Effect of Differentiation and Focus Strategies on the Financial Performance of Small and Medium Enterprises

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Abstract

Strategy is the key determinant of an organization sustainability in the current competitive business environment. Most strategies are replicated by competitors and thus a company must position itself in the minds of the consumer in order to remain competitive. Small and medium sized enterprises (SMEs) plays a significant role to the world economies and Kenya in particular. They make up the largest business sector in every economy. 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. The study endeavored to determine how differentiation and focus strategies affected the performance of SMEs 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 sampling. Structured questionnaires were used to collect data, which was then analyzed using descriptive and inferential statistic. Findings indicated that differentiation strategy and market focus strategy were positively and significantly related to financial performance. The study concluded that that differentiation strategy and market focus strategy had positive and significant effect on the financial performance of SMEs. The study recommended that to accomplish the mission and objectives of SMEs with consideration on growth and profitability, management need to have a positive rethink towards the use of strategic management.

Keywords: *Differentiation Strategy, Focus strategy, financial performance and Small and Medium Enterprises*

1.0 Introduction

1.1 Background of the Study

Strategic management is based on the belief that an organization should continually monitor internal and external events and trends so that timely changes can be made as needed. An organization must be capable of astutely identifying and adapting to change. The need to adapt to

change leads the organization to key questions such as: what kind of business should the firm engage in? is the firm in the right field? Should the firm reshape its business? What strategies should it pursue? Other cognate questions could also be raised (Aluko, Odugbesan, Gbadamosi, & Osuagwu, 2004).

Business is a high-stakes game. Repetitive plan or action to solve immediate and future problem and to move along with changing condition is a necessary prerequisite for organizational competitiveness and survival. Wrong or poorly planned and executed strategic move could lead to the loss of millions of dollars, thousands of jobs lost, jeopardized or even business to be bankrupt. Strategy to be successful, manager should consider the organization as a whole and not as any entity made of distinct and independent business units, and must include everyone in the organizational. Strategy is a detailed plan for a business in achieving success (Kazmi, 2008).

Today it is estimated that, 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'. To its credit, Kenya, unlike most developing countries, has in official development policies recognized informal enterprise as more than a residual employer for the survival of poor households. In its Sessional Paper Number 2 of 1992, Small Enterprise and Jua Kali Development in Kenya, the government identifies the small-scale and Jua Kali enterprise sector for support to assist it to "graduate into the formal sector" and to become a major player in the creation of new jobs and economic growth. Strictly speaking, the term Jua Kali refers to the full range of enterprises employing between 1-49 workers in all sectors. Access to technical and managerial training, work sites, involvement of Jua Kalis in technological innovation, and creation of a positive enabling environment are key elements in the Government's Jua Kali development strategy'.

It is also noteworthy that most of the businesses in this sector remain micro, employing less than five people and having such a high mortality rate as such, they never graduate into large or even medium organizations (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. This study hinged under the resource based theory. Resource based theory focuses on the idea that resources, skills and core competences and distinctive competence are important for companies to gain competitive advantage.

1.2 Statement of the Problem

The significance of small and medium sized enterprises to world economies and Kenya in particular cannot be over emphasized (Olson, Bokor 1995); Pushpakumari & Watanabe, 2005). They play a great role in the economy, however, 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 innovativeness, risk taking, proactivity and overall poor entrepreneurial orientation have negatively impacted on the SMEs (Rumba, 2008). These investors are not economically and technically capable of dealing with the dynamics and frequent changes that take place within the business.

Previous studies have been anchored on perpetual failure- ranging from inadequate accounting procedures to their inability to manage growth (Beaver, 2007). Nonetheless, it is the overall lack

of strategic management skills and abilities that seem to be the overarching reason (Beaver, 2007). Therefore, it is reasonable to suggest that strategic management could be a key determinant in improving business performance of SMEs. Nevertheless, it remains unclear from studies on subject matter conducted in Kenya, the relative order of importance of the strategic management practices on business performance (Ochako, 2007; Rumba, 2008). None of the aforementioned studies focused on strategic management practices and performance among SMEs. The study addressed the effects of differentiation and market focus strategy on the financial performance of SMEs in Nairobi County, Kenya.

1.3 Specific Objectives

i.   To determine how differentiation strategy affect the financial performance of SMEs.
ii.   To assess the extent to which market focus strategy affect the financial performance of SMEs.

1.4 Research Hypothesis

i. H_{01}: Differentiation strategy does not influence the financial performance of SMEs.
ii. H_{02}: Market focus strategy does not affect the financial performance of SMEs.

2.0 Literature Review

2.1 Theoretical Review

The theories that supported the study are Resource Based View theory and Porter's Generic Competitive Strategies**.** This are presented in figure 1.
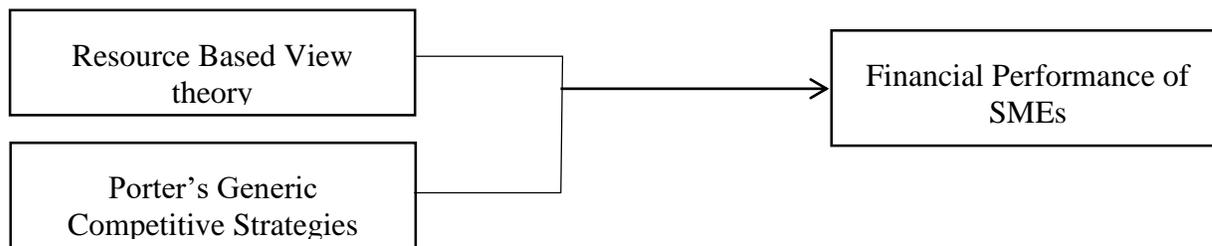
2.1.1 Resource Based View Theory

According to Teece (2007), the RBV does not adequately explain the process via which some firms reach positions of competitive advantage in dynamic markets or in situations of change. An approach based on dynamic capabilities endows the basic RBV perspective with a more dynamic nature which emphasizes the strategic value of higher order resources (dynamic capabilities) allowing the generation of and renewal of core competences and competitive advantage (organizational learning process). Teece, Pisano and Shuen (2009) emphasize the key role of managers in appropriately adapting, integrating and reshaping organizational skills and resources as well as internal and external functional competences. Dynamic capabilities act as a buffer between firms' resources and the shifting business environment by helping a firm adjust its resource base and thereby maintain the sustainability of its competitive advantage, which otherwise might be eroded. So, while the resource-based view emphasizes resource choice, or the selection of appropriate resources, the dynamic capabilities view focuses on resource development and renewal.

2.1.2 Porter's Generic Competitive Strategies

Porter (1980) hypothesizes that the level of competitiveness within an industry is dictated by a complex interaction of suppliers, customers, substitute products and the threat of new competitive entry onto the market. Companies in a highly competitive environment are forces to find competitive edge to survive. Porter (1985) claims that companies competing in a given industry must fulfil many different activities that form cost and create value for the customers. By using the competitive strategy, a company targets to position itself in a sustainable and profitable position against the forces shaping the industry. He asserted that there are basic businesses strategies –

differentiation, cost leadership, and focus – and a company performs best by choosing one strategy on which to concentrate.

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┌─────────────────────┐
│ Resource Based View │
│       theory        │──────────┐
└─────────────────────┘          │         ┌──────────────────────┐
                                 └────────▶ │ Financial Performance of │
┌─────────────────────┐          │         │         SMEs          │
│  Porter's Generic   │──────────┘         └──────────────────────┘
│ Competitive Strategies │
└─────────────────────┘
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Figure 1: Theoretical Framework
2.2 Empirical Review

Kamau (2013) conducted a study on effects of product differentiation strategy on sales performance in supermarkets in Nakuru town central business district. This study employed non experimental research survey design and used purposive sampling and simple random sample to get the sample size of the respondents. Data was collected using questionnaire and interview schedules. It was analyzed using descriptive and inferential statistics. The outcome of the study shows that product differentiation and physical differentiation plays a major role in activating annual sales performance at the supermarkets unlike service differentiation which showed a weak relationship. The study recommended that supermarkets should scale up on the attributes of product and physical differentiation strategies if they are to compete in the growing market. The study had contextual gaps since it focused on supermarkets while the current study focuses on telecommunication sector. The study also differs from the current study since it used an experimental research design while this study will use descriptive research design. This constitutes a methodological gap.

Reilly (2002) noted that Differentiation is also one of Porters key business strategies .When using this strategy; a company focuses its efforts on providing a unique product or service. Since the product or service is unique, this strategy provides high customer loyalty. Product differentiation fulfils a customer need and involves tailoring the product or service to the customer. This allows organizations to charge a premium price to capture market share. Aaker (1984) further argues that a differentiation strategy is often but not always associated with a higher price because it usually makes price less critical. A conceptual gap exists in the study because it only addressed one construct that is product differentiation while the current study addresses additional constructs.

Powers and Hahn (2004) examined the performance impact of generic strategies in banking. Their study indicated that banks fall into five clusters based on the type of strategy they used: general differentiation strategy, focus strategy, stuck in the middle, cost leadership strategy, and customer service differentiation strategy. They found that, overall firms employing a strategy perform better (in terms of return on assets) than the ones that are stuck in the middle. The performance of cost leadership followers was significantly higher than that of stuck in the middle firms. However, other strategy followers could not gain significant performance advantage over the stuck in the middle group.
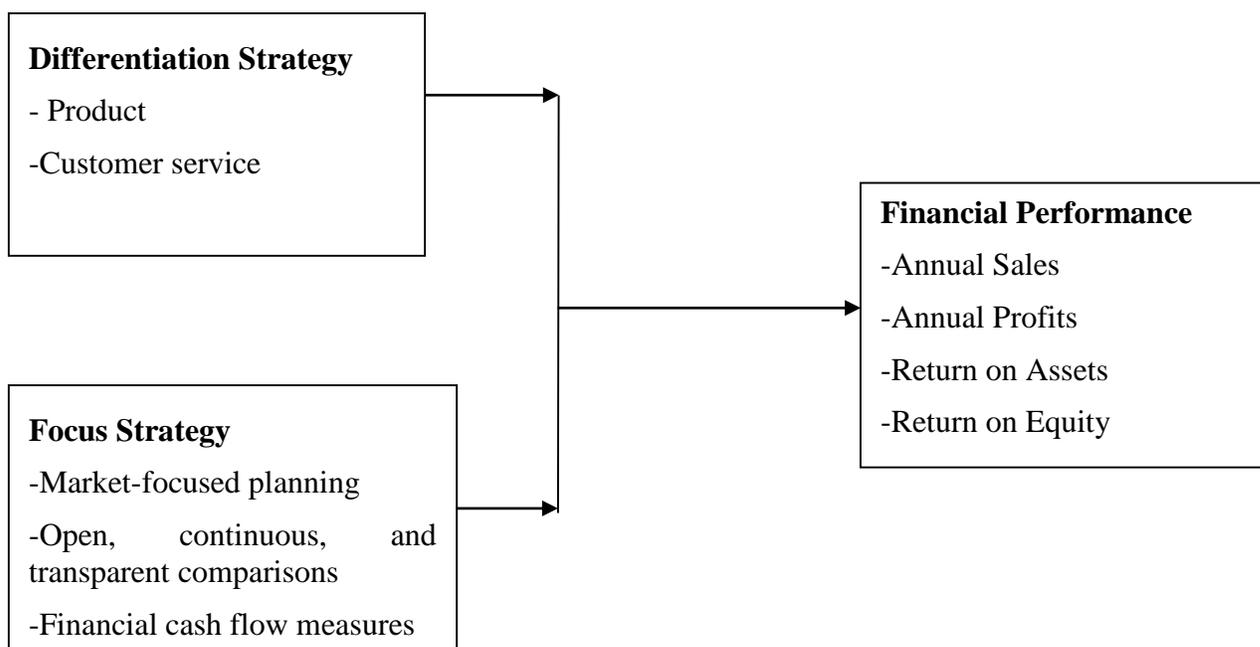
Miller (2001) studied differences in management strategies of 384 small family businesses in small communities in United States. In their study ten strategy items represented four management functional activities, with three items for planning, two for organizing, two for leading and three for controlling. Using a five point Likert Scale (with l=Not done at all and 5 = Very great extent)

respondents were asked to indicate the degree to which they used of those ten different strategies. The highest mean score was recorded by item related with evaluating of the quality of services or product, followed by analyzing customer satisfaction on a continual basis, estimating cost and expense figures for business and preparing financial records. Overall, their studies showed that small businesses exercised more on organizing strategies than planning and controlling and leadership in their businesses.

Sadaghiani (2011) conducted a study on Impact of International Market Entry Strategy on performance of Iranian export companies. The study had a conceptual gap as it did not address other factors that would affect performance. In addition, the study failed to utilize factor analysis and odd ratio regression as this is the appropriate methodology of analyzing likert scale data.

2.3 Conceptual Framework

The study focused on how the differentiation strategy and market focus strategy affected financial performance of SMEs. Each of the predictor variables had its own indicators that could be used to measure the target variable. The concepts were represented as shown on figure 2.

Differentiation Strategy

- Product

-Customer service

Financial Performance

-Annual Sales

-Annual Profits

-Return on Assets

-Return on Equity

Focus Strategy

-Market-focused planning

-Open, continuous, and transparent comparisons

-Financial cash flow measures

Figure 2: Conceptual Framework

3.0 Research Methodology

The study employed an explanatory research design. The target population of the study was 7384 Small and Medium Entrepreneurs operating in Nairobi County. A sample size of 95 respondents was picked using random sampling. Structured questionnaire was used to collect the data and analyzed using descriptive statistic and inferential statistic. Inferential statistics (correlation and linear multiple regression analysis) were used to establish the relationship between differentiation strategy, focus 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 = Differentiation strategy

X_2 = Focus strategy

e=Error term

4.0 Results and Findings

4.1 Response Rate

The number of questionnaires that were administered was 95 and total of 80 questionnaires were properly filled and returned. This represented an overall successful response rate of 84.21% as shown on Table 1. Babbie (2004) also asserted that return rates of above 50% are acceptable to analyze and publish, 60% is good, 70% is very good while above 80% is excellent. Based on these assertions from renowned scholars, 84.21% response rate was excellent for the study.

Table 1: Response Rate

Response	Frequency	Percent
Returned	80	84.21%
Not filled	15	15.79%
Total	**95**	**100%**

4.2 Descriptive Statistics

4.2.1 Differentiation Strategy

The study determined the effect of differentiation strategy on performance of SMEs. The results were presented in table 2 show that71.2% (31.2%+40%) of the respondents agreed that the enterprise emphasized on the uniqueness of products offered and thus leading to profitability of the enterprise. Further results found that the enterprise does not change the product. However, additional services were offered. These extra services motivated consumers to buy the product as indicated by 68.7 % of the respondents. Results also showed that 75.0% of the respondents agreed that the enterprise sourced products from cheap domestic suppliers and from low-wage foreign markets. This allowed the company to sell their items at low prices and to profit off thin margins at a high volume. In addition, results show that 67.4% of the respondents agreed that the enterprise made product differentiation purely through packaging. All the essentials of the packaging; colour, print, form, etc; combined to communicate important differences in the perception of the consumer. Further, 75.0% of the respondents agreed that the lack of genuinely distinctive product qualities was compensated for through direct communication with consumers. These results implied that differentiation strategy influenced the performance of SMEs. The average likert scale of the responses was 3.88 which indicated that majority of the respondents agreed to the statements. The standard deviation was 1.28 which indicates that the responses were varied.

Table 2: Differentiation Strategy

Statement	Strongly disagree	Disagree	Neutral	Agree	Strongly agree	Mean	Std. Dev
The enterprise emphasize on the uniqueness of products offered and thus leading to profitability of the enterprise	6.20%	17.50%	5.00%	31.20%	40.00%	3.81	1.303
The enterprise does not change the product. However, additional services are offered. These extra services motivate consumers to buy the product.	11.20%	11.20%	8.80%	21.20%	47.50%	3.82	1.421
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.	6.20%	3.80%	15.00%	35.00%	40.00%	3.99	1.131
The enterprise makes product differentiation purely through packaging. All the essentials of the packaging; colour, print, form, etc; combine to communicate important differences in the perception of the consumer.	6.20%	7.50%	18.80%	26.20%	41.20%	3.89	1.212
The lack of genuinely distinctive product qualities are compensated for through direct communication with consumers	11.20%	5.00%	8.80%	32.50%	42.50%	3.9	1.318
Average						**3.88**	**1.28**

4.2.2 Market Focus Strategy

The study also established the effect of market focus strategy on performance of SMEs in Nairobi County. Results in table 3 show that 80% (35%+45%) of the respondents agreed that the market-focused planning process has was seen and practiced as a continuous strategic review and fast-change process in the enterprise, 68.7% of the respondents agreed that the enterprise supported open, continuous, and transparent comparisons between product/market performance and cross-enterprise teams to identify problem and failure products, and act on them quickly, 67.5% of the respondents agreed that the enterprise culture and management compensation metrics were explicitly and financially linked to market focus. Another 68.7 % of the respondents agreed that

financial cash flow measures, tracking, and information were valid and continuously available at every level of the business and product portfolio while 83.8% of the respondents indicated that enterprise management understood and shared the meaning of market focus and the impact of their cross-enterprise decisions on it. On an average likert scale the responses had an overall mean of 3.95 which indicated that the respondents agreed to the majority of the questions asked. The standard deviation of 1.07 indicates that the responses were varied. The results implied that market focus strategy influenced the performance of SMEs in Nairobi County.

Table 3: Market Focus Strategy

Statement	Strongly disagree	Disagree	Neutral	Agree	Strongly agree	Mean	Std. Dev
The market-focused planning process has is seen and practiced as a continuous strategic review and fast-change process in the enterprise.	5.00%	3.80%	11.20%	35.00%	45.00%	4.11	1.079
The enterprise supports open, continuous, and transparent comparisons between product/market performance and cross-enterprise teams to identify problem and failure products, and act on them quickly.	5.00%	8.80%	17.50%	41.20%	27.50%	3.78	1.102
The enterprise culture and management compensation metrics are explicitly and financially linked to market focus.	5.00%	10.00%	17.50%	27.50%	40.00%	3.88	1.195
Financial cash flow measures, tracking, and information are valid and continuously available at every level of the business and product portfolio	8.80%	10.00%	12.50%	32.50%	36.20%	3.78	1.283
Enterprise management understand and share the meaning of market focus and the impact of their cross-enterprise decisions on it.	0.00%	0.00%	16.20%	45.00%	38.80%	4.22	0.711
Average						**3.95**	**1.07**

4.4 Correlation Analysis

The study established the association between independent variables (differentiation strategy and market focus strategy) and dependent variable financial performance of SMEs. Results established that differentiation strategy was positively and significantly related with financial performance as supported by($r=0.380$, $p=0.001$). Similarly, results showed that market focus strategy and financial performance were positively and significantly related ($r=0.349$, $p=0.002$). This implied that an increase in any unit of the variables led to an improvement in financial performance. Results were presented on table 4.

Table 4: Correlation Matrix

		Financial performance	Differentiation Strategy	Market Focus Strategy
Financial performance	Pearson Correlation	1.000		
Differentiation Strategy	Pearson Correlation	.380**	1.000	
	Sig. (2-tailed)	0.001		
Market Focus Strategy	Pearson Correlation	.349**	0.107	1.000
	Sig. (2-tailed)	0.002	0.345	

** 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 differentiation strategy, market focus strategy and the financial performance of Small and Medium Enterprises in Nairobi County Kenya. The results on table 5 presented the fitness of model used in regression in explaining the study phenomena. Differentiation strategy and market focus strategy were found to be satisfactory variables in explaining financial performance. This was supported by coefficient of determination /R square of 62.5%. This meant that differentiation strategy and market focus strategy explained 62.5% of the variations in the dependent variable which is performance of SMEs in Nairobi County. This results implied that the differentiation strategy and market focus strategy were good predictors of performance of SMEs in Nairobi County.

Table 5: Model Fitness

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

Table 6 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 6: 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 differentiation strategy and financial performance were positively and significant related (r=0.189, p=0.005). The findings agreed to Kamau (2013) who conducted a study on effects of product differentiation strategy on sales performance in supermarkets in Nakuru town central business district. The outcome of the study showed that product differentiation and physical differentiation played a major role in activating annual sales performance at the supermarkets unlike service differentiation which showed a weak relationship.

The table further indicated that market focus strategy and financial performance were positively and significantly related (r=0.161, p=0.042). The findings informed that of Miller (2001) who studied differences in management strategies of 384 small family businesses in small communities in United States. The finding indicated that mean score was recorded by item related with evaluating of the quality of services or product, followed by analyzing customer satisfaction on a continual basis, estimating cost and expense figures for business and preparing financial records. Overall, their studies showed that small businesses exercised more on organizing strategies than planning and controlling and leadership in their businesses.

Table 7: Regression of Coefficients

Variable	B	Std. Error	t	sig
(Constant)	0.659	0.366	1.799	0.076
Differentiation Strategy	0.189	0.066	2.862	**0.005**
Market Focus Strategy	0.161	0.075	2.812	**0.042**

Thus, the optimal model for the study is;

Financial performance of SMEs= 0.659 + 0.189X$_1$ + 0.161X$_2$.

Where:

X$_1$= Differentiation Strategy

X$_2$= Market Focus Strategy

5.0 Conclusions

Based on the findings above the study concluded that differentiation strategy and market focus strategy have positive and significant effect on the financial performance of SMEs. Product differentiation fulfilled a customer need and involved tailoring the product or service to the customer. This allowed organizations to charge a premium price to capture market share. Differentiation strategy was often but not always associated with a higher price because it usually makes price less critical.

6.0 Recommendations

The study recommended that SMEs should scale up on the attributes of product and physical differentiation strategies if they are to compete in the growing market. Equally the study recommended that SMEs should use strategies that establish solid long term corporate visions and leaving flexibility for the specifics of daily operations to adapt. This is because it is difficult to properly anticipate future events and hence plan resource allocation and actions for long term strategies. The study further recommended that SMEs should consider building institutional capacities and competencies so that they have the resources to understand, confront and respond to unexpected changes in the market.

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