

## What Moves the Enterprises?

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### A Question?

Business is a human endeavor organized in varied forms. Most businesses start small, some grow into large enterprises, a few with annual revenue exceeding GDP of some countries. Conversely, small businesses are small kids on the block. The perennial underdogs, no-frills, friendly with customized offering.

Which form of enterprises should play a greater role in our society? Small businesses or large enterprises?

### An Equilibrium?

These forms of enterprises have been co-existing since time immemorial. Now, co-existence does not imply an equilibrium state. There is a constant change in the mix between the 2 main forms of businesses. This can be encapsulated as a function of the following factors at play at any point in time in a particular context:

**=  $f$  (Consumer Preference, Survivability, Employee Preference, Role of Government,...)**

**Consumer Preference.** Large businesses frequently force their customers to adapt to them; and enrich themselves. Small businesses serve customer needs first and enrich themselves as a consequence.

**Survivability.** Small businesses are more creative as they struggle to compete with the giants for survival. There is often too much orderliness and bureaucracy in large businesses. Struggle brings out the best.

**Employee Preference.** Small businesses treat their employees better because they realize it is the employees help them succeed. Everyone knows everyone. Conversely, in large enterprises, large departments, formalities and bureaucracy weigh on the human spirit.

**Role of Government.** Huge businesses can grow too big and challenge governments. Often, governments influence the relative role that small businesses and large enterprises play in the economy and society.

Are the above facts or mere opinions?

The above factors or forces have influenced the preference of one form of business over another, through time and locality. It is noteworthy that only a few large global corporations have survived more than 100 years. In addition, globalization and emergence of a new breed of high growth companies such as Google has also put into question the conventional wisdom about large companies.

That is enough food for thought, but let us take...

### **A refreshing look at the Equilibrium**

Expressing this as a function =  $f$  (...***Society's attitude towards risk, Corporatising the businesses, life cycle of a corporation...*** ) and focusing on 3 of them.

#### **1) Society's Attitude toward Risks**

In modern portfolio theory, returns correlate strongly to risks. Expected higher returns compensate for expected higher risks.

In the business world, the correlation is just as strong. A sole proprietor, partners in a partnership work for higher expected payoff, and for greater freedom and control over decision-making and their personal time.

Compared to large enterprises, small enterprises suffer from much higher failure rate. As high as 70-80% of them fail in the first few years. Lack of experience, wrong business model, inadequate market research and product offering are the main culprits. This is risk taking.

Compared to salaried employees, owners of businesses have to tolerate wildly fluctuating earnings. Again, this is risk taking.

The question is: are these risks compensated?

Take a hypothetical example of Mr. Ang, a small business owner. His average earnings over the last 5 years are \$250,000 per annum. However, these have been fluctuating with the highest being \$550,000 and lowest being a loss of \$400,000, the year the company almost went bankrupt. The standard deviation is computed as \$200,000. This translates to a ratio of average earnings over standard deviation of 1.25.

Now, take Mr. Ang's classmate, Raymond, a salaried employee, who has seen his salaries rise through the years from \$30,000 per annum to an average of \$200,000 per year for the last 5 years. The standard deviation (mainly in the form of variable bonus) has been only \$50,000. Taking a ratio translates to 4. This is much higher than Mr. Ang's. A higher ratio means a higher return per unit of risk taken. Most importantly, there is no risk of a loss for Raymond.

Hence, a society's attitude towards risk plays a key role. The capital structure of a large corporation allows shareholders to assume the risks of the business up to the share equity that they have put in, with employees and Management working for the corporation, and rewarded for their efforts, with the excess going towards the corporation and the shareholders (profits attributable to shareholders). This model of shareholders-employees-management has worked well to propel the enterprises to the like of biggest MNCs in the world.

On the other hand, the smallest enterprises, in the form of sole proprietors and partnerships, carry unlimited risks to the business owners as a tradeoff for a higher expected return. This higher resultant stress in the society has to be appropriately compensated. We have seen many businesses stagnate over the years, with high overheads, small profits to the owners, while there is constant fear of competition and operating losses. All these mean low Return on Investment or Return on Efforts where the main inputs are the long hours that small business owners put into their businesses and the opportunity cost.

Drawing parallel to the modern finance theory, we say there appears to be some 'mispricing' in the market, as there is a mismatch between returns and risks.

## ***2) 'Corporatising' the Businesses***

Theoretically, all types of businesses from groceries to hawker food to karang guni can be corporatised into Shareholders-Employees-Management model. Why is this not happening?

First, the business model. Take the familiar hawker centre. The operating model is typically one of converting labour and recipe to generate sales with a margin above the rental, salaries and cost of food sold. Out of 10 hawkers, 1 is flourishing, 2-3 well enough to pay reasonable salaries normally to family members involved in the business, and the rest are mediocre and struggling to make a decent living.

While it is possible for large enterprises to own all these hawker businesses and have employees working for them, there are hurdles. Food recipe and cooking skills are difficult to transfer, short of patenting in the future. Adverse selection will see the successful hawkers reluctant to sell their businesses while the less successful ones more than willing to sell out but there will be no takers. Taken in total, this business model will not take off. What we then have is franchising of only the more successful food businesses, which is what we have been seeing.

Second, economies of scale of large enterprises are negated by their higher overheads. Small businesses which can function as small standalone units such as hawker stall, will not benefit as much from any economies of scale but will be dragged down by the overheads of large enterprises, such as supervision and control function.

Third, small businesses can serve only the local society. Only the large enterprises and MNCs can compete on the world stage. Economic powers have the likes of Microsoft, Google, Toyota, Samsung, British Petroleum, and Shell to carry the torch for them. Of course, they can mostly grow to such size, thanks to a large domestic market and hinterland.

## ***3) Life Cycle of a corporation***

One hypothesis is that a business is small only because it is still at the early stage of its life cycle to grow into a large corporation in the future. While this is true in general, there will be enterprises which will remain small and local, such as the example of hawkers given earlier.

There is also the optimum size of a corporation to consider. For industries with high entry barriers and high capital investments such as automobiles and oil exploration, only the biggest will survive. For others which require manual skills and labour such as cottage industry and artists, they will remain largely small and autonomous.

***Conclusion: It is now obvious that there is no obvious answer to the question. We at least know from the insights in this article that small businesses and large enterprises are likely to co-exist into the future, much like what they had been in the past.***

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