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How Do Small Firms Compete? A Demand-Based Perspective

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Small firms are disadvantaged when competing with large firms. Conventional wisdom suggests small firms should target niche markets neglected by large firms, but most large firms have used a niche strategy for some of their products, suggesting small niches are not safe anymore. This study attempts to address a key challenge small firms face: how to survive competition with few advantages. My main argument is that small firms should shift attention from the supplier-side competition to value creation in the demand environment. If consumer value is created, competition is likely rendered irrelevant.

INTRODUCTION

Organizational size has important impact on firms' competitive behavior and performance (Dean et al, 1998). Because of resource limitations, small firms are disadvantaged when competing with large firms. They face greater pressure to survive than their larger counterparts in a competitive market (Aldrich & Auster, 1986). How do they compete in order to survive and grow? It has been argued that small firms should pursue a niche strategy rather than confront their large rivals in the mass market (e.g., Cohn & Lindberg, 1974; Kao, 1981; Lee et al, 1999, MacMillan et al, 1982). They are encouraged to design specialized products serving market segments overlooked by large firms and be satisfied with low market share. These arguments are intuitively appealing because small firms possess insufficient financial resources and limited managerial capacity. In addition, they also suffer from a "liability of smallness" (Aldrich & Auster, 1986).

A niche strategy might be a best choice for small firms, but even niche markets are not safe anymore. According to Linneman and Stanton (1991), more than 75 percent of Fortune 500 companies have used a niche strategy for some of their products, suggesting that small firms cannot always avoid meeting with large rivals in the marketplace. If they do have to meet with large competitors, how should they compete? Can they survive competition given few advantages they possess? The literature does not have clear answers to these questions. This study attempts to fill the gap and explore small firms' competitive strategy from a new perspective. According to Adner and Zemsky (2006), research on competitive strategy tends to focus on "firms' supply-side interactions and largely neglect the demand environment in which these interactions take place" (P215). Thus, they introduced a demand-based perspective on firms' competitive strategy, emphasizing the importance of creating value for consumers. In this study, I argue that focusing on the demand environment is particularly important for small firms. It can help address a difficult challenge small firms face: surviving competition but having few advantages.

The remainder of the paper is organized as follows. First, I review the literature on firms' competitive strategy. Traditionally, the focus of strategy is to win competition by doing a better job than competitors (i.e., gaining competitive advantage), but the problem is that defeating competitors does not necessarily win consumers. Second, I introduce a demand-based perspective and develop a value creation framework for small firms. Finally, I discuss how small firms implement the demand-based approach.

LITERATURE REVIEW

Firms employ competitive strategy to survive and win competition in the marketplace. Studies on how firms should compete are not rare, but Porter's (1980) generic model of competitive strategy has been widely used. When it comes to small firms, scholars have argued Porter's generic model does not apply well. Therefore, Lee and colleagues (1999) developed a generic model specifically for small and medium-sized firms. In this section, I review the two generic models and discuss their limitations in the small firm context.

Porter's Generic Model of Competitive Strategy

According to Porter (1980), firms should pursue one of three generic strategies in a competitive market: differentiation, cost leadership, and focus. The differentiation strategy attempts to offer products or services that are unique and valued by customers. The unique value often results from product innovation and marketing. Differentiation allows firms to charge premium prices to increase profit margins. It also helps create customer loyalty which renders customers less price sensitive. Firms employing a cost leadership strategy attempt to be a low-cost producer for a given level of quality. It allows firms to either set prices below industry average to gain market share or set industry average prices to increase margins. Large scale is often needed to implement this strategy successfully. On the one hand, large scale can help reduce production costs; on the other, it may also give firms cost advantages in purchasing. A focus strategy targets a specific segment, whether it is a narrow market niche, a certain customer group, or a narrow geographic area. This strategy allows firms to concentrate resources. It also helps develop customer loyalty in the local area which discourages new entries.

Lee et al's Generic Model for SMEs

According to Lee et al (1999), most studies on competitive strategy do not explicitly take into account the impact of resource constraints. As a result, their applicability to small firms is limited. Because of resource limitations small and medium enterprises (SMEs) face, Lee et al developed three generic strategies specifically for them: niching strategy, free-riding strategy, and strategic alliances. To implement the niching strategy successfully, SMEs should first find appropriate niche markets. Then, they should offer products that are substitutable to those offered by their bigger rivals who are assumed to have no interest attacking SMEs in those niches. Lee et al's niching strategy is similar to Porter's focus strategy in terms of targeting narrow segments, but they are not the same. A focus strategy needs a cost advantage or differentiation to be effective, but a niching strategy does not need any of the two advantages.

SMEs employing the niching strategy use substitutable products to satisfy customer needs when competing with large firms. If substitutability is limited, SMEs may supply identical products and then free-ride on large competitors' market development and promotion efforts. How could large firms tolerate small firms' entry into their territory without retaliation? According to Lee et al, large firms sometimes would incur more costs if they choose to retaliate than accommodate. For example, if they aggressively attack small firms by depressing prices in the niche markets small firms are present, they would have to reduce prices in all other markets where substitutable products are currently supplied by them. Under this circumstance, they would be forced to accommodate small competitors in order to protect their own interests, though they have to incur a loss of some market shares.

As discussed above, the effective use of the niching and free-riding strategies is based on no direct challenges posed by large firms. However, this assumption may not always be true. If large rivals choose

to fight against SMEs, SMEs should signal that they are committed to staying in the market. To make their commitment credible, they need to form strategic alliances to overcome their resource disadvantages. Therefore, SMEs' choice of strategy is dependent on their large competitors' behaviors. If large firms are accommodating, SMEs can use the niching or free riding strategy. Based on Lee et al, each of the two strategies can be implemented successfully even if SMEs have cost disadvantages. If large firms are aggressive, SMEs should form strategic alliances with other firms to ensure effective competition. Compared with Porter's model of competitive strategy, Lee et al's model not only takes into account resource constraints, but also competitive interactions.

Discussion

The two generic models provide implications for strategy formulation in a competitive environment. How well do they guide small firms' choice of competitive strategy? Porter's differentiation and cost leadership strategies have limited applicability in small firms. Differentiation can be achieved through innovation or marketing. Large firms often have comparative advantages in developing technologically advanced products. Differentiation through marketing might even be less relevant to small firms because they lack marketing dollars to establish brand awareness (Ebben & Johnson, 2005). For cost leadership strategy, Porter noted that the size of small firms prevents them from achieving economies of scale, so they rarely succeed when competing on low prices.

Among Porter's three generic strategies, probably only the focus strategy applies well in the small firm context (e.g., Cohn & Lindberg, 1974; Kao, 1981; Rugman & Verbeke, 1987). To implement a focus strategy effectively, firms still need to achieve either a cost advantage or differentiation within the narrow segments, i.e., focused cost leadership or focused differentiation. How do small firms gain cost or differentiation advantages in niche markets? They may use the following approaches to reduce operating costs: adopting a simple organizational structure and administrative process, employing a "shoe-string" approach (Weinrauch et al, 1991), or providing standard products (Ebben & Johnson, 2005). Though these approaches can help lower costs, they do not necessarily give small firms cost advantages over large firms. Small firms are agile and flexible, while large firms are subject to structural inertia (Hannan & Freeman, 1984) and are likely "locked into" existing products, prices, and cost positions (Cooper et al, 1986). Therefore, small firms may differentiate themselves through agility and flexibility. For example, they could challenge large competitors in a speedy and secretive way (Chen & Hambrick, 1995). However, small firms may not always be able to exploit their agility and flexibility well. In relatively stable markets, for example, these strengths may not translate into real competitive advantages.

In Lee et al's model, a niche-based strategy is also emphasized, but it is implemented in different ways. They introduced competitive interactions into their model: small firms' strategy in niche markets will depend on large competitors' responses. They argued that large firms may not always attack small competitors in the same market because by doing so they will have to incur high costs. Therefore, large firms are likely to sacrifice some market shares to protect their overall interest. As a result, small firms do not have to possess cost or differentiation advantages in order to survive in niche markets. Other scholars have also suggested that small firms use a niche-based strategy based on competitive interactions. For example, MacMillan, Hambrick, and Day (1982) argued that small firms can seek out niche markets small enough so that larger firms do not bother to exploit them. In addition, small niches often require customized products and specialized customer services large firms might hardly offer on an individual basis. Therefore, small firms are "protected" and are able to avoid head-on confrontation with their larger counterparts.

Lee et al's model seems to be different from Porter's model, but they share a common feature: using competition as a frame of reference when designing strategy. Porter's model emphasizes gaining competitive advantage, but small firms are disadvantaged due to their resource limitations. It is harder for small firms to gain competitive advantage than their larger rivals. Lee et al's model directs attention from competitive advantage to competitive interactions: how small firms compete will depend on how large firms will respond. If large competitors choose to accommodate, small firms do not need competitive advantage to survive. While this approach helps small firms address a challenge they face, that is,

surviving competition with few advantages, it has an application problem: how to precisely predict large competitors' behaviors. Lee and colleagues themselves noted that large firms do not always act predictably or rationally and they sometimes attack small firms in the same market without consideration of high costs.

The discussion above suggests that though it has generally been agreed that small firms should focus on niche markets, it is still not clear how small firms can implement a niche-based strategy effectively. Based on Adner and Zemsky (2006), existing studies on competitive strategies have largely used a supply-side perspective. This perspective focuses on how firms, that is, suppliers of products or services, compete with each other in order to survive and grow in the marketplace. A main problem of this perspective is that when it guides strategy formulation, it often starts from competition and neglects the demand environment in which competition takes places. To engage in competition, firms often vie to offer better products or services to consumers but fail to consider whether consumers would really appreciate increased performance or added features. When firms participate in this competitive game, they are also less likely to investigate whether consumers are willing to pay. Both Porter's model and Lee et al's model employ the supply-side perspective, though the latter includes a particular competitive situation: small firms' coexistence with large competitors.

I argue that in the small firm context, the problem of the supply-side perspective would become worse. Lacking resources is small firms' basic issue. As a result, they can hardly match large firms' practices in aspects like scale and innovation, let alone surpass them. They can be easily driven out of the competitive game. Therefore, using competition as a frame of reference is less workable for small firms. In addition, they are rarely mentioned in the business press and very few can earn well-known names and reputation (Fiegenbaum & Karnani, 1991). If products are comparable, consumers would be more likely to choose well-known brands. This is another reason why competitive benchmarking is less successful for small firms. Caves and Pugel (1980) found that small firms often performed better if they used strategies that were different from large firms, suggesting a reexamination of using competition as a frame of reference.

If small firms do not use competition to guide strategy formulation, how can they survive competition? One solution is to turn attention from the supply-side to the demand-side and create value for consumers rather than try to defeat large competitors. This perspective is based on the assumption that "competitive battles are fought in the minds and hearts of consumers" (DeSarbo et al, 2006). In other words, the firm needs to win consumers' hearts to succeed in a competitive world, which is dramatically different from the supply-side perspective: the firm needs to offer better products than those offered by its competitors in order to succeed. Consumer value is a key concept of the demand-based perspective. To win consumers' hearts, the firm will need to create value for them. Understanding what consumers actually value in a product or service and then creating value for them are a necessary condition for firm survival.

This demand-based perspective is likely to help answer the question: how small firms can survive competition when possessing very few advantages. According to Kim and Mauborgne (2004), if a firm is able to solve customer problems, competition is rendered irrelevant. For small firms, therefore, they can start from the demand side. If their value proposition meets consumers' expectations, they do not have to benchmark their products or services against competitors and then try to beat competition. In the next section, I discuss how to implement the demand-based approach in the small firm context.

A DEMAND-BASED APPROACH FOR SMALL FIRMS

A Demand-Based Approach

Firms employing a demand-based approach start from the demand environment and then create value for consumers. Defining the demand environment is often the first step. It is composed of consumers, but to be a viable demand environment, it must provide opportunities for firms to create value for consumers. From this point of view, we need to know both the consumers and the value created for them in order to understand this environment well. Consumers can be described in many ways. For the purpose of this

study, I address them in a context of value creation. According to DeSarbo et al (2001), consumer heterogeneity is an important component in the analysis of consumer value, but it has often been neglected. Consumers are often assumed to be affected in the same manner. Actually, they are more likely to have heterogeneous interpretations of perceived value regarding a particular product or service. Their tastes for quality vary across market segments. Therefore, consumer value needs to be addressed on the individual basis.

Desarbo and colleagues (2001) defined consumer value as a tradeoff between perceived product quality and perceived product price. Perceived quality is subjective, so it is less measurable and verifiable. Perceived price is consumers' subjective perception of the objective price of the product (the actual price of the product). Since both quality and price are perceived, consumer value is also perceived. According to Zeithaml (1988), consumers also view price as 'what is given up or sacrificed to obtain a product' (P10), suggesting the importance of value creation. The more value a product is perceived, the more likely consumers are to give up other things in order to acquire it. Porter (1985) treated consumer value as a tradeoff between perceived product performance and buyer cost. The two definitions are similar. They convey three common features regarding consumer value. First, the overall excellence of the product, whether expressed as product quality or product performance, has positive impact on consumer value. It is often used to solve the consumer's problems. Second, the price the consumer pays to obtain the product has negative impact on consumer value. It is the cost the consumer bears to get his/her problem solved. And third, consumer value has a subjective element. Based on the three features, consumer value may also be understood as a surplus between what the consumer obtains and the price the consumer pays. This surplus is perceived, thus, subjective.

Brandenburger (1996) defined consumer value in a different way: the consumer's "willingness-to-pay for the firm's product minus the price paid to the firm" (P10). Since consumers' willingness-to-pay is affected by perceived product quality or performance, a link exists between Brandenburger's definition and the definitions by Desarbo et al (2001) and Porter (1985). I argue that the concept "willingness-to-pay" provides more practical implications than the concept "perceived product quality" or "perceived product performance" in guiding value creation for consumers. Value creation will not materialize until consumers are willing to pay. The perception of high product quality or performance does not necessarily make consumers pay because there exist other influencing factors. In this study, therefore, I adopt Brandenburger's (1996) definition of consumer value.

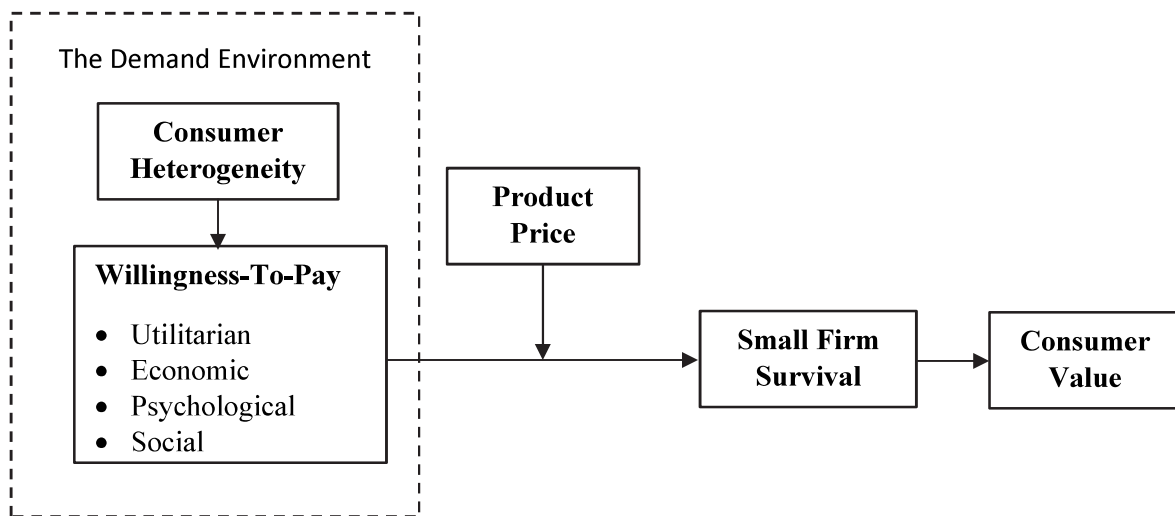
The concept "willingness-to-pay" (WTP) has been widely used in the field of marketing. It has recently been introduced to strategy research (e.g., Adner & Levinthal, 2001; Adner & Zemsky, 2006; Brandenburger, 1996). Homburg et al (2005) defined WTP as "the maximum amount of money a customer is willing to spend for a product or service" (P85). Most basically, people spend money for a product in order to solve their problems and meet their needs, so product quality or performance, as discussed previously, is often a fundamental reason for them to pay. Because consumers perceive product quality or performance (Brandenburger, 1996; Porter, 1985), so WTP is often subjective. Scholars have also identified other factors that may influence WTP. When studying WTP for technology-based products, Adner and Zemsky (2006) identified two influencing factors: taste for quality which is affected by the intensity of interest and ability to pay, as well as product performance. Ajzen and Driver (1992) used the theory of planned behavior to explore the nature and meaning of WTP. They treated WTP as a behavioral intention determined by the individual's attitude toward purchasing the product, perceived social pressure to buy it, and ability to afford it. The attitude toward purchasing is affected by the utility of the product and affective factors like interests or preferences.

In summary, WTP results from multiple reasons. First, product quality or performance has positive impact on WTP, though they are perceived. Consumers are less likely to pay for a product if it cannot help solve their problems. This is a utilitarian aspect of WTP. Second, affordability affects WTP. If the product is not affordable, consumers are unlikely to pay. This is an economic aspect of WTP. Probably, the utilitarian and economic aspects of WTP are necessary conditions for consumers to pay. Third, since WTP is subjective, it may also be affected by psychological factors like personal interests and preferences. Finally, WTP may have a social dimension. If peers or friends have purchased the product,

WTP is likely to increase. The utilitarian, economic, psychological, and social factors will not only affect consumers' willingness to pay but also how much they are willing to pay, so they drive consumer value. The multiple dimensions of WTP are associated with consumer heterogeneity. When different consumers purchase the same product, their heterogeneous conditions are likely to make their WTP different. Consumer heterogeneity and WTP are two important concepts which help understand the demand environment.

Based on the demand-based approach, a main task for small firms is to look for value creation opportunities in the demand environment and then create value for consumers. To create value, small firms need to increase consumers' WTP. They also need to price their products appropriately. Because of the subjective nature of WTP, any quick or effective solution to consumers' problems is likely to increase consumer value and thus WTP. Figure 1 shows how small firms use the demand-based approach to survive in a competitive market.

FIGURE 1
A DEMAND-BASED APPROACH FOR SMALL FIRMS



Implementation of the Demand-Based Approach

To implement the demand-based approach, small firms should first locate where they are going to be active, then identify what consumers actually value, and finally design products to solve their problems and exceed their expectations (making WTP greater than the price of the product). Since consumer heterogeneity plays an important role in value creation, small firms can look for segments where consumer needs are diverse rather than stable. For example, when a market is growing, it tends to involve a variety of consumer needs. According to Dean and Meyer (1996), a growing market can attract both small and large firms, but it often favors the speed and flexibility of small firms more than the deep pockets of large firms. If small firms are able to solve consumer problems in a quick and flexible way (satisfying utilitarian needs), WTP are likely to increase. Dean and Meyer also found that if a variety of needs exists in a market, brand loyalty enjoyed by incumbents would be a lesser problem, which creates opportunities for small firms.

When it comes to product offerings, customization is key. Ebben and Johnson's (2005) empirical study suggests that small firms can compete either on efficiency or flexibility. They measured efficiency as standard products and flexibility as made-to-order products, so their efficiency and flexibility are different from Porter's (1980) low cost and differentiation. When small firms offer made-to-order products, they customize the products to satisfy individual consumer needs. Offering standard products can be viewed as a special form of customization, which is to satisfy consumers' economic needs. Though

Ebben and Johnson's customization strategy was studied in a context of competition, it is consistent with the demand-based perspective. First, customization creates unique value for consumers. Second, consumer heterogeneity creates conditions for customization. From an operational point of view, small firms can implement customization effectively because compared with large firms, they are less bureaucratic and diversified. In addition, they employ fewer formal systems and procedures and conduct less planning.

DISCUSSION AND CONCLUSION

This study explores small firms' strategy in a competitive environment. Whether they should compete with large firms is a key question in the small firm literature. Answers to this question have not been consistent, but it has generally been agreed that a niche-based strategy is more realistic for small firms. The problem with this strategy is that large firms may not neglect niche markets, implying that small firms would need to compete with them. Traditional strategy theory suggests that to survive competition in the marketplace, firms need to possess competitive advantage. Compared with large firms, small firms are in a disadvantageous position. Though strategies specific to small firms have been developed, they are not easy to implement. In this study, I argue that to survive competition with few advantages, small firms need to avoid using supply-side competition as a frame of reference. They can shift attention to the demand environment and look for value creation opportunities. If small firms can create value for consumers, competition would be irrelevant. Adner and Zemsky (2006) equated added consumer value with competitive advantage. If firms create value for consumers, they actually gain competitive advantage, though not in the traditional way: doing better than competitors.

In the context of creating value for consumers, I develop a framework illustrating the demand environment and value creation opportunities small firms might exploit. Value creation will not materialize until consumers are willing to pay. Consumers' WTP is affected by multiple factors which result from consumer heterogeneity. Consumer heterogeneity is particularly important for small firms because it leads to opportunities small firms may exploit in an effective way. Compared with their larger rivals, small firms possess different resources and capabilities that make them particularly suited to certain environmental conditions (Dean & Meyer, 1996). They can target the markets where consumer needs are diverse rather than stable. Then, they can customize products to satisfy consumers' individual needs. Small firms have comparable advantages to implement customization due to their simple structure and systems.

The debate about whether small firms should confront big competitors has been going on for a long time, but there is still no clear answers. This study suggests that small firms may meet with large rivals in the same markets. They do not have to seek protected niches that are too small to attract large firms' attention (Carter et al, 1994; Cooper, Willard, and Woo, 1986). They can not only survive competition, but also grow. However, they should not focus on how to conquer large competitors. In reality, it is not very likely that small firms gain competitive advantage over large firms, but they can turn attention from large rivals to consumers. If they can create value for consumers, competition may become less important. They can exploit value creation opportunities from different angles, including utilitarian, economic, psychological, and social. These angles provide implications for small firms to design and customize products to satisfy consumers' diverse needs. Acs & Audretsch (1988) found that in industries dominated by large firms, small firms were more innovative, suggesting that small firms are able to create consumer value in an innovative way.

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