Can SMBs in Network Create Competitive Advantage?

Experiences from a Norwegian Study

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Abstract

This paper addresses the changing competitive environment, sometimes named "the new economy", and the resulting opportunities created for SMBs organised in networks.

Some of the balance of power seems to be shifting from the traditional large corporations to smaller, innovative companies. Change is taking place in many industries and in many forms. Information technology and the Internet phenomenon seem to be instrumental in this paradigm shift.

Any period of instability creates new opportunities for innovative players in the field. The opportunities that are created for SMBs and problems of larger companies under environmental instability are addressed.

The essence is that SMBs can cooperate in networks that make room for specialization and creativity at the same time as they can reap the benefit of being part of a larger entity. Said in another way: they can maintain the small company strengths and at the same time compete with the larger companies.

SMBs can, by rethinking their *external* relationships establish powerful alliances that make the cooperating network a worthy competitor to the incumbents.

In addition to the overview of trends, the paper describes three SMB networks in Norway, pointing out the success factors and pitfalls associated with establishing and operating a network with independent participants.

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Introduction

Even people outside the business community have become aware of changes in the way businesses operate. They can perhaps also observe that some of the balance of power seems to be shifting from the traditional large corporations to smaller, innovative companies. Change is taking place in many industries and in many forms. Information technology and the Internet phenomenon seem to be instrumental in this paradigm shift. "The new economy" may be at its beginning.

Any period of instability creates new opportunities for innovative players in the field. This paper addresses the opportunities that are created for SMBs (i.e. companies with less than 500 employees) and problems of larger companies under environmental instability. *The essence is that SMBs can cooperate in networks that make room for specialization and creativity at the same time as they can reap the benefit of being part of a larger entity. Said in another way: they can maintain the small company strengths and at the same time compete with the larger, incumbent companies.*

The competitive setting

As competition is increasing both locally and globally, companies are trying to reconfigure their value chains to maintain profitability, or for that matter, survival. For the larger corporation this often means a concentration in the areas where they have the best competencies, in an attempt to fend off aggressive, specialized SMBs.

Core competencies

Larger companies are therefore working hard on identifying their core competencies. A core competency is normally based on knowledge and skill in combination that makes it valuable, unique, and difficult to imitate. The result is superior value to the customer and results in a competitive advantage for the company.

Identifying and nurturing core competencies is therefore considered to be an important issue for the company as it is through them that the sustainable competitive advantage may evolve.

Critical success factors for survival on the new competitive arena: Can the large company compete?

For success in the future, focus on core competencies may be an important first step. It is not enough, however. The large companies are of course well suited for focusing on one or several core competencies, and they have the potential to leverage these over multiple business units. Concentrating on the core competencies and outsourcing the remainder, can result in competitive advantage. In addition, the larger resource base and purchasing and market powers create advantages that the smaller firms cannot match.

A successful company must, however, be excellent in four other areas to be a superior performer:

Innovation

In a world where there is over production of just about all goods and services, the ability to innovate is a key to superior profitability. Innovation may be in the traditional product development, but also in sales, distribution channels, service delivery, etc. An innovative move does, however, also entail elements of risk. The market leaders would have a propensity to continue their proven, successful activities until they are threatened by those who have less at stake in changing the products or ways to do business.

The rate of innovation in larger companies seems generally to be lower than desired for the future market dynamics. An article in the Economist (December 4, 1999) states that "Big American companies fear that innovation is the secret of success – and that they cannot innovate". The article further quotes Pasadena based *Patent and Licence Exchange* saying that trading in intangible assets in the United States has risen from $15 billion in 1990 to $100 billion in 1998, with an increasing proportion of the rewards going to small firms and individuals.

Time to market

Once an innovative product has been developed, there is a competition to bring it to the marketplace. In an intensively competitive environment, other players are most likely just behind, trying to copy the innovation. To create first mover advantages and superior profits, a product must be commercialized rapidly.

The time to market aspect is also generally a weak point in the large company. Thanks to numerous internal planning and approval procedures, the chance to grasp initiative and achieve first mover advantages is reduced. Could one reason be that it is the *risk averse* managers who have made no mistakes that are promoted and today are the ones who approve or disapprove new initiatives?

Adaptability

Considering the increased pace of change in the competitive environment that must be expected, an organization's ability to meet this is critical. Examples may be the way work is designed, employee incentive systems or organizational structures to match new environments.

Rapid response to a changing business environment is not the strong point of the large, established company. Functional rigidity and individual resistance to change can be expected in traditional, hierarchical organization structures.

Talent

The three success factors above cannot materialize unless the company has the very best people in the market. That is easier said than done. Firstly, the company must attract the talents, usually based on its reputation. Secondly, it must give the employees challenging tasks, opportunities for self-development and a stimulating company culture. Thirdly, it must be able to keep the best employees by means of incentive systems and opportunities for making a professional career.

Impatient, innovating individuals with entrepreneurial spirit seem to prefer to work for smaller organizations. The latest placement survey (1999) from Stanford Graduate School of Business, arguably one of the leading business schools in the world, shows that more than one third of the graduates were employed in companies with less than 1000 employees. This in spite of the fact that MBA programs generally are oriented towards employment in the large companies. The motives for selection of employer were dominated by “Compatibility with people in the firm”, “Opportunity for career broadening” and “Offers intellectual stimulation”. All of these are often strong points in the smaller firms.

Opportunity for SMBs

Considering the above points, SMBs should be well positioned to benefit from the disequilibrium in the business environment. In many cases, however, they end up as sub-contractors to larger firms after competitive price negotiations. The larger firm with bargaining power retains more of the profits that could have improved the SMB’s financial performance. The answer for the SMBs could be the network organization.

Network organizations have caught the attention of academia over the past decade. Nohria (1992) refers to the “New Competition” which refers to

> “the competitive rise over the last two decades of small entrepreneurial firms of regional districts such as Silicon Valley in the US and Prato and Modena in Italy ---. If the old model of organization was the large hierarchical firm, the model of organization that is considered characteristic of the New Competition is a network of lateral and horizontal interlinkages within and among firms”.

According to Powell (1990), the appeal of this type of organization is their greater flexibility and adaptability and their capacity to circulate know-how or tacit knowledge. He further argues that a combination of small size and ample technology to enable communication and coordination between the members of the network make these organizations very competitive.

Two main types of networks can be considered. One may be called the *related network,* which typically consists of firms carrying out more or less the same activities. An example of this is manufacturers that formerly competed with a full range of products establish a network or alliance in which each only makes part of the range. Scale advantages, organizational learning and more efficient marketing are examples of benefits of this type of network.

Another, and more complicated model is the *unrelated network.* In this type of network SMBs join forces in a more or less formal, cooperative network that performs all the functions of the larger companies – and actually compete with them. In the unrelated network, each participant contributes its specialized skill, for example R & D, production, marketing, administration, etc. The participants may even belong to several networks, performing the same task in each one. The network may be permanent or temporary. As a result, the "virtual" organization is created!

A strong argument for the network organization is that it gives opportunity for the members to maintain their ownership structure, company culture, incentive systems and innovative behavior.

Sources of advantages for the networked SMB

Resource utilization

In case there are several potential vendors in the network, resource balancing can be achieved by allocating tasks to those with unused capacity. The network can also act as an internal market mechanism, using the price mechanism for allocation of work to partners in the network.

Specialization

Resource based theory, (see for example Barney (1997)), suggests that organizations that can develop leading edge skills or utilizing specialized production equipment are particularly well suited in network organizations. By combining the members' specialized capabilities, the network as a whole will get a broader and deeper competency than the integrated firm.

Flexibility

The partners in the network can be *geographically dispersed*. Information technology eliminates distance. Theoretically, the network can consist of firms on different continents.

The participants can have *numeric* flexibility; i.e. they may achieve their optimal capacity utilization and scale advantages, resulting in the lowest unit cost of production.

Functional flexibility is the ability to combine the unique competencies of each of the participants in ways that can create a value chain different from the traditional one of the large, integrated competitor. Such a reconfigured value chain can result in competitive advantage.

Four important issues for the network

Hakansson and Sharma (1996) point out some important focus areas in developing the network:

Value concept

A "network captain" develops the value concept that defines a target market and a product or service offering that will provide clear value to the target customers.

Relationship development

Gaps between the value concept and the resources necessary to execute the value concept help define the characteristics of ideal partners and the capabilities they will contribute to the network.

Network management

The underlying motivation for network members to organize and integrate activities is to create competitive advantage for the network as a whole. Joint value objectives are important and must be constantly reinforced for the partners to focus on cooperation in the network.

Partner learning

This includes both transfers of specific skills as well as tacit learning as the partners work together.

Cluster – an interesting model

What is a cluster? According to Porter (1998), clusters are geographic concentrations of interconnected companies and institutions in a particular field. Clusters encompass an array of linked industries and other entities important to competition. Network organizations may have fertile ground in such an environment.

A cluster can be seen as a critical mass of activities of unusually competitive success in one place. Before, location of a firm used to be important due to "comparative advantage" such as cheap labor or energy, access to natural resources, etc. In "the new economics of competition", knowledge, relationships and motivation are more important to create competitive advantage.

The firms, (and supporting institutions), within the cluster are linked informally to allow each member to benefit as if it had greater scale or as if it joined with others formally – without having to sacrifice flexibility. The cluster is a network organization within the boundaries of geographic area satisfying a set of *factor conditions,* i.e. labor resources, knowledge and competencies en risk capital. There should be a *competitive arena* with both cooperation and competition, and a quest for productivity, quality and innovation. The *demand conditions* should ideally be early in the industry life cycle with differentiation opportunities to satisfy demanding customers. Finally, *related and supporting industries* should encompass strong research and development institutions, specialized support capabilities and advanced suppliers.

Do the participants in a cluster really have to be co-located?

One of Porter's (1998) arguments is that a successful cluster requires location in the same geographic region. There is no doubt that a co-location offers advantages. Interaction and competition on the personal level is stimulating. A pool of skilled labor and competent supporting enterprises is an added value.

It may be argued, however, that the successful, networked company of the future must be linked with the *very best* partners, and they are not always located in the same geographic area. The evolution of information and communication technology could change the way businesses are interacting. Visual communication in real time seems just before a general break-through. The net may thus become the preferred way for both intra- and inter company communication. In that case, distance will be considered less important, and the choice of network partners the crucial one.

Case study of Norwegian SMB networks

Three *unrelated* networks were studied. All three were co-located. One is successful, one is less so, and the third cannot show any results at all. The varying success rates offer an opportunity to compare them and identify success factors as well as problem areas. In depth interviews were carried out among the participants in the networks to disclose underlying factors that determine success or failure.

Rationale of the networks

The purpose of all three networks is market expansion by being able to offer a wider array of services to their defined, regional markets. The networks were *unrelated*, i.e. each partner contributed its specialty, and had been established 5-6 years ago. The time span is a bit short to make definite conclusions as to final outcome.

Description of the networks

Network 1 was established in 1995 in connection with the completion of a new main airport near Oslo. The purpose is to create a full service offering to the firms that are established around the airport. There are four areas of activity:

1. Operation and maintenance of buildings
2. Snow removal and gardener services
3. Car park with auto services
4. Maintenance and service on rolling equipment at the airport

The network has no less than 50 partners, coordinated by a "*network captain"* i.e. a dedicated organization established for that purpose. In addition to coordinating the offers to customers and administrative tasks such as billing etc., it also is heavily engaged in marketing of the group.

The network has shown substantial growth for all principal partners and is considered very successful.

Network 2 was established in 1996. It has three partners within the field of industry and building automation. The partners each cover one area of the field. The network is coordinated on a part time basis by one of the partners.

The network has only had three jobs as network organization. It can only be considered to be partly successful, considering a high aspiration level when created.

Network 3 was established in 1997. It also has three partners each covering a particular field of service to the process industries in southwest Norway. The network can theoretically handle large assignments, but none has materialized. There is no active coordination of the network, but it has merely a cooperative agreement as basis.

The network is not successful by any measure.

What can we learn from the cases?

General

The participants' experience from earlier networks is of major importance for success in the present network.

In an *unrelated* network, competence transfer between participants is of less importance than normally assumed in a *related* network.

Before establishing the network

Social relations between top management of the participating firms improve the likelihood of success.

Competence is of great importance when choosing network partners. It is the collective competence that determines the quality of the final product.

Thorough preparations over an extended period, including market analyses, increase the success rate.

When the network has been established

A confidence building mechanism is essential for successful cooperation. Such activity may include regular evaluation meetings, strategy development and informal, social gatherings.

Similar company culture of the participants in an *unrelated* network seems to be of lesser importance as the participants each contribute their specialty to the total product offering.

One participant in the network should be held responsible for the total operation of the whole network. This increases the focus on the network activities, which seem essential to success.

Transaction specific investments, i.e. investments for the participant’s role in the network, are not prevailing. That reduces the investment risk.

The network must develop gradually, allowing time for personal operating mode adjustments.

The easy part is creating a network

SMB managers and owners will probably see increased business opportunities by operating in network. They may even have a good idea with whom they would like to cooperate. Establishing the network conceptually and formally is an intellectual and contractual process that owners and managers can handle. That is unfortunately not enough.

The difficult part is operating a network

Dedicated and systematic work is required to make a network successful. It takes time to align the partners’ expectations and weed out hidden agendas. Some partners may be asked to leave the network for lack of loyalty or non-performance. Members of the participants’ organizations must understand and accept the logic and modes of operation in the network. Cooperation mechanisms must be developed for effective operation. Time and money must be allocated to develop the network into a functional competitive entity.

Conclusion

"The new economy" seems, in many respects, to favor the smaller organizations. The SMBs have the flexibility, ability to innovate and ability to attract competent employees. By joining forces in network organizations, the SMBs can act as if they were a larger firm. They indeed seem to extract the best of both worlds: Keeping the soul of the smaller firm and acting as a large one.

The network operation requires careful planning, careful selection of partners and systematic development to succeed. This is not by far an easy task, and it may be assumed that only a limited number of network organizations will be successful. Perhaps the core competency of the future is development and operation of network organizations?

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