Hallmarks of Successful Growth Companies

By Knowledge@Wharton

Being an entrepreneur is difficult. Yet some start-up and growth-stage companies do more than survive — they thrive. Experts from Wharton and GE Capital reveal that business success often doesn't depend on stunning innovations but instead on common-sense business practices such as embracing change and choosing the right partners and board members.

The Four Hallmarks of Successful Growth Companies

Businesses that wish to ramp up for growth face a tricky and difficult business environment today. Banks are willing to lend but cautious, and institutional investors are slow to put up cash because of the sluggish economy in the U.S. and many other areas, including Europe, China, India and Japan.

Yet some businesses crack the code. They do more than survive — they thrive. Through all the tumult, they optimize their own businesses, access the right financing, take advantage of opportunities and ultimately propel growth. How do they do it? Do these companies have distinguishing characteristics? Are there particular pitfalls they've managed to steer around that trap others? In the end, how might others emulate their success?

To get answers to some of these questions, The National Center for the Middle Market, a partnership of The Ohio State University (OSU) Fisher College of Business and GE Capital, surveyed 2,028 middle market businesses (defined as those with $10 million to $1 billion in revenue). As part of the analysis, the center zeroed in on the "growth champions" in the group — companies that grew 10% immediately after the financial crisis and that also were expected to grow 10% in 2012. The survey found 131 of these growth champions, of which 80% defined themselves as being either in the start-up stage or growth stage as opposed to a mature stage.

By analyzing the survey results and separately canvassing various experts who help these types of companies grow, some patterns began to emerge regarding the ways certain mid-market companies propel growth. While no silver bullet can guarantee success, the survey did uncover several traits or hallmarks common to successful growth companies.

1. Innovate with customers in mind

One common misconception is that "early stage companies fail because their product or technology did not solve their customer's problem. More often that's not the case," says Michael Fisher, a senior managing director at GE Capital's equity investment group. A big reason for failure is being unable to pivot from the initial business plan and make changes based on customer feedback.

In other words, being a clever innovator is not enough. Entrepreneurs need to embrace change. That's why a business plan shouldn't be seen as a map. Rather, it should be a dynamic set of assumptions that's constantly changing based on feedback from customers. That might seem obvious, but so often innovators claim victory without having input from a single paying customer. Successful companies start by identifying and quantifying the market for their product. They win by adapting to customer feedback, consistently delivering an acceptable ROI and having a distinctive solution compared to the competition.

imagination at work

Stephen Sammut, a senior fellow and lecturer at Wharton and a venture partner at Burrill & Co. in San Francisco, agrees that an early, keen focus on customers is critical. "One near universal truth among successful companies is that very early on they enter into discussions with prospective customers to make sure the product they have defined and developed meets the needs of the marketplace." That investigation requires more than just a market survey. "It's intense one-on-one meetings with customers and then redefining the product after each meeting to make sure you are getting this right."

Robert J. Borghese, also a Wharton lecturer and a corporate attorney who has represented hundreds of early-stage companies, says the idea of coming up with something novel can be exciting but, in reality, boring can be more profitable. "About 99% of the time, new and novel means untried and untested, and lacking a market willing to pay for the product or service." Innovations, he says, attract the most customers and yield the most profits when they occur at the edge of established businesses, such as insurance companies that decide to offer pet insurance.

Good execution depends on choosing the right success metrics and then tracking performance. Once a company has launched its product, monitoring results helps ensure that customers are getting the expected benefits. "One hallmark of a good company is that the managers have a handle on key business drivers and manage against the data," Fisher says. "They establish an operating rhythm and communicate based on key success metrics to make the right adjustments over time."

Results from The National Center for the Middle Market survey back up the importance of metrics: 58% of growth champions say they have a formal process to track their progress toward a growth goal, while just 33% of the broad group says the same.

2. Raise adequate capital

Another big reason young companies fail is they underestimate the money and time necessary to scale a business from a great idea to a full-fledged company with customers, suppliers, distributors, salespeople and marketing. "The bottom line is, you need sufficient capital to execute your plan," says Tyler Wry, a management professor at Wharton. "It's going to take more time and money than you think. A good VC (venture capitalist) might make the difference between becoming a regional ripple or a supernova."

Another hallmark of success among growth companies is the ability to raise funds at every step of development and to think creatively about funding options. The National Center found that growth champions were twice as likely as other mid-market companies to have a diversified funding strategy in place. Successful company leaders "are constantly anticipating the financing needs of the business and comparing them against their ability to raise capital or grow with internally generated funds," says Fisher. Fundraising while continuing to run the business is very demanding. You have to think about where you stand with both every day. A miss can mean huge setbacks or even failure. In this area, experience and leadership skills are essential."

At the very earliest stages, entrepreneurs depend on friends and family as well as "angel" investors, who have become a linchpin of early-phase investing. "Angel associations are very active and have become quite sophisticated in terms of deal structures, and in many industries very little would get financed without them," Sammut says. Later, after there's been some proof of concept, the company can start looking at other funding sources, such as venture capital firms. "Once you're beyond the startup phase and are in a growth stage, that's when alternative sources of capital or leverage start to become available."

Sammut says a growth company might qualify for a plain vanilla bank loan. Alternatively, it could explore venture debt instead of equity. Venture debt financing — usually secured by intellectual property — can be an effective way to finance operations between rounds of equity fund raising.

"Venture debt is a non-dilutive way to extend the cash runway without tapping investors while allowing the company to reach future inflection points that can drive better valuations," says Anthony Storino, a senior managing director of the life science finance group at GE Capital, Healthcare Financial Services.

3. Do you need a VC firm?

Eventually, most young startups and growth companies will confront the question of whether to pursue venture capital. Borghese says, "You need to be careful and judicious, otherwise you'll be impoverished from an equity perspective. For thousands of years, people bootstrapped. It's only been in the past 25 years that the assumption has been 'I need a VC.'"

Borghese argues that VC money is only appropriate for companies that must grow very fast for competitive reasons or that need huge amounts of start-up capital. However, if taking venture capital is the correct route, picking the right VC firm is critical to get the most out of the relationship. Borghese divides the universe of VC firms into three groups:

- White-shoe firms — such as Kleiner Perkins Caufield & Byers, and Sequoia Capital — that can open doors and have long track records of success;
- VC firms run by former entrepreneurs that know the industry and have experience growing a company; and
- Everyone else.

"If you think you're going to get corporate strategy from this last group, forget it," Borghese says. "They're not deep enough in your business."

For instance, a VC firm without experience in the biotech industry could be disastrous for a young biotech company. The long development cycles and required FDA approvals in the industry mean that any VC partner would have to be especially patient. Biotech companies "need financial partners with deep pockets and the stomach to live through trials that don't always yield expected results, but might open up a secondary opportunity," says Storino.

Sammut further points out that the right VC firm brings many benefits in addition to capital. A VC with industry experience will have extensive contacts, and can help a growing company identify and recruit top-notch managers and board members. The right VC can also help secure additional sources of financing. They can give a young company credibility with potential customers, strategic partners and Wall Street (if an IPO is the end-game). And they can counsel young companies on how to structure critical early alliances so they don't put themselves at a future disadvantage, for example, by giving up too much control over marketing, technology or product rights.

4. Build management skills

As companies evolve from the start-up stage to growth and beyond, the management skills needed to maintain momentum often change. New talent must be recruited, which can threaten and sometimes marginalize current managers. The conventional wisdom in this instance is correct: The dilemma is most acute when the person who needs to step aside is the founder. "Some entrepreneurs are very good at conceptualizing a company, bringing in management and managing it for one to three years," Sammut says. "But the founding entrepreneur is often not the right person to run the company. Sometimes that's clear so early in the process that it's a condition of the financing."

Fisher adds, "Once a business is established, achieving growth through idea generation and new product development is very different from the skills required for a new venture. Don't assume the founder is the best person to run the company as it continues to grow."

Adds Wharton's Wry, "A hallmark among successful companies is that, after a successful start-up, the founding entrepreneur has turned the reins over to someone who can run the business better than the founder. By the third round of venture capital, the number of founders still involved is a small fraction."

When founders do survive past the startup phase, it's usually because "they are self-aware, or forced by investors to accept a change. It can be very difficult for founders to let go. In either case, as the business expands, success comes from a team with complementary experiences and a wider range of management skills," Fisher says. There's danger when a management team surrounds itself with partners that are unwilling to offer new ideas or to adjust as the environment changes.

A good board can help enormously by recruiting directors that provide both strategic insight and operating experience to help managers. "In one of our investments, a board member is helping to raise money, another is lending IT expertise and yet another has extensive customer selling experience. Each brings specific skills that augment the company's day-to-day activities," Fisher says. Board meetings provide a forum to step back and look at the business' performance against long-term objectives — including talent management. "Don't underestimate the potential of the board when you have the right experts and good chemistry," Fisher adds.

Given the huge of amount of change occurring in the U.S. business climate today, propelling growth has never been more difficult. Every company's circumstances are unique and there is, of course, no universal formula for high performance. But a close examination of what is working for growth champions reveals that several of the hallmarks of success often are not stunning new concepts but instead are common-sense business practices that nevertheless too often go ignored.

Key Take-Aways

- Innovations are important, but it's crucial to refine your product or service as you grow. What do potential customers think of it? Are they willing to pay for it?
- Be prepared to adapt your business plan as necessary. Set goals and track your progress.
- Do you have sufficient capital to move forward? An initial funding strategy might be made up of friends, family and angel investors. As you grow, you may want to diversify into venture capital and, later, bank loans and other sources.
- Choosing the right partners can bring many benefits beyond financing. Consider investors who have experience in your industry and valuable contacts who may become employees or board members to help lead your company into the future.

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