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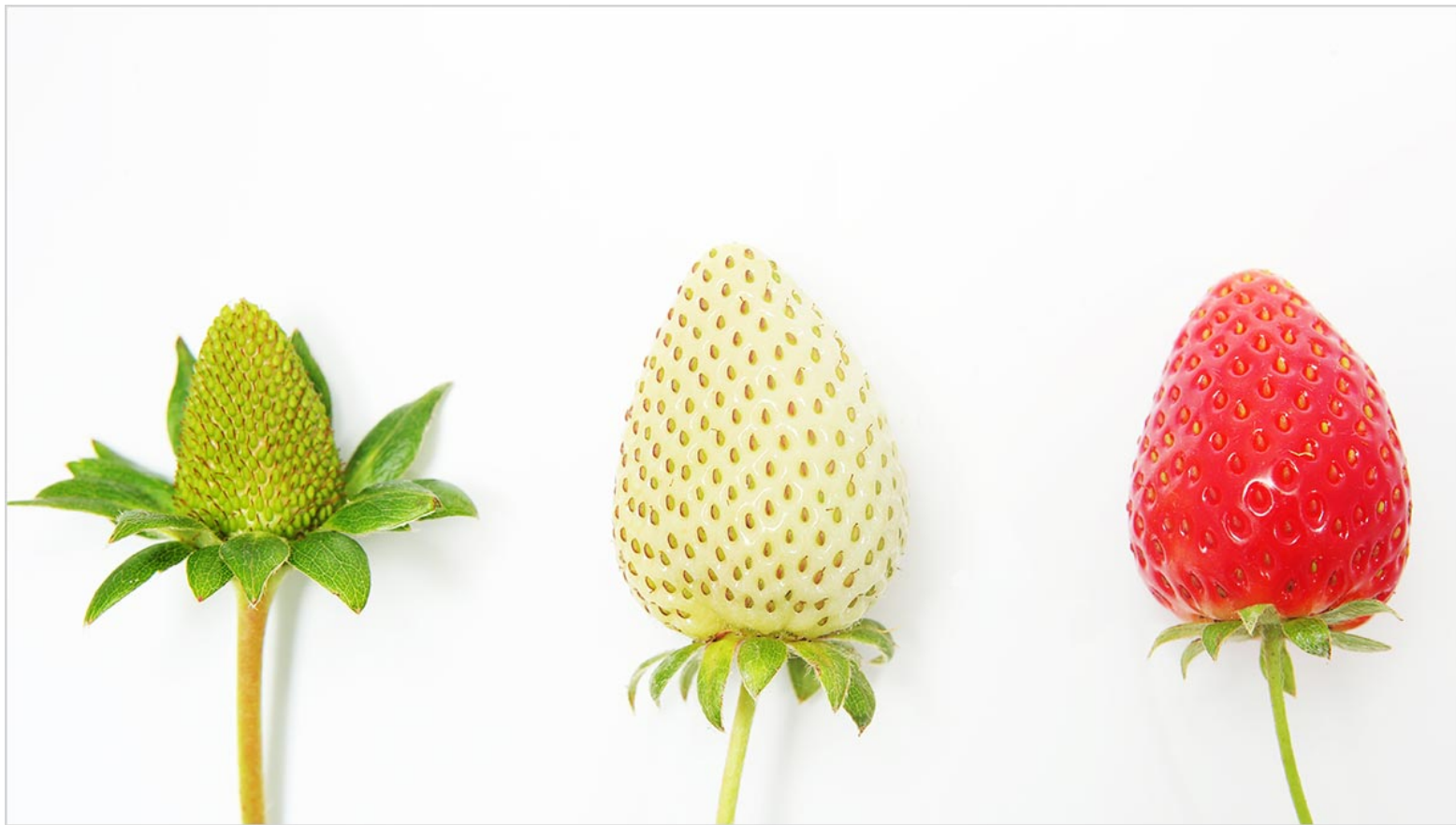


Entrepreneurial Management

The Five Stages of Small Business Growth

No researcher has explored the earliest period of a business's development in detail—until now. by Neil C. Churchill and Virginia L. Lewis

From the Magazine (May 1983)



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Categorizing the problems and growth patterns of small businesses in a systematic way that is useful to entrepreneurs seems at first glance a hopeless task. Small businesses vary widely in size and capacity for growth. They are characterized by independence of action, differing organizational structures, and varied management styles.

Yet on closer scrutiny, it becomes apparent that they experience common problems arising at similar stages in their development. These points of similarity can be organized into a framework that increases our understanding of the nature, characteristics, and problems of businesses ranging from a corner dry cleaning establishment with two or three

minimum-wage employees to a \$20-million-a-year computer software company experiencing a 40% annual rate of growth.

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For owners and managers of small businesses, such an understanding can aid in assessing current challenges; for example, the need to upgrade an existing computer system or to hire and train second-level managers to maintain planned growth.

It can help in anticipating the key requirements at various points—e.g., the inordinate time commitment for owners during the start-up period and the need for delegation and changes in their managerial roles when companies become larger and more complex.

The framework also provides a basis for evaluating the impact of present and proposed governmental regulations and policies on one's business. A case in point is the exclusion of dividends from double taxation, which could be of great help to a profitable, mature, and stable business like a funeral home but of no help at all to a new, rapidly growing, high-technology enterprise.

About the Research

STAGE	NUMBER OF COMPANIES	PERCENTAGE
I Existence	0	0.0%
II Survival	17	20.5
III Success		
Disengagement	15	18.1
Growth	33	39.8
IV Take-off	10	12.0
V Resource-mature	1	1.2
Unclassifiable		
Lack of data	6	7.2
Joint venture	1	1.2
Total	83	100

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Finally, the framework aids accountants and consultants in diagnosing problems and matching solutions to smaller enterprises. The problems of a 6-month-old, 20-person business are rarely addressed by advice based on a 30-year-old, 100-person manufacturing company. For the former, cash-flow planning is

We started with a concept of growth stages emanating from the work of Steinmetz and Greiner. We made two initial ...

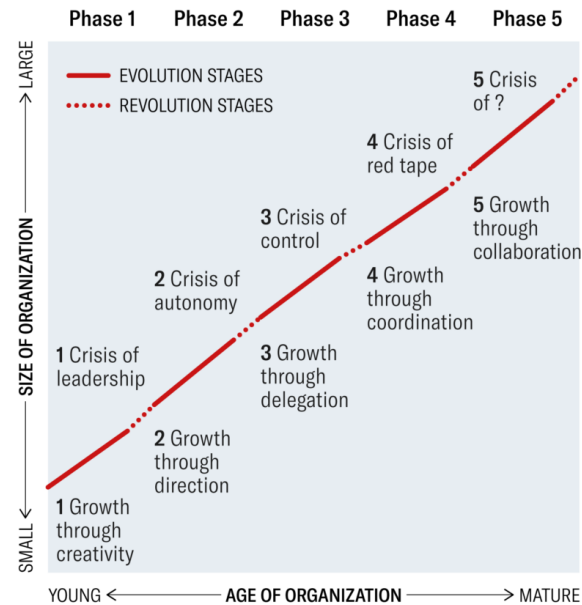


paramount; for the latter, strategic planning and budgeting to achieve coordination and operating control are most important.

Developing a Small Business Framework

Various researchers over the years have developed models for examining businesses (see Exhibit 1). Each uses business size as one dimension and company maturity or the stage of growth as a second dimension. While useful in many respects, these frameworks are inappropriate for small businesses on at least three counts.

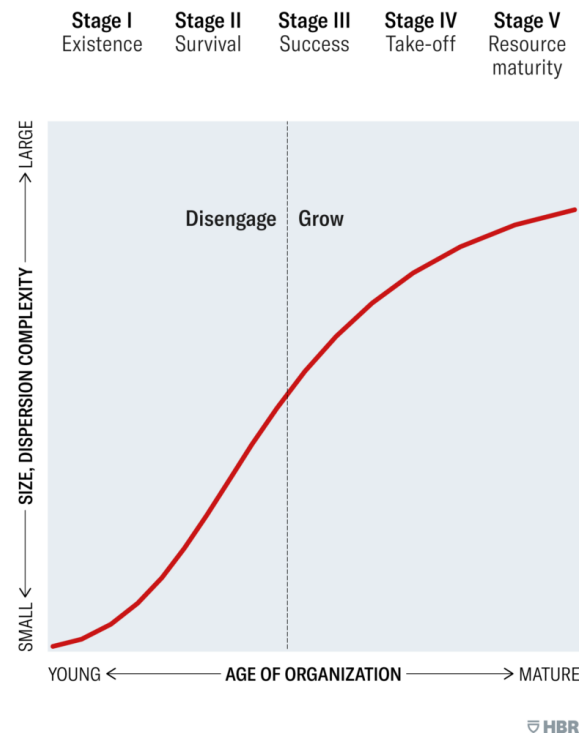
Exhibit 1: Growth Phases



First, they assume that a company must grow and pass through all stages of development or die in the attempt. Second, the models fail to capture the important early stages in a company's origin and growth. Third, these frameworks characterize company size largely in terms of annual sales (although some mention number of employees) and ignore other factors such as value added, number of locations, complexity of product line, and rate of change in products or production technology.

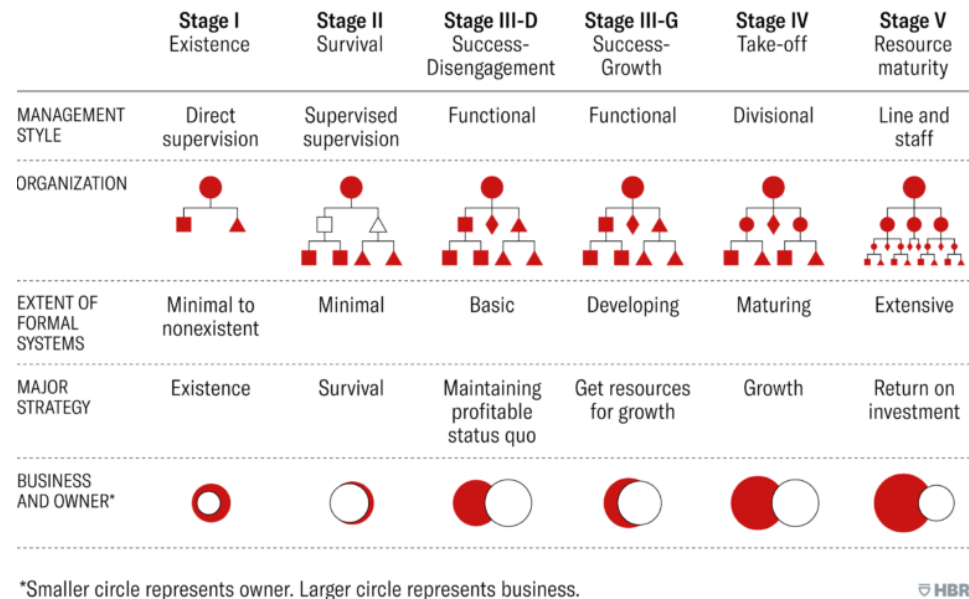
To develop a framework relevant to small and growing businesses, we used a combination of experience, a search of the literature, and empirical research. The framework that evolved from this effort delineates the five stages of development shown in Exhibit 2.

Exhibit 2: Growth Stages



Each stage is characterized by an index of size, diversity, and complexity and described by five management factors: managerial style, organizational structure, extent of formal systems, major strategic goals, and the owner's involvement in the business. We depict each stage in Exhibit 3 and describe each narratively in this article.

Exhibit 3: Characteristics of Small Business at Each Stage of Development



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Stage I: Existence. In this stage the main problems of the business are obtaining customers and delivering the product or service contracted for. Among the key questions are the following:

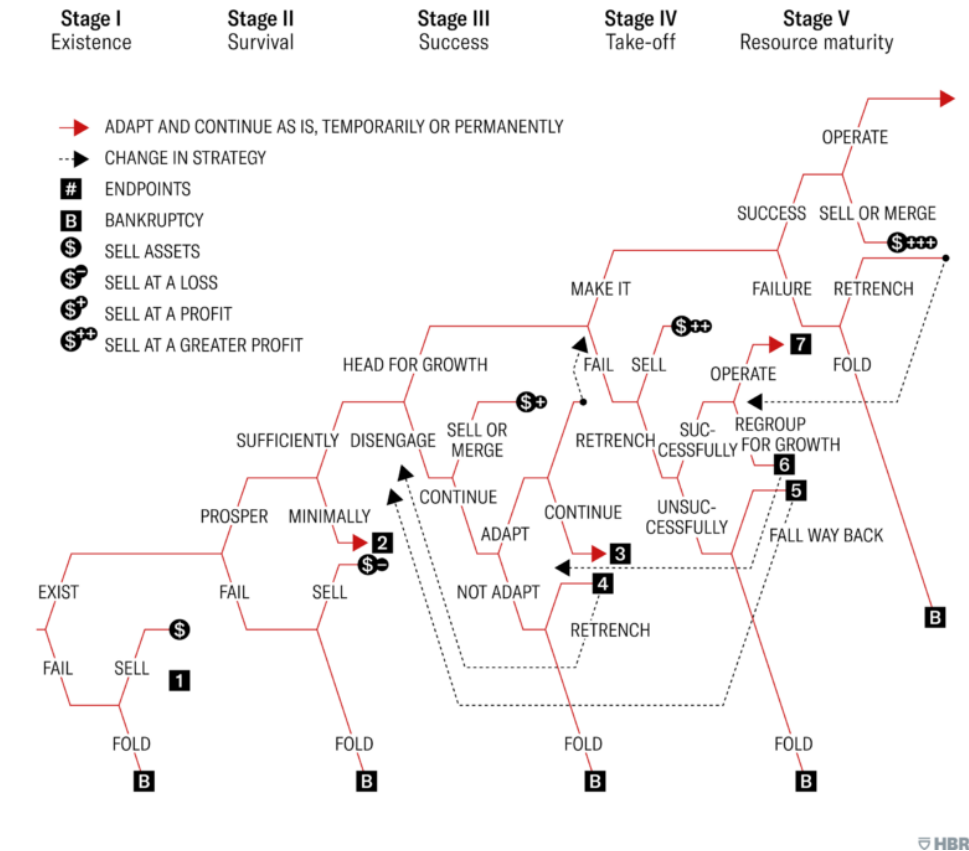
- Can we get enough customers, deliver our products, and provide services well enough to become a viable business?
- Can we expand from that one key customer or pilot production process to a much broader sales base?

- Do we have enough money to cover the considerable cash demands of this start-up phase?

The organization is a simple one—the owner does everything and directly supervises subordinates, who should be of at least average competence. Systems and formal planning are minimal to nonexistent. The company's strategy is simply to remain alive. The owner *is* the business, performs all the important tasks, and is the major supplier of energy, direction, and, with relatives and friends, capital.

Companies in the Existence Stage range from newly started restaurants and retail stores to high-technology manufacturers that have yet to stabilize either production or product quality. Many such companies never gain sufficient customer acceptance or product capability to become viable. In these cases, the owners close the business when the start-up capital runs out and, if they're lucky, sell the business for its asset value. (See endpoint 1 on Exhibit 4). In some cases, the owners cannot accept the demands the business places on their time, finances, and energy, and they quit. Those companies that remain in business become Stage II enterprises.

Exhibit 4: Evolution of Small Companies



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Stage II: Survival. In reaching this stage, the business has demonstrated that it is a workable business entity. It has enough customers and satisfies them sufficiently with its products or services to keep them. The key problem thus shifts from mere existence to the relationship between revenues and expenses. The main issues are as follows:

- In the short run, can we generate enough cash to break even and to cover the repair or replacement of our capital assets as they wear out?

- Can we, at a minimum, generate enough cash flow to stay in business and to finance growth to a size that is sufficiently large, given our industry and market niche, to earn an economic return on our assets and labor?

The organization is still simple. The company may have a limited number of employees supervised by a sales manager or a general foreman. Neither of them makes major decisions independently, but instead carries out the rather well-defined orders of the owner.

Systems development is minimal. Formal planning is, at best, cash forecasting. The major goal is still survival, and the owner is still synonymous with the business.

In the Survival Stage, the enterprise may grow in size and profitability and move on to Stage III. Or it may, as many companies do, remain at the Survival Stage for some time, earning marginal returns on invested time and capital (endpoint 2 on Exhibit 4), and eventually go out of business when the owner gives up or retires. The “mom and pop” stores are in this category, as are manufacturing businesses that cannot get their product or process sold as planned. Some of these marginal businesses have developed enough economic viability to ultimately be sold, usually at a slight loss. Or they may fail completely and drop from sight.

Stage III: Success. The decision facing owners at this stage is whether to exploit the company’s accomplishments and expand or keep the company stable and profitable, providing a base for alternative owner activities. Thus, a key issue is whether to use the company as a platform for growth—a substage III-G company—or as a means of support for the owners as they completely or partially disengage from the company—

making it a substage III-D company. (See Exhibit 3.) Behind the disengagement might be a wish to start up new enterprises, run for political office, or simply to pursue hobbies and other outside interests while maintaining the business more or less in the status quo.

Substage III-D. In the Success-Disengagement substage, the company has attained true economic health, has sufficient size and product-market penetration to ensure economic success, and earns average or above-average profits. The company can stay at this stage indefinitely, provided environmental change does not destroy its market niche or ineffective management reduce its competitive abilities.

Organizationally, the company has grown large enough to, in many cases, require functional managers to take over certain duties performed by the owner. The managers should be competent but need not be of the highest caliber, since their upward potential is limited by the corporate goals. Cash is plentiful and the main concern is to avoid a cash drain in prosperous periods to the detriment of the company's ability to withstand the inevitable rough times.

In addition, the first professional staff members come on board, usually a controller in the office and perhaps a production scheduler in the plant. Basic financial, marketing, and production systems are in place. Planning in the form of operational budgets supports functional delegation. The owner and, to a lesser extent, the company's managers, should be monitoring a strategy to, essentially, maintain the status quo.



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As the business matures, it and the owner increasingly move apart, to some extent because of the owner's activities elsewhere and to some extent because of the presence of other managers. Many companies continue for long periods in the Success-Disengagement substage. The product-market niche of some does not permit growth; this is the case for many service businesses in small or medium-sized, slowly growing communities and for franchise holders with limited territories.

Other owners actually choose this route; if the company can continue to adapt to environmental changes, it can continue as is, be sold or merged at a profit, or subsequently be stimulated into growth (endpoint 3 on Exhibit 4). For franchise holders, this last option would necessitate the purchase of other franchises.

If the company cannot adapt to changing circumstances, as was the case with many automobile dealers in the late 1970s and early 1980s, it will either fold or drop back to a marginally surviving company (endpoint 4 on Exhibit 4).

Substage III-G. In the Success-Growth substage, the owner consolidates the company and marshals resources for growth. The owner takes the cash and the established borrowing power of the company and risks it all in financing growth.

**Looking Back on
Business Development
Models**

Among the important tasks are to make sure the basic business stays profitable so that it will not outrun its source of cash and to develop managers to meet the needs of the

Business researchers have developed a number of models over the last 20 years that seek to delineate stages of ...



growing business. This second task requires hiring managers with an eye to the company's future rather than its current condition.

Systems should also be installed with attention to forthcoming needs.

Operational planning is, as in substage III-D, in the form of budgets, but strategic planning is extensive and deeply involves the owner. The owner is thus far more active in all phases of the company's affairs than in the disengagement aspect of this phase.

If it is successful, the III-G company proceeds into Stage IV. Indeed, III-G is often the first attempt at growing before commitment to a growth strategy. If the III-G company is unsuccessful, the causes may be detected in time for the company to shift to III-D. If not, retrenchment to the Survival Stage may be possible prior to bankruptcy or a distress sale.

Stage IV: Take-off. In this stage the key problems are how to grow rapidly and how to finance that growth. The most important questions, then, are in the following areas:

Delegation. Can the owner delegate responsibility to others to improve the managerial effectiveness of a fast growing and increasingly complex enterprise? Further, will the action be true delegation with controls on performance and a willingness to see mistakes made, or will it be abdication, as is so often the case?

Cash. Will there be enough to satisfy the great demands growth brings (often requiring a willingness on the owner's part to tolerate a high debt-

equity ratio) and a cash flow that is not eroded by inadequate expense controls or ill-advised investments brought about by owner impatience?

The organization is decentralized and, at least in part, divisionalized—usually in either sales or production. The key managers must be very competent to handle a growing and complex business environment. The systems, strained by growth, are becoming more refined and extensive. Both *operational* and *strategic* planning are being done and involve specific managers. The owner and the business have become reasonably separate, yet the company is still dominated by both the owner's presence and stock control.

This is a pivotal period in a company's life. If the owner rises to the challenges of a growing company, both financially and managerially, it can become a big business. If not, it can usually be sold—at a profit—provided the owner recognizes his or her limitations soon enough. Too often, those who bring the business to the Success Stage are unsuccessful in Stage IV, either because they try to grow too fast and run out of cash (the owner falls victim to the omnipotence syndrome), or are unable to delegate effectively enough to make the company work (the omniscience syndrome).

It is, of course, possible for the company to traverse this high-growth stage without the original management. Often the entrepreneur who founded the company and brought it to the Success Stage is replaced either voluntarily or involuntarily by the company's investors or creditors.

If the company fails to make the big time, it may be able to retrench and continue as a successful and substantial company at a state of equilibrium (endpoint 7 on Exhibit 4). Or it may drop back to Stage III (endpoint 6) or, if the problems are too extensive, it may drop all the way

back to the Survival Stage (endpoint 5) or even fail. (High interest rates and uneven economic conditions have made the latter two possibilities all too real in the early 1980s.)

Stage V: Resource Maturity. The greatest concerns of a company entering this stage are, first, to consolidate and control the financial gains brought on by rapid growth and, second, to retain the advantages of small size, including flexibility of response and the entrepreneurial spirit. The corporation must expand the management force fast enough to eliminate the inefficiencies that growth can produce and professionalize the company by use of such tools as budgets, strategic planning, management by objectives, and standard cost systems—and do this without stifling its entrepreneurial qualities.

A company in Stage V has the staff and financial resources to engage in detailed operational and strategic planning. The management is decentralized, adequately staffed, and experienced. And systems are extensive and well developed. The owner and the business are quite separate, both financially and operationally.

The company has now arrived. It has the advantages of size, financial resources, and managerial talent. If it can preserve its entrepreneurial spirit, it will be a formidable force in the market. If not, it may enter a sixth stage of sorts: ossification.

Ossification is characterized by a lack of innovative decision making and the avoidance of risks. It seems most common in large corporations whose sizable market share, buying power, and financial resources keep them viable until there is a major change in the environment.

Unfortunately for these businesses, it is usually their rapidly growing competitors that notice the environmental change first.

Key Management Factors

Several factors, which change in importance as the business grows and develops, are prominent in determining ultimate success or failure.

We identified eight such factors in our research, of which four relate to the enterprise and four to the owner. The four that relate to the company are as follows:

1. Financial resources, including cash and borrowing power.
2. Personnel resources, relating to numbers, depth, and quality of people, particularly at the management and staff levels.
3. Systems resources, in terms of the degree of sophistication of both information and planning and control systems.
4. Business resources, including customer relations, market share, supplier relations, manufacturing and distribution processes, technology and reputation, all of which give the company a position in its industry and market.

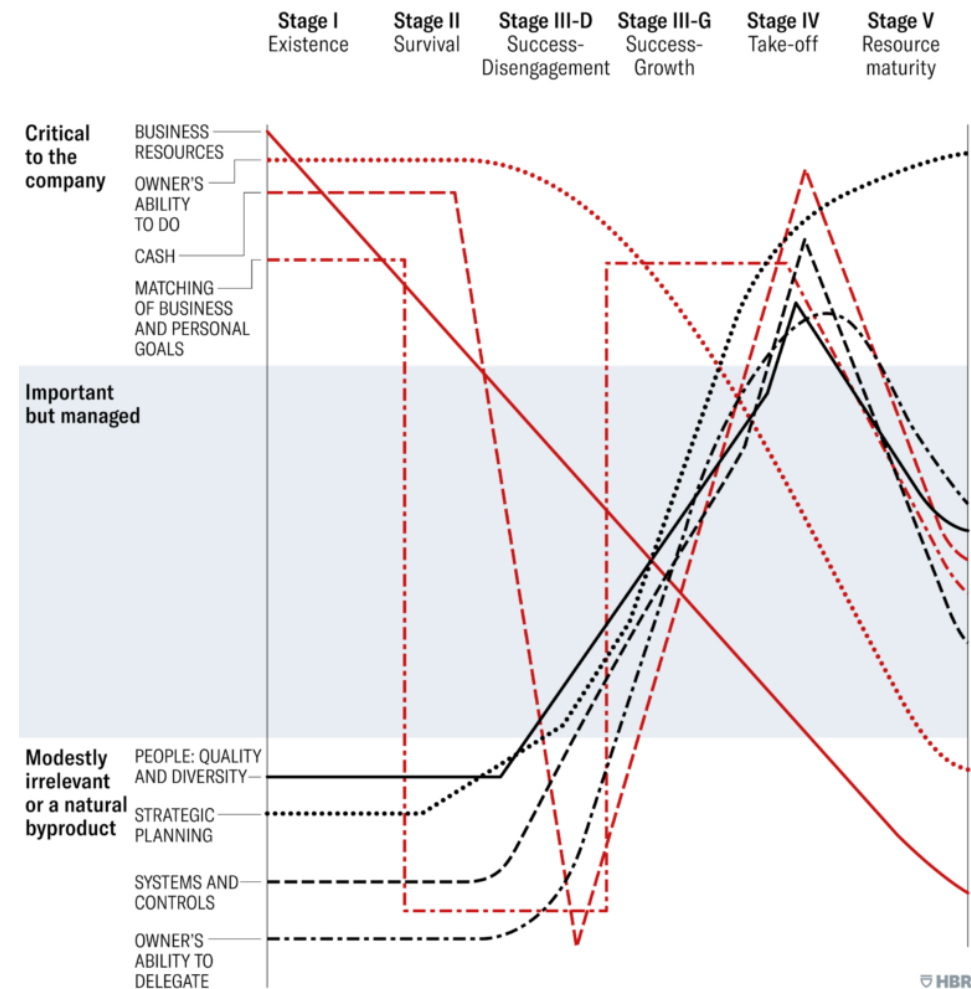
The four factors that relate to the owner are as follows:

1. Owner's goals for himself or herself and for the business.
2. Owner's operational abilities in doing important jobs such as marketing, inventing, producing, and managing distribution.
3. Owner's managerial ability and willingness to delegate responsibility and to manage the activities of others.
4. Owner's strategic abilities for looking beyond the present and matching the strengths and weaknesses of the company with his or her goals.

As a business moves from one stage to another, the importance of the factors changes. We might view the factors as alternating among three

levels of importance: first, key variables that are absolutely essential for success and must receive high priority; second, factors that are clearly necessary for the enterprise's success and must receive some attention; and third, factors of little immediate concern to top management. If we categorize each of the eight factors listed previously, based on its importance at each stage of the company's development, we get a clear picture of changing management demands. (See Exhibit 5.)

Exhibit 5: Management Factors and the Stages



Varying Demands

The changing nature of managerial challenges becomes apparent when one examines Exhibit 5. In the early stages, the owner's ability to do the job gives life to the business. Small businesses are built on the owner's talents: the ability to sell, produce, invent, or whatever. This factor is thus of the highest importance. The owner's ability to delegate, however, is on the bottom of the scale, since there are few if any employees to delegate to.

As the company grows, other people enter sales, production, or engineering and they first support, and then even supplant, the owner's skills—thus reducing the importance of this factor. At the same time, the owner must spend less time doing and more time managing. He or she must increase the amount of work done through other people, which means delegating. The inability of many founders to let go of doing and to begin managing and delegating explains the demise of many businesses in substage III-G and Stage IV.

The owner contemplating a growth strategy must understand the change in personal activities such a decision entails and examine the managerial needs depicted in Exhibit 5. Similarly, an entrepreneur contemplating starting a business should recognize the need to do all the selling, manufacturing, or engineering from the beginning, along with managing cash and planning the business's course—requirements that take much energy and commitment.

The importance of cash changes as the business changes. It is an extremely important resource at the start, becomes easily manageable at the Success Stage, and is a main concern again if the organization

begins to grow. As growth slows at the end of Stage IV or in Stage V, cash becomes a manageable factor again. The companies in Stage III need to recognize the financial needs and risk entailed in a move to Stage IV.

The issues of people, planning, and systems gradually increase in importance as the company progresses from slow initial growth (substage III-G) to rapid growth (Stage IV). These resources must be acquired somewhat in advance of the growth stage so that they are in place when needed. Matching business and personal goals is crucial in the Existence Stage because the owner must recognize and be reconciled to the heavy financial and time-energy demands of the new business. Some find these demands more than they can handle. In the Survival Stage, however, the owner has achieved the necessary reconciliation and survival is paramount; matching of goals is thus irrelevant in Stage II.

A second serious period for goal matching occurs in the Success Stage. Does the owner wish to commit his or her time and risk the accumulated equity of the business in order to grow or instead prefer to savor some of the benefits of success? All too often the owner wants both, but to expand the business rapidly while planning a new house on Maui for long vacations involves considerable risk. To make a realistic decision on which direction to take, the owner needs to consider the personal and business demands of different strategies and to evaluate his or her managerial ability to meet these challenges.

Finally, business resources are the stuff of which success is made; they involve building market share, customer relations, solid vendor sources, and a technological base, and are very important in the early stages. In later stages the loss of a major customer, supplier, or technical source is more easily compensated for. Thus, the relative importance of this factor is shown to be declining.

The changing role of the factors clearly illustrates the need for owner flexibility. An overwhelming preoccupation with cash is quite important at some stages and less important at others. Delaying tax payments at almost all costs is paramount in Stages I and II but may seriously distort accounting data and use up management time during periods of success and growth. “Doing” versus “delegating” also requires a flexible management. Holding onto old strategies and old ways ill serves a company that is entering the growth stages and can even be fatal.

Avoiding Future Problems

Even a casual look at Exhibit 5 reveals the demands the Take-off Stage makes on the enterprise. Nearly every factor except the owner’s “ability to do” is crucial. This is the stage of action and potentially large rewards. Looking at this exhibit, owners who want such growth must ask themselves:

- Do I have the quality and diversity of people needed to manage a growing company?
- Do I have now, or will I have shortly, the systems in place to handle the needs of a larger, more diversified company?
- Do I have the inclination and ability to delegate decision making to my managers?
- Do I have enough cash and borrowing power along with the inclination to risk everything to pursue rapid growth?

Similarly, the potential entrepreneur can see that starting a business requires an ability to do something very well (or a good marketable idea), high energy, and a favorable cash flow forecast (or a large sum of cash on hand). These are less important in Stage V, when well-developed people-management skills, good information systems, and budget controls take priority. Perhaps this is why some experienced people from large

companies fail to make good as entrepreneurs or managers in small companies. They are used to delegating and are not good enough at doing.

Applying the Model

This scheme can be used to evaluate all sorts of small business situations, even those that at first glance appear to be exceptions. Take the case of franchises. These enterprises begin the Existence Stage with a number of differences from most start-up situations. They often have the following advantages:

- A marketing plan developed from extensive research.
- Sophisticated information and control systems in place.
- Operating procedures that are standardized and very well developed.
- Promotion and other start-up support such as brand identification.
- They also require relatively high start-up capital.

If the franchisor has done sound market analysis and has a solid, differentiated product, the new venture can move rapidly through the Existence and Survival Stages—where many new ventures founder—and into the early stages of Success. The costs to the franchisee for these beginning advantages are usually as follows:

- Limited growth due to territory restrictions.
- Heavy dependence on the franchisor for continued economic health.
- Potential for later failure as the entity enters Stage III without the maturing experiences of Stages I and II.

One way to grow with franchising is to acquire multiple units or territories. Managing several of these, of course, takes a different set of

skills than managing one and it is here that the lack of survival experience can become damaging.

Another seeming exception is high-technology start-ups. These are highly visible companies—such as computer software businesses, genetic-engineering enterprises, or laser-development companies—that attract much interest from the investment community. Entrepreneurs and investors who start them often intend that they grow quite rapidly and then go public or be sold to other corporations. This strategy requires them to acquire a permanent source of outside capital almost from the beginning. The providers of this cash, usually venture capitalists, may bring planning and operating systems of a Stage III or a Stage IV company to the organization along with an outside board of directors to oversee the investment.

The resources provided enable this entity to jump through Stage I, last out Stage II until the product comes to market, and attain Stage III. At this point, the planned strategy for growth is often beyond the managerial capabilities of the founding owner and the outside capital interests may dictate a management change. In such cases, the company moves rapidly into Stage IV and, depending on the competence of the development, marketing, and production people, the company becomes a big success or an expensive failure. The problems that beset both franchises and high-technology companies stem from a mismatch of the founders' problem-solving skills and the demands that "forced evolution" brings to the company.

Besides the extreme examples of franchises and high-technology companies, we found that while a number of other companies appeared to be at a given stage of development, they were, on closer examination, actually at one stage with regard to a particular factor and at another

stage with regard to the others. For example, one company had an abundance of cash from a period of controlled growth (substage III-G) and was ready to accelerate its expansion, while at the same time the owner was trying to supervise everybody (Stages I or II). In another, the owner was planning to run for mayor of a city (substage III-D) but was impatient with the company's slow growth (substage III-G).

Although rarely is a factor more than one stage ahead of or behind the company as a whole, an imbalance of factors can create serious problems for the entrepreneur. Indeed, one of the major challenges in a small company is the fact that both the problems faced and the skills necessary to deal with them change as the company grows. Thus, owners must anticipate and manage the factors as they become important to the company.

A company's development stage determines the managerial factors that must be dealt with. Its plans help determine which factors will eventually have to be faced. Knowing its development stage and future plans enables managers, consultants, and investors to make more informed choices and to prepare themselves and their companies for later challenges. While each enterprise is unique in many ways, all face similar problems and all are subject to great changes. That may well be why being an owner is so much fun and such a challenge.

A version of this article appeared in the [May 1983](#) issue of *Harvard Business Review*.

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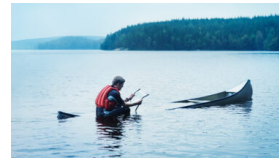
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