

## **Service Competence and Firm Performance – towards a Concept for Strategic Differentiation for Small and Medium-sized Enterprises**

### **Urs Fueglistaller**

Swiss Research Institute of Small Business and Entrepreneurship  
University of St. Gallen  
Dufourstr. 40 a  
CH-9000 St. Gallen  
Tel.: 0041 71 224 71 00  
E-Mail: urs.fueglistaller@unisg.ch

### **Thomas Schrettle**

Swiss Research Institute of Small Business and Entrepreneurship  
University of St. Gallen  
Dufourstr. 40 a  
CH-9000 St. Gallen  
Tel.: 0041 71 224 71 00  
E-Mail: thomas.schrettle@unisg.ch

### **Abstract**

Even though small and medium-sized enterprises (SMEs) play a vital role in world economies, strategic management research provides only limited insight into SME strategies. Scholars to date have mainly emphasized size-related disadvantages which small firms have to face in comparison to large corporations. In this paper we therefore argue that SMEs can gain competitive advantage through providing high quality services to their customers. Based on their service competence, long-term service relationships enable small business firms adapt their services to changing business environments and to offer customized services and hence to outperform large corporations. To stay ahead of competitors, providers must have a bundle of dynamic capabilities to constantly reshape their activities and the way they operate. In this paper, we introduce service competence as a construct to describe these capabilities and develop a set of propositions on how organizational antecedents influence the service competence of an organization.

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The explanation why some firms perform better than others has always been of central interest for strategic management research. But as the research field evolves, small and medium-sized enterprises, while playing a vital role in all economies, have not received adequate attention by strategic management scholars yet. Most research to date has mainly concentrated on large corporations which are dominant both in researchers' and in public awareness. Concerning small firms, disadvantages which SMEs face on behalf of their limited resource endowment were emphasized albeit they can gain considerable competitive advantages due to limited size and the resulting flexibility (Fiegenbaum & Karnani, 1991), which enables SMEs to offer customized products and services, which large corporations cannot. There is considerable potential for strategic differentiation in this ability. As mature economies have turned from industrial towards more service-oriented economies, organizations have to adapt to the requirements of this "information-based, knowledge-driven, service-intense economy" (Bartlett & Goshal, 2002: 34). While firms face considerable challenges from that, there are also large opportunities arising, especially for SMEs with the ability to adapt rapidly and to provide value to the markets through commitment and superior services. Due to high degrees of flexibility and good knowledge of their customers' present and future preferences, small business firms have the potential to differentiate themselves on behalf of service quality (Zeithaml et al., 1992). We hence consider service quality as a strategic option and as an opportunity for SMEs to compete against large corporations.

However, changing business contexts make acquired competences obsolete or create new opportunities, either of which may require new competences to be built (Daneels, 2008). Service providers have to constantly develop their services and the way they are produced. We hence introduce service competence as a dynamic capability: a "firm's ability to integrate, build and reconfigure internal and external competencies to address rapidly changing environments" (Teece et al., 1997: 516). A high level of service competence to continuously adapt to changing customer needs hence is crucial for SMEs to secure present and future success in a highly competitive market context. It has to be mentioned that we consider this to be valid both for b2c and b2b relationships and also for small product companies as they can differentiate themselves by offering superior value to customers through complementary services. While dynamic capabilities have been of central interest in management research in recent years, yet there is still limited understanding on how organizational antecedents can influence dynamic capabilities and thus on how a high level of service competence can be achieved. Entering a discussion about service competence as a dynamic capability, we hence make some propositions on the relationship between organizational antecedents and service quality.

By doing this, we strive to contribute to the existing literature in three different ways.

- First, we try to improve our knowledge about strategic options for small and medium-sized enterprises, as we think that this is an underdeveloped research field.
- Second, we contribute to the service management literature by integrating a dynamic capabilities perspective into the existing research.
- Third, we want to give indications to practitioners in SMEs on how to develop the abilities to successfully compete within their markets.

Therefore we will do a short review of the relevant literature in the next part of this paper and we will develop a set of propositions as a basis for further research.

## Theoretical Background and Propositions

Strategic management as a research field is basically concerned with the creation, survival and performance of all different types of organizations and with the notion that organizations cannot survive over time unless they can deliver some sort of value for the society in which they are embedded (Schendel & Hitt, 2007). In mature economies, value creation is increasingly based on the delivery of services to customers as they have turned from industrial towards more service-oriented economies. Accordingly, organizational scholars are more and more interested in service settings. However, we believe that there is still considerable imbalance within the field: while strategic management research has created huge amounts of knowledge in the last decades, the literature has mainly concentrated on large corporations. Even though SMEs constitute the bulk of enterprises in all economies and make a major contribution to economic growth, private sector output and employment, they are not adequately represented in management research. Especially with the rise of the Industrial Organization in the late 1970s, economics has provided the theoretical basis for strategic management with structural characteristics of an industry as main determinants for firm performance (Porter, 1980). A major line of research has hence concentrated on firm size as an important factor and on the positive relationship between firm size and profitability. As a result, many scholars emphasized size-related disadvantages in terms of economies of scale, experience curve effects, brand name recognition, managerial expertise, access to capital and bargaining power with suppliers and buyers and it was widely assumed that large firms have all strategic options that SMEs have, but not vice versa (Fiegenbaum & Karnani, 1991). Management research still suffers from what Robinson and Pearce (1984) called the “little big business” syndrome: concepts of strategic management are mainly developed in a large firm context and then just scaled down to be used in small businesses. However, SMEs are not just smaller versions of large companies, but differ significantly in the way they interact with their environments (Shuman & Seeger, 1986).

It is direct interaction with customers which helps small business firms to build sustainable service relationships based on profound knowledge of customer requirements and preferences and which enables them to offer personalized or customized services that are unique and special (Zeithaml et al., 1992). Customers and providers get to know each other and develop a relationship and a history of shared interaction which they can draw on in future interactions (Guttek et al., 1999). In increasingly service-oriented economies, which are dominated by service focused businesses, SMEs hence have the potential to gain an advantage over large firms and to outperform rivals if they can deliver greater value to their customers or if they can deliver equal levels of value at lower cost. Recent research has indicated the selection of a strategy is especially important for SMEs as they cannot pursue different strategic configurations with contradictory strategic and organizational demands due to limited resource endowments (Ebben & Johnson, 2005). We hence argue a clear strategic positioning on behalf of service quality and service relationships is necessary to realize competitive advantages and to outperform rivals in today’s business environments. Strategic positioning arises from the choice of activities performed and from the way they are performed; or in other words, competitive strategy is about “being different” (Porter, 1996). Service activities are hence the basis for competitive advantage and for strategic differentiation along the different dimensions of service quality (Zeithaml et al., 1992) which is determined by levels of

- Reliability: The ability to fulfill customer requirements dependably and accurately,

- Empathy: A customer's perception of individual attention given by service providers,
- Assurance: Employees knowledge and courtesy and their ability to inspire trust and confidence,
- Responsiveness: The willingness to provide prompt service and to give immediate assistance,
- Tangibles: The appearance of physical facilities, equipment, personnel and written materials.

Porter (1996) pointed to the problem that failures often occur in distinguishing between organizational effectiveness and strategy. An improvement of operational effectiveness, while it is essential for performance, might not be sufficient for long term survival, as "best practice" is easily imitable by rivals and does not offer a unique position in a market. In fact one might argue that service quality is rather an aspect of the operational processes than of an actual strategic position. But while operational effectiveness means performing the same activities better than rivals, our understanding of service quality, though including high levels of efficiency in operations, is mainly based on offering different service activities along the dimensions of service quality.

While high levels of service quality are time-consuming and imply higher cost compared to low-quality services, we assume that good service quality allows firms to gain a price premium for their services. Furthermore, good quality leads to a higher number of service encounters and sustainable service relationships which positively influences efficiency in service operations. The ability to offer customized services hence provides the potential for superior firm performance and to gain a unique market position.

*Proposition 1: A high degree of service quality is positively related to firm performance.*

New strategic positions are created through change, as new customer groups develop or new needs emerge while societies evolve, new distribution channels appear and new technologies are developed (Porter, 1996). Changing business environments make acquired competences obsolete or create new opportunities, either of which may require new competences to be built (Daneels, 2008). Based on our prior research (Fueglistaller, 2001), we hence want to introduce service competence as a dynamic capability which enables organizations to continuously adapt to changing customer requirements and business environments: a "competence to add competences" is required to change services, the way they are produced or the customers who buy them (Daneels, 2008; Teece et al. 1997; Winter, 2003).

A capability is defined here as a "high-level routine (or collections of routines) that, together with its implementing input flows, confers upon an organization's management a set of decision options for producing significant outputs of a particular type" (Winter, 2003: 991). There is a sometimes confusing variety in the literature on labelling capabilities: while different authors refer to the concept as (core) competence, collective skill, complex routines, architectural competence or best practice, the term "capability" will be used throughout the paper to prevent confusion. This corresponds to recent literature on the topic (Schreyögg & Kliesch-Eberl, 2007). According to the taxonomy of Winter (2003), routines are zero-level capabilities or operational capabilities. They can be defined as "repetitive, recognizable patterns of interdependent actions, carried out by multiple actors" (Feldmann & Pentland, 2003: 95). To gain competitive advantage, organizations in a highly dynamic environment have to systematically reconfigure capabilities over time, using dynamic capabilities. These are first-order capabilities, enabling organizations to constantly change their organizational capabilities (Winter, 2003). Zollo and Winter (2002) additionally introduce learning mechanisms as meta-routines to change dynamic capabilities, which could be defined as second-order capabilities. Using the general

definition of Zahra et al., the qualifier “dynamic” distinguishes one type of capability from another type of a lower order (2006: 921). Different competences within firms have been identified as dynamic capabilities and have been used to explain why some firms perform better than others. Research and Development (R&D) for example is a technological competence of a higher order which preserves enterprises from technological obsolescence. Marketing as a second-order customer competence helps firms to better serve a particular customer segment: First-order customer competence consists of specific knowledge of customers' needs and preferences, purchasing procedures, competitors and communication channels. Second-order competences help firms to identify new customers, to acquire knowledge about them and adjust the activities operated (Daneels, 2008). In this paper, we propose service competence as a dynamic capability which enables service providers to continuously improve their offered services and their service processes in accordance with technological changes, customer needs and other changes in business environments. We argue that service competence enables service firms to anticipate changes in the market and to translate these changes into strategies accordingly.

Recent literature has emphasized the role of employee adaptiveness for service customization and customer satisfaction on an individual level (Gwinner et al., 2005). In this paper, we want to discuss how antecedents and structures on an organizational level influence service competence as a dynamic capability and hence service quality as a strategic option. The influence of organizational antecedents on organizational outcomes and relationships is a recurring theme in strategic management research (Aiken & Hage, 1968). However, there is yet no general understanding of how formal and informal coordination mechanisms can influence the emergence of dynamic capabilities within organizations by knowledge creation and absorption, knowledge integration and knowledge reconfiguration (Verona & Ravasi, 2003) This paper will therefore examine the impacts of centralization of organizational decision making, firm connectedness, and formalization on service competence and make some propositions accordingly. A positive relationship between service competence and service quality is assumed.

Several authors have pointed to the impact of the adoption of semistructures on organizational change and innovativeness (Brown & Eisenhardt, 1997) and also on the creation of dynamic capabilities (Teece, 2007; Verona & Ravasi, 2003). An important feature of a semistructure is a moderate level of centralized decision making. Centralization refers to the extent to which processes of decision making are concentrated within an organization. High concentration narrows communication channels and reduces quality and quantity of innovative ideas (Jansen et al., 2006). A high degree of centralization hence decreases knowledge utilization and explorative activities in organizational learning (Jansen et al., 2006; Jaworski & Kohli, 1993). Furthermore, a strong centralization of decision making structures causes an intense top-down knowledge flow from higher levels to lower levels in hierarchy, while horizontal knowledge flows are constricted concomitantly, which also has a negative impact innovative action and on organizational adaptiveness (Mom et al., 2007). Thus it is assumed that centralized decision making negatively impacts organizational service competence due to limited knowledge utilization and an overly concentration on existing routines:

*Proposition 2: There is a negative relationship between a unit's centralization of decision making and the emergence of service competence.*

Previous empirical research has strongly indicated the importance of intra-firm communication for organizational change and innovation (Brown & Eisenhardt, 1997) and for the creation of dynamic

capabilities (Verona & Ravasi, 2003). Knowledge sharing between business units can be fostered by the existence of knowledge networks (Hansen, 2002) and thus positively influence the creation of capabilities. Especially the roles of informal interfirm or interunit relations affecting knowledge transfer and organizational learning have been highlighted in recent years, because horizontal as well as bottom-up knowledge flows increase within informal networks, which positively influences explorative activities of firm management (Jansen et al., 2006; Mom et al., 2007). Informal social relations thus have a highly positive impact on interaction and exchange of information as well as the integration and utilization of the acquired knowledge (Jaworski & Kohli, 1993). Therefore, a positive relationship between connectedness and the creation of dynamic capabilities within an organization is assumed because organizations can make better use of acquired knowledge and of customer interactions.

*Proposition 3: There is a positive relationship between a unit's connectedness and the emergence of service competence.*

Another hierarchical structure within organizations which is supposed to affect the creation of capabilities is formalization of rules, procedures and structures which hampers experimentation and ad-hoc problem solving procedures (Jansen et al., 2006). Articulation and codification of organizational knowledge is necessary to put down formal procedures in a document or manual which can act as a frame of reference for individual and organizational behaviours. It hinders deviation of organizational actors from structured behaviour and existing knowledge (Jansen et al., 2006). The cognitive simplification by formalizing and codifying existing knowledge has been argued to be advantageous to behavioural adaption in dynamic environments (Brown & Eisenhardt, 1997; Zollo & Winter, 2002). Concerning the effect on the emergence of service competence, we assume that the formalization of procedures and rules has a positive impact, as it canalizes and aligns individual activities which leads to a higher effectiveness, lower failure rates and short response times. However, when a certain degree of formalization is reached, further increases are assumed to negatively affect the adaptiveness and innovation as the variance of knowledge creation is limited considerably and actors strongly focus on existing capabilities instead of searching for new ones. Organizational inertia can thus be created by excessive formalization. The existence of an optimal level of formalization within organizations is therefore assumed:

*Proposition 4: There is an inverted U-shaped relationship between a unit's formalization and the emergence of service competence.*

## Discussion and Limitations

We consider this paper and the developed propositions as a first step to discuss the role of service competence for organizations and especially for SMEs as a strategic option. As organizational structures like centralization, connectedness and formalization in small firms differ significantly from large corporations, we argue that there is considerable potential for strategic differentiation on behalf of service quality and service customization. To keep ahead of competitors, service competence as a dynamic capability is essential to continuously adapt these services.

Various limitations of this paper merit discussion which could however point to interesting directions for future research. Due to limited space, we just point to two of the most important ones in this section. First, while service competence has been described as a bundle of capabilities, we did not point out, which capabilities we include in the construct. Yet we do not have a precise definition of service competence and this is an important point for our future research. Second, numerous scholars remain sceptical about the value and contribution of the Capability-based View (CBV), as the literature is still riddled with inconsistencies, overlapping definitions and inherent contradictions (Winter, 2003; Zahra et al., 2006). As capabilities are per definition highly patterned activities, some authors criticize the assumption of a dynamic process of renewing capabilities as being contradictory in itself. They consider it a deep-seated discrepancy which even challenges the whole concept of dynamic capabilities (Schreyögg & Kliesch-Eberl, 2007). Thus, the discussion about the usefulness of the CBV to explain competitive advantage is still ongoing and further research will be needed to better understand the role of dynamic capabilities.

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