Journal of Strategic Management

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Stratford Peer Reviewed Journals and Book Publishing
Journal of Strategic Management
Volume 1||Issue 1||Page 1- 12||November||2017|
Email: stratfordjournals.org ISSN: XXXX-XXXX

Effect of Product Innovation and cost leadership Strategy on the Financial Performance of Small and Medium Enterprises

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Abstract

The success and sustainability of any organization in a competitive environment is determined by its choice of strategy. Most strategies are replicated by competitors and thus a company must position itself in the minds of the consumer in order to remain competitive. The significance of small and medium sized enterprises to world economies and Kenya in particular cannot be over emphasized. SMEs make up the largest business sector in every economy. The lack of proactivity, innovativeness, risk taking and overall poor entrepreneurial orientation have negatively impacted on the SMEs. The study sought to determine whether product innovation and cost leadership strategy were positively associated with business performance of Small and Medium Enterprises in Nairobi County Kenya. Explanatory research design was used in the study. The target population of the study was made up of 7384 SMEs and a sample of 95 SMEs was picked using systematic random. Primary data was collected using a questionnaire with both structured and unstructured questions. Descriptive statistics such as mean and frequencies and inferential statistics such as regression and correlation analysis was used to perform data analysis. The study found out that product innovation and cost leadership strategy were positively and significant related to and financial performance. The study concluded that that product innovation and cost leadership strategy have a positive and significant effect on the financial performance of SMEs. The study recommended that to accomplish the goals of SMEs in the light of growth and profitability, management need to have a positive rethink towards the use of strategic management.

Keywords*: Product innovation, Cost leadership strategy, Financial performance and Small and Medium Enterprises*

1.0 Introduction

1.1 Background of the Study

Small scale business constitutes the real fabric of a nation's economic development. Globalization has made business system to have undergone a number of changes in recent years. These changes are accompanied by growth both in size and magnitude. To cope with these changes, modern management techniques are used in contemporary business environment. One of such techniques is strategic management. Strategic management refers to the managerial decisions taken by organization to cope with the changing environment for improved short and long-term performance (Stahl & Grigsby, 2007). The principal responsibility of the practicing manager is to ensure that the organization keeps in touch with the external environment. The manager must also see the essence of management in terms of services to customers.

Development strategists have advocated the progressive use of SMEs to accelerate the pace of economic growth especially in the developing countries. In the process, entrepreneurship education and promotion of entrepreneurial spirit has received adequate attention in several countries, particularly the so-called Asian Tigers (Owualah, 2001). Typically, entrepreneurship development follows a cycle consisting of stimulating, supporting and sustaining activities (Fadahunsi, 2002). The stimulating activities ensure the supply of entrepreneurs ready to take initiatives and organize their enterprises by risk taking through awareness programmes. The supporting activities however, provide infrastructures and resources like information, finance, technology, ability and skills for enterprise launching. The sustaining activities refer to those efforts that facilitate the growth and continuity through expansion, modernization, diversification, technology and provision of enabling environment for growth and survival of small and medium scale enterprises (National Investment Promotion Commission, 2004).

In Kenya, the Micro, Small and Medium enterprises are variously referred. Micro and small enterprises fall under the popular informal sector called Jua Kali as they largely start in the open sun under no roof. The sector employs over 80% and is currently receiving a lot of government attention as it is seen as the solution to the crippling unemployment especially for the youth. Over 65% of Kenyan population is youthful and unemployed. It is estimated that today, Kenya's informal sector constitutes 98 percent of all businesses in the country, absorbs annually up to 50 per cent of new non-farm employment seekers, has an employment growth rate of 12-14 percent, contributes 30 percent of total employment and 3 percent of GDP'.

The Kenya Economic Blue Print espouses that by the year 2030, the country would have been transformed into a newly industrialized nation. If the country has to make this leap, then SMEs are expected to play a key role in transforming the economy. However, in order to effectively play this role, the SMEs have to succeed and the failure rate characterizing the sector be minimized if not abolished. However, challenges still abound (Nyanja, 2009). Studies have shown that many do not celebrate their third birthday (Sessional paper, 2005). Among the reasons that have been advanced to explain the high rate of business failure is poor strategic management practices as the latter is normally associated with the large organizations.

Strategy has been proven to plays a crucial role in the firms' performance (Hlavacka, Ljuba, Viera & Robert 2001)) as it gives the direction that a firm has in mind and in which way they want to achieve their goals. The performance of an enterprise is determined by the business strategy it adopts. Since business environment is dynamic, firms need to review their competitive strategies on periodic basis. The review is necessary to ensure that firms only invest in the strategies that can make their business improve performance.

1.2 Statement of the Problem

Despite the great role which the SMESs play, major benefits have remained a mirage due to lack of proper strategic managements practices by the owners and total failure by the regulatory authorities in properly playing their part (Nyanja, 2009). Both the investors and their employees are not trained or well developed for the long term need of the industry. Lack of proactive, innovativeness, risk taking and overall poor entrepreneurial orientation have negatively impacted on the SMEs (Rumba, 2008). The said investors are not economically and technically capable of dealing with the dynamics and frequent changes that take place within the business.

Previous studies on SMEs have attributed to a number of factors on their perpetual failure- ranging from inadequate accounting procedures to their inability to manage growth (Beaver, 2007). However, it is the overall lack of strategic management skills and abilities that seem to be the overarching reason (Beaver, 2007). From this stand point, it is reasonable to suggest that strategic management could be a key determinant in improving business performance of SMEs. Studies carried in Kenya (Ochako, 2007; Muthangya, 2007; Olunga, 2007; Rumba, 2008) emphasized on the importance of strategic management practices. The study focused on the effect of product innovation and cost leadership on the financial performance of Small and Medium Enterprises in Nairobi County Kenya.

1.3 Specific Objectives

i. To determine the effect of product innovation on financial performance of SMEs.
ii. To establish the effect of cost leadership strategy on the financial performance of SMEs.

1.4 Research Hypothesis

H_0: Product does not influence financial performance of SMEs.

H_0: Cost leadership strategy does not influence the financial performance of SMEs.

2.0 Literature Review

2.1 Theoretical Review

The theories that informed the study are Theory of Dynamic capabilities and Porter's Generic Competitive Strategies. This are presented in figure 1.

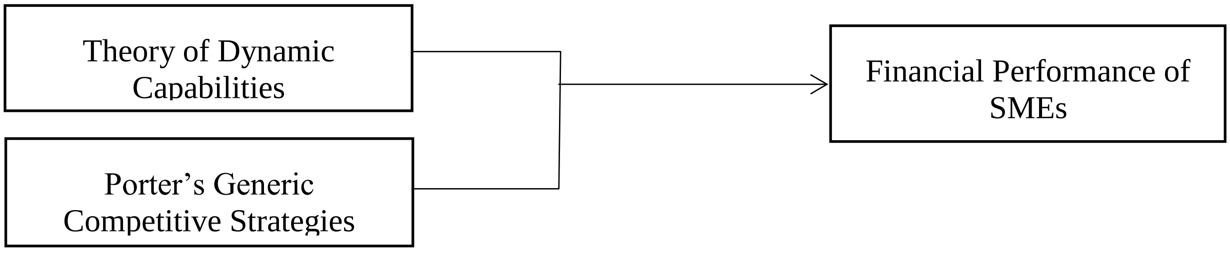

Figure 1: Theoretical Framework

2.2 Empirical Review

Several studies have empirically investigated the impact of Porter's generic strategies on the performance of companies.

Ofunya (2013) conducted a study on the relationship of strategic management practices and firm performance in Post bank. The findings show that the strategies adopted by Post bank so as to cope with the competitive environment include vigorous pursuit of cost reductions, providing outstanding customer service, improving operational efficiency, controlling quality of products/services, intense supervision of frontline personnel, developing brand or company name identification, targeting a specific market niche or segment, and providing specialty products/services. The findings also show a significant relationship between the strategies adopted by Post bank in Kenya and their respective performances with respect to the following objective performance indicators: total revenue growth, total asset growth, net income growth, market share growth and overall performance or growth. This study presents a conceptual gap since the study was conducted on post banks while the current study is on SMEs (Hlavacka *et al.,* 2001).

Etim Udoh and Agu (2012) conducted a study on the impact of strategic management on corporate performance of selected small business enterprises in cross river state of Nigeria. The objectives of the study were; to determine the relationship between strategic management practices and performance of (Small Business Enterprises) SBEs; to determine the relationship between strategic management practices and market share of SBEs; to determine factors affecting strategic management practices of SBEs. Cross sectional survey design was adopted. The population of the study was hundred and two (102) owners/managers of the selected organizations. Systematic sampling technique was employed in selecting the organizations from the list of registered companies in the state. Questionnaire was the main instrument for data collection and was designed in a 5 point Likert scale format supported with personal interview. The data collected were analyzed with descriptive statistics, while the corresponding hypotheses were tested with Pearson Product Movement Correlation and Chi –square.

The findings indicate that there was a significant positive relationship between strategic management practices and performance of SBES; there was a significant relationship between strategic management practices and market share of SBEs. Infrastructural factors, macro environmental factors, and socio-cultural factors were found to be the major issues influencing the strategic management practices of SBEs. However, it was recommended that to accomplish the goaals of SBEs in the light of growth and profitability, management need to have a positive rethink towards the use of strategic management. The study had a contextual/geographical gap since it focused on Nigerian Economies. In addition, the study had a methodological gap since it failed to utilize factor analysis and odd ratio regression as this is the appropriate methodology of analyzing likert scale data.

Mutemi (2014) conducted a study on strategic management practices and performance of small scale enterprises in kitui town in Kenya. The objective of the study was to establish the strategic management practices employed by small enterprises in Kitui town, and how investment in personnel and skills, reaction to competitor actions, maintaining customer loyalty and product differentiation influenced performance of enterprises. The research involved a survey of 99 small enterprises in Kitui town out of a population of 7,246. Data was collected using questionnaires. Frequency tables and percentages were used to present the findings. Responses in the questionnaires were tabulated, coded and processed by use of a computer Statistical Package for

Social Science version 20 to analyze the data. Descriptive statistics like the mean and inferential statistics were used to derive meaningful findings and inferences. Results indicated that investment in personnel and skills was a key determinant strategic management practice influencing performance among small scale businesses. Results indicate that innovative products and services, levels of efficiency, ethical standards and new market entrants inflation ended performance to a great extent. The study findings reveal that investment in personnel and skills, competitor responses, management of customer loyalty and product differentiation are some of the strategies that can be used to manage performance of small enterprises. Communication was also found to act as a pertinent element of customer loyalty .Product differentiation ensures that a small enterprise is relevant and successful even in a highly competitive environment. Delegation of duties is also a crucial aspect that facilitates for excellent standards of motivation. This study focused on Kitui town thus presenting a geographical gap. The current study will focus on Nairobi County.

Dess and Davis (1984) examined the performance effects of generic strategies based on a sample of non-diversified manufacturing firms. They found that those firms can be classified into four clusters based on the strategies they adopt: cost leadership, stuck in the middle, focus, and differentiation. In terms of sales growth, the four groups were found to be significantly different from one another. The focus cluster was found to have the highest sales growth, followed by cost leadership, differentiation, and stuck in the middle clusters. In terms of return on total assets, the performance difference was not significant among the four groups. While the highest return was evident in the cost leadership group, the lowest was evident in the focus groups.

Grant (2000) observed that integrating Corporate Social Responsibility performance in the strategic management process by developing long term goals, improving the understanding of the complexity of a competitive environment, and assisting in the development of capacities and resources to learn and change as a parastatal, contributes to implement a successful strategy in the parastatals. Fan (2005) notes that the success of a parastatal depends on the relationship with its major stakeholders, understanding of the competitive environment, image and reputation built on transparency, information, communication and reporting practices. The study presents a conceptual gap since it strategic management practices on CSR performance only while the current study focused on the financial performance of SMEs.

2.3 Conceptual Framework

It is conceptualized that SME performance (dependent variable) is a factor of a set independent variables; innovation, cost leadership and integrated strategies. Each of the independent variables was assessed on how they influence the dependent variable. A schematic representation of the conceptual framework is presented in figure 2.

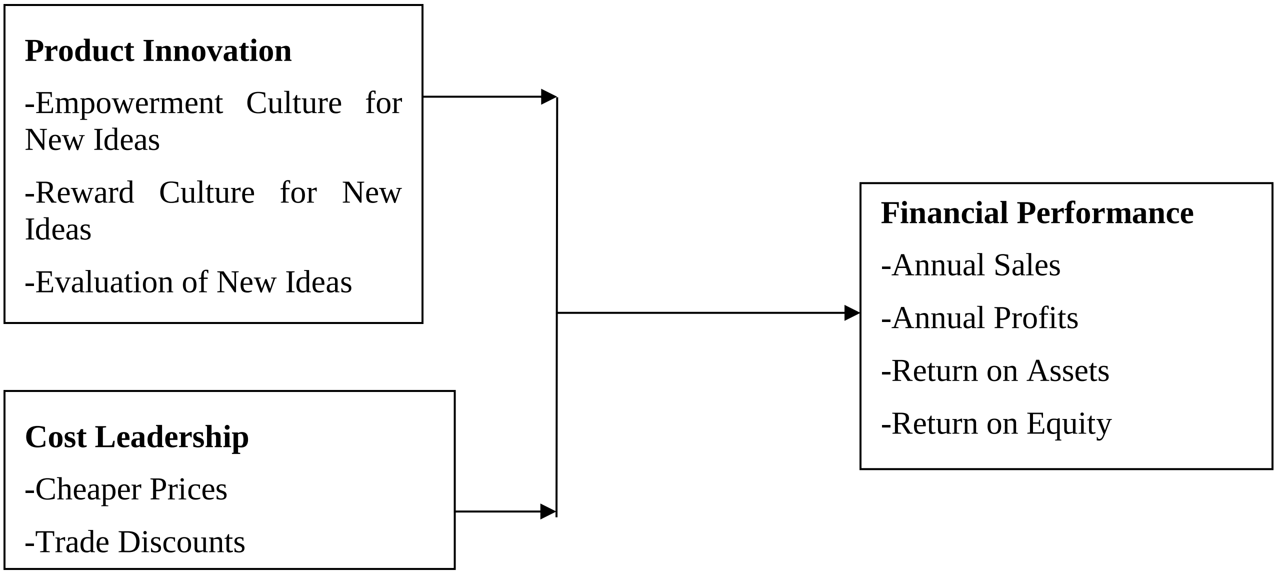

Figure 2: Conceptual Framework

3.0 Research Methodology

The study adopted an explanatory research design. The study target population was 7384 Small & Medium Entrepreneurs operating in Nairobi County. A sample size of 95 respondents was selected using random sampling. Primary data was collected using a questionnaire with both structured and unstructured questions. Inferential statistics (correlation and linear multiple regression analysis) were used to generalize the sample results to the population and these include ordinary least squares regression to test the relationship between product innovation and cost leadership strategy and financial performance of SMEs. A multivariate regression model was used to link the independent variables to the dependent variable as follows;

Model Specification

$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + e$

Where;

Y=Financial performance

X_1 = Innovative strategy orientation

X_2 = Cost leadership strategy

e=Error term

4.0 Results and Findings

4.1 Product Innovation

The study determined the effect of product innovation on the financial performance of SMEs. The respondents were asked to respond on statements on organization subculture. The responses were rated on a five likert scale as presented in Table 1. Majority of 78% of the respondents agreed that the enterprises have an empowerment culture and flexible organizational structure that support product innovation, 70% agreed that their enterprise reward an employee/group of employees for

Stratford Peer Reviewed Journals and Book Publishing
Journal of Strategic Management
Volume 1||Issue 1||Page 1- 12||November||2017|
Email: stratfordjournals.org ISSN: XXXX-XXXX

coming up with new ideas on products, 68.8% of the respondents agreed that employees have freedom to act without supervision if they, 78.8% of the respondents agreed that being innovator of a product/service is worth the risk and this has led to an increase in the enterprises' profits., while 83.8% of the respondents agreed that the manager regularly evaluates new ideas for products and processes in the enterprise On a five point scale, the average mean of the responses was 3.92 which mean that majority of the respondents were agreeing with most of the statements; however the answers were varied as shown by a standard deviation of 1.10. The results herein imply that product innovation influence the performance of SMEs.

The study informed that of Etim Udoh and Agu (2012) who conducted a study on the impact of strategic management on corporate performance of selected small business enterprises in cross river state of Nigeria. The findings indicated that there was significant positive relationship between strategic management practices and performance of SBES. Infrastructural factors, macro environmental factors, and socio-cultural factors were found to be the major issues influencing the strategic management practices of SBEs.

Table 1: Product Innovation

Statement	Strongly disagree	Disagree	Neutral	Agree	Strongly agree	Mean	Std. Dev
My organization have an empowerment culture and flexible organizational structure that support product innovation	5.00%	6.20%	10.00%	48.80%	30.00%	3.93	1.05
My organization reward an employee/group of employees for coming up with new ideas on products	5.00%	10.00%	15.00%	35.00%	35.00%	3.85	1.16
Employees have freedom to act without supervision if they	10.00%	5.00%	16.20%	40.00%	28.80%	3.73	1.22
Being innovator of a product/service is worth the risk and this has led to an increase in the enterprises' profits.	6.20%	10.00%	5.00%	55.00%	23.80%	3.8	1.11
The manager regularly evaluates new ideas for products and processes in the enterprise	0.00%	10.00%	6.20%	30.00%	53.80%	4.27	0.97
Average						**3.92**	**1.10**

4.2 Cost Leadership Strategy

The study also determined the effect of cost leadership strategy on financial performance of SMEs. The results are presented in Table 2 show that 70% of the respondents agreed that the enterprise lowers prices for products in order to maintain cost leadership and maintain a high turnover, 72.5% of the respondents agreed that the enterprise offer products at a cheaper rate than competitors on a consistent basis, rather than relying on sales, 80% of the respondents supported that the enterprise source products from cheap domestic suppliers and from low-wage foreign markets. This allows the company to sell their items at low prices and to profit off thin margins at a high volume, 82.5% agreed that the enterprise was able to keep prices low through a division of labor that allows it to hire and train inexperienced employees rather than trained ones while 71.3% agreed that the enterprise relies on few managers who typically earn higher wages. These staff savings allow the company to offer its products for bargain prices. Using a five point scale likert mean, the overall mean of the responses was 3.93 which indicates that majority of the respondents agreed to the statement of the questionnaire. Additionally, the standard deviation of 1.20 indicates that the responses were varied. The results herein imply that cost leadership influence the performance of SMEs.

The findings agrees to those of Mutemi (2014) who conducted a study on strategic management practices and performance of small scale enterprises in Kitui town in Kenya. Results indicated that investment in personnel and skills was a key determinant strategic management practice influencing performance among small scale businesses. Results indicate that innovative products and services, levels of efficiency, ethical standards and new market entrants inflation ended performance to a great extent.

Table 2: Cost leadership Strategy

Statement	Strongly disagree	Disagree	Neutral	Agree	Strongly agree	Mean	Std. Dev
The enterprise lowers prices for products in order to maintain cost leadership and maintain a high turnover	16.20%	5.00%	8.80%	11.20%	58.80%	3.91	1.54
The enterprise offer products at a cheaper rate than competitors on a consistent basis, rather than relying on sales	3.80%	15.00%	8.80%	40.00%	32.50%	3.83	1.16
The enterprise source products from cheap domestic suppliers and from low-wage foreign markets. This allows the company to sell their items at low prices and to profit off thin margins at a high volume.	5.00%	3.80%	11.20%	41.20%	38.80%	4.05	1.05
The enterprise is able to keep prices low through a division of labor that allows it to hire and train inexperienced employees rather than trained ones.	3.80%	5.00%	8.80%	42.50%	40.00%	4.1	1.01
The enterprise relies on few managers who typically earn higher wages. These staff savings allow the company to offer its products for bargain prices.	10.00%	5.00%	13.80%	42.50%	28.80%	3.75	1.21
Average						**3.93**	**1.20**

4.3 Correlation Analysis

The association between independent variables (product innovation and cost leadership strategy) and dependent variable financial performance of SMEs was established by the study. The results revealed that product innovation and financial performance are positively and significant related (r=0.484, p=0.000). The table further indicated that cost leadership strategy and financial performance are positively and significantly related (r=0.660, p=0.000). This implies that an increase in any unit of the variables leads to an improvement in financial performance. Results are presented on Table 3.

Table 3: Correlation Matrix

		Financial performance	Product Innovation	Cost Leadership Strategy
Financial performance	Pearson Correlation	1.000		
Product Innovation	Pearson Correlation	.484**	1.000	
	Sig. (2-tailed)	0.000		
Cost Leadership Strategy	Pearson Correlation	.660**	.401**	1.000
	Sig. (2-tailed)	0.000	0.000	

** Correlation is significant at the 0.01 level (2-tailed).

* Correlation is significant at the 0.05 level (2-tailed).

4.4 Regression Analysis

The study established the relationship between product innovation and cost leadership on the financial performance of Small and Medium Enterprises in Nairobi County Kenya. The results on table 5 present the fitness of model used in regression model in explaining the study phenomena. Product innovation and cost leadership strategy were found to be satisfactory variables in explaining financial performance. This was supported by coefficient of determination also known as the R square of 62.5%. This means that product innovation and cost leadership strategy explain 62.5% of the variations in the dependent variable which is performance of SMEs in Nairobi County. This results further means that the model applied to link the relationship of the variables was satisfactory.

Table 4: Model Fitness

Indicator	Coefficient
R	0.790
R Square	0.625
Adjusted R Square	0.429
Std. Error of the Estimate	0.3767297

Table 5 provides the results on the analysis of the variance (ANOVA). The results indicate that the overall model was statistically significant. Additionally, the results imply that the independent variables are good predictors of performance. This was supported by an F statistic of 22.719 and the reported p value (0.000) which was less than the conventional probability of 0.05significance level.

Table 5: Analysis of Variance

	Sum of Squares	df	Mean Square	F	Sig.
Regression	10.045	4	2.511	22.719	**.0000**
Residual	8.29	75	0.111		
Total	18.336	79			

Regression of coefficients results in table 6 shows that product innovation and financial performance were positively and significant related (r=0.179, p=0.005). The table further indicated that cost leadership strategy and financial performance were positively and significantly related (r=0.585, p=0.000).

Table 6: Regression of Coefficients

Variable	B	Std. Error	t	Sig
(Constant)	0.659	0.366	1.799	0.076
Product Innovation	0.179	0.061	2.916	**0.005**
Cost Leadership Strategy	0.585	0.117	4.996	**0.000**

Thus, the optimal model for the study is;

Financial performance of SMEs$= 0.659 + 0.179X_1 + 0.585X_2$.

Where:

X_1= Product Innovation

X_2= Cost Leadership Strategy

5.0 Conclusions

From the findings, the study concluded that product innovation, cost leadership strategy have positive and significant effect on the financial performance of SMEs. The study concluded that the strategies tend to be associated with higher levels of firm performance, particularly those strategies which place emphasis on a greater number of strategic dimensions, and specifically on innovation differentiation.

6.0 Recommendations

Based on the research findings, the study recommended that to accomplish the goals of SMEs in the light of growth and profitability, management need to have a positive rethink towards the use of strategic management. The study recommends that SMEs should scale up on the attributes of product and physical differentiation strategies if they are to compete in the growing market. The study recommends investment in product innovation, personnel and skills among small scale businesses. Investment in personnel and skills, competitor responses and management of customer loyalty are some of the strategies that can be used to manage performance of small enterprises.

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