Surviving the "Valley of Death": How Social Distancing Will Affect American Organizations

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Executive Summary

- Surviving the proverbial "Valley of Death" has taken on a new, double meaning for businesses during the current global crisis of COVID-19.
- Small businesses are struggling to survive due to social distancing restrictions. For these business, regular cash flow is critical for survival.
- A few organizations, however, are experiencing an unprecedented influx of demand. These organizations must focus on their talent, product(s) and business model to capitalize on this increased demand and grow sustainably.

Macroeconomic Trends

While the business environment is undergoing rapid change, research into small businesses can help point to what can make or break these organizations. Research from Diana Ferrell, Chris Wheat and Chi Mac at the JPMorgan Chase Institute examines how small businesses' cash flows correlate with their survival rates (Ferrell, Mac, & Wheat, 2018).

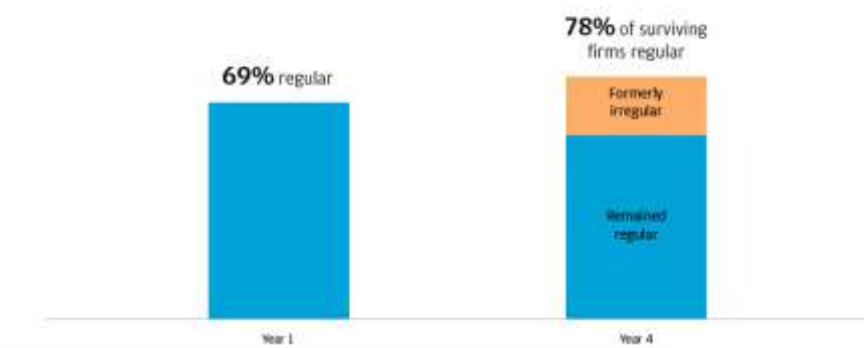

Figure 1: Cash Flow Type Across Surviving Small Businesses

Using data from more than 1 million small businesses, they classify the cash flows into regular and irregular patterns. They find that 69 percent of small businesses have regular cash flow patterns in their first year of operation. By the fourth year, 78 percent of surviving businesses have regular cash flow patterns, and roughly one quarter of those formerly had irregular cash flows. What this data suggests is that small business survival is strongly correlated to the ability to generate regular a cash flow. The current economic climate presents an unprecedented challenge to the ability of small businesses to do this. Ideally, Paycheck Protection Program (PPP) loans and other government programs will provide some relief. However, for businesses to stabilize and survive, they will need to return to cultivating a stable cash flow.

Switching gears to high-growth businesses, we know that such businesses are a major driver of new employment opportunities. Research from Ryan Decker at the Federal Reserve has shown that young, high-growth (with a growth rate in the top 25 percent) companies are critical to the economy. They drive almost 60 percent of job creation, even though they account for only 15 percent of U.S. companies. In the current environment, however, many of these young firms that previously drove growth in employment opportunities are stagnating or even shrinking in size. Rather than reallocating resources to enhance the aggregate output, these organizations are having to focus on running lean, efficient businesses in order to survive.

Overall, research on both small and high-growth businesses suggests a somewhat grim outlook for the short-term future of the U.S. economy. The major growth engines of job creation have been shuttered, and the country's small business backbone is also seriously struggling. The outlook is not all dire, though. Americans are known for their exceptional ingenuity in the face of adversity. Past research in entrepreneurship has shown that when entrepreneurs are faced with stark changes and resource constraints, they engage in an activity known as *bricolage* (Baker & Nelson, 2005). This involves combining previously unutilized resources into products or services that defy traditional norms. While many businesses will be devastated by the COVID-19 crisis, we can also expect to see a wave of entrepreneurs engaging in bricolage to develop solutions for the post-COVID world.

Scaling Through Hypergrowth

Throughout the coronavirus pandemic, a subset of companies has seen an explosion in demand. From video conferencing services to restaurant delivery apps, many firms are experiencing a sudden influx of customers. These hypergrowth organizations need to rapidly scale their business and face a very different "Valley of Death" than flagging businesses.

At the Kenan Institute Frontiers of Entrepreneurship Conference, Kristen Nimsger, CEO of Social Solutions, offered advice on how a business can manage through a phase of hypergrowth. According to Nimsger, growth ultimately comes down to luck and execution. Specifically, at the hypergrowth stage, she said companies should focus on three areas: talent, product and business model. The big question with respect to product is whether it is better to take big or small growth steps. For the business model, it is critical to think about the long-term value of the business (repeatability and sustainability).

> **"Scaling through hypergrowth is just as painful as running a failing business."**
> **-- Kristen Nimsger, CEO, Social Solutions**

We know from academic research that all three of these aspects are critical to successful business growth. In particular, the business model is something managers need to understand when rapidly scaling. An optimal business model takes into account both the value creation and value capture mechanisms in an organization. By understanding both of these mechanisms, managers can create a revenue capture strategy that fits with the product or service they offer (Tidhar & Eisenhardt, 2020). Organizations that fail to find a fitting business model will end up either struggling to scale or struggling to capture value as they scale.

A concrete example of this is Zoom. While the video conferencing software company has had a surge in users since social distancing began, it is unclear if it has found an optimal business model. The company reportedly went from 10 million to 200 million daily active users between December 2019 and March 2020. However, almost all of these new users are individuals using the free version of the software. Given this change in use case, Zoom will need to reevaluate the fit between its revenue capture—traditionally B2B sales—and its value creation activities, that is, who is Zoom generating value for and are they able to actually capture this value? Look for Zoom to reassess who their primary customer is and how they can capture revenue in light of the new economic and physical realities.

Policy and/or Practitioner [Actionable] Takeaways

- Regular cash flow is correlated with survival for small businesses. Government support currently provides irregular and unpredictable cash flow. To the extent possible, government programs that can provide a stable cash flow source *over time* would be the most beneficial to small businesses.

- High-growth firms account for an outsized number of new jobs in the American economy. With the challenges currently faced by small businesses, policymakers should expect to see unemployment continue to rise while workers are asked to remain at home.
- Organizations experiencing hypergrowth should focus on their talent, product and business model. Managers should pay close attention to the business model and ensure that there is a strong fit between the revenue capture and value creation elements.

List of panelists and affiliations from the Kenan Institute Frontiers of Entrepreneurship Conference

- Ryan Decker, Senior Economist, Federal Reserve Board of Governors, Ryan.A.Decker@frb.gov
- Kristin Nimsger, CEO, Social Solutions, knimsger@socialsolutions.com
- Mark Tebbe, Entrepreneur-in-Residence, University of Chicago Polsky Center for Entrepreneurship and Innovation; Adjunct Professor of Entrepreneurship, University of Chicago Booth School of Business, Mark.Tebbe@chicagobooth.edu
- Chris Wheat, Director of Business Research, JP Morgan Chase Institute, chris.wheat@jpmchase.com

References

Farrell, D., Mac, C., & Wheat, C. (2018). Growth, Vitality, and Cash Flows: High-Frequency Evidence from 1 Million Small Businesses. JP Morgan Chase Institute

Baker, T. & Nelson, R. (2005). Creating something from nothing: Resource construction through entrepreneurial bricolage. *Administrative science quarterly* 50.3 (2005): 329-366.

Tidhar, R. & Eisenhardt, K. M. Get rich or die trying… Finding revenue model fit using machine learning and multiple cases. Strategic Management Journal (2020).