

## **Hungarian Small and Medium Enterprises' Strategies and their Effects on the Economic Performance**

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**Abstract:** The impact of large company's strategy on its performance constitutes an interesting subject for the strategic management research. There is little attention given to the analysis of this relationship at the small and medium enterprise (SME) scale and even less studies published to examine it from a regional perspective. The aim of this study is to empirically investigate the link between strategies and performance of SME's. Data for the research were obtained primarily from a survey of SMEs conducted in Hungary. Results indicate that the different indicators of financial performance of SMEs are having a strong link with the firm's strategy, while the firm regional location may have a limited influence, depending on financial indicators. The findings of this study might be useful to managers of Hungarian SMEs, while contributing to the SMEs field research.

**Keywords:** Hungarian SMEs; Small and medium enterprises' strategy; Economic performance

**JEL Classification:** L22; M21

### **1. Introduction**

Restricted management resources of SMEs (Small and Medium-size Enterprises) corroborated with a relatively low activity makes unlikely for them to have the same strategic footprint as the larger enterprises have. However, because usually the decision is made by a restricted number of peoples, they could change their strategy much faster than a large enterprise could do- their strategy can be built on this ability to respond quickly to economic uncertainty, to environmental change, both external and internal, despite their lack of resources. However, the SME and the large strategies are proudly much similar; essentially, differ substantially from those of larger companies. SME strategy, at enterprise level, is future-oriented and comprises a set of defined actions to be taken in order to improve the economic indicators, to use their resources efficiently and strengthen their position on the market. From a business perspective, SME strategy should deal with competitiveness and the better use of competitive advantage so as to compete effectively on their market. Functional strategy comprises adopting measures to

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employ resources efficiently and implementing new processes or technologies. A clear strategy would be very helpful to a firm's management in facing any situation - for example, the need to take an immediate decision which will have a long-term effect, in which case agreed strategic boundaries will act as a guide. From the many forms of management strategy practised by SMEs, this paper attempts to search for relevant and realistic strategies which are actually followed by SMEs and also to examine the implications for economic results in general. An interesting new field of research is to define the strategy of Hungarian SMEs by examining those factors that contribute to SMEs' approach to generic strategy - to market and cost reduction strategy. In addition, it will be valuable to assess the benefits offered by strategies, by examining their impact on a firm's overall performance at different levels. The simple fact that SMEs actually follow strategies is not in itself sufficient to reach their economic goals, which is why the results must be examined. If strategy is budget-related, then this has associated costs, and it is vital, even for the SMEs, to determine the outcome of their resource allocation and investments in strategy. Even without being formulated in detail, the strategy to be adopted differs from company to company, depending on a variety of factors such as company size, area of activity, years of existence, type of management and so on - and also by geographical location, at regional, national or EU level. At the same time SMEs cannot afford to waste their limited resources by following multiple strategies simultaneously without losing efficiency. Focusing on a limited number of compatible strategies seems more likely to produce success in terms of financial results.

Little research is to be found on SME strategies and performance, and we challenge us to fill the gap by determining those strategies which are easy to carry out.

## **2. Strategies in Small Enterprises**

### **2.1 Strategic Management and Strategic Planning**

The literature is full of articles pointing out the differences in terms of strategy and management between large companies and SMEs. Strategic management is long-term strategy, a doctrine concerned with the firm's external environment, customers, competitiveness, company success (Kvint, 2009). Strategic planning is an instrument which could be used as a guide to reach the firm objectives, since it offers the opportunity to recognise trends in the shorter term, as opposed to strategic management which deals with concepts such vision, mission and objectives (Kraus et al). The field of strategic management and international business is defined by the focus on performance; managers are interested in gaining competitive advantage and sustaining it in time and across borders (Peng 2009).

Knowledge of the business environment of the industry where the enterprise is operating is very important when a choice of strategy is to be made, with direct repercussion on its existence. De Kluyver (2010) argues that industry growth is limited in developed markets but offers high opportunities in developing markets which are not mature. For SMEs management is a good opportunity to turn their enterprise towards profitability if following marketing strategy for immature markets where competition is not so fierce and where the margins might be higher than in developed markets, but in niche markets, where volume is not important and where high customization of products or services is required. SMEs are also important players from global and regional perspectives as they are the backbone of the large multinationals; they are part of the integrated supply chain of large MNCs (Rugman et al., 2006). SMEs can benefit from any economic upsurge of larger companies (and eventually from knowledge spill over) if they settle in their vicinity. In the same way, SMEs need to define strategy to re-engineer themselves continuously as a response to changes in their internal environment that are not static but dynamic. These changes represent the trigger for strategy modulation, directed to exercising control of those factors that are within direct reach of the firm: financial means, technology, human resources, processes, organization culture and assets (Hunger, Wheelen, 2010).

## 2.2 Specifics of SME Strategy

Developing methodologies to formalize strategy for managing SMEs is often met in academic papers. SMEs have limited resources and their low managerial capacities along with their financial limitations constitute a barrier in their international development (OECD, 2009). To increase their competitive advantages the SMEs will have to implement measures to make the survival of enterprises more plausible. Grouped in the form of strategy, these actions are representing the enterprise vision for dealing with their challenging environment (Porter, 1985). When facing the larger enterprises, the SMEs could gain advantages building up on their recognized entrepreneurship, creativity, innovation (Knight, 2000). One interesting characteristic of SMEs in private family ownership is that they do not always have as their objective the creation of profit, but something different, and in that case their strategies will be different (Szerb, 2007). In an attempt to formalize the SMEs' strategy, Miles and Snow (1987), proposed a four dimension typology: prospectors<sup>1</sup>, analyzers<sup>2</sup>, defenders<sup>3</sup>, and reactors<sup>4</sup>. This typology is largely

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<sup>1</sup> Companies focusing on new markets using innovation and willing to apply the newest technologies (Miles and Snow, 1987)

<sup>2</sup> Companies might take "prospector" or "defender" actions depending on the environment conditions (Miles and Snow, 1987)

<sup>3</sup> Companies concentrating on niche which are defending their market share (Miles and Snow, 1987)

<sup>4</sup> Companies that are not capable to act properly to their environment (Miles and Snow, 1987)

widespread in SMEs literature (Sanchez & Sanchez 2005; Pittino & Visintin 2009; Parnell & Wright 2005). The strategies of SMEs, whether domestic or foreign, generally include such attributes as promptness, responsiveness in taking decisions - together with essential quality and innovation. All of these should make up a solid core of competitive advantage. They are, in general, likely to be less competitive in marketing, in generating capital and in technology. An appropriate strategy could be to strength their Firm-Specific Advantages (FSA), whilst, at the same time, improving their competitiveness in those areas which are generally less developed by the very nature of SMEs. If their activity is manufacture, they need to adapt quickly to new technologies and processes. Their structure has to permit them to implement strategies rapidly to respond to the challenges from their environment. This could be achieved by a flexibility strategy. The factors which have an impact on flexibility and competitiveness strategy are grouped into three categories: internal, external and enabling factors (Gunasekaran et al 2011). Internal factors comprise organizational behaviour, managerial characteristics and quality. The organizational behaviour and characteristics of managers have a direct relationship with the quality of goods and services which the SME delivers. Internal factors act on the efficiency of enabling factors - and can be changed by external factors. Enabling factors include: the use of technology, supply chain integration, the generation of capital, location and marketing. According to Gunasekaran *et al* (2011), globalization is identified as an external factor.

### **2.3 Strategy and the Firm's Performance**

The analysis of economic results such as sales growth, earnings before interest and taxes (EBIT), profit after interest (PAI), return on assets (ROA), operating profit (OP), weighted average cost of capital (WACC) are important factors when adopting strategy. Taking strategic decisions based on the performance of these indicators is good practice and may help to acquire competitive advantages for the firm. In our study we will examine whether these findings on strategies and performance could be applied to Hungarian SMEs. In an empirical study on SMEs from Japan and Sri Lanka carried out by Pushpakumari and Watanabe in 2009, to determine if strategies really improve the SME performance, the authors found that, certainly, performance can be explained by the SME management's choice of strategy (defined as 'strategy orientation'), but the other factors that contribute to performance cannot be ignored. Recently the authors of two separate researches on the strategy of SMEs, one on the Austrian SMES (Leitner & Guldenberg, 2010), the other on the Chinese SMEs (Tang & Hull, 2011), claimed that a combination strategies produces better results than concentrating on only one strategy.

In many SMEs, as well as in large companies, performance is monitored continuously using different tools such as, for example, the balance score card in

which all activities are listed and measured through key performance indicators for financial, and non-financial activities such as production, sales, human resource, technical components (Kaplan & Norton, 1996). The balanced scorecard (BSC), in the classic view, is the *link* that communicates effectively the company mission to departments and makes possible the strategic management out of performance measurements' (Kaplan & Norton, 2001). We saw above that a combination of differentiation strategies such as marketing, and cost reduction, are among those employed by SMEs aiming for success in their industry. SMEs may have no strategy at all, or their management may adopt reactive strategies in response to events, or take proactive strategies - in which case they anticipate the trend and prepare themselves with a pre-defined set of actions (Pushpakumari & Watanabe, 2009). Implementing a proactive strategy had a positive effect on some important performance indicators such as annual sales, profit, employee numbers, changes in market share, reinvestment - as was found in SMEs in Japan and Sri Lanka - while apparently, adopting reactive strategy decreased these indicators or had had no impact at all (Pushpakumari & Watanabe, 2009). Clearly, between the two types of strategy it is very difficult to draw a demarcation line; they may co-exist and/or overlap at various times and at various amplitudes (Pushpakumari & Watanabe, 2009).

In regional SMEs, the reactive type of strategy dominates, changing the course of action as a response is the most frequently used strategy among SMEs, whilst the proactive strategy (which implies initiative and assumes a higher risk) is found in fewer (Julien, 2007). The same author argues that, in a given area, some 10% of firms are proactive, approximately 20% are active and the remaining 70% are reactive firms - which are catalogued as defensive by Miles and Snow (1987). Further, the proactive firms, "*the gazelles*", the source of "*regional dynamism*" are defined as taking the higher risk when facing uncertainty. In spite of a lack of information, they act according to their manager/owner's instinct, as he aims to win most of the time, giving priority to adventure and to analysis. The active firms are more balanced in that respect, willing to take their time to acquire enough information to make a correct decision, but acting rapidly enough to avoid losing the opportunity. The third type of firm, the reactive, apparently takes no risks, preferring stability to the possibility of higher profit (Julien, 2007). Pursuing this line and to grasp the relationship between SME strategy and performance, our research model is based on identifying SME strategy in aspect of two factors; on proactive and on cost-reduction strategies and their impact on performance.

### 3. Research Data

To investigate whether SME strategies are related to performance, a survey was employed conducted in 2012-2013 on SMEs from all Hungarian regions. The survey was designed not only to reflect the economic environment in which Hungarian SMEs work, but also to pose questions relating to strategies and financial indicators. The questionnaires were completed during face to face interviews by university students on field visits to business managers - one interview per company - and then manually entered into data sets through a webpage interface with individual login credentials. The interviews were carried out with the owner, manager or director of the company – whoever was most knowledgeable about the business. The survey comprised 1,074 questions, and data was gathered from 799 respondents.

To maximise the response a mixture of closed and open-ended questions was employed in the interviews, producing a compilation of quantitative and qualitative data. The dataset used contained general data on the size of the company, field of activity, organization type, region, county, city and year when established, together with information on their strategy, their financial situation, organizational structure, personnel and management skills.

By type of entity, the majority of SMEs (591 firms) are Limited Liability Companies (Ltd. or, in Hungarian, “Kft”) followed by 118 “Partnerships” (the Hungarian, “Bt”), whilst the association form being the least present. The distribution of SMEs presented in survey based on their size over the regions size of Hungary. The most interviewed SMEs are originated from the Central Hungary followed by Southern Transdanubia region. With respect to size of the firms, the micro-firms are best represented in Central Hungary region followed by the Southern Transdanubia while the small firms four times less than former, are relatively better represented in Southern Transdanubia, in Central Hungary and also in Southern Great Plain regions. As for the medium firms we see a less representative presence in the survey. The survey succeeded to capture the dominant distribution of micro-firms in Hungary. With the respect of SME’s industry the collected data shows a massive presence of 50% of the firms activating in G sectors—whole sales and repair, repair of motor vehicles and motorcycles and R-services activities. The other important sectors are: F Construction, Other activities and Manufacturing. The scale of the above distribution is not changed when the data is plot by Hungarian regions.

## 4. Analysis and Discussion

### 4.1 Research Questions and Hypotheses

The principal research questions are:

- Which management strategies do Hungarian SMEs follow? Are they concerned with strategic management or strategic planning in terms of proactive strategy?
- How effective are their strategies? Do these strategies have a measurable impact on the firm's overall performance?
- Should SMEs concentrate their resources on one strategy or on several?
- Whether regional location or company size play a role in performance-related strategy.

As shown in several empirical research projects, there is a strong relation between strategic planning and company performance (Rue & Ibrahim, 1998). To measure one dimension of strategic planning, proactive strategy as opposed to reactive strategy is employed in our study.

These questions are the basis for our hypotheses, which are then tested by quantitative methodology:

*Hypothesis H1: For Hungarian SMEs, a combination of cost reduction and proactive strategies has a positive effect on the possibility of improving financial performance. In this respect, regional location is irrelevant.*

Financial strategy is one of the pillars of value creation in the company regardless of size - whether a large company or an SME. The potential to raise funds is determined by its ability to generate profit and positive cash flow. An SME with positive financial results will be able to raise funds more easily. Consequently, for a SME with a poor cash flow or low profitability, it will be more and more difficult to obtain credit from the banks, and so financing strategy determines the future of an enterprise – both its existence and its ability to grow.

*Hypothesis H2: For the Hungarian SMEs, a strategy of applying for programme assistance could enhance the chances of improving results.*

### 4.2 Method for Testing Hypotheses H1 and H2

The research uses binary logistic, correlation and linear regression methods on multiple models to test the hypotheses. To be able to build a significant model in which the indicator of strategies could affect the financial performance, attention was paid carefully attention to the selection of those questions that are in relation with generic strategies: differentiation quality-cost, differentiation niche, differentiation marketing.

**Table 1. Variable description**

Variable type	Variable name	Variable description	Measure type
Dependent variable	Sales growth in 2012	Measures the relative growth in sales in 2012, dividing the firms into two categories: positive or negative sales growth.	Categorical, 0= no or 1=yes.
Independent variable	Proactive Strategy ( <b>Strategy_proactive</b> )	Categorizes firms as following or not proactive strategies. If reactive strategy is chosen, the firm cannot follow at the same time, reactive strategy.	Categorical, 0= no or 1=yes.
	Reactive Strategy ( <b>Strategy_reactive</b> )	Categorizes firms as following or not reactive strategies. If reactive strategy is chosen, the firm cannot follow at the same time, proactive strategy.	Categorical, 0= no or 1=yes.
	Market strategy: quality and reduction of cost ( <b>Strategy_CostReduction</b> ),	Categorizes the firms into following or not cost reduction strategies. If reactive strategy is chosen, the firm cannot follow in same time, differentiation, or niche strategy.	Categorical, 0= no or 1=yes.
	Tender submission for assistance programs ( <b>SubmittedTender</b> )	Evaluates either the firm submitted tender for assistance program.	Categorical, 0= no or 1=yes.
	Regional component: ( <b>STRegion, CHregion, SGPreion</b> )	Indicates SMEs location in a Hungarian region: STRegion for Southern Transdanubia, CHregion, for Central Hungary and SGPreion for Southern Great Plain	Categorical, 0= no or 1=yes.
	Firm size ( <b>Microfirm</b> )	Indicates if the SMEs' size falls in Microfirms category (0-9 employees)	Categorical, 0= no or 1=yes.

Dependent variable: Assesses firm's overall financial performance for year 2012 (Table 1). It measures the relative growth in sales in 2012. Its value positive or negative is discrete (0, 1) and not continuous - the reason for using logistic regression. Seven models were proposed, based on their significance and representativeness in respect of our research.

Model 1: Predicted logit of SalesGrowth2012= Strategy\_Reactive\*  $\beta_1$  + Strategy\_CostReduction\*  $\beta_2$

Model 2: Predicted logit of SalesGrowth2012= Strategy\_Proactive\*  $\beta_1$  + Strategy\_CostReduction\*  $\beta_2$

Model 3: Predicted logit of SalesGrowth2012= Strategy\_Proactive\*  $\beta_1$  + Strategy\_CostReduction \* $\beta_2$  + SubmittedTender\*  $\beta_3$

Model 4: Predicted logit of SalesGrowth2012= Strategy\_Proactive\*  $\beta_1$  + Strategy\_CostReduction \* $\beta_2$  + STRegion\*  $\beta_3$

Model 5: Predicted logit of SalesGrowth2012= Strategy\_Proactive\*  $\beta_1$  + Strategy\_CostReduction \* $\beta_2$  + CHregion\*  $\beta_3$

Model 6: Predicted logit of SalesGrowth2012= Strategy\_Proactive\*  $\beta_1$  + Strategy\_CostReduction \* $\beta_2$  + SGP\*  $\beta_3$



Model 7: Predicted logit of SalesGrowth2012= Strategy\_Proactive\*  $\beta_1$  + Strategy\_CostReduction \* $\beta_2$  + Microfirm\*  $\beta_3$

In Table 2 we show the results of running the logistic regression on the models presented before, the variables of models being described briefly in Table 1.

**Table 2. Logistic regression**

Model	Model 1 (Hungary)	Model 2 (Hungary)	Model 3 (Hungary)	Model 4 (Southern Transdanubia region)	Model5 (Central Transdanubia region)	Model 6 (Southern Great Plain)	Model 7 (Micro-firms)
Predictability of the model (%)	82.3	82.3	82.2	82.3	82.3	82.3	83.0
-2 Log likelihood	880.36	833.4	782.24	825.1	824.2	811.8	552.2
Cox & Snell R Square	0.20	0.25	0.26	0.26	0.26	0.27	0.32
Nagelkerke R Square	0.27	0.34	0.35	0.35	0.35	0.36	0.43
Beta of 1st variable/p-value	1.68/0.00	1.28/0.00	1.13/0.00	1.17/0.00	1.180.00	1.04/0.00	0.7/0.00
Beta of 2nd variable/p-value	1.38/0.00	0.91/0.00	0.82/0.00	0.84/0.58	0.86/0.02	0.8/0.00	0.8/0.00
Beta of 3rd variable/p-value			0.851/0.00	0.5	0.5	0.7/0.00	0.9/0.00
First variable//Exp(B)	5.4	3.6	3.11	3.25	3.26	2.83	2.03
Second variable//Exp(B)	3.9	2.5	2.28	2.32	2.37	2.25	2.25
Third variable/Exp(B)			2.35	1.7	1.72	2.14	2.62

In this analysis, and for all models, the probability of the model “chi-square” for all the models has the p value  $p= 0.00$ , therefore all models are statistical significant. Model 7 has the smaller statistic 2 Log Likelihood which makes it better than the other models. Further, based on the value of “2 Log Likelihood”, Model 2 which employs the proactive strategy it is a better fit than Model 1 which has reactive strategy as dependent variable. Model 7 has the highest value of these pseudo-coefficients, followed by Models 2 to 6. In Model 7 the Nagelkerke R Square value indicates that 43 % of the total variance of the dependent variable the relative increase in sales of 2012 for the SMEs could be explained by the fact of adopting a combination of strategies composed by cost reduction, proactive strategies and by the fact that the SME’s size in terms of number of employees is micro-firm (0 to 9 employees).

The probability of the Wald statistic was 0.00 for all three models, which supports the conclusion that the sales growth is more likely to be related to the combination of strategies. In Model 3, keeping constant the variable for generic strategy (cost reduction), the value of first variable/Exp(B) was 3.1, which tells us that this model predicts that the odds for having positive sales growth are 3 times higher for those SMEs following proactive strategy than those which are not - which implies that a one unit increase in this variable for strategy increased the odds of a positive sales growth by 100%. This confirms the statement of the amount of change in the likelihood of belonging to the modelled group of the dependent variable associated with a one unit change in the independent variable, age. Standard Error (SE) values for all three models for beta indicate that there is no multi-collinearity among the independent variables. In Models 4, 5 and 6 a regional component was introduced into the equation to examine the role of a firm's location on the firm's strategy in relation to their performance. This component is set to the South Transdanubia region for model 4, to Central Hungary region in model 5 and to the Southern Great Plain in model 6. As could be seen, the "-2 Log likelihood" decreased slightly from 833.4 to 825.1 which makes these three models with regional dependent, a better fit, while the Nagelkerke R Square is almost the same. Therefore, it can be said that the regional nexus of the SMEs has a negligible role for the study of Hungarian SME strategy. At the same time, based on the same method of comparison, the models, the value of '-2 Log likelihood' coefficient dropped from 833.4 in Model 2 to 552.2 in Model 7, which indicates clearly that the firm's size is an important control factor for SME strategy and performance. The predictability of the model (%) allows us to correctly classify the 82-83% of the subjects where the predicted event (sales growth in 2012) was observed.

We found a statistically significant overall relationship between the combination of independent variables (SMEs' proactive, cost reduction, program assistance funding strategies, firm size) and the dependent variable represented by sales growth in 2012. No evidence of numerical problems in the regression was observed. This helped us to conclude that hypothesis H1 and H2 are proved. Indeed, the combination of proactive and cost reduction strategies for the regional SMEs led to achieving better financial results for SMEs such as sales growth in 2012 (see Model 2), which is clearly expressed by hypothesis H1. If SMEs also follow a strategy for applying for funds from programs available at regional level, the likelihood of better financial results is even higher (see Model 3).

## **5. Limitations and Further Research Questions**

This study entailed various limitations that need to be dealt with in our future work. It is assumed that the questions formulated to investigate the strategy and those related to firm financial indicators were well understood and answered accordingly. Therefore our analysis could not employ entirely the information and should be confined to a lower scale. Further research is needed to investigate such control factors as years of activity, membership of SME networks, innovation effect and field of activity.

## **6. Conclusions**

The SME sector is continuously developing in the EU and Hungary, and its share of employment and value added is huge. In Hungary, in recent years, SMEs have faced difficult times, their environment drastically changing. To be able to face increased competition, and to react quickly to changes in their environment, SME management needs to follow suitable strategies. SMEs, however, have limited resources and adopting inadequate or multiple strategies could raise the costs of strategy implementation if SME management cannot share their resources efficiently. The research attempted - successfully - to find those strategies relevant for SME management and to performance. The study was carried out keeping in mind that only those strategies are worth analysing which has an impact on SME performance.

The studied literature revealed that the relation between the strategy and performance of enterprises depends on the industry sector and also on the size of the enterprise. The SME are encouraged to take the opportunity to develop strategies for niche or non-maturated markets which are more accessible and profitable. In addition, we found that SMEs should follow more than one strategy - in fact, a combination of strategies - which varies from author to author. As the outcome of this study partially in line with the findings of SME scholars, adopting combination of strategies is more efficient than relying on one only. Firstly, the results demonstrated that, by adopting a proactive strategy, a market strategy of quality and cost reduction, Hungarian SMEs should improve the likelihood of achieving a positive growth in sales, which means also an increase in market shares. With respect to the regional perspective of a firm's strategy, as shown in our results, the location of SMEs in one of the three regions studied does not greatly affect these findings. Our findings support our clear conclusion that, if SMEs in the region adopt a combination of strategies, this may well have a great impact on their performance.

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