WHAT THE TOP 1% OF SMALL BUSINESS OWNERS DO TO ACHIEVE SUSTAINED GROWTH

Prepared by Dr. Gary Kunkle and Evolution Capital Partners

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EVOLUTION CAPITAL PARTNERS℠
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Abstract

This paper explores sustained growth as a method for small-business owners to overcome the challenges of surviving the first five years of a new venture and beyond. Its purpose is to communicate the benefits of sustained business growth so that more small-business owners can understand and mirror the methods utilized by the top 1% of small-business owners. Research methods used for this paper include accumulating and analyzing both qualitative and quantitative data from scholarly sources, including long-term research studies, public records, surveys and interviews. Preliminary findings show notable commonalities exist among the practices and philosophies of top business owners that ultimately position their ventures for sustained growth. Findings also depict that sustained-growth businesses lead to increased regional economic success, job creation and social equity.

Background

Half of all new small businesses fail within the first five years and about two-thirds fail within 10 years.[1] Among companies that survive any five-year period, regardless of age, just 1% experience sustained growth as measured by an increase in employment or capacity. Not only does this population outlive the average lifespan of a small business, but the top 1% of small businesses also accounts for the creation of about 60% of new private-sector jobs.[2]

TOP 1%

of small businesses also account for the creation of about 60 percent of net new private-sector jobs.[2]

Back in 2012, Dr. Gary Kunkle—the leading researcher on sustained growth—found that the U.S. economy was losing corporate scale at a frightening pace, reversing long trends of expansion. Large firms became fewer and smaller, and their total share in the economy fell by half. Simultaneously, the private sector grew by 73% and growth was concentrated among firms with fewer than 100 employees. The latest data is currently being reviewed to see if this trend has continued, corrected itself or become more severe, but so far, it indicates that the U.S. economy is becoming increasingly reliant on small businesses to provide added labor and capital, equitable job opportunities and an increased tax base.[6] So, why do the elusive top 1% of small businesses thrive while most other small businesses and their corporate counterparts decline? The common thread between the most successful small businesses is sustained growth. Fortunately, this is a practice that can be learned by small-business owners across all geographic locations and industries.

WHAT IS
SUSTAINED GROWTH ?

In a business context, sustained growth is the realistically attainable growth that a company can maintain without running into problems.[4] Exceeding the calculated or estimated growth limit threatens a business's stability. According to financial management expert Robert C. Higgins, "If sales expand at any greater rate [than what is sustainable], something in the company's constellation of financial objectives will have to give—usually to the detriment of financial soundness."[4] Indeed, scaling too rapidly presents the risks of being unable to fund the growth and mismanaging operations. This is because if a business grows on a foundation of debt, it loses profitability. And as a business's growth speed increases, these stressors become more and more unmanageable. On the flipside, businesses with stagnant growth may struggle to profit or break even, which jeopardizes their survival. To avoid the dangers of both extreme ends of the growth spectrum, a business should aim for sustained growth—the middle way between scaling rapidly and stagnation. Higgins rationalized, "If sales grow at less than [the calculated growth ceiling] rate [and above the floor], the firm will be able to increase its dividends, reduce its leverage or build up liquid assets."[4] By pacing growth to keep production close to the actual demand for the product or service, businesses can better navigate the inevitable changes that come with getting bigger, such as hiring and training new employees, adopting formal procedures, moving offices and increasing production.

SUSTAINED GROWTH is the realistically attainable growth that a company can maintain without running into problems.[4]

To calculate a business's sustainable growth rate, first divide its net income by average shareholders' equity. The quotient will represent the business's return on equity (ROE). Then, determine the dividend- payout ratio by dividing the total number of dividends paid out by the company's total net income. These figures can be applied to the equation: Sustainable Growth Rate = ROE * (1 – dividend payout ratio). The answer will represent an estimate of the ceiling (Sustainable Growth Rate) for maximum sales growth that can be achieved without exhausting operating cash flow, assuming that a business aims to maintain a target capital structure without issuing new equity, while expanding sales as quickly as possible.[5]

SUSTAINABLE GROWTH RATE = RETURN ON EQUITY X *(1 – DIVIDEND PAYOUT RATIO)*

Discrepancies in the Sustained Growth Rate formula arise when considering variances in the ways that different businesses maximize their dollars. Some companies hold onto returns, while others spend returns irresponsibly, so the formula must be used with caution. In addition, the figures are inapplicable to small businesses that do not have shareholders and dividend payouts.

GROWTH FREQUENCY:

an increase in capacity or human capital—even marginally—approximately every 18 months of a five-year period

Therefore, a less specific but more reliable way to measure and plan for sustained growth is growth frequency. If a business increases capacity or human capital—even marginally—approximately every 18 months of a five-year period, then its growth is considered sustained.[2] Thus, sustained growth is incremental growth, which accumulates overtime and prepares a business for future growth.

BENEFITS
OF SUSTAINED GROWTH

Businesses that experience sustained growth are more likely to successfully repeat the incremental growth process again in the future. Every time a business grows, the likelihood of it growing again increases. According to Kunkle:

It's a modern equivalent of Aesop's tortoise and hare story: slow and steady wins the race. Incremental advancement, repeated over time, achieves greater results in the long run than a few short bursts. In other words, the more times a company grows, the more likely it is to be in the top 1% of growth.[6]

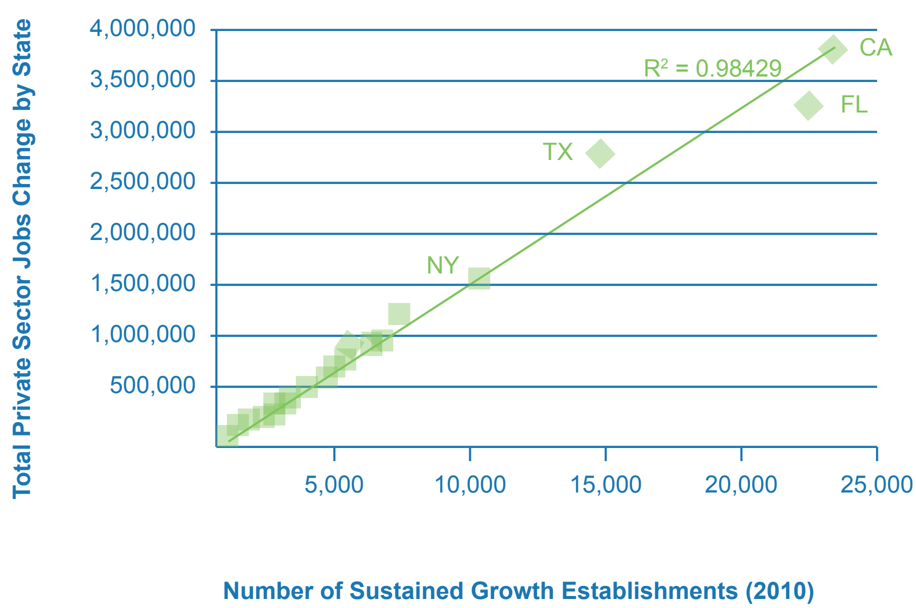
Therefore, sustained-growth companies can enjoy long-term success without the disorienting internal chaos that a one-time surge of exponential growth brings. Given the dismal 50% survival rate of small businesses within the first five years, taking the sustained-growth approach to business success is conclusively the most practical strategy.[1]

But the benefits of sustained growth extend far beyond the success of a business. Increased job creation, higher average incomes and economic prosperity are all byproducts of sustained- growth companies that cyclically contribute to the business's success and ultimately set the stage for more equitable communities. As a business grows more frequently, it accumulates productive scale, which leads to the creation of high- quality jobs.[6] Research shows that growing at a sustainable rate significantly increases the long- term survival rate of a business, so the jobs that are created offer security, longevity and opportunity for advancement. Research also qualifies that states with more sustained-growth establishments have higher numbers of total jobs added.[6] Hence, sustained-growth businesses are singlehandedly responsible for the creation of most of the lasting employment opportunities within the U.S. economy. In Kunkle's words:

Policy makers are fond of large one-off events, such as startups and new plant openings, as these generate exciting media coverage. Yet, the evidence shows that one-off events aren't the primary driver of lasting job growth… Sustained incremental expansion over time tends to drive total jobs created during that period.[6]

Furthermore, the sustained growth of a business correlates to the sustained income growth of its employees—when it flourishes, employees are direct beneficiaries.[6] Higher earnings equate to increased disposable income, which can stimulate the local economy and prime other businesses for sustained growth as well, creating a multiplier effect of employment and spending throughout the region. Because sustained-growth companies are found in every industry and nearly every populated county across the country, its benefits are spread to a diverse range of workers and owners. As a result, opportunities that transcend race, class and gender are greater than those presented by large companies traditionally favored by public policy.[6] In contrast, businesses with stagnant growth create significantly fewer high-quality jobs. While fast-growing companies initially ignite job creation, the employment positions are not as secure as those at sustained growth companies. And if the fast-growing company fails or suddenly plateaus, the fallout from it entering a community and then abandoning it can outweigh out the temporary benefit from its brief burst of success.

Sustained growth establishments and private sector job growth by US state

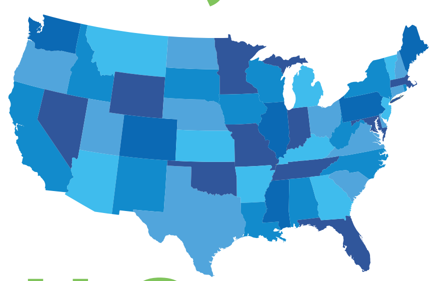


WHAT DO THE TOP 1% OF BUSINESS OWNERS DO TO ACHIEVE SUSTAINED GROWTH?

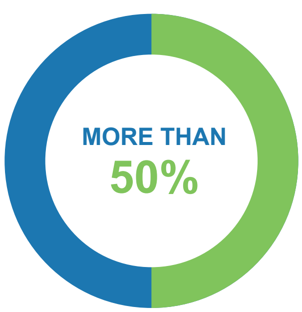
HOW TO
ACHIEVE SUSTAINED GROWTH

So, what do the top 1% of business owners do to achieve sustained growth? Sustained growth is not exclusive to any particular industry or location. Research contradicts the preconceived notion that growth is more common in "hot industries" or areas with greater access to capital, ideas and people.[7] Although the businesses can't be easily clustered, they do share notable commonalities in their practices and philosophies. Trends from a study of more than 100,000 U.S.-based, mid-sized businesses show that sustained-growth companies embody the business habits detailed below.[7]

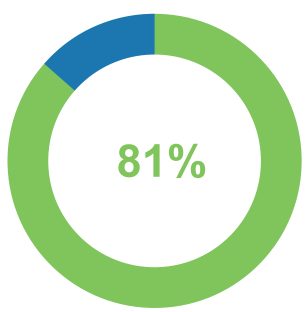
100,000



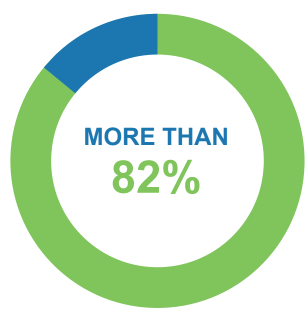
U.S.-based midsize businesses



of survey respondents reported that employees and their standard of customer service were the only drivers of competitive advantage for their business



of respondents named sudden loss of a key employee as a major concern



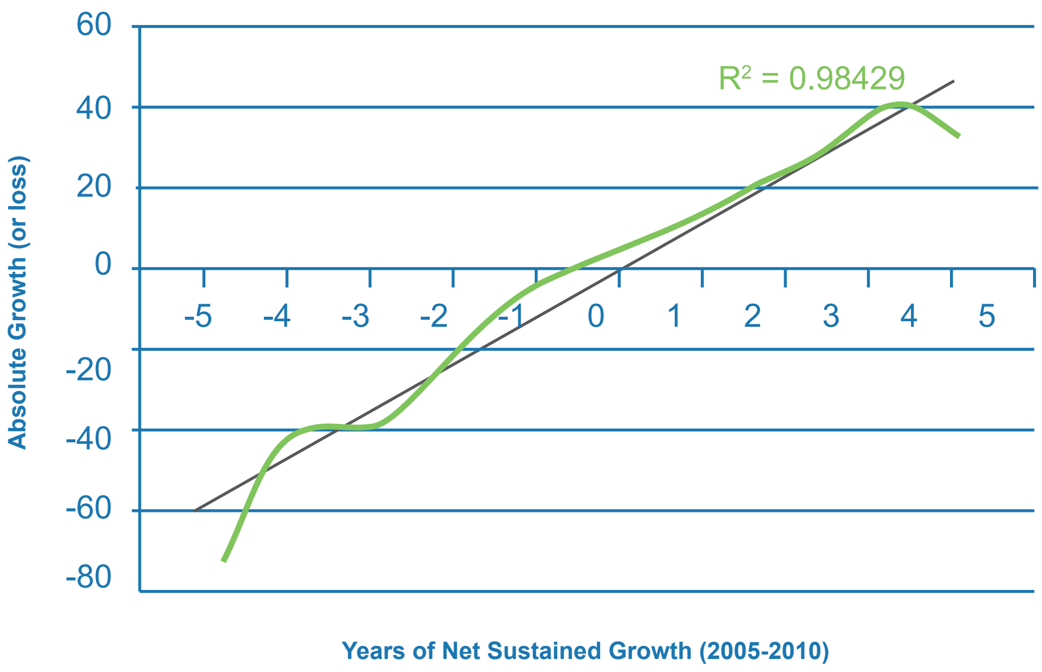
of respondents said sharing financial success with your employees helps a company grow

1

Learn Virtuous Growth Cycles

Sustained growth is tied to learning through repetition. In other words, each time a company expands, it becomes more skilled at surviving the transitions involved with catering to an increased demand for products or services. The first time a business grows, the process is likely to be bumpy, yet transformative. But as a business experiences bursts of success over and over again, its owners become more knowledgeable about the process. Over time, business owners can learn to harness the virtuous growth cycle, which involves setting an intention to evolve the business, developing an articulate plan, taking action, learning throughout the process and then repeating it again to increase returns and efficiencies.[7] More than any other factor, past performance of a company is a better indicator of its propensity to grow in the short-term and survive in the long-term. If a business has achieved sustained growth in the past, there is a better chance that it will continue to progress.[8]

Frequency and Amount of Growth



When striving for healthy, sustained growth, guidance from a business growth expert—such as a private equity firm or consultant—is valuable. Learning in general is easier and more effective with a teacher. For example, a child being taught how to tie a shoe by someone who already knows will catch on quicker than a child alone in a room trying to teach himself. Growing a business is the same—learning from someone who already understands the ins and outs is more effective than fumbling through it independently.[2] This is because an experienced growth partner can identify a business's priorities and chart the most efficient routes to growth. Unfortunately, small-business owners may lack the time and foresight required to create a logical growth plan while simultaneously juggling the day-to-day demands of running a business.[2] Because growth experts have already mastered virtuous growth cycles, taking them on as a partner means saving time and money from being wasted on the trial-and-error process, while allowing the owner time to focus on what they do best: running the business. As a result, business owners do not have to cope with the relentless uncertainty of growing by guesswork. The potential of misstepping is drastically reduced, and the business owner has a support system for making critical decisions.

As a business repeats the growth cycle, having the guidance of an external partner only becomes more valuable. Although owners gain knowledge and competency each time the business grows, the growth process simultaneously gets more complex each time. The bigger the business, the greater the responsibility. Therefore, the stressors involved with business growth become increasingly unmanageable, which is the number-one reason why companies that have extremely fast growth fail. Recognizing a need for help is an important step for maintaining upward momentum that is too often jeopardized by business owners' egos interfering with them reaching out for help.[2]

2

Practice Transparency

Transparency is a recurring theme throughout every aspect of commonalities among the top 1% of small-business owners. Having transparent operations builds a foundation of trust between the business owner, employees, shareholders and customers. Although a business can grow without fully transparent practices, top business owners recognize that being secretive, withholding information or making decisions behind closed doors is not a likely route to building a motivated, loyal workforce. Brendan Anderson, a growth management expert and co-founder of Evolution Capital Partners, said:

> *A transparent approach to business, even when the information is unfavorable, will gain your company respect from its employees, vendors, shareholders and other critical business partners. In the event of a crisis, the foundation of transparency already laid out will help those affected trust that you will do everything possible to rectify the situation, even in the most challenging of circumstances.*[9]

Otherwise known as open-book management, transparency also enforces a level of accountability on everyone from upper management down to entry-level hires. When everyone knows one another's roles, their successes and failures are out in the open for everyone to see. Employees may also recognize that the success of the business directly correlates to their individual successes. Not only does this method promote a high-performance culture by encouraging employees to self-monitor their own work, but it also heightens stakeholdership throughout the business.[2]

MORE THAN 82% of mid-sized business survey respondents said that sharing financial information with employees helps a small business grow.[8]

3 Maintain Positive Financials

The philosophy of transparency is especially valued among the top 1% of business owners when it comes to sharing financial information. More than 82% of mid-sized business survey respondents said that sharing financial information with employees helps a small business grow.[7] The practice enhances communication between departments, eliminates surprises and motivates employees to contribute to the bottom line.

Sustained-growth companies are those with the ability to profit, as well as generate and manage cash flow. Money is the life source of a small business, so there must be enough of it to fuel progress. Furthermore, carefully tracking earnings and expenditures is key to evaluating progress on the business's growth goals. Top business owners cross-examine financial reports with previous years and break them down into smaller details, such as profit by production, location and customer.[2] Cost accounting provides insight on where to cut costs or increase growth efforts. Another best practice for small business owners is thoroughly recording all transactions in an accounting journal and keeping an updated general ledger with dashboards that detail balances of the business's assets, liabilities, equity, expenses and revenue.[10] Growth management expert and co- founder of Evolution Capital Partners, Jeffrey Kadlic, recommends tracking all of the above information on a financial dashboard:

> *In business, financial dashboards play a similar role to that of a vehicle's dashboard—displaying everything from your automobile's speed and fuel level, to its engine temperature and RPMs. Without this display available, it would be extremely difficult to know how fast you're traveling, whether your vehicle is in good condition or if you're moments away from running out of gasoline.[10]*

4

Create an Effective Plan

The top 1% of small-business owners identify goals to pursue that are simple yet specific in their metrics and timeframe.[2] Notably, goals are different than strategies. A goal is something you must strive to attain, whereas a strategy outlines how to attain a given goal. For each goal, top business owners create a clear set of choices that define what the business is going to do and what it's not going to do. Without outlining a detailed strategy, a business risks sprinting toward a goal in the wrong direction. For example, achieving sustained growth is a challenging goal that demands a rigorous strategy to be successful. To ensure the business is on track for sustained growth, top business owners—alongside their growth advisors—break down their long-term goals into achievable parts that are ambitious, yet not overextending of growth expectations. Planning for future success begins with a clear plan of what the team needs to accomplish for the day. Daily goals fit into quarterly priorities that are incorporated into a one-year plan, which lays the foundation for a three-year plan and so on. Ultimately, each short- term plan should play a role in inching a business toward its long-term aspirations. Otherwise, a business is merely surviving.

A business's growth plan, Kunkle emphasizes, should be transparent and well-communicated to all employees. Top business owners keep their team informed about the direction the business is headed and, more importantly, the meaning behind the plan: why the business exists. This population of highly successful business owners typically sees money as a byproduct of contributing something more important to the world. They are often on a mission to solve problems or create better models for business and daily life alike. Kunkle said:

> *In terms of productivity, human beings are not primarily motivated by money. They are motivated by what makes their work meaningful. And the more you can hold up a beacon to that, the more people you are able to draw in to the business, and the more loyal and hardworking they are.*[2]

5

Build a Strong Team

To build scale, a business needs to add human capital. More specifically, in order to increase sales, a business needs more salespeople. Although adding onto the sales team is oftentimes a pain point for business owners, it's necessary for sustained growth. Even if the majority of sales comes from the top-performing salespeople, as is often the case, it's impractical to rely on a small team of superstars to carry the weight of a growing business.[2]

And, relying too heavily on a single player is dangerous—81% of respondents from the survey of 100,000 U.S.-based, mid- sized businesses named the sudden loss of a key employee as a major concern.[7] Top business owners report that a well-trained team is more productive and secure than a few great individuals, which is why attracting and retaining talent who can deliver positive customer experiences is so important. In fact, more than 50% of survey respondents reported that employees and their standard of customer service were the only drivers of competitive advantage for their business.[7] Especially considering that a growing business has an ever-increasing headcount, developing good hiring and training practices is essential for maintaining sustained growth.

MORE THAN 50% of survey respondents reported that employees and their standard of customer service were the only drivers of competitive advantage for their business.[8]

However, attracting top managerial talent and training future supervisors were also listed as two of the top three greatest obstacles for growth—creating a paradox, given that a good team is the driving factor for growth.[7] As a result, the common practice among top business owners is to focus on hiring entry-level talent who possess the right skills for the position, fit in with the company culture and have the aptitude and desire to eventually become a supervisor. Kunkle said:

> *If you're rewarding people to learn, be good team members, be on track and aligned with the goals of the company—and hopefully those goals are beyond just making money—then all that knowledge gets invested in the employees… It's not wise to hire in middle management. You want to matriculate middle management. Instead, hire in entry-level workers and know that those are the best people to enter supervisory and management roles as the company continues to grow.*[2]

Promoting internally builds a positive atmosphere. It communicates that hard work gets recognized and rewarded. When employees feel appreciated, they are more likely to feel a sense of purpose in their work and be loyal to the company. Transparency also plays a role in building productive teams. Top business owners share the vision and passion of upper management with the rest of the team, making it infectious. And in order to avoid leaving employees in the dark about their standing, top business owners have performance check-ins regularly.[2]

CONCLUSION

The themes explored in this paper indicate that sustained growth, as opposed to stagnant growth and exponential growth, is the most reliable method for achieving long-term success for a small business. Sustained growth can be classified as an incremental increase in employment or capacity every 18 months over a five-year period. Only 1% of companies are able to achieve this level of sustained success. Sustained-growth companies bolster the overarching economic success of a region through increasing employment, providing secure incomes and creating equitable opportunities. To gain the benefits of sustained growth, small-business owners may strive for it through adopting the practices and philosophies embodied by the most successful small-business owners. Although attaining sustained growth presents countless challenges that are often beyond the capabilities of an average small-business owner, growth is a learning curve that can be mastered through repetition. Concurrently, every time a business grows, the complexity of decision making also increases, meaning business owners face more decisions with higher-stake outcomes. Hence, small businesses can increase the likelihood of realizing growth aspirations by enlisting a growth partner.

The findings of this paper present significant opportunity to expand research into each of the areas where there are similarities in the practices and philosophies of the top 1% of business owners. Learning virtuous growth cycles, practicing transparency, maintaining positive financials, creating an effective planning and building a strong team are all subjects that warrant additional investigation to better understand the best practices for achieving sustained growth. Kunkle regularly researches these trends through big data analysis and large-scale, targeted executive surveys, indicating that knowledge on sustained business growth is valuable and worth expanding. Additional research into how sustained-growth companies affect employment rates within the community, region and country could also be beneficial to shaping economic policy.

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About:

DR. GARY KUNKLE

Dr. Gary Kunkle is a leading expert on the drivers and impact of sustained growth for businesses and regional economies. He is the founder of Outlier LLC, a consultancy that serves corporate and government clients related to economic research and strategy, and the Research Fellow at Business Dynamics Research Consortium (formerly the Institute for Exceptional Growth Companies) based at the University of Wisconsin–Madison.

Evolution Capital Partners

Evolution Capital Partners is a small-business private equity fund investing growth equity nationwide in Second Stage Companies generating at least $500,000 of EBITDA. Evolution specializes in helping entrepreneurial businesses transform their organizations by providing a foundation for growth through its process, The Five Pillars of Business Freedom℠, which leverages the time and energy of the business owner. For more information, visit www.evolutioncp.com.

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