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Profitability Effects of Firm Size: Evidence from Fast-Growing SMEs in Bulgaria

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Aleksandar B. Todorov*

Abstract

Does firm size matter for the performance of small and medium-sized companies? To answer this question, the study at hand employs data from the well-established *Gepard* ranking of small and medium-sized fast-growing enterprises in Bulgaria. Ordinarily least-squared regressions techniques are applied on a cross-section of more than 2000 observations with the results showing that returns on revenue are negatively related to firm size in our sample. Additional regressions show that sectoral effects are quite strong and explain a non-trivial part of the variation in profitability. Although significant, regional effects are not that strong. Specifically, our results show that firms in the northern regions are more profitable than firms in the southern regions. Overall, the results are in favor of the hypothesis that firms in the sample follow a growth-focused strategy rather than a profit-focused strategy. The study contributes to the ongoing discussion on the size-growth-profitability nexus by providing evidence from a less researched area of small and medium enterprises in South-East Europe, particularly in Bulgaria.

Keywords: profitability; small firms; firm performance; firm size; growth

JEL: L21; L25; L26

Introduction

Does firm size influence the profitability of small and medium-sized enterprises (SMEs)? This question has long attracted attention from economists, investors, and policy-makers alike. Economic theory posits that larger firms may benefit from economies of scale, potentially translating into higher profitability. Yet, empirical findings on the size-profitability relationship remain mixed – some studies report a positive effect, others negative, and many find no significant link at all. This paper contributes to the debate by empirically examining the relationship between firm size and profitability among SMEs.

The role of firm size for profitability has also gained attention in recent entrepreneurship research. Researchers interested in the nexus between the growth of SMEs and their profitability hypothesize that the relationship between size and profitability might depend on the firm's initial strategic orientation. Firms could either pursue growth first to achieve economies of scale, or they could alternatively

* Department of General Economic Theory, University of Economics – Varna, Bulgaria, Corresponding Author

try to achieve competitive advantage first, indicated as superior profitability, and then pursue growth opportunities to exploit that competitive advantage. Small firms form a special case for this reasoning, as their limited resources and inferior size might put more pressure on growing first before significant profits can be achieved. At the same time, high growth is positively related to a firm's survival and is positively perceived by investors. Therefore, owners and managers of small companies often rely too heavily on growing their businesses to be able to achieve size-related benefits.

This study attempts to contribute to this discussion by empirically quantifying those effects for a relatively large sample of fast-growing SMEs in Bulgaria. Small and medium enterprises provide an interesting example as previous literature has provided mixed results regarding the relationship between size and profitability. Of special interest here is the discussion of the nexus between size, growth and profitability where recent research points out that the effects of size on profitability are determined by the current strategy (growth-focused vs. profit-focused). At the same time the case of Bulgaria is of special interest as despite the importance of SMEs for the economy much of the research focuses either on large companies in specific sectors or on broader geographical areas (e.g. Mueller et al. 2003; Todorov 2015; Yalamov et al. 2021; Todorov 2023). Additionally, the data also enable an explicit examination of external factors affecting SMEs in Bulgaria, uncovering distinct regional and sectoral disparities in firm profitability.

The study is structured as follows. The next section provides a brief overview of the relevant literature with a special focus on research on firm's size and profitability in South-East Europe and outlines the contribution of the present paper, as well as the formulation of hypotheses. Afterwards, the data set and the methodological approach are described. Subsequently, the main empirical findings from the econometric analysis are reported and discussed. The final section concludes and proposes some practical implications.

Literature Review

The study contributes to two strands of literature. The first strand studies the effects of firm size on profitability among firms in South-East Europe. The second strand is concerned with the nexus between firm size, firm growth and profitability.

Table 1 provides an overview of thirteen recent studies investigating the relationship between firm size and profitability in six countries in South-East Europe (Albania, Croatia, Greece, Romania, Serbia, Slovenia). Four of those studies analyze the profitability of large firms in Greece. All four studies report a positive effect of size on profitability. Starting with Agiomirgianakis et al. (2006), which uses a panel of 3094 Greek manufacturing firms for the period between 1995 and 1999 to reveal that profitability is highly positively correlated with size. Those findings are confirmed by Papadogonas (2007), which analyzes a similar sample, and by Asimakopoulos et al. (2009), which analyzed listed companies on the Athens Stock Exchange over the period from 1995 to 2003. Finally, Liargovas and Skandalis (2010) focus again on listed companies and find that, on average, large, young, and export-oriented firms are more profitable.

For Romania, Popa and Ciobanu (2014) and Vătavu (2014) report a positive relationship between firm size and profitability, while Lazar (2016) finds a negative relationship. Similarly, for Serbia, Rađo and Peštović (2022) report a

positive relationship, while Mijić et al. (2018) find that small firms are more profitable than large ones, but limiting the sample only to SMEs shows a negative relationship. For Slovenia, Močnik and Širec (2015) analyze a large sample of fast-growing SMEs and report a negative effect of firm size on profitability. Finally, Barbullushi and Kiri (2020) analyze a sample of 100 small and medium businesses in Albania and found that size is not a significant factor.

These largely diverging findings suggest that the formulation of a unifying hypothesis regarding the relationship between a firm's size and profitability is not possible. It appears that the direction of this relationship depends on the sample at hand. For instance, studies focusing on large companies tend to report positive findings (six studies), while studies using more balanced samples report negative size effects or no effects at all (three studies). To the best of our knowledge there is no empirical study focusing on the relationship between firm size and profitability among small and medium enterprises in Bulgaria.

Table 1. Studies on Firms Size and Profitability in South-Eastern Europe

N	Study	Country	Sample	Size effect
1	Agiomirgianakis et al. (2006)	Greece	3094 firms 1995-1999	Positive
2	Papadogonas (2007)	Greece	3035 firms 1995-1999	Positive
3	Asimakopoulos et al. (2009)	Greece	119 listed firms 1995-2003	Positive
4	Liargovas and Skandalis (2010)	Greece	102 listed firms 1997-2004	Positive
5	Pervan and Višić (2012)	Croatia	2050 firms 2002-2010	Positive
6	Popa and Ciobanu (2014)	Romania	35 SMEs 2009-2012	Positive
7	Vătavu (2014)	Romania	126 listed firms 2003-2012	Positive
8	Močnik and Širec (2015)	Slovenia	782 SMEs 2008-2009	Negative
9	Lazar (2016)	Romania	50 listed firms 2000-2011	Negative
10	Dashi (2018)	Albania	49 large firms 2014-2016	Not significant
11	Mijić et al. (2018)	Serbia	1801 SMEs 321 large firms 2010-2014	Negative
12	Barbullushi and Kiri (2020)	Albania	100 SMEs 2005-2007	Not significant
13	Rađo and Peštović (2022)	Serbia	55 listed firms 2017-2020	Positive

Source: Compiled by the author.

The second strand of literature, to which the present study is related, focuses on the nexus between profitability, firm growth, and the role of firm size. An influential study by Davidsson et al. (2009) analyzes a large sample of Swedish and Australian firms to show that firms emphasizing profitability before growth (profit-focused firms) perform on average better than firms that aim at high growth first before securing profitability (growth-focused firms). In addition, they estimate that growth-focused firms are twice more likely to report poor performance on both dimensions – low profitability and low growth than profit-focused firms. These findings have been confirmed in a recent study by Ben-Hafaïedh and Hamelin (2023) on a large panel of European small and medium enterprises. Additionally, they find that these results exhibit a strong path-dependency on the initial strategy (growth vs. profit focus).

Another recent study by Mansikkamäki (2023) reinforces these results. Mansikkamäki (2023) studies the growth-profitability dynamics of 66 000 Finnish firms. Her results not only support the findings of the previously cited studies, but also show that a firm's age and size play an important role in these dynamics. For instance, the benefits of firm size depend on the firm's current profitability. More specifically, size turns out to be beneficial for performance only when the firm is initially in a high profitability state. In other words, companies benefit from a larger scale when their growth strategy is profit-based. For firms starting from low-profitability states, size does not bring any benefit and could even be disadvantageous.

Given the above-mentioned empirical findings and their theoretical implications, and considering that the data sample in this study consists of fast-growing SMEs, one could hypothesize that if a profit-focused strategy is the dominant paradigm, then a positive relationship between size and profitability could be expected. If, however, firms in the sample are on average more growth-focused than profit-focused, then firm size would be negatively related to profitability. In other words, if firms sacrifice profitability for revenue growth, then firms' size and profitability are expected to be negatively related (see also Močnic and Širec 2015, 39).

Data and Methodology

The data used in this study stems from *Gepard* 2024, an annual ranking of the fastest-growing small and medium enterprises in Bulgaria published by *Economedia* – a private business media publisher (Todorov 2024). The ranking is based on revenue growth for 2022 compared to the previous year 2021. The full data set from the ranking covers 2523 SMEs and contains information on revenue (in thousand BGN), revenue growth rate (in percentage), number of employees (in absolute numbers), net profits (in thousand BGN), sector affiliation, as well as regional location. This secondary data is used in the present study to analyze the empirical relationship between profitability and firm's size – both variables to be defined below.

According to the authors of the *Gepard* ranking, to be included in the final ranking, a company should fulfill the following criteria: the company has realized positive revenue growth over the last two years, for the current year, 2022; the company is classified as small or medium (not micro) enterprise, that is, revenues should be between 3.9 Mio BGN and 97.5 Mio BGN; only private companies are included; companies in the financial, health, and gambling industries are excluded (Todorov 2024). According to these criteria a

"fast-growing" company is a company that has experienced a positive growth rate of revenue over the last two years and the companies fulfilling the above-mentioned criteria are then ranked based on the growth rate of revenue for 2022 compared to the previous year. The exclusion of companies in some industries implies that the ranking is primarily focused on non-financial companies, that is on the real side of the economy – manufacturing and service companies. The exclusion of those industries might reduce the study's generalizability but at the same time allows for a comparison with previous studies which focus mainly on manufacturing and/or service firms as explained in the literature review. The use of fast-growing firms might introduce a potential bias, which is to be considered in the interpretation of the empirical results. Using this data set, seven variables are constructed and deployed in the subsequent analysis. Table 2 provides a short description of the variables.

Profitability for each company is defined and calculated as a ratio between net profit (profit after taxes) and revenue (ROR) and then written as a percentage. The size of a company is measured in revenue (in Mio BGN) as well as in number of employees (in absolute numbers). Both figures are transformed using a natural logarithm. Growth of a company (GROWTH) is measured as the percentage growth rate of revenues for 2022 compared to the previous year 2021. Finally, three categorical variables are formulated. As indicated in the primary ranking, each company belongs to a specific sector (SEC) and the ranking identifies 23 sectors in total. For each of those sectors, an indicator (dummy) variable is created. The basis for this variable is the "Retails" sector, as the largest share of the companies are affiliated with that sector. The second categorical variable indicates the region (REG) in which the company is registered. In the *Gepard* ranking firm's location is provided using the official designation by the National Statistical Institute (NSI) of Bulgaria. Thus, the variable REG has 28 categories, corresponding to the official NSI designation, with the base set at Sofia City, where the largest share of companies is located. The final categorical variable indicates whether a company is in the northern region or in the southern region of Bulgaria (NORTH). If a company is in a southern region, then this variable has a value of 0 and if a company is in a northern region, then the variable has a value of 1.

Using this data set, several econometric models are estimated. The baseline models

Table 2. Description of variables

Variable	Description
ROR	Return on revenue: Profit to revenue ratio (%)
REV	Natural logarithm of revenue
GROWTH	Annual growth rate of revenue (%)
EMP	Natural logarithm of number of employees
SEC	Sector (Categorial, 23 sectors, Retail = 0)
REG	Region (Categorial, 28 regions, Sofia City = 0)
NORTH	North Region of Bulgaria (Categorial, 0 = South, 1 = North)

Source: Author's illustration.

include regression of profitability (ROR) on size, measured as the natural logarithm of revenue (REV), and the two primary control variables – sector affiliation (SEC) and regional location (REG). The extended regression models include separate regressions of profitability (ROR) on growth, measured as percentage growth rate of revenue (GROWTH), as well as the natural logarithm of the number of employees (EMP), an alternative measure of size, and on the categorical variable NORTH, which takes the value of 1 if a company is in the northern part of Bulgaria. Possible non-linearities in the variable of primary interest, that is firm's size, are investigated through the introduction of second-order (quadratic) term for size. This would allow us to empirically trace a possible U-shaped or an inverted U-shaped relationship between size and profitability. In the case of a U-shaped relationship profitability would first decrease with increasing size and then increase after reaching a certain threshold of size. In the case of an inverted U-shaped relationship the opposite would hold. As for the rest of the control variables the possibility of non-linear relationships is tested empirically using a formal regression specification error test (RESET) (Wooldridge 2016; Kleiber and Zeileis 2008). All models are estimated using ordinary least squares (OLS) on cross sectional data with 2523 observations.

Empirical Results

Summary statistics for the variables in the sample are shown in Table 3. The average rate of profitability among the firms in the sample is 9.45 percent, which means that on average 9.45 BGN out of 100 BGN in revenues is a profit. The average firm size in the sample, measured as revenue, is 15 million BGN (or about 7.5 million euros). The growth rate of revenue is on average about 39 percent, and the average number of employees of the firms in the sample is about 46. Dummy variables are not included in Table 3, but are discussed in detail further below. These are 23 sectors, with the largest one ("Retail"), set as base, and 28 indicator variables for the different statistical regions in Bulgaria, with the capital, Sofia city, set as a base for comparison.

For the indicator variables, SEC and REG, conditional means are calculated. The results are shown in Table 4 and Table 5, respectively. Table 4 shows that firms in thirteen out of 23 sectors report above average profitability (ROR > 9.45; Table 4 does not report profitability for firms in sectors categorized as "Other"), while firms in ten sectors report below average profitability (ROR < 9.45).

Table 3. Descriptive statistics of Bulgarian fast-growing SMEs

Variable	Code	Mean	Std. Dev.	Min.	Max.
Profitability	ROR	9.45	13.26	-212.16	89.38
Size	REV	15080.00	15802.82	3917.00	96509.00
Growth	GROWTH	38.85	160.22	20.06	622.00
Employees	EMP	45.87	46.36	3.00	245.00
Number of observations = 2523					

Source: Author's calculations.

Table 4. Profitability and Number of Firms across Sectors

N	Sector	ROR	Firms	%Firms	N	Sector	ROR	Firms	%Firms
1	Energy	30,14	45	1,78	12	Tourism	9,69	134	5,31
2	Agriculture	16,17	239	9,47	13	Metals	8,51	117	4,64
3	Restaurants	15,13	71	2,81	14	Retail	7,71	583	23,11
4	Publishing	13,20	17	0,67	15	IT	7,11	107	4,24
5	Raw materials	10,97	8	0,32	16	Transport	6,77	251	9,95
6	Woodworks	10,92	40	1,59	17	Car service	6,33	54	2,14
7	Machinery	10,58	79	3,13	18	Foods	6,10	111	4,40
8	Construction	10,58	207	8,20	19	Communal services	5,68	17	0,67
9	Chemicals	10,33	99	3,92	20	Automobiles	5,60	2	0,08
10	Textiles	10,00	23	0,91	21	Pharmacy	4,14	28	1,11
11	Repairs	9,94	13	0,52	22	Fuels	3,30	149	5,91

Note: Sectors are ordered by profitability (ROR) in descending order. Sector "Others" is excluded from the table; in this category there are 129 firms (5.11 percent of all firms in the sample) with an average profitability (ROR) of 10.94 percent.

Source: Author's calculations.

The three most profitable sectors in the sample are "Energy" (ROR is 30.14 percent), "Agriculture" (ROR is 16.17 percent), and "Restaurants" (ROR is 15.13 percent). Half of the firms in the sample (50.73 percent) are affiliated with four major sectors. These are "Retail" with a share of 23.11 percent, "Transport" with a share of 9.95 percent, "Agriculture" with a share of 9.47 percent, and "Construction" with a share of 8.20 percent. Finally, it should be noted that more than half of the firms in the sample (55.99 percent) are in sectors reporting below average profitability. This observation suggests that the distribution of profitability is skewed, with few firms reporting extraordinarily high returns while most firms report below average profitability. These findings and the fact that there is a concentration of firms in few sectors suggest that results should be treated with caution. It should be noted also that the sample focuses on firms reporting steady growth and not ranking high on profitability.

Table 5 shows the mean profitability and the number of firms across regions. Firms in roughly half of the 28 regions report above average profitability (ROR > 9.45), while firms in the other half report below average profitability (ROR < 9.45).

Table 5 also shows that nearly 60 percent of all firms in the sample are in the three largest cities in Bulgaria: 40 percent are in the city of Sofia, 10 percent in the city of Plovdiv, and 10 percent in the city of Varna. Furthermore, the descriptive statistics on the categorical variable NORTH (not reported in Table 5) show that nearly 74 percent of all firms (1857 out of 2523) in the sample are in the southern regions, while only 24 percent (666 out of 2523) are in the northern regions. In addition, firms that are in northern regions are on average more profitable than firms in the south. Average profitability for companies in the north is slightly above 11 percent and thus higher than the average for the whole sample, which is 9.45 percent.

Table 5. Profitability and Number of Firms across Regions

N	Region	ROR	Firms	%Firms	N	Region	ROR	Firms	%Firms
1	Dobrich	16.19	50	1.98	15	Smolyan	9.73	15	0.59
2	Razgrad	15.74	32	1.27	16	Plovdiv	9.26	273	10.82
3	Targovishte	14.80	20	0.79	17	Yambol	9.12	21	0.83
4	Pernik	14.05	27	1.07	18	Sofia City	8.39	980	38.84
5	Varna	11.37	228	9.04	19	Lovech	8.22	18	0.71
6	Stara Zagora	11.23	96	3.80	20	Kyustendil	8.17	19	0.75
7	Silistra	11.17	21	0.83	21	Pazardzhik	7.96	37	1.47
8	Veliko Tarnovo	10.88	65	2.58	22	Montana	7.89	8	0.32
9	Kardzhali	10.62	19	0.75	23	Sofia	7.88	50	1.98
10	Haskovo	10.46	48	1.90	24	Gabrovo	7.87	34	1.35
11	Vratsa	10.08	24	0.95	25	Blagoevgrad	7.86	101	4.00
12	Burgas	10.07	138	5.47	26	Shumen	6.71	38	1.51
13	Pleven	10.03	53	2.10	27	Vidin	6.61	10	0.40
14	Ruse	9.94	65	2.58	28	Sliven	6.36	33	1.31

Note: Regions are shown by profitability (ROR) in descending order.

Source: Author's calculations.

Table 6. OLS Results from Baseline Models. Dependent Variable: Profitability (ROR)

Independent variables	(1)	(2)	(3)	(4)
log(REV)	-1.02** (0.34)	-1.23*** (0.34)	-0.94*** (0.35)	-1.13*** (0.35)
Sector dummies?	No	Yes	No	Yes
Region dummies?	No	No	Yes	Yes
Observations	2523	2523	2523	2523
R-squared	0.0034	0.1088	0.0223	0.1200

Note: Levels of significance: * = $p < 0.05$, ** = $p < 0.01$, *** = $p < 0.001$. The quantities in the parentheses below the estimates are the White's heteroskedasticity robust standard errors.

Source: Author's calculations.

Average profitability of companies in the southern regions is nearly 9 percent and thus slightly lower than the average for the sample. Explaining the empirical differences in profitability among companies located in northern versus southern regions goes beyond the scope of the present study. It should be noted that the interpretation of those results require some caution as companies located in northern regions represent about 26 percent of the total sample and thus are a relatively small fraction of the total sample size.

The main empirical analysis begins with a set of baseline regression models in which profitability, measured as returns on revenue (ROR), is regressed on the logarithm of

Table 7. OLS Results from Extended Models. Dependent Variable: Profitability (ROR)

Independent variables	(5)	(6)	(7)	(8)
log(REV)	-9.26 (7.81)	-1.13*** (0.35)		-1.20*** (0.34)
$log(REV)^2$	0.42 (0.41)			
GROWTH		0.00 (0.81)		
log(EMP)			-0.51 (0.32)	
NORTH				1.20* (0.54)
Sector dummies?	Yes	Yes	Yes	Yes
Region dummies?	Yes	Yes	Yes	No
Observations	2523	2523	2523	2523
R-squared	0.1204	0.1200	0.1173	0.1103

Note: Levels of significance: * = $p < 0.05$, ** = $p < 0.01$, *** = $p < 0.001$. The quantities in the parentheses below the estimates are the White's heteroskedasticity robust standard errors.

Source: Author's illustration.

revenue (REV). The results from these models are represented in Table 6.

Model (1) in Table 6 is the simplest version of the model with one independent variable. Models (2) to (4) subsequently introduce the sector dummy variables (23 sectors in total) and the regional dummy variables (28 regions in total). The results show that size is negatively related to profitability and has a statistically significant coefficient (based on White's heteroskedasticity robust standard errors). Its economic significance is rather small, as a one percent increase in size is associated with an approximately one percentage point decrease in profitability. In other words, if a firm size increases by 10 percent, say from 15 Mio BGN to 16.5 Mio BGN, then average profitability falls by 10 percentage point, say from 10 to 0 percent. In Model (4), the most comprehensive model of all four, the percentage points increase in profitability is 1.13. The values of the R-squared statistic, the last line in Table 6, show that size and regional effects explain a relatively small portion of the variation in profitability; 0.3 percent and 2 percent, respectively. Sectoral effects, on the other hand, explain nearly 10 percent of the variation in profitability in the sample.

In Table 7, the baseline models are extended by introducing a quadratic term of the logarithm of a firm's revenue, the growth rate of revenue, employment as an alternative measure of size, and an aggregate measure of regional effects.

In Model (5) in Table 7, size as well as squared size are not statistically significant. As expected, a RESET test on the baseline model does not suggest the inclusion of a squared size term. The same procedure has been applied with higher order terms with the same results. Controlling for firm growth in Model (6) does not improve the explanatory power of the model and the coefficient for growth is statistically insignificant. Model

(7) uses the logarithm of the number of employees as an alternative measure of a firm's size. It turns out, however, that this measure is not statistically significant either. Model (8) estimates additional regression across regions using different regional coding, namely, south versus north, to investigate whether fast-growing SMEs are more profitable in the Southern than in the northern regions of Bulgaria, controlling for size. The categorical variable used for that purpose, namely NORTH, indicates a company located in the northern part of Bulgaria (value of 1) and not in the southern part (value of 0). The results suggest that companies located in the north are, on average, by 1.20 percentage points more profitable than companies located in the south after controlling for size. The size effect in this case is similar in magnitude, but again works in the opposite direction, i.e. the sign of its regression is negative. Of course, this could be due to sample bias, but future studies could focus on the role of broader economic and institutional factors that could possibly contribute to the explanation of regional differences in profitability. Additionally, the relatively low explanatory power of the econometric models suggests that other variables are needed to explain profitability. Indeed, variables measuring the internal environment of the firm are potential candidates but could not be explored in the study due to the nature of the data at hand.

Conclusion

To estimate empirically the effect of an increasing firm size on profitability, the study used a relatively large data set on 2523 small and medium fast-growing enterprises in Bulgaria. The results from our baseline regressions show that profitability, measured as a return on revenue, is negatively related to a firm's size. Specifically, on average, a one percentage increase in size is associated with a one percentage point decrease in returns. Although size does not explain much of the variance in profitability, its effect is highly significant. This is in line with previous studies, especially those focusing on firms in South-East Europe. For instance, it has been shown that the size-profitability relationship for small firms tends to be negative, while for large firms it tends to be positive, which suggests that it could take a U-formed shape in the total population of firms. Controlling for sectoral and regional effects is of great importance – sectoral effects, for instance, explain about 10 percent of the variation in profitability; regional effects, on the other hand, explain a smaller portion, but appear to be highly significant. The empirical estimation reveals that firms in the northern regions are more profitable than firms in the southern regions.

The results from the study imply that achieving significant scale is not necessarily associated with higher profitability. As suggested by previous theoretical and empirical research on the nexus between firm size, firm growth, and profitability, firm size brings benefits only if the firm has a higher profitability path, otherwise size could have negative effects. From a managerial perspective, this implies that putting extraordinary pressure on achieving a larger size could be misleading. Following a growth strategy to achieve larger scale becomes profitable when firms do have a competitive advantage which they can then scale up. Indeed, a recent study on the IT sector in Sofia, Bulgaria, suggests that companies focusing on products and services that create higher value to the customer tend to achieve a faster and sustained growth path (Endeavor

Insight 2022). To challenge or reinforce those results, future research could extend the data set used in the study. For instance, complementing size effects with effects of the institutional and internal (financial and organizational) environment on profitability might be interesting and also provide more ground for discussing implications for public policy. Finally, since one of the limitations of the study is the usage of cross-sectional data, employing panel data techniques across countries in the region of South-East Europe or across firms in Bulgaria could also help answer other questions related to the dynamic nature of the relationship between size, growth, and profitability in the region.

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