WHEN BIGGER ISN'T BETTER: THE STRATEGIC COMPETITIVE ADVANTAGE OF SMALL FIRMS

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Academic discourses are rife with implicit and explicit explanations for the benefit of firm size in today's increasingly global economy. Yet both in Canada and the United States an overwhelmingly large majority of businesses are small. This article first explores the theoretical bases of the widespread views that large firms have performance advantages over smaller firms, then proffers three types of competitive advantage most easily achieved by smaller firms.

Introduction

Canada is a small open economy in which a wide range of firms have achieved considerable success both domestically and internationally. Historically this success has come from a seemingly endless supply of natural resources, and to somewhat a lesser extent the processing of these resources into finished or semi-finished products. More recently success has come in the telecommunications and financial services sectors as the Canadian economy slowly reduces its dependence on the low value-added industries that contributed so greatly to our nation's wealth and the high standard of living we enjoy as a result. In fact Canada is evolving quickly into a knowledge-based economy with service industries employing three of four Canadians.

At a recent academic conference in Toronto there was a presentation on the high-profile failures of Canadian businesses. Underlying the analysis presented by these researchers was an implicit acceptance of the fact that due to the relatively small size of Canadian businesses and the domestic economy, failure was almost inevitable (and success stories were therefore more exceptions than the rule). At the heart of the issue is what constitutes 'success' and 'failure.' Beyond the most obvious type of failure, bankruptcy, there were examples of Canadian firms merging or being acquired with foreign firms as well as Canadian firms failing to thrive and not rising to the challenge of competing on a global basis. Implicit in these views of 'failure' are two assumptions, both of which are likely widely shared by the business community. The first is that a firm fails when it loses its Canadian ownership and identity. This is an ideological privileging of ownership and control that is perhaps poorly suited to today's increasingly global economy and the emergence of multi-national firms that have less of a clear foundation in any particular country. The second, and perhaps more interesting from the perspective of strategic management and organizational theory, is that firms must continue to grow in order to be viewed as 'successful.' In this article I explore the second issue by outlining the basis for this assumption in the academic discourses on organizing and subsequently challenge this privileging of organizational size as a prime determinant of firm performance.

Theoretical Bases of the Size-Performance Relationship

In one way or another, most theories of organization explicitly or implicitly privilege large organizations. These theories are the foundation of business school curricula and popular press writings that shape notions of 'common sense' business practices in ways that help form the assumptions I just described. Prior to challenging these assumptions it is important to first understand where they come from and identify the circumstances under which they are correct. I will focus here on three distinct theories of organization: resource dependence, transaction cost theory and population ecology.

Resource dependence theory[i] is premised upon the view that organizations are largely externally constrained. In other words, no organizations are internally self-sufficient – they rely on resources from their environment for survival and are therefore interdependent with the elements of the environment in which they interact. This theory is fundamentally about explaining the bases for a firm's survival, which is done by first understanding its ability to remain effective. Key to organizational survival is the ability to acquire and maintain resources, an activity that is made problematic by the interdependence of an organization and its environment. This interdependence is not in and of itself problematic – it is inevitable. The problem comes from the fact that the environment is not dependable. Environments can change in many ways, for example as new organizations enter and exit an industry, or the supply of resources changes in terms of location, price or quality. An organization is therefore driven by its external dependencies, most notably so by sources of resources necessary and important for its continued survival. The two elements to resource dependence theory that are important to this discussion are therefore: first, that organizations must respond more to the demands of those organizations in the environment that control critical resources; and second, that organizations must manage critical dependencies to ensure survival and to acquire more autonomy and freedom from external constraint. In light of these observations, larger firms should have advantages in terms of minimizing the power imbalances that exist between themselves and those who supply critical resources. An organization's desire for uncertainty reduction and autonomy are intuitively appealing and reflect the inherently competitive nature of most industries. The larger organization is better able to reduce or stabilize the interdependencies that potentially threaten its survival by reducing power asymmetries and securing a more reliable supply of resources on more favorable terms.

Transaction cost theory,[ii] sometimes referred to as organizational economics or agency theory, is centrally concerned with the transactions firms engage in as they exchange goods and services with other people/organizations. This theory has a somewhat unique focus. Rather than examining the bases for effective production, it directs attention to the exchange of goods and services, in particular the structures that govern these exchanges. In a 'market' system, exchanges occur based on contractual arrangements. This system works under conditions when all parties act competitively (that is governed by self-interest), and the price system signals what goods and services in what quantities are desired, and therefore profitably produced. This logic is very clearly rooted in Adam Smith's notion of the 'invisible hand of competition,'[iii] a foundational concept in economics. As Smith pointed out so long ago, one does not need to know much about the participants in any transaction as long as individuals know their own preferences and price can act as a basis on which to make decisions. The reality is, however, that complexity and uncertainty make it difficult to create contracts to deal with all possible contingencies. This gives rise to the 'organization' as an alternative to market-mediated transactions. In the context of less than perfect information and opportunism of exchange partners, exchanges may be inefficient due to cheating and misrepresentation. Organizations bring these exchanges under a hierarchical structure that can better monitor them and discourage opportunism through incentives. Transaction costs can also be minimized through employment contracts that create relatively diffuse, open-ended contracts between parties. This theoretical perspective is therefore very clearly efficiency-seeking, with the firm choosing a governance structure that is best "in terms of their capacities to economize on transaction costs."[iv] Organizations exist only as a result of market failures – a rather simplistic argument but one that makes complete sense. This is seen on a practical level in the make/buy decisions of firms, with the preference being for the latter only to the extent to which transaction costs associated with monitoring performance exceed the costs of internalizing the transaction. Larger organizations should be at an advantage due to their ability to internalize more exchanges of a wider variety. Whether or not they do so reflects their choice, something that small firms are often unable to do. A smaller firm, due to its limited financial and human resources, is often able to choose only between possible contractual partners rather than provide an alternative to market exchanges that would minimize transaction costs.

Population ecology[v] focuses on the study of organizational diversity. Using an ecological metaphor it explains how environmental conditions influence the creation of new organizations and organizational forms, their subsequent rates of demise, and the rates of change in organizational forms. By emphasizing the evolutionary dynamics of the process influencing organizational diversity, this theory directs attention to the role of selection processes. By focusing on populations of organizations, this theory attempts to explain why certain organizations or types of organizations survive while others do not. Central to this theory is the notion that the environment differentially selects organizations for survival. For this to happen there must be variety in organizational forms, the selection of some forms over others, and the preservation of those forms. In other words, this theory tries to account for the births and deaths of organizations. One such explanation is the 'liability of smallness'[vi] thesis. The principal tenet of population ecology is that once founded, organizations are subject to strong inertial pressures. Because inert organizations have lower mortality rates, selection processes provide survival advantages to larger organizations. Some reasons for this include the difficulty in raising money, relatively high costs of complying with regulations and an inability to compete in a labor market for highly skilled workers.

As the preceding discussion shows, the 'bigger is better' logic is firmly embedded in management thought. This is perhaps most clearly seen in Michael Porter's treatment of industry competitive forces in his famous five-forces analysis.[vii] As a tool for assessing industry attractiveness, this framework draws heavily on notions of power – in a competitive industry the powerful will exploit the powerless to their advantage in a relentless pursuit of self-interest. Buyers exert power through their ability to switch suppliers and/or demand more favorable terms and conditions of their transactions. Suppliers exert power by virtue of their control of important resources, and the resulting ability to raise prices or reduce quality. Although power is not synonymous with size, it is highly correlated with it. This leaves many organizations in a rather precarious position. Most Canadian organizations are not large by any standard, so what strategies can they employ to be successful in the long run? And more interestingly, new organizations invariably start off quite small, so how can they survive in an increasingly competitive industry that in so many ways favors large organizations?

Strategic Advantages of Small Firms

The discipline of strategic management is primarily concerned with firm performance. In other words, how does a company become successful and stay successful? In the introductory chapter of *Concepts in Strategic Management* [viii] I address this by first questioning what it means to be successful and then categorizing environmental and organizational factors that directly influence firm performance. In this article I will reorient this discussion to the size-performance relationship paying particular attention to the competitive advantages that smaller firms are more likely to possess. These come from (i) developing and implementing strategies of restricted scope, (ii) building capacities for innovation and change, and (iii) resisting the temptation to make growth a strategic priority.

A good place to start is with the firm's strategy itself. Michael Porter introduced the notion of 'generic competitive strategies' a long time ago, and despite the inherent problems associated with creating any sort of typology, his ideas are still influential in shaping ideas about *how* firm choose to compete. The smaller organization invariably adopts a focus strategy, one that concentrates efforts on "a particular buyer group, segment of the product line, or geographic market."[ix] The potential for success of this strategy rests on serving a relatively small segment of the market particularly well (and the concomitant inability of larger firms who compete more broadly to do so). This is a common strategy for new firms, especially those not particularly well resourced. Because the market opportunity sought is relatively small, a focus strategy can be implemented with minimal investment in resources and at the same time not pose any significant competitive threat to established rivals.

A firm that has done this exceptionally well is Nautel Limited of Hackett's Cove, Nova Scotia. It specializes in high power, exclusively solid state RF equipment operating in LF through VHF frequency bands, earning an international reputation in the design and manufacturing of exclusively solid state radio transmitters. Since 1969, customers have put Nautel's transmitters in the field for AM broadcast, FM broadcast, and navigation assistance applications. Nautel products can be found in more than 160 countries, on every continent, and in climates ranging from arctic, to desert, to jungle. This firm owes much of its success to being able to take very mature technologies (AM and FM broadcasting) and using them in relative narrow market segments (Aeronautical/Marine Navigation) in which it gradually established dominance. It also used this technology in many parts of the world affected by civil wars and political conflict to provide temporary mass communication. The strategy used by Nautel has consistently been one of using an established technology in a limited number of market segments in order to establish its reputation and help build a leadership position. Any focus strategy creates an upper limit on overall market share and sales – the consequence of focusing is to forego sales volume in the pursuit of superior need satisfaction and profitability.

A second type of advantage that smaller firms can use to offset the various benefits of size rests on building capacities for innovation and change. Although smaller firms have no monopoly on these capacities, their less complex organizational structures and more informal procedures permit them to adapt to changing environments and develop strategic flexibility. This demands a commitment to developing and nurturing organizational capabilities that facilitate change, both in response to exogenous events and in the ways work is currently performed. In other words, by becoming a 'learning organization'[x] that is skilled at creating, acquiring and transferring knowledge, and at modifying its behavior to reflect new knowledge and insights, organizations can more successfully compete in competitive environments characterized by more intense rivalry, changing customer tastes and rapid technological change. In order to gain these advantages firms need to foster organizational cultures that reward innovation and risk-taking as well as normalize continuous learning and change. At an operational level, this could involve the manifestation of a core value in continual self-examination and experimentation in decision-making processes, employee training and development, staffing decisions and communication processes. This process should not be all that daunting because it builds on people's inherent commitment and capacity to learn.

A relatively new management ideology that attempts to capture the benefits of innovation thinking at the production level is 'lean thinking,'[xi] a production strategy that identifies and eliminates waste (non-value-added activities) through continuous improvement. Developed in Japan by Toyota, this strategy involves not only manufacturing processes, but also organizational culture. In a lean environment, products are made just-in-time, and quality management is embedded into all processes. Hermes Electronics Maritime Systems (UEMS) of Dartmouth, Nova Scotia is a leader in the development and manufacture of advanced electronic and electromechanical systems. It has earned this reputation over a fifty-year period of success at designing and producing products for critical applications in extreme environments. UEMS is wholly owned by Ultra Electronics Holdings plc, UK, an internationally based group of businesses specializing in aerospace and defense electronics. A modern 150,000 square foot facility houses a skilled staff of engineers, technologists, and production personnel. The company's strengths include product and systems engineering, the design and development of electronics and mechanical piece parts, and expertise in packaging of electro-mechanical assemblies. In the past twenty years, UEMS has developed and produced more than 1.5 million sonobuoys and is currently recognized as a market leader in the field of passive acoustic sensors. Lean manufacturing was originally introduced to UEMS in 1999, however the real benefit to the organization was not realized until 2001 when senior managers began mapping current and future state value streams and implementing continuous flow cells. This has been fully supported by a comprehensive TQM program, with production personnel being empowered to identify and implement areas for continuous improvement.

The third component of this discussion takes a different look at the way small firms can be successful. Whereas the previous advice suggested ways to successfully choose restricted scope strategies and develop capacities for innovation and change, I now turn to perhaps my more controversial piece of advice – to resist the temptation to make growth a strategic priority. In other words, managers should think about the 'bigger is better' logic very closely before attempting to turn a successful smaller firm into a successful bigger one. The point here is that growth will naturally follow from an organization's success, but it should not be a goal or objective that determines major strategic decisions. Michael Porter's more recent work highlights the role of 'strategic positioning'[xii] in achieving superior performance. This requires performing different activities from rivals or performing similar activities in different ways – which ever way we look at it, firms need to be different and not simply copy the bases for operational efficiencies that lead to temporary advantages because it leads to relative improvement for no one in the long-run. Successful strategies therefore rest on doing something unique and being prepared to make the trade-offs necessary to capture the advantages of being unique. This requires choices to be made, ones that purposefully limit what a company offers and where it chooses to compete. We can see this very clearly in the strategy of CanJet Airlines, a division of I.M.P. Group International Inc. of Halifax, Nova Scotia. As a national discount carrier, CanJet's strategy illustrates a willingness to choose and the refusal to imitate everything about its rivals. In order to improve its cost structure and optimally serve its market niche (price-sensitive customers) it foregoes the potentially lucrative trans-Atlantic routes and upper-class seating. These choices reflect a willingness to sacrifice top-line sales growth for bottom-line profitability. Porter highlights the tendency for firms to be uncomfortable making these decisions because they appear to constrain growth – a decision-maker knows that an increase in sales has the potential to increase profitability and the value of a firm, but the exact amount cannot be identified as easily. Managers are therefore tempted to make incremental changes to its strategy to capture these opportunities, but this often occurs at the cost of eroding the firm's original competitive advantage. Rather than fall into this 'growth trap,' a focus on profitable growth is crucial, one that does not compromise competitive advantage, destroy firm value or create inconsistencies among a firm's activities.

Conclusions

The relationship between size and firm performance is by no means simple, as I have attempted to show in this article. Many theories of organization are quite explicit about the advantages of large firms, but in today's economy with all its environmental uncertainty, new possibilities for successful smaller organizations are presenting themselves. Richard D'Aveni's popular book *Hypercompetition* describes a new competitive reality in which change, rather than stability, is the norm.[xiii] Under such conditions, "market stability is threatened by short product life cycles, short product design cycles, new technologies, frequent entry by unexpected outsiders, repositioning by incumbents and tactical redefinitions of market boundaries as diverse industries merge." Regardless of whether or not industries ever evolve to this extreme form of competition, the competitive landscape faced by many firms is now one of much more uncertainty and instability than ever before.

The three strategic advantages of small firms I described in this article represent generic bases of success that are available to any organization. I argue that they are more easily obtained by smaller firms and therefore represent a competitive strength that can be used to offset the many benefits of size discussed in the first section of this article. My purpose in showing both sides of the size-performance relationship is to illustrate that any strategic decisions involve tradeoffs and that only very rarely do optimal solutions present themselves in a straightforward way. When teaching strategy I encourage students to recognize the tradeoffs that are inherent in any strategy, and rather than make these uncritically (as unfortunately many organizations do), to make them consciously so that they will more likely result in consistent and reinforcing activities within the organization that strengthen competitive position rather than weaken it by, for example, creating an inconsistent image of a firm's products or by sending mixed signals within an organization with respect to its strategic priorities. The organizations I have featured in this article are examples of strategically sound and inarguably successful companies. They each display at least one important characteristic that portends an organization's success. I hope this discussion begins to challenge the 'common sense' notion that a successful business is necessarily a large or global business. If that were the case, most businesses (not only in Canada) would have to be considered unsuccessful. Rather than privileging size among the determinants of firm performance, we should be more alert to the capabilities that more flexible and responsive smaller organizations can develop and exploit more easily than larger ones. In other words, bigger isn't necessarily better when it comes to business.

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