THE LOGIC OF PROFIT IN A NEW VENTURE: DEVELOPING AND TESTING
A PRAGMATIC MODEL

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ABSTRACT

This study proposes a comprehensive framework for characterizing the economic model that underlies an entrepreneurial venture. The proposed framework includes four components: revenue drivers, operating leverage, margins, and volumes. Further, volumes and revenue drivers have two sub-components. A foundation for each is established. To test the framework, a survey instrument was developed and administered to entrepreneurs from a cross-section of retail ventures. Cluster analysis is used to identify more commonly employed models among firms. Further, evidence is produced of differences in the models relied upon based on organization descriptors, and differences in company performance based on the firm’s economic model. The study demonstrates a practical approach to measuring a firm’s economic model that can be used by researchers, educators and practitioners. Implications are drawn for theory and practice, and suggestions are made for ongoing research.

EXECUTIVE SUMMARY

The purpose of this study is to propose a comprehensive framework for characterizing the economic model that underlies an entrepreneurial venture. The proposed framework includes four overall components: revenue drivers, operating leverage, margins, and volumes. Further, volumes are further broken down into the number of transactions and the size of the average transaction, while revenue drivers are further broken down into the number of drivers and the price flexibility of the various drivers. Based on the extant literature, a foundation for the notion of an economic model, as well as for each component of the proposed framework is established. The key to the model is the manner in which the elements are combined. Examples are provided of highly attractive (profitable) combinations and combinations that produce non-viable or survival types of ventures. Using the framework, any new venture can be evaluated in terms of the attractiveness of it profit model. As such, the potential for the framework as a practical tool for use in designing new ventures that can make money, and as a diagnostic for ensuring the sustainability of a venture, are demonstrated.

Beyond its managerial applications, the framework is presented as a research tool. An approach to measuring the elements of a firm’s economic model consisting of nineteen
dichotomous measures is presented. To test the proposed measurement approach, a survey instrument was developed and administered to entrepreneurs from a cross-section of retail ventures. The sampling frame consisted of privately-held retail firms identified from the Reference USA® database for two major metro areas in the State of New York, each having at least 10 employees, and being associated with six NAICS codes representing retail establishments. Out of the 1218 firms solicited, a usable set of 168 surveys were received, a 13.8 % response rate.

Cluster analysis was used to identify more commonly employed models among firms. Five clusters were identified: Cluster 1: High Value Model, Cluster 2: Middle-of-the-Road Model, Cluster 3: High Turnover Model, Cluster 4 (High Leverage Medium Fixed Model), and Cluster 5 (Low Leverage Medium Flexible Model). Using the original dichotomous variable set to predict cluster membership, the logistic regression correctly classified 99.3% of the organizations. Further, evidence is produced of differences in the models relied upon based on organization descriptors, and differences in company performance based on the firm’s economic model. The study demonstrates a practical approach to measuring a given firm’s economic model that can be used by researchers, educators and practitioners. Implications are drawn for theory and practice, and suggestions are made for ongoing research.

The findings provide support for the proposed framework. Specifically, owners were able to describe their decisions on the key variables that constitute a firm’s economic model, and an analysis across a cross-section of companies was able to produce dominant models or approaches to making money. Consistent with general perspectives on profitability models (e.g., Monroe, 2003), the results confirm the existence of a pair of diametrically opposed economic models involving a relatively low number of transactions with high margins (High Value) and high number of transactions with low margins (High Turnover). The three additional clusters in this study are distinguishable based on the degree of operating leverage, relative flexibility of revenue drivers, typical transaction value and quantity, number of locations, and annual revenue. Overall, these results suggest that there are at least five different economic paths to profitability, at least in a retail context.

The proposed framework, when applied to the evaluation of a new venture, allows for the performance of sensitivity analyses, where both opportunistic and problematic combinations of the four model components can be identified. The model can also be used to characterize the inherent risk in a venture and evaluate growth potential. It becomes possible to examine ways in which economic models evolve as a firm matures. The framework and measurement approach can also have important implications for operating decisions that affect the four elements of the firm’s economic model. Based on the findings and these implications, additional research priorities are established.