In Chapter 2 we reviewed the extensive body of research into corporate diversification that has been published in the past four decades. It turned out that despite hundreds of studies published in major journals, much remains to be understood about corporate diversity and diversification. Put straightforwardly, the aggregate outcome of diversification research is contradictory, fragmented and conclusions are largely general in nature. We concluded that a fundamental change in the research strategy is needed to give diversification research new impulse and gain new insights. More in particular, fine-grained methodologies are needed to examine the process of diversification in detail and pay close attention to managerial knowledge and processes of individual and organisational learning. Insights into these aspects can contribute to the development of a theory of diversification.

The review on diversification research also revealed that researchers have hardly paid attention to small and medium-sized enterprises (SMEs). This chapter focuses on the few studies that have studied diversification by SMEs and which indicate that a substantial percentage of SMEs is diversified to a greater or lesser degree. In addition to these studies, we turn to the (more extensive body of) research that has been conducted on the growth of SMEs to identify factors that may influence success and failure of diversification projects. On the basis of both streams of research and considering the characteristics of SMEs in general (as opposed to large, multinational corporations), we expect that some fundamental differences exist between diversification by SMEs and large companies. Most intriguing in this respect is the omnipresence of the owner-manager(s) and the effects this may have for processes of individual and organisational learning.

This chapter starts with a description of SMEs and shortly enumerates their main characteristics. It then turns to the research that has been conducted on diversification by SMEs. As diversification often involves growth, the next section examines the extensive research into the growth and development of SMEs. It is not our intention to give a full and comprehensive overview of this stream of research; we limit our review to factors that may (also) be relevant to diversification by SMEs.
Characteristics of SMEs

There is no single, uniformly satisfactory, way to define an SME and distinguish it sharply and neatly from large firms. Zwart (1991), for example, reviews nine different definitions of SMEs and Storey (1994) reviews another five. The most commonly used criteria relate to measures of size, such as number of employees, sales turnover and balance sheet value. For example, firms with less than 100 employees are generally considered as small enterprises while firms that employ between 100 and 500 employees are rated among the medium-sized enterprises. Although the measurability of such criteria is attractive, their simplicity is deceiving. Both Zwart and Storey note considerable differences across countries and between industries that seriously hinder a univocal delineation. Moreover, problems with size criteria increase when a multiplicity of criteria is used. But what is more important, the essence of what an SME is, goes well beyond measures of size per se. As Penrose (1959) remarks, small and large firms are as different as ‘a caterpillar is from a fly’. The true differences between SMEs and large firms hide in the qualitative characteristics of SMEs. In the SME-literature a number of these return time and again and together characterise SMEs.

Although the diversity among SMEs and its owner-managers is large (see e.g. Nooteboom, 1994; van Dijk and Thurik, 1998; Scherjon and Thurik, 1998), the dominance and omnipresence of its owner-manager(s) is without doubt its most outstanding characteristic (e.g. Gibb and Scott, 1985; Zwart, 1991; Burns, 1996). The owner-manager of an SME has an overwhelming influence on ‘his’ firm that makes his position incomparable to the position of (most) top-managers in large firms. For one thing, it places his personal characteristics (e.g. need for achievement and risk taking propensity), abilities and skills, education, leadership and management style in a central position (McClelland, 1961; Schollhammer and Kuriloff, 1979; Perry et al., 1984; Begley and Boyd, 1987; Bird, 1988; Davidsson, 1991). The importance of the owner-manager(s) is well illustrated by the central position of ‘the abilities of the owner-manager’ in Churchill and Lewis’ (1983) stage model of small business growth, ‘the individual’ as one of the dimensions in Gartner’s (1985) conceptual framework for describing new venture creations, and Gibb and Davies’ (1990) overview of ‘the personality dominated approaches’ for understanding how SMEs are affected by growth (cf. Smidt and Zwart, 1994). Relevant to this project, Kets de Vries and Miller (1984) notice that because the owner-manager has such a central position in a firm, his learning comes closer to the learning by the organisation than the learning of top-managers in large firms (see also Schneider and Angelmar, 1993).

Second and closely related, SMEs are generally independently owned, operated, and financed (Committee for Economic Development, 1978; Peterson et al., 1986; Hatten, 1997). For many owner-managers the search for independence was a major reason to start up the firm in the first place (Hornaday and Aboud, 1971; DeCarlo and Lyons, 1979), although this may differ between
urban and rural areas (Westhead and Wright, 1998) and across countries (Scheinberg and MacMillan; 1988; Zhuplev et al., 1998). The independence of ownership has a number of implications, involving such issues as funding, ambitions for growth, aspired returns, and time horizons. Normally, the owner-manager himself or a small group of relatives and acquaintances (Borrower et al., 1996) supply capital and hold ownership. In specific instances private investors or development companies may hold a (minority) share in the company. Whatever the case, the relationship between the owner(s) and the business is fundamentally different from that between the shareholder and a large firm quoted on the stock exchange. Amongst other things, SME-managers may feel less pressure to maximise profitability, at least not in the short run. Note that as firms age and grow, ownership patterns often dilute (Hendry et al., 1995). As a result, even many so-called small firms are not strictly ‘owner-managed’ anymore.

Thirdly, due to their independence, SMEs tend to face constraints with respect to resources and skills (e.g. Adams, 1982; Churchill and Lewis, 1983; Hambrick and Crozier, 1985; Hunsdiek, 1985; Weinrauch et al., 1991; Hay and Kamshad, 1993). Gadenne (1999) found that financial leverage was the only factor across three different industry groups that explained the success of SMEs. Constraints are not limited to financial resources but (may) extend to resources and capacities in every other functional area, in particular marketing-skills (Adams, 1982; Siropolis, 1990; Weinrauch et al., 1991; Huang and Brown, 2000). Managerial constraints are reflected in the lack of staff personnel and departments within SMEs. Many owner-managers largely take care themselves of most or many staff activities as diverse as controlling, marketing, and production and logistics operations.

Finally, SMEs are likely to face greater uncertainty in the environment in which they operate (Wynarczyk et al., 1993). SMEs tend to operate in a single market or a limited number of markets and to have a limited customer and product base (Burns, 1996). As a consequence, the scope of their operations is mostly limited and they find it more difficult to spread their business risk. Moreover, they are generally small relative to the industry in which they operate compared with competitors, suppliers or customers (Committee for Economic Development, 1978; Burns, 1996; Hatten, 1997). As a consequence, SMEs are unlikely to exert much influence on their market and they often find themselves to be price-takers (which is another reason why SMEs face more risk than large firms).

Research on diversification by SMEs

In Chapter 2 we observed that the mainstream of diversification research has focused on large, multinational corporations. Only a few (survey) studies have investigated diversification among SMEs. Due to these studies, we know that diversification is not limited to large, multinational corporations. Moreover, the
studies indicate that diversification by SMEs differs in several respects from diversification by their larger counterparts. Based on the studies available, we will successively estimate the degree to which SMEs are diversified (on average), consider the motives for diversification by owner-managers of SMEs, and list the major findings of these studies.

**Degree of diversification among SMEs**

It is not precisely deducible from the small number of studies that have investigated diversification among SMEs how diversified SMEs on average are (Bood, 1996c). When comparing these studies, a rather varied picture of the degree of diversification of SMEs emerges. The main reason for this is that the studies employ rather different definitions of both SMEs and diversification. With this in mind, we will only make a rough estimate of the diversity of SMEs based on three studies at hand to get an indication of the importance of diversification for SMEs (and thus of the relevance of the present research project).

The STRATOS research project (STRATOS; 1990) investigated more than 1,100 SMEs with less than 500 employees in eight European countries. It concluded that SMEs are fairly diversified. Well over 88% of these firms had two or more product groups, while almost 70% also served two or more consumer groups. During the past three years, 38% of the firms in the STRATOS-project added new product groups from within their industry and almost 20% added product groups from another industry to their portfolio. Unfortunately, the project did not define what constituted a ‘product group’ leaving it to the interpretation of the responding owner-manager.

Robson et al. (1991) examined 110,000 firms with less than 200 employees in the British Dunn & Bradstreet database. Each company record in this database can have up to four entries for the areas of business (i.e. SIC-codes) in which the company operates; only business areas that account for at least 10% of the company’s turnover are recorded. Robson et al. found that 40,000 (36.4%) of the firms in the Dunn & Bradstreet database had two or more business economic sector entries, indicating a fair degree of diversification. The proportion of the firms that were diversified steadily increased with firm size, but the difference between the largest and the smallest firms in the database only differed 10% (on average).

Gankema et al. (1994) examined the Dutch INTERSTRATOS-data (Internationalisation of Strategic Orientation of Small European Businesses) that encompasses 978 firms employing less than 500 people. On the basis of a cluster-analysis, they characterised the strategy of 49 firms (5%) as one of diversification. These firms had a large number of both products groups (on average 11.6) and customer groups (on average, 14.3). Note that the Dutch firms in the INTERSTRATOS-sample on average had 3.7 products groups in their portfolio and served 3.8 different customer groups. The group of firms following
a diversification strategy were substantially larger than the average firm in the sample (81 employees compared with 41.2 employees for the whole sample).

The three studies clearly differ strongly in their conclusion on the diversity of SMEs. Considering the large number of possible definitions of a ‘product group’ as perceived by an owner-manager, the 80% found in the STRATOS-project most likely is an overestimation of SME diversity. Given the methodology used, the 5% based on the INTERSTRATOS-data, on the other hand, may underestimate the degree to which SMEs are diversified (which is also suggested by the average number of product groups in the entire sample). A realistic estimation of the degree of diversification lies somewhere in between these two percentages, possibly near the figures Robson et al. (1991) found. Therefore, a rough guess is that approximately one third of the SMEs is diversified to a more or lesser degree. Note that this estimation is slightly higher than Lynn’s (1998) estimation that roughly a quarter of the SMEs in Eastern Europe and Russia are diversified to some extent. Future studies may want to use more precise definitions of diversity (for example following Rumelt’s classification scheme) to throw more light on the ‘true’ degree of diversification among SMEs.

**Reasons for SMEs to diversify**

Why do so many SMEs diversify? Only a few studies examined the motives owner-managers of SMEs have to diversify. Lynn and Reinsch (1990) conducted the most extensive study; their sample included 91 diversified, owner-managed businesses operating in the state of Texas that together diversified 174 times (ranging from one to three times per owner). Their findings largely correspond with the general motives behind diversification moves that we listed in Chapter 1, but there are some notable differences. ‘Growth and financial exigencies’ were mentioned in as many as 90% of the diversification projects and by nearly 100% of the owners. This category includes motives like seeking financial growth, meeting a need in the market, stimulating sales, and reducing risk. Also, the use of excess resources like market position, use of by-products, and surplus cash provided an important incentive for diversification. Taken together financial and growth reasons were mentioned by nearly two thirds of the business owners and in more than half of the instances of diversification.

Only five business owners (in 4% of the cases) in Lynn and Reinsch’s research mentioned ‘escaping a saturated market’ as a main reason to diversify. Sandvig and Coakley’s (1998) research among nine small defence contractors that were forced to diversify when confronted with declining markets illustrates this motive. They found that the most successful firms retained their strategy of providing highly specialised products and services and, in addition, relied on their existing core competencies to attain a competitive advantage in their new markets. Lynn and Reinsch’s finding contrasts with Mosakowski (1990) who found strong support for the existence of the survival motive in a sample of 122
small entrepreneurial U.S. firms. She found that firms with inferior performance diversified significantly more than firms with superior performance. Moreover, the presence of organisational slack had a positive effect on the initiation of new business activities, which confirms the importance of excess resources in diversification decisions.

Lynn and Reinsch’s research also identified a major and intriguing difference with diversification by large firms: nearly 88% of the business owners stated that they had personal reasons for all or some of their diversification attempts. With these figures, personal reasons occupied the second place, just behind growth and financial exigencies. Among the personal reasons, ‘benefit my spouse’ (in 52% of the instances) and ‘provide variety for me’ (35%) were mentioned most often. Clearly, for large manager-controlled companies listed at the stock exchange such reasons would be marked as ‘irrational’ and illegitimate. But are they for SMEs? When managers of large firms pursue their own personal goals instead of the objectives of the shareholders they are said to misuse the funds that are trusted to them (cf. Shleifer and Vishny, 1989; Morck et al., 1990). But in SMEs owner and manager are one and the same. It is interesting to note that, as mentioned in Chapter 1, Jensen (1986) and Shleifer and Vishny (1989) advise large firms that managers should have significant ownership stakes in their companies to protect shareholders against the dangers of such value-reducing strategies.

On the basis of (qualitative) research among 23 Scottish ‘habitual’ entrepreneurs, who are simultaneously involved in two or more businesses, Rosa (1999: 58) concluded that serendipity and opportunistic behaviour play a central role in diversification into new ventures:

‘Many entrepreneurs were alert for new opportunities, and ready to act when they came, but nevertheless did not rigidly plan in advance which particular business they wanted to move into. Only when entrepreneurs were in financial difficulties and wanted to diversify out of trouble did proactive searching for new businesses start.’

Although most of the surveyed entrepreneurs did not plan the next business, Rosa found that background and experience might make a difference. Entrepreneurs from corporate backgrounds were more apt to rely on planning and other corporate management practices.

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1 Although there is a vivid and ongoing discussion among SME-scholars on the differences between these entrepreneurs and SME-owners (see e.g. Carland et al., 1984; Cunningham and Lischeron, 1991), we will make the two interchangeable for the purpose of this study. In doing so, it is not our intention to degrade this discussion or to deny that all entrepreneurs are SME owner-managers and vice versa.
Findings of diversification research among SMEs

Next to determining the degree of diversification and the motives behind diversification moves, the few empirical studies, that are at hand, have examined the diversification processes and track records of diversified SMEs. Probably thanks to the small number of studies, the findings are less confusing than those produced by the mainstream diversification research among large firms.

With respect to the process of diversifying, Lynn and Reinsch (1990) found that owner-managers of SMEs preferred diversifying by initiating new activities themselves (84%) over acquiring other firms. They also observed, however, that the activities of the diversified SMEs tended to be relatively distinct. Resources like technology and machinery (28.5%), marketing and advertising (23.5%) and own products (20%), which may indicate relatedness between activities, were only rarely shared. More general resources like accounting and consultant services were the only resources shared by more than half of the firms in the sample (58%). An absence of close relatedness between existing and new activities may well be explained by the high percentage of personal motives for diversification.

SMEs that diversify into a variety of distinct activities may well run into problems as a result of a lack of skills and resources. On the basis of research among 95 small, fast-growing U.S. firms, Fombrun and Wally (1989) concluded that fast-growing firms hired external managers at the expense of internal promotions as their product diversity increased. They suggested that in doing so these firms met a felt need for a broader portfolio of skills. In addition, Fombrun and Wally (1989) found that firms became more bureaucratic and formal as their product diversity increased; note that this finding is in line with general organisational development theory (e.g. Gibson et al., 1994).

Taken together, the studies that have evaluated the track record of diversified SMEs suggest a curvilinear relationship between firm size and diversification performance. These studies indicate that diversification only pays off beyond a certain organisational size but gains disappear when an SME diversifies too widely and turns into a conglomerate. Robson et al. (1991) qualified the poor growth performance of diversified companies with less than thirty employees, compared to their non-diversified counterparts, as their major research finding. They conclude that the ‘maxim of “do not put all your eggs in one basket”, is only applicable after a solid base has been established in the primary business in which the firm operates’ (Robson et al., 1991: 42). Moreover, non-diversified firms beyond a certain size (> 40 employees) had a significantly higher chance to go bankrupt than diversified firms of the same size. This suggests that diversification may be an effective way to reduce the risk of bankruptcy for larger SMEs. Note that this finding may explain the relatively high percentage of SMEs that are diversified: in the STRATOS-project (STRATOS; 1990), SME-business owners ranked ‘survival’ as the second most important objective of their business. Also note that Robson et al.’s (1991) ‘minimum-efficient scale
Theoretical Background

Rule of diversification may depend on the dynamics of the industry in which SMEs operate: in a research project among 100 young, technology-based firms McCann (1991) observed that the highest performing firms actively sought for product diversification independent of their size and age.

Robson et al.’s (1991) findings are confirmed by Siegel et al. (1993) and Gankema et al. (1994). The former compared small and medium-sized firms and found that the high-growth companies in their sample of medium-sized firms displayed a greater propensity for market and product diversification. On the basis of this finding Siegel et al. (1993) suggest that the owner of a (very) small firm may lack the required resources, skills and experience for success in a new field. Gankema et al. (1994) found the most strongly diversified SMEs (i.e. the firms following a diversification strategy) in their sample to be the best performers in terms of sales and turnover received from exports. Diversification may, however, come at the expense of growth. Robson et al. (1991) observed that larger diversified SMEs faced lower growth rates and were more likely to see their turnover decline. Smallbone et al. (1991), who studied 126 manufacturing firms in depth, found the strategy of diversification to be weakly associated with high growth. Moreover, when SMEs diversify too widely the costs of diversification may well exceed the advantages: Lynn and Reinsch (1990) noted that ‘conglomerate’ SMEs experienced a much higher overall volatility in performance and showed a far higher bankruptcy rate than the other SMEs in their research. These findings should, however, be interpreted with similar reservations as the findings of mainstream diversification research (see observation 2, Chapter 2). For one thing, the causality between diversity and performance may go both ways (cf. Grant et al., 1988).

In closing this subsection, Lynn and Reinsch (1990) observed a relationship between profitability and age of diversification: while most diversification projects in their sample were profitable, the profitability of older diversification projects was significantly higher than those of younger projects.

Conclusions on diversification by SMEs

Given the few studies on diversification by SMEs, we can only draw a few tentative conclusions. Firstly, diversification appears to be a viable strategy for an SME beyond a certain firm size. The studies at hand suggest that a solid base is required before diversification adds to the performance of an SME. It seems that larger firms either have developed the necessary skills through experience or have the resources to buy these (e.g. hire external managers). Secondly, SMEs that diversify too widely and grow into small conglomerates run the risk of bankruptcy as they lack resources and skills to manage a large variety of distinct businesses. Finally, although based on a narrow empirical sample, the performance of diversified smes seems to be somewhat better than the results obtained by their bigger counterparts. We can only loosely hypothesise about the reasons for this (and hope that the present research throws some more light on this).
Research into the growth of SMEs

Because the number of empirical studies on diversification in SMEs is small and diversification often involves growth, we decided to additionally explore the research into the growth and development of SMEs to identify factors that may be relevant to diversification in SMEs. This stream of research shares several characteristics with mainstream diversification research. Just as diversification is a major research topic within the field of strategic management, research into the growth of SMEs occupies a prominent place in the research on SMEs. Moreover, both streams of research have predominantly employed large-scale statistical methodologies and produced highly fragmented findings. Many factors have been found to correlate with the growth of SMEs but the knowledge on how these factors interact is limited. Furthermore, comparison across studies on SME-growth is seriously hindered by, amongst other things, the lack of common terminology for many major concepts (d’Amboise and Muldowney, 1988; see also the discussion on the definition of SMEs above), the lack of using theory in identifying variables (Gibb and Davies, 1990), the use of a wide variety of growth measures (Storey, 1994; Delmar, 1996), and differences in the periods of time over which growth occurred (Storey, 1994). Like in the mainstream of diversification research, SME-studies on growth often reach contradictory conclusions on the impact of variables on firm performance. In fact, Storey (1994) found that this observation applies to nearly every factor that has been included in studies on SME-growth!

The fragmented nature of the research on SME-growth is well illustrated by the four fundamentally different approaches to the study of SME-growth Gibb and Davies (1990; see also Snuif and Zwart, 1994) identified. Personality dominated approaches explore the impact of the entrepreneurial personality and capability on firm growth, which include the owner-manager’s personal goals and strategic vision. Organisational development approaches seek to characterise the way in which the organisation of an SME develops and influences (and is influenced by) its owner-manager. Business management approaches focus upon the importance of business skills and the role of functional management, planning, control and formal strategic orientations. Finally, sectoral and broader market led approaches are more macro in scope and include research on regional development and specific industry sectors.

The diversity of research approaches and the fragmentation of research findings have led to harsh conclusions on the current state of growth research by prominent SME-scholars. Consider, for example, the following quotes:

‘There is no grand management theory for small business, no all encompassing theoretical framework capable of explaining and guiding the management of small firms.’ (d’Amboise and Muldowney, 1988: 236)

‘... there is no comprehensive theory of small and medium enterprise development which clearly brings together all the relevant parameters into a model and indicates how each part interacts with the other. The production of
such a theory and explanation in the near future is unlikely.’ (Gibb and Davies, 1990: 26)

These quotes, which are still very relevant today, breath a similar atmosphere as the quotes by Ramanujam and Varadarajan (1989) and Datta et al. (1991) on the current state of diversification research cited in Chapter 2. We therefore argue that research findings on the growth of firms should be interpreted with considerable caution. Table 3-1 shows the main themes that emerge from the literature on SMEs; in the following we will briefly discuss each theme.

(Un)importance of personality characteristics

(1) Reluctance to involve outsiders
(2) Engaging in external networks
(3) Changing role of owner-manager
(4) Adapting the internal organisation
(5) Building a management team
(6) Managing ‘soft’ resources
(7) Problem-initiated learning
(8) Benign environments

Table 3-1
Themes in research on growth of SMEs

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(Un)importance of personality characteristics

The early Schumpeter (1910) loudly praised the creative nature of independent entrepreneurs (‘animal spirit’) to whom he ascribed the initiation of many important innovative developments (see for an example in the Dutch retail market, Nooteboom, 1984). Following Schumpeter, over the years several specific personality characteristics have been attributed to successful entrepreneurs and SME owner-managers alike. Many SME authors have extrapolated these characteristics to explain the existence of successful and fast-growing SMEs. In general, successful SME owner-managers are thought to have an internal locus of control (Rotter, 1966; Brockhaus, 1982), a high need for achievement (McClelland, 1961), a high tolerance of ambiguity (Sexton and Bowman, 1985; Begley and Boyd, 1987), a high need for independence and autonomy (Hornaday and Aboud, 1971; DeCarlo and Lyons, 1979), and an
action-oriented mode of learning (Gibb, 1999). In addition, they are seen as measured risk takers (McClelland, 1961; Brockhaus, 1980), who are able to perceive opportunities long before others do (Kaish and Gilad, 1991; Palich and Ragby, 1995), are able to manage a wide range of tasks (Gibb, 1999), and are highly motivated to reach their goals (Davidson, 1991; Storey, 1994). Carland et al. (1989) suggest that the development of formal written plans may be an indication of the presence of such personality characteristics but their observation has only found limited support. Above all, successful owner-managers seem to be able to cope with, and enjoy an entrepreneur’s ‘life world’ as characterised by properties like freedom, control, responsibility, and uncertainty (Gibb, 1999).

Over the years the importance of personality characteristics to the growth and performance of SMEs has been seriously criticised. Several authors have pointed to the contradictory evidence or even to the total absence of the influence of personality characteristics (e.g. Gasse, 1982; Chell, 1985; O’Farell and Hitchens, 1988; Gibb and Davies, 1990; Stevenson and Jarillo, 1990). Gibb and Davies (1990) argue that the literature on personality characteristics ignores the capacity of people to learn and change over time (see also MacMillan, 1987; Reuber, 1990; Hendry et al., 1995). Personality characteristics may, therefore, at best explain why people start a business of their own (e.g. Begley and Boyd, 1987), whether or not they are successful with it depends upon (the interaction with) a host of other factors as well (e.g. Sandberg and Hofer, 1987; Feeser and Willard, 1990; Keeley and Roure, 1990).

The reason for the fragmented findings on the importance of personality characteristics may be that the entrepreneur does not exist. As Gartner et al. (1989: 184) put it, ‘there is no “average” in entrepreneurship [because] exploiting opportunities is more often doing things differently, rather than following the typical’. Entrepreneurs have different backgrounds, education, skills and motivations, they behave differently and lead different businesses that operate in different environments (Sexton and Bowman, 1985). A large part of the research on personality characteristics nevertheless (mostly implicitly) assumed that all entrepreneurs are the same. Empirical evidence undermining this assumption is growing (see e.g. Cromie and Johnson, 1983; Gartner et al., 1987; Woo et al., 1991; Begley and Boyd, 1987; Merz et al., 1994). In the end, given opportunity and ability, mere intention, motivation and commitment to grow and develop a business seems to be crucial (cf. Davidson, 1991; Smallbone et al., 1991; Gibb and Scott, 1985). As Bird (1988: 442) puts it:

‘Even though entrepreneurial ideas – for new products, new services, new social movements – begin with inspiration, sustained attention and intention are needed in order for them to become manifest’. 
Reluctance to involve outsiders

The personality characteristics of entrepreneurs appear to hide an interesting paradox: **the same factors that stimulate an entrepreneur to build a business may limit its subsequent success.** Entrepreneurial characteristics like a search for independence and autonomy, a resistance to conformity, a low need for support, and interpersonal aloofness – which, as we noted, are found to be necessary requirements to start a business in the first place – can lead to serious problems when the internal organisation and management structure have to be changed and to a reticence to use external resources. SME owner-managers are found to have difficulties with delegating responsibilities and sharing information (Adams, 1982; Sexton and Bowman, 1985). Moreover, they have ‘a deep seated reluctance to use debt to finance long term growth’ (Hay and Kamshad, 1993: 19; see also Grieve Smith and Fleck, 1987). Their reluctance to change and attract external financial resources in the company may limit further growth.

Similar considerations that prevent SME owner-managers to use external funds may hinder them in recruiting suitable qualified management from the outside. As a consequence, Hay and Kamshad (1993) found that most management teams were insufficiently large and not suitably balanced, making the skill base among existing managers somewhat lop-sided. Not suprisingly, many owner-managers felt themselves to be “too busy to grow”. They lack the managerial slack necessary to identify growth opportunities and the managerial resources to exploit them (see also Kleinknecht, 1989). According to Adams (1982), the reluctance to use external funds and recruit external managers is interrelated: because SMEs lack sufficient financial resources they find it difficult to recruit the high-calibre staff required in a growing company. The firms that do hire external managers see themselves rewarded by high growth (Fombrun and Wally, 1989). When discussing the importance of building a management team we return to this issue.

Engaging in external networks

The reluctance of SME owner-managers to involve outsiders in their business, be it financially or managerially, also seems to extend to their networking practices (Birley, 1982; Cannon, 1985; Curran et al., 1992; Hendry et al., 1995). Scholars increasingly recognise the value of networks for the survival and growth of SMEs. Networks are intricate structures constituting of both ‘manifest’ and ‘latent’ links (Kamann and Strijker, 1989). Whereas the former are (possibly) observable from the outside, the latter are essentially only known to those that are directly involved in the network. Networks offer SMEs access to necessary resources that are otherwise unobtainable, stimulate learning and secure flexibility, which is threatened by the progressive accumulation of resources (Cooper, 1982, Thorelli, 1986; Bäckström and Linquist, 1991; Jarillo, 1989; Kamann, 1998). Coleman (1988) and Johannisson (1988) even argue that an
entrepreneur’s ‘social capital’ is an absolutely crucial resource to his business. In a similar vein, Deakins and Freel (1998) and Gibb (1999) consider the ability to network as a key component of successful entrepreneurship. In addition, successful and high-growing SMEs seem to use (professional) external advisors more often and have more skills in using them (Woodworth, 1969; Cooper, 1982; Cooper et al., 1986).

Changing role of owner-manager

The same personality characteristics that characterise an entrepreneur may hinder him in a role as CEO of a growing firm. Both the literature on stage models of firm growth (e.g. Greiner, 1972; Kimberly and Miles, 1980; Churchill and Lewis, 1983; Smith et al., 1985; Scott and Bruce, 1987; Kazanjian, 1988; Kazanjian and Drazin, 1990) as well as research on the growth of firms (e.g. Cooper, 1982; Gibb and Scott, 1985; Hambrick and Crozier, 1985; Hunsdiek, 1985; Fombrun and Wally, 1989; Armstrong, 1991; Smallbone et al., 1991; Merz et al., 1994) indicate that owner-managers of high-growing firms have to change their role and management style for their company to grow in size and diversity. Amongst other things, this research indicates that successful owner-managers delegate more responsibilities, hire external managers that complement their existing skill and knowledge bases or even replace these, are able to envision and anticipate the firm as a larger entity, and have a greater concern for efficiency, organisational co-ordination and political support. By way of illustration, consider Gibb and Scott’s (1985: 619) remark about envisioning the future state of the firm:

‘The essence of small company planning for new development and growth . . . lies in its ability to project in the future the consequences of its present actions and to think strategically about these.’

Their need for autonomy and dominance, more often than not hinder owner-managers in adapting their role and managerial style to a growing company. As a result the growth of their company stagnates. Growth may continue again if a new, succeeding generation enters the company (Clifford et al., 1990) and, being more receptive to less conventional managerial views, changes the dominant managerial style significantly (Stanworth and Curran, 1976).

Adapting the internal organisation

Research that has examined the life cycle of organisations indicates that during the early developmental phases of a business, external environmental problems are paramount but as SMEs grow and develop internal problems (seem to) become more important (Kazanjian and Drazin, 1990; Dodge and Robbins, 1992). The necessary changes in the owner-manager’s role and management
style are but one aspect of such problems. Kazanjian and Drazin’s (1990) research, for example, indicates that different stages of growth require different organisational structures; there is no ‘universal best way of organising’ (see also Burns and Choisne, 1991). As the technology-based ventures in their research grew and the number of managers increased, delegation, decentralisation, and formalisation increased (see also Bitner and Powell, 1987). Fombrun and Wally (1989: 120) suggest that in fashioning their management systems to the greater size and complexity of their organisations, the management of growing firms successfully responds to various contradictory pulls:

‘(1) the need to control while simultaneously enhancing quality and creating new products to maintain parity with competitors; (2) the pull to centralize in order to retain control while simultaneously diversifying product offerings to remain competitive; (3) the desire to formalize so as to maintain internal consistency while also encouraging the contributions of autonomous, self-managed professionals to an embryonic corporate culture.’

In essence, these pulls seem to come down to cherishing the entrepreneurial behaviour that is critical in retaining the growth and competitive advantage of any firm. To secure and stimulate such behaviour, special organisational arrangements may have to be installed (Burgelman, 1983, 1984; Kanter, 1985; Stevenson and Jarillo, 1990). Moreover, high-performing SMEs appear to introduce organisational changes gradually as supplements to, rather than replacements for, existing approaches (Hambrick and Crozier, 1985; see also Cannon, 1985; Santarelli and Sterlacchini, 1990). Sometimes they install a consolidation period after a growth surge (Perry, 1985).

Building a management team

This theme is closely related to the preceding two. Empirical studies indicate that the size and composition of management teams determine the potential growth of an SME. The management teams of high-growth firms tend to be both larger and more balanced in terms of functional backgrounds (Argenti, 1976; Kazanjian, 1988; Feeser and Willard, 1990; Armstrong, 1991; Hay and Kamshad, 1991; Siegel et al., 1993). Well in advance of the realisation of growth, high-growing firms enlarge their management teams, often by hiring managers that have experience in larger firms. As Hambrick and Crozier (1985: 32) put it: ‘the team needed for tomorrow is hired and developed today’ (see also Wynarczyk et al., 1993). The need to hire managerial expertise seem to apply especially to the marketing function, which often appears to hinder SMEs in realising growth (Adams, 1982; Kazanjian, 1988; Carson and Cromie, 1989; Weinrauch et al., 1991).
Managing ‘soft’ resources

The discussion of the theoretical views on diversity in Chapter 2 highlighted the central role of managerial knowledge in processes of growth and diversification. The economic and the managerial view on diversity in particular point to the crucial importance of idiosyncratic human capital with fungible characteristics, proprietary knowledge, and managerial (process) knowledge on how to effectively manage a diversified company. Although SME scholars do not use this particular terminology, they widely stress the importance of managerial knowledge for the success of firms (e.g. Gibb and Scott, 1985; Carson and Cromie, 1989; Rothwell, 1989; Hay and Kamshad, 1991; Chandler and Hanks, 1994). What is more, they suggest that ‘soft’ resources may even be more important to the success of SMEs, in particular given the limited availability of physical resources. Gibb and Scott (1985), for example, argue that the growth in turnover that an SME is able to realise strongly depends on the strengths and weaknesses of its resource base and on its ability to manage and use it effectively. Four out of the five resources they distinguish – based on both a literature search and their own, extensive empirical work – are of a ‘soft’ or ‘behavioural’ nature and refer to managerial knowledge:

- the material/physical resources that dictate the ease with which the company can move from any existing position;
- the accumulated experiences that include the skills and experience in offering new products and entering new markets;
- the degree to which the firm is able to control its activities;
- the personal characteristics and management style of the owner-manager;
- the quantity of new business ideas and their stage of development.

Closely related to the central role of managerial knowledge is the importance of education and experience to the growth of firms. Whereas the evidence on the importance of education for the performance of firms is mixed (compare e.g. Gasse, 1982; Gibb and Davies, 1990; Storey, 1994; Storey and Westhead, 1996), the importance of relevant managerial knowledge and experience seems to be more widely recognised (see e.g. Cooper, 1982; Cooper et al., 1989; Keeley and Roure, 1990).

Problem-initiated learning

Stage models on SME growth describe the various phases SMEs go through as they grow in size and complexity and how firms are affected by this (see e.g. Greiner, 1972; Kimberly and Miles, 1980; Churchill and Lewis, 1983; Smith et al., 1985; Scott and Bruce, 1987; Kazanjian, 1988; Kazanjian and Drazin, 1990). Over the years, these models have been severely criticised for, amongst other things, lacking a solid empirical base (e.g. O’Farrell and Hitchens, 1988; Gibb and Davies, 1990) and their inability to provide sound explanations for the
growth of firms (Snuif and Zwart, 1989; Snuif, 1995). However, justified this criticism often is, (at least) one particular aspect of stage models seems to be increasingly supported by empirical evidence: small firms grow as they effectively respond to the set of distinct problems they are confronted with in each subsequent stage (Churchill and Lewis, 1983; Kazanjian, 1988; Kazanjian and Drazin, 1990). These problems function as triggers for learning if the owner-manager is motivated to accept the challenges to acquire and develop the knowledge and competencies that are necessary to deal adequately with these problems (or support its development). Note that the nature of this learning process matches closely with the nature of innovation processes in (small) firms, which, according to Nonaka and Yamanouchi (1989; see also Burgelman, 1983; Khan and Manopichetwattana, 1989), can serve as ‘catalyst for the self-renewal of the organisation’. The very nature of the learning processes owner-managers go through, characterised by significant and critical learning events, may result in non-linear and discontinuous growth paths in which sudden spurts of growth are followed by periods of stagnation (O’Farrell and Hitchens, 1988; Smallbone et al., 1995; Deakins and Freel, 1998).

**Benign environments**

The foregoing themes all centre on the owner-manager of the SME, be it directly or indirectly. Looking at the literature on SME-growth, it appears to us that only one external factor is found to substantially influence the growth potential of SMEs: firms that operate in attractive industries are more likely to grow than firms that operate in less attractive markets (Sandberg and Hofer, 1987; Feeser and Willard, 1990; Keeley and Roure, 1990; Lundström and Gandemo, 1991). This finding corresponds with the superior performance of certain non-diversified firms that have no need to, or do not wish to, diversify (see Chapter 2). Although findings like this are not extremely useful for existing SMEs that already operate in a particular industry, research by Hay et al. (1993) indicates that SMEs do have some choice when they decide to start up new activities. Based on an analysis of 37,000 new U.S. ventures and a number of U.K. case studies, they found that new ventures have higher chances of success if the frequency with which the new offering is purchased is low, if it is a major expenditure for the buyer, and if the role for service is high. In these instances potential buyers will inform themselves well before they buy a product or service, which offer the company better opportunities to show its competencies.

**Conclusions on the growth of SMEs**

If we overlook the (fragmented) research on the growth of SMEs, two, highly complementary, themes strike us. The first theme centres on the personality characteristics of SME owner-managers. Whereas personality characteristics do influence the decision to start a company, empirical research has not been able
to prove a relationship with the growth performance of SMEs. What is more, apart from strong motivation, personality characteristics that stimulate an entrepreneur to start up a company in the first place may even limit its subsequent success. Typical entrepreneurial characteristics have been found to prevent SME owner-managers from involving outsiders in their firm, using external (financial) resources, engaging in, and making extensive use of, formal networks, recruiting qualified managers and building a balanced management team well in advance of growth (e.g. in terms of functional knowledge), adapting the internal organisation of their company, and taking on a different role themselves if (strong) growth is realised.

The second theme that surfaces from the research on the growth of SMEs is the importance of managerial knowledge and experience. In fact, management of these ‘soft’ resources may well be more important to the growth of SMEs than the availability of the ‘hard’ physical resources. Important ‘soft’ resources include skills and experience on how to offer new products and enter new markets as well as process knowledge on how to manage and control a growing company. There is a clear correspondence with the central elements of the economic and managerial views on diversity, which we discussed in Chapter 2.

The reluctance of owner-managers to involve outsiders and use external resources on the one hand and the importance of knowledge and experiences to the growth of SMEs on the other hand, seems to be different sides of the same coin. Crucial knowledge concerns managerial knowledge on how to adapt the internal organisation, take on a different role when required, hire managers from outside, build management teams that are balanced, engage in networks to acquire knowledge and take notice of the experience of other firms, etc. Growing SMEs seem to be led by owner-managers – committed to growth – that have conquered their reluctance to involve outsiders and use external resources. Learning plays an important role in this process. At distinct phases in their growth, SMEs meet different problems to which its owner-managers will not always have clear answers immediately. Apart from (extremely) benign environments, SMEs will only grow if its owner-manager(s) sees these problems as a trigger for learning and is willing to develop and acquire the knowledge and competencies that are necessary to effectively deal with these problems. Note that, in addition to bringing in relevant knowledge and experience, outsiders may help an owner-manager in recognising important problems, especially those that involve his own role and personal characteristics.

The research on the growth of firms as discussed in the foregoing pages is dated in one important respect: none of the studies refers to the growing role of the Internet in stimulating entrepreneurship and enabling the growth of SMEs. The rise of the Internet has been accompanied by many new and largely (still) small firms that often operate in a fundamentally different way from the (now) traditional companies we are familiar with. The Internet enables small firms to reach a broad customer base all over the world and, in doing so, defeat much larger competitors. Within a period of only a few years, many Internet-firms
have grown at astonishing rates and are now quoted on the stock exchange. Although the long-term implications of the Internet are far from clear, it holds the potential to change the corporate landscape dramatically. Given these developments, SME-researchers have an obligation to study the role of the Internet and its influence on the growth of SMEs.

Conclusions on diversification and growth by SMEs

After enumerating the stereotypical characteristics of SMEs, this chapter reviewed the research on diversification and growth by SMEs. On the basis of the small number of studies available we concluded that a substantial part of SMEs is diversified (our rough estimation is a third of all SMEs). One of the most remarkable observations, especially when compared with large firms, is that SMEs often diversify for strictly personal reasons. Unfortunately, the main research findings on diversification by SMEs are far from conclusive and rather general in nature. They do not give owner-managers of SMEs much to go on. Based on the studies available, we concluded that diversification can be an attractive strategy for SMEs as it may improve profitability and reduce the risk of bankruptcy. This may, however, come at the cost of lower or even declining growth rates. Several studies indicate that SMEs are better to reach a certain minimum size (a ‘solid base’) before diversifying. Moreover, if they choose to diversify into new fields, they should not diversify too far away from their primary lines of business.

The (more extensive) research on growth by SMEs has produced more guidelines to owner-managers. Many findings in this stream of research can be brought back to the prime characteristics of SMEs. In particular the omnipresence of the owner-manager(s) sets the tone in the small and medium-sized firm. The same personality characteristics that drive an entrepreneur to start up his business may easily limit the subsequent growth of his company. Especially the reluctance to involve outsiders in his firm and use external sources and knowledge may hinder the firm in pursuing further growth. Growth of SMEs seems to depend largely on the availability or development of the ‘proper’ managerial knowledge and experience on ‘how to do business with a growing company and manage this effectively’. SMEs may, for example, greatly benefit from dropping a ‘natural reluctance’ of their owner-managers to keep the outside out and instead involve outsiders in the company and make extensive use of external sources and resources. Moreover, as Gibb and Davies (1990) emphasise in the context of SMEs, many owner-managers do have a capacity to learn and change their thinking and behaviour over time. For one thing, as their company develops owner-managers may learn about their own role and (cognitive) limitations and act accordingly. Moreover, compared with large companies, the owner-manager’s thinking and organisational action, and individual and organisational learning tend to be more closely connected than in large firms (Kets de Vries and Miller, 1984; Schneider and Angelmar, 1993).
A priori we have no reasons to believe that the results of the research on the growth of SMEs do not apply to diversification by SMEs. Growth and diversification often (although not always) go hand in hand as owner-managers identify attractive opportunities in other markets. Remember also that Ansoff (1957, 1965) saw diversification as one of four possibilities for a firm to grow. In fact, given that diversification is in several respects the most extreme of the growth strategies, it may boast some of the problems that SMEs meet when they grow. If this is the case, the findings of growth research apply the more to the strategy of diversification. We are, however, aware that there are specific instances when these results do not apply at all to diversification by SMEs. This may, for example, be the case if a diversification attempt grows out of sheer necessity as an owner-manager finds his firm in a rapidly declining market and faces strongly decreasing profits and turnover.