately addressed the issue of whom the value is created for.

B. State 2: Breakthrough

A small business reaches this state once it obtains a clear understanding of whom to create value for by identifying its market segments and target customers. However, the business is still unclear about what value to create because it lacks well-defined value proposition or value content in its products (i.e., the product functionalities and features are not well specified). Therefore, the issue of what value to create has not been resolved yet.

C. State 3: Sprout

In this state, a small business has a clear idea of its target customers and value content in its product. Yet the business has not figured out suitable value creation activities or configurations of value creation activities, nor has it designed an effective and efficient organizational platform for conducting the value creation activities. In other words, the business model is still not mature as it only addresses the issues of whom to create value for and what value to create. The issue of how to create value remains unsettled.

D. State 4: Sapling

A small business operates in this growth state if it has not only specified its target customers or market segments and the value proposition in its product, but also conceived a set of business activities to deliver the value and generate revenues. However, the business remains unclear about the direction, goals, strategies, capabilities and resources for successful implementation of the value activities to generate profit. In other words, the business is still struggling with how to capture the value from its business model.

E. State 5: Young Tree

In this advanced state, a small business understands how to conduct business for its target customers with a value proposition in its product offering and the establishment of the value creating activities. The business has also demonstrated a good grasp of how to capture the value created by developing the goals and strategies for reaping profit from its product and obtaining the necessary resources and capabilities for carrying out the value creating activities. By addressing all the fundamental issues in business value, the business model has become mature.

IV. Model Assessment

To empirically evaluate the validity of this five states growth model, we developed twenty open-ended questions to assess the extent to which a small business addresses the four fundamental issues (for whom to create value, what value to create, how to create value, and how to capture value) in business value. Below are some of the questions we developed.

1) For whom does your company provide products/services and create value?
2) What are the needs and preferences of your customer groups?
3) What are the functionalities and contents of your product(s)?
4) What are the unique features or advantages of your products/services as compared to those of your competitors?
5) What R&D, marketing, operation and HR procedures have you developed for creating customer value?
6) What marketing channels does your company have?
7) What kinds of human, financial, marketing and production resources have you specified and secured for the next three years?
8) What are your company's R&D, marketing and operation strategies for the next three years?

We then sent the questions to the CEOs or general managers of 112 small and micro companies that had participated in the program of 'Grow with Entrepreneurship' in the City of Changsha, China in 2013. These companies came from the industries of food and pharmaceutical (27), environmental protection and conservation (28), electronics and telecommunications (26), and machinery (31). The maximum age of a micro business in the sample was 3 years and that of a small business was 6 years. One hundred companies provided and returned answers to all the questions, with an effective response rate of 89%. From the answers received, we classified the 100 companies in the sample into five groups corresponding to the five states in our model: 47 companies were in the sprout state, while the numbers of the companies in the other four growth states were 10 (seed), 14 (breakthrough), 15 (sapling), and 14 (young tree) respectively. The distribution of the companies among the five growth states resembled a normal distribution.

V. Conclusions

In this study, we developed a five states model of early growth of small businesses based on the business model to assist researchers and small business owners in understanding how small firms develop in their early years of existence. Our model contributes to research on the early growth process of small businesses by further exploring what influence the initial development phases of young small firms. Armed with the knowledge from the model, a small start-up firm can quickly identify where it stands in its early stage of existence and what critical problems it needs to resolve in order to move to a more advanced state and increase its viability. Our work in this study also contributes to the stage theory literature by linking stages of business growth with the development of the business model. Previous studies have identified certain internal factors (e.g., strategy, structure, systems and size) as influential with the evolution of a firm. Our research suggests that the path a business takes in its early stage of development may also be affected by the sophistication of its business model (i.e., its ability in creating and capturing business value). While our model awaits further validation with additional data from other industries and countries, it appears that investigating the early development phases of small businesses from the perspective of the business model may warrant further research consideration.

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