

# WHAT MAKES A SUCCESSFUL BUSINESS?

By Dr Ed Hudson

## Introduction

Every entrepreneur, business owner/manager, investor, lender and business student wants to know the secret to business success. Volumes have been written about the so called “laws of success”. The obvious question is, is there any empirical evidence for the keys to business success? This paper is a summary of a more detailed article by the author on this subject.

In undertaking this review the author surveyed the current research literature pertaining to business success. This research targeted three principal areas that may provide answers to identifying the laws for business success. The first section explores the empirical evidence associated with how strategy influences a business’s success. The second section reviews the decision criteria used by venture capitalists in identifying investment “winners”. The third section explores human capital and how personal demographics and various human attributes affect business success. In last section summarises the key factors to business success and how these can be combined into an objective decision-making tool for effective investment risk assessment.

## Does strategy formulation have a significant affect on business success?

At first glance this appears to be a foregone conclusion and not worth the time and effort associated with undertaking research to answer this question. Volumes have been written on strategy, its formulation and crafting and the development of various strategy models that should produce stand out business success.

The problem with reviewing strategy and its affect on business success is that 40 times more of the literature is dedicated to strategy formulation than to execution [Dulmanis 2003]. Not withstanding this phenomenon researchers have consistently found that strategy execution (performing activities) is far more important than strategy formulation. There appears to be unanimous agreement amongst practitioners and researchers on the effectiveness of strategy formulation/crafting compared to that of strategy execution (implementation) as summarised below:

- *Fewer than 10% of strategies are effectively executed*" [Kiechel, 1982]
- *"70% of failures are due to poor strategy execution by senior management"* [Charan and Colvin, 1999]
- *"Superior execution is required to achieve excellence"* [Blount and Joss, 1999]
- *"Execution is more important than good vision"* [Kaplan, 2001]
- *"Strategy execution is more important than the quality of strategy"* [Ernst and Young, Measures that matter report on 275 portfolio managers, 1998]
- Between 70% and 90% of a firm’s success can be directly attributed to strategy execution and not to the firm’s vision or strategy [Kaplan & Norton, 2001]
- The real value of strategy can only tested through execution [Dulmanis 2003]
- Execution is more important than strategy theory [Hubbard et.al 2002].
- Understanding & clarity is only gained when one is immersed in the execution process & getting ones hands dirty. It is doing it rather than observing it that counts [Dulmanis 2003]
- *"Good ideas and good products are a dime a dozen. Good execution and good management – in a word, good people – are rare"* [Arthur Rock 1987 p.63].
- *"Activities are the basic units of competitive advantage"* [Porter 1996, p64]

The above evidence is unequivocal; strategies by itself will no guarantee business success. However, what is important is how well strategy is implemented by the management team. Empirical research suggests that if strategy is going to have any effect on business performance it is going to

entirely depend upon management and a firm's employee's ability at implementation and effectively and efficiently performing the necessary activities that relate to the chosen strategy. The research results are not without intuitive appeal especially when one considers the number of successful competitors that exist in any one industry. Clearly, all industry competitors do not adopt exactly the same strategies, yet they are individually successful.

Kaplan and Norton conducted extensive research to determine what is required for effective implementation. They concluded that the single most important condition to create a successful Strategy-Focused Organisation is the ownership and active involvement of the executive team. *"If those at the top are not energetic leaders of the process, change will not take place, strategy will not be implemented, and the opportunity for breakthrough performance will be missed"* (Kaplan Monograph 2003).

It is worthy to note that the conventional wisdom which holds that *"management practices need to be contingent on the firm's particular product, market strategy"* [Pfeffer & Veiga 1999, p 56], is not supported by either logic nor empirical results. A recent study found that there was no evidence supporting the notion that management practices on organisational performance is contingent upon the firm's strategy [Pfeffer & Veiga 1999]. The key to success and survival is directly related to an organisation's commitment to management practices that treat people as assets and not necessarily the organisation's "fit" to its strategy. Couple this with Porter's (1996) comment that *"Activities are the basic units of competitive advantage"* it becomes obvious that strategy on its own is deficient.

The obvious implication here is that it is people, the human factor(s) that have a significant impact on a business's economic performance and that *"business situations always come down to the people"* [McCormack 1984, p 19]. Strategy is all about planning for the future and of course there is no one who can predict the future accurately and do it consistently. Yet strangely it is this very human dimension mentioned that gives us this ability. *"It is your insight into people that gives you the ability to predict the future"*. (McCormack 1984, p 21).

A number of researchers explored the human element by examining the link between business success and various human demographics (Age, Sex, Race, Parental Background, Intelligence, level of Education, Personality). Moreover, the researchers found that *"There is no clearly established link between business success and personality traits or personal factors of the individual"* [Carsrud, Olm, Thomas 1989; Stuart & Abetti 1990]. The negative results obtained by researcher's has ultimately lead to virtually no further significant research in personality traits and personal factors and their impact on business performance/success for over 20 years.

## **Conclusion & Comment**

Numerous studies and research has consistently reported that formulating and crafting strategy of its self is no guarantee to business success. This same research has highlighted the importance of strategy execution/implementation as the key to business success. Furthermore, the research has concluded that the key to successful strategy execution/implementation is dependant upon human factors. This human element (human capital) will be reviewed in more detail in the third section of this report.

## **How Venture Capitalists Make Their Decisions**

The initial interest of researchers was in finding out what evaluation criteria were being used by venture capitalists (VCs) in evaluating investment opportunities. They were interested because it was thought that VCs were successful at picking winners. Research in VC is relatively new and was initiated by researchers on the assumption that VCs have been very successful at picking winners and therefore knowing the secrets of success would be advantageous.

A recent review of the current research on how venture capitalists make their investment decisions found that the decision-making process adopted by venture capitalists is more an art than a science. The review also highlights the fact that researchers have not been able to identify the key decision-making variables that lead to making a successful investment choice [Hudson 2002].

The original research proved promising in that a number of evaluation criteria were identified that appeared to be key determinants on how VCs make a successful investment decision. One of the first such studies was undertaken by Wells in 1974 and Poindexter in 1976. A more detailed study was undertaken some ten years later by Tyebjee & Bruno in 1984. Since then, a number of follow-on studies have been undertaken to overcome some of the limitations identified in the earlier studies with the aim of improving the reliability and validity of the research results. Many of these studies found that researchers could not replicate previous research findings. In fact, continued research into VCs decision-making showed a low convergence of the evaluation criteria used by VCs.

Only six factors; (1) management skill and experience; (2) the venture team; (3) product attributes; (4) market size; (5) market growth; and (6) expected ROI, had 50% or more of some eight different studies reviewed agreeing. This has led some researchers concluding that some VCs do not use the same decision-making criteria.

A study of some 150 investee companies found that there were only three necessary and sufficient predictors of venture success. These are (1) the management team's skills, experience and capability; (2) the extent to which a venture is initially isolated from competition (monopolistic power); and (3) the degree to which there is a demonstrated market acceptance of the product/service (demand elasticity) [MacMillan et.al. 1987]. Some business practitioners have appeared to have stumbled upon these success factors more by chance than design and have incorporated them into their own investment strategies [Spann 2001].

## **Conclusion and Comments**

The research evidence suggests that VCs place significant importance on the management team when evaluating a potential investment opportunity. A secondary element emerging from this research appears to be that business success is also linked to: (1) the uniqueness of the product/service being offered; (2) the market acceptance of the product/service; (3) the degree to which customers/consumers are prepared to pay for the product/service (elasticity of demand); and (4) the degree of monopolistic power that can be exerted in the market place. Clearly, there is a link between these key criteria and managerial experience, expertise and capabilities that not only recognise the importance of the above elements but also is capable of their effective implementation. The next section explores in greater detail the human capital component in business success.

## **Human Capital Assessment**

It is well known amongst VCs, private equity investors, credit providers, managers and business owners that an investment in a new venture is an investment in the founders/entrepreneurs/management team. Hence the focus of VCs on conducting due diligence specifically directed at human capital assessment (HCA). A number of VCs and researchers believe that the HCA is the most important aspect of the due diligence process. Investors also believe that it is the management team that ultimately determines the businesses success or failure [Graham 1973; Buffet 1996; Spann 2001].

Researchers and practitioners agree that a venture's success depends upon how well its intangible assets are used and developed. Intangible assets (networks, know-how, patents, location, functional skills, systems and procedures, and distinctive competences) are less likely to be imitated and are more difficult to be substituted. Distinctive competences contain all that is necessary for developing a sustainable competitive advantage, which is difficult to reproduce (unique product/service; market willingness to pay the price & degree of monopolistic power). It is the activities undertaken by a firm that forms the basic

units of a competitive advantage [Porter 1996]. Arthur Rock an American VCs, puts it another way *'strategy is easy, but tactics (activities) are hard'* [Rock, 1987 p.63]. This is why there is considerable focus on HCA when VCs undertake their due diligence. The focus is on the founder and/or the management team as it is they that bring the distinctive competences to the venture and it is the team that performs the day to day and month to month activities.

This focus on HCA by VCs has culminated into a number of familiar statements that describe the importance of HCA to the success of a VCs performance. For example, the well known US VCs Arthur Rock states that *'Good ideas and good products are a dime a dozen. Good execution and good management – in a word, good people – are rare'* [Arthur Rock 1987 p.63]. Rodney Adler described his investment philosophy as *'I would always prefer to invest in the right team in the wrong industry than the wrong team in the right industry'. 'Nearly every mistake I've made has been picking the wrong people, not the wrong idea'* [Bygrave and Timmons 1992 p. 6]. *'Human capital accounts for at least 20% of a venture's financial success and 50% of its performance'* [Gladestone 1988]. *"It is fair to say that an outstandingly successful company has unusually good management"* [Graham 1973]. Researchers have found in favour of this general rule claiming that *'it is better to back the jockey not the horse'* [Siegal, Siegel and MacMillan 1993 p.170].

Practitioners unanimously agree that business is all about managing people. *"Working effectively with people is the key to success"* [David Mackay, President Kellogg Company 2004]. *"The one common denominator in business and in management is people & relationships with people"* (Murphy, Chairman General Motors). *"The most important element in managing is choosing the right people"* (Sir David Barran, Chairman Midland Bank). *"The assessment and choice of people for a team is vital"* (Pursell Deputy Chairman Guinness). *"Business situations always come down to the people"* (McCormack 1984, p 19)

The due diligence process conducted by VCs will, among other things, include a business valuation based on projected cash flows and working backwards to determine its value today. HCA likewise has to do with determining future human behaviour by discounting future streams of behaviours [Smart 1998]. Researchers have confirmed what VCs have known all along, that human capital was a strong predictor of a venture's performance. In fact many VCs believe that *'you can predict an individual's future by what he has done in the past'* [Gladestone 1988]. This statement appears to be supported by business practitioners. *"It is your insight into people that gives you the ability to predict the future"*. (McCormack 1984, p 21).

What practitioners desire to know is how this can be assessed accurately prior to making an investment in a venture or business. VCs want to know how to accurately assess which entrepreneurs are likely to succeed rather than fail.

Researchers have identified various human capital attributes that VCs consider important. [Eisenhardt and Schoonhoven 1990; Timmons 1990; Hall 1992; Cooper, Gimeno-Gascon & Woo 1994; Elango et.al. 1995]. What were missing from these studies was identifying the methods and techniques used by VCs in HCA. More importantly, what methods and techniques led to better investment selection. Stated another way, can human capital be assessed accurately [Kozmetsky, Gill and Smilor 1985; Gladestone 1988; Harvey and Lusch 1995]. However, there are those practitioners and researchers who believe that HCA cannot be accurately modelled nor can it be performed with a success rate greater than chance [Smart 1998].

The method that consistently had a high impact on the accuracy of the HCA process was the past-orientated interview technique. The work sample interview technique (assessing current behaviour) had a positive contribution in early stage ventures but had a significant negative impact on accuracy in later stage ventures. This result indicated that the past-orientated interview method had the best all round result on accuracy of predicting a venture's future performance.

## **Implications to Practitioners**

In order to improve a VC's investment portfolio performance and increase IRR, Smart's (1998) research identifies a set of do's and don't's. Positive actions include adopting HCA best practice will increase IRRs over time. Adopting HCA best practice will lead to greater HCA accuracy. Establishing a human capital needs analysis before meeting with management will focus attention on the important behavioural attributes that would be expected to underpin success. Learning how to conduct effective past-orientated interviews will increase a VC's effectiveness and efficiency in HCA.

## **Human Demographics and Business Success**

Human demographics were first mentioned in the review of the research into strategy and its impact on business success at the beginning of this article. As previously indicated there is no direct link between human demographics and business success.

Research suggests that the most outstanding human factors that do impact on business success are: (1) prior industry knowledge and (2) similar business experience. Age, sex, parental background, race, intelligence and personality had very little to no effect on business performance. What was not expected was the relative low impact of education level attained.

Some researchers believe that the education factor may be inextricably intertwined with "prior industry experience", "similar business experience", and "managerial skill". Others believe that "knowledge" is the more relevant factor than education as it measures the direct influence of experience and education and its impact on a particular business and its industry [Zack 1999]. Of course knowledge can be gained through education, real-life practice or a combination of both.

## **Conclusion & Comment**

In summary, empirical evidence indicates that HCA can be undertaken in a systematic approach resulting in greater accuracy and higher IRRs. Research has also indicated that human demographics do not have an impact on business success. These empirical results suggest that to achieve business success practitioners need to adopt HCA best practice.

## **Conclusions and Summary**

The conclusions that can be drawn from this article's research into the empirical evidence on what determines business success suggests that the following are important and contributory to business success/failure:

- The ability of the management team to effectively implement the firm's chosen strategy
- The management team's cohesiveness and ability to work with each other
- The management team's commitment and energy to strategy implementation/execution
- The management team's prior industry experience
- The management team's similar business experience
- Managerial skills of the management team
- Product/service uniqueness (Product/Service Differentiation)
- The degree of demand elasticity (Market Acceptance)
- Degree of protection from competitors (Monopolistic power)
- The business's ability and propensity to earn a return greater than its economic cost

Research has proven that there are key factors that govern business success. When one is making a decision on investing/lending to a business entity it is important to identify and evaluate the business according to these key success factors (due diligence). A further advantage in knowing these key factors is the reduction in business risk. If these key factors for success are not present, then a program for effective implementation must be designed, managed and incorporated into the business.

Furthermore, adopting the above elements (along with their corresponding sub-elements), into an objective framework underpinned by factual substantiation, will remove the ever present subjective bias from the decision making process. This is essential if an objective view is to prevail resulting in better choices and a reduction in making investment decisions which result in business failure.

### **Modelling Business Success**

This research concludes that there is no one element that guarantees success. Success is built upon a mix of elements. Any investment or business evaluation process that attempts to predict business success must incorporate all the elements in the decision criteria. A successful business can therefore best be described as one which has a ***“a strong management team with a successful track record; a product/service that possesses unique attributes (differentiation); which has strong market acceptance; significant barriers to entry; the ability to produce attractive returns on investment; an attractive economic profit (value creation) that is not overly capital intensive; the product/service has global appeal; all of which are supported by well developed business systems and procedures; and a management team that works well together to ensure effective strategy implementation”***.

The identification of the above elements of business success enables business owners/managers to develop a risk assessment profile that can be segmented into their constituent parts namely: (1) Management Risk; (2) Implementation Risk; (3) Business Risk; (4) Leadership Risk; and (5) Financial Risk. Combining these elements will provide an overall risk assessment of any business or investment proposition.

Such a model has been developed by EQUILINX™ called “Human Capital Assessment” and used in determining enterprise risk for debt providers and equity investors. For further details contact Dr Ed Hudson at [ed.hudson@equilinx.com.au](mailto:ed.hudson@equilinx.com.au).