

# Competitive Strategy and Business Environment: The Case of Small Enterprises in China

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## Abstract

As an important participant in Chinese market, SMEs are confronted with the tasks of keeping themselves competitive, which concern their survival and future growth. To help Chinese SMEs maintain and improve competitiveness, a theoretical framework is built up through organizing the existing theories and findings in studying SMEs in China. The framework investigates competitive strategy and business environment influencing Chinese SMEs' performance. Based on data collected from SMEs in China, this study has confirmed the importance of competitive strategy to achieve their competitive advantage. Moreover, there is a negative relationship between competitive pressure and SMEs' performance.

**Keywords:** SMEs, Competitive strategy, Business environment, China

## 1. Introduction

After the Third plenum of the 11th Central Committee of the Chinese Communist Party in December 1978, the government started to provide guidelines for reform and development of the agricultural economic system, which led to the legalization of small market-oriented businesses in the rural areas (Leo, 1999). SMEs flourished in the market-oriented economy as the government gradually relaxed restrictions on the development of small enterprises. The SMEs have grown to be an important force in promoting the development of Chinese economy. They accounted for 99 percent of the total number of firms, 69.7 percent of overall employment, and 65.6 percent of China's gross output value of industry (National Bureau of Statistics of China, 2006). It is therefore necessary to enhance the management system by expanding the operations of the business and strengthening strategic management.

As most early studies in small business have focused on the context of advanced market economy, small business development in transitional economy remains by and large an unexplored and important agenda (Tang *et al.* 2007). Moreover, Chinese SMEs face a dynamic and competitive environment in the China's post-WTO era. Little research has been undertaken to systemically analyze the challenge and opportunity posed by such situation, which would give rise to an effective and integrative strategy for SMEs to compete in the Chinese market. The current study represents a first step towards bridging the research gap. It synthesizes and integrates the strategic choice approach and the environmental management perspective to build an expanded notion of competitive advantage for SMEs in China.

## 2. Literature review

In the study of the competitive advantages developed by small businesses in operations, researchers have acknowledged that generic competitive strategy and external conditions have their impact on Chinese SMEs' performance. The outstanding performance and development of SMEs can be attributed to business environment change in China. With the reforms taking effect in 1980s, small enterprises were provided with the opportunity to retain profits, which brought the first stage of an incentive structure (Sun 2000). Luo (1999) investigated environmental factors, such as complexity, dynamism and munificence, influencing small firms' performance. Based on an analysis of survey data collected from SMEs, Luo confirmed that environmental characteristics have a significant influence on SMEs' strategic orientations. Tan (2001) proposed that the environmental turbulence brought about the rapid rise in entrepreneurship in China. Entrepreneurial firms, being small and faster than state-owned enterprises (SOEs), adopt strategies that distinguish them from their lagers to achieve their success.

The SME's competitive advantage is not only affected by the environment, but also depends on competitive

strategy it involved. Chew *et al.* (2004) built up a conceptual framework for the competitive strategies for Chinese SMEs, which includes strategic alliances, innovation and differentiation. The framework was also illustrated by a case study of a prominent Chinese SME. Tang *et al.* (2007) examined the association between marketing strategy and business performance of small firms in China. Based on data collected from SMEs in China, they suggest small Chinese firms would adopt a long-term differentiation strategy, focusing on R&D and new product development.

### 3. Research hypotheses

Competitive advantage of the firm is a function of industry analysis, organizational governance and firm effects in the form of resource advantages and strategies (Mahoney and Pandian, 1992). From an environmental management perspective, environmental factors are important predictors to the organization's performance. The environmental factors are mainly in regard to economic and competitive conditions, including market turbulence, government interference and competitive intensity (Dalgic, 1998). The strategic choice approach is embedded in strategic management literature and focuses on the central role of strategy as a determinant of firms' performance. According to strategic choice approach, firms are assumed to be open systems that confront and respond to challenges and opportunities in their environment (Child, 1997). The research aims to integrate these two dominant perspectives based on frameworks that were proposed or adopted in previous studies (Luo, 1999; Chew *et al.*, 2004; Tang *et al.*, 2007). The conceptual framework in this study proposes Chinese SMEs' performance is critically dependent on two levels of factors: competitive strategy and business environment.

#### 3.1 Competitive strategy and SME's performance

The competition strategy is the strategic choice that can influence SMEs' performance. In analyzing the strategies of firms, the Porter's framework has been the dominant tool for the past two decades. Greenfield (1989) suggested the use of Porter's (1980) three generic strategies by SMEs in competing for markets. Sandberg (1986) found that business strategies have direct influence on growth performance of SMEs. In addition, such factors as strategic types, the adoption of new technologies, quality products and other organizational strategy related factors are also revealed to have important influence on superior performance of SMEs. Tang *et al.* (2007) stated that market differentiation strategy through ancillary intangibles might prove effective to achieve success for small firms. Chandler and Hanks (1994) suggested that small firms should use innovation strategy to obtain competitive advantage in rapidly changing environment. Chew *et al.* (2008) further proposed that the SME should form a strategic alliance with other firms to pre-empt such aggressive actions by the bigger firms. As such, Chinese SMEs should rely heavily on developing competitive strategy in order to be sustainable in the industry. Based on these considerations, the hypotheses of this study are:

Hypothesis 1: Cost strategy is positively related to Chinese SMEs' performance.

Hypothesis 2: Differentiation strategy is positively related to Chinese SMEs' performance.

Hypothesis 3: Innovation strategy is positively related to Chinese SMEs' performance.

Hypothesis 4: Strategy alliance is positively related to Chinese SMEs' performance.

#### 3.2 Business environment and SME's performance

The complex industry environment is seen as multidimensional, with numerous and differentiated effects on various organizational characteristics and processes (Keats and Hitt, 1988). Business environment provides a window to market opportunities and threats, and SMEs are a deliberate response to those dynamics. During economic transition, the business environment in China has revealed several characteristics. First, growth in sales and profitability varies markedly due to the industrial policy that allows only some sectors to be privatized and also to the deep-rooted imperfections in industry structure (Sun, 2000). Second, government regulations frequently changed due to idiosyncratic paths of decentralization and government needs for controlling strategically vital industries. Third, competitive pressure varies by the level of equilibrium between market demand and market supply. These characteristics of the environment have a direct impact on the nature of competition and the competitive strategy available to Chinese SMEs. Drawing on the literature, business environment would appear to have a strong effect on the SMEs' performance. In light of the above, the following relationships are predicted:

Hypothesis 5: Environmental dynamism is positively related to Chinese SMEs' performance.

Hypothesis 6: Competition pressure is negatively related to Chinese SMEs' performance.

## 4. Research methodology

### 4.1 The sample and survey instrument

The survey method used a structured questionnaire. The questionnaire survey was conducted in major cities and provinces in China. To control for possible industry effect, the research focused on the fast growing construction industry. The average annual growth rate in the construction industry has been over 10% since 1980. The contribution of the construction industry to the GDP of China increased from 4.17% in 1981 to 6.58% in 2004 (National Bureau of Statistics of China, 2006). The sampling frame consists of SMEs which were selected from the name list of Directory of Chinese Construction Industry Association. The selected construction SMEs meet the criterion with registered total turnover below RMB 400 million and employees less than 3000 (SETC, 2003).

The original English questionnaire was first reviewed and revised by two professors (one in marketing and another in strategic management) with substantial research experience in the subject area in China and then translated into Chinese. The questionnaire, together with a cover letter explaining the methodology and objective of the study, was distributed to 1,000 construction SMEs in those areas by mail. A total of 133 responses were received, out of which 121 were deemed effective for analysis. Thus the actual response rate is 12.1 percent. This response rate is acceptable with most studies of SMEs in the Western contexts as Chandler and Hanks (1994) suggested that response rates to random mail survey are frequently in the order of 10% to 33%. Table 1, 2 summarize the respondents' particulars and firm size, ownership and age of the respondents.

### 4.2 Measurement of variables

Most of the factors in the questionnaire are self-developed to suit the practice in the industry. The instrument has been tested for face-to-face validity on contractors. All key variables in the study were assessed using multiple measures. Such measures are necessary to capture the domain of the constructs adequately and accurately (Churchill, 1979; Nunnally, 1978). In addition, this approach is believed to reduce measurement error and increase the reliability and validity of the measures (Churchill, 1979; Peter, 1979).

The competitive strategy variables were measured using 5-point Likert scales ranging from 1 "not at all important" to 5 "extremely important". Competitive strategy includes four variables: cost, differentiation, innovation and strategic alliance, which determine SMEs' competitive advantage. Cost was measured by a four-item scale: (1) access to low cost labor, (2) access to low cost raw materials, (3) reducing cost in operation management, and (4) reducing cost in administration activities.

Differentiation strategy attempted to capture a company's ability to market and sell products effectively and efficiently, and achieve marketing performance (Hann *et al.*, 2002). A four-item scale was partly adopted from Chew *et al.* (2008) as follows: (1) develop brand identification; (2) achieve high quality beyond the requirements in the specifications; (3) adopt bidding strategy with competitive price; and (4) deliver constructed facilities ahead of schedule. Five items were identified for innovation strategy as follows: (1) technical and managerial expertise, (2) competence in technology and process, (3) IT technology, (4) innovation in finance; and (5) innovation in operation mechanism. Strategic alliance presented as an important way of improving performance through the direct benefits accruing to both parties involved. Strategic alliance was measured by four items: (1) subcontractor of a large enterprise, (2) partnering with customer on a long-term basis, (3) cooperation with reliable suppliers, and (4) cooperation with research institutes and universities.

Business environment items are factored as two broad concept- environment dynamism and competitive pressure. The scale was a 5-point Likert-type scale and responses ranged from 1 "not at all important" to 5 "extremely important". The measure of environment dynamism was based on a five-item scale developed by Luo (1999) and Langford and Male (2001). Environmental dynamism included five items as follows: (1) condition of economic; (2) development of legal system; (3) the product/service technology; (4) reform of the industry; and (5) the service efficiency of government department. Competition pressure describes the degree for rivalry among construction firms in the construction industry. The measure was adopted from a modified version of the scale used by Luo (2003) and included four items: (1) government intervention; (2) the rivalry for competitor; (3) impact of local government policy; and (4) the extent of threats from new entrants.

### 4.3 Firm's performance

Firm's performance was the ultimate criterion in the theoretical model. The competitive performance was often measured by the business volume (including sales, profit) (Cheah *et al.*, 2007), efficiency (productivity, return on equity, net profit) (Davies and Walters, 2004), business growth and sustainable growth (Fu *et al.*, 2002). In this research, sales growth and profit growth were used for measuring construction SMEs' competitiveness.

## 5. Analysis and results

### 5.1 Correlation analysis

Table 3 presents the descriptive statistics and correlations among all variables used in the analysis. As indicated, the correlation analysis had shown that there was significant and substantial level of correlations among variables of the same construct. For example, a medium to high level of correlations from 0.26 to 0.56 was found among the competitive strategy areas. This could be explained by the fact that they were all sub-constructs of similar behavioral characteristics reflecting a higher-level construct. Cronbach's coefficient alpha was used to measure the degree of covariation among competitive strategy and business environment variables. Table 4 shows the cronbach's coefficient of each variable, the resulting values range from 0.65 to 0.83, indicating an acceptable level of internal consistency (Churchill, 1979; Nunnally, 1978).

### 5.2 Research findings

Regression analysis is used to determine the degree to which selected independent variables were able to predict SMEs. The measure of "overall performance" is given by the average of sales and profit growth rates. The results are presented as standardized regression coefficients in Table 5. As indicated, For Model 1c, the independent variables explained 34 percent of variance in the construction SMEs' sales growth ( $R^2=0.29$ , Adjusted  $R^2=0.28$ , F value=7.73). These adjusted  $R^2$  are consistent with studies of SMEs by Lerner and Almor (2002) and Sadler-Smith *et al.* (2003). Lerner and Almor (2002) regressed growth and strategic volume and reported adjusted  $R^2$  is 21 percent. The adjusted  $R^2$  reported by Sadler-Smith *et al.* (2003) is 12 percent. Thus, the values of adjusted  $R^2$  in this case could be deemed acceptable for evaluating Model.

The results showed that cost strategy has significantly positive relationship with overall performance with a coefficient of 0.27 at 0.01 levels, indicating that H1 is supported. Differentiation strategy had significantly positive relationship with overall performance ( $\beta=0.29$ ,  $p<0.01$ ). Therefore, H2 is supported. Innovation strategy is significantly related to construction SMEs' performance with  $p<0.05$ , thus H3 is also supported. Strategic alliance is not significantly positive relationship with construction SMEs performance ( $\beta=0.10$ ,  $p>0.05$ ). Thus H4 is not supported. As for environmental variables, environment dynamism is not significantly related to construction SMEs' performance with  $p>0.05$ , thus H5 is not supported. Competitive pressure is negatively related to construction SMEs with a coefficient of 0.13, therefore H6 is supported.

### 5.3 Discussion of the findings

The study investigated the key competitive strategy variables and showed that cost, differentiation, and innovation strategy were key competitive strategies used by SMEs in China's transitional economy. The study's findings mesh with generic strategy research which suggests that cost, differentiation and innovation are appropriate strategies in dynamic environments (Miller, 1988; Chew *et al.*, 2004; Tang *et al.*, 2007). Strategic alliance significantly contributed to the SMEs' sale growth, but not to the profit growth. A plausible explanation is that, for SMEs, the use of strategic alliance attempts to satisfy the needs of market expansion through covering multiple market segments. On the positive side, strategic alliance results in improved client focus and satisfaction as well as better responsiveness to changing market conditions. Thus SMEs may expand its market position and lead to output growth. On the negative side, pursuing strategic alliance involves high costs to develop and sustain the resource to support the strategy. Given the limited resources of SMEs, gains in market position may adversely effect the profitability.

Furthermore, the study investigated the impact of environment factors on Chinese SMEs' performance. Contrary to the prediction in the research, environment dynamism was not related to SMEs' performance. A plausible explanation is that, the success of SMEs is largely attributed to top managers' ability to develop effective strategies that are compatible with environmental conditions. Small business managers may face dynamism environment that were unclear and that presented few well-alternatives and few clear evaluations criteria by which to select among alternatives (Luo, 1999). Competitive pressure challenged the competitive positions achieved by incumbent firms and reinforces dependence on other firms. High competitive pressure may create more chaos in the market including the appearance of extensive pseudo- and inferior projects and escalating prices. The chaos may lower customers' loyalty to products and thus increase the costs for using competitive strategies.

The study has several limitations, which merit some consideration when evaluating the findings. From a theoretical point of view, this paper used a strategic perspective when discussing the relationships among competitive strategy, business environment and SMEs' performance. The limitation as a result of data collection was related to the sample size adopted in this research. Although no significant non-response bias was found, the

relatively low response rate had resulted in the smaller than expected sample size, which was less desirable for the statistical precision and confidence of the study. Moreover, given the large number of variables involved, this small sample had limited the ability to develop a casual model through the structural equation model. Thus, a much larger sample size would have provided stronger tests of all the hypotheses and greater confidence in the results. The research has inherent limitations as a result of operationalization of variables. With the transition of China's economy from the highly centralized planning economy to a market-oriented one, environmental factors become the concern of most construction enterprises. Future research should address this issue in order to better interpret the relationship between industry structure and SMEs' performance. Finally, the research may be limited by common method variance resulting from perceptual measures of firm-level constructs used in this research. However, the design of the research was cross-sectional rather longitudinal, and hence the conclusions themselves must be treated as correlational rather than casual.

## 6. Conclusions

The research integrated the environmental management perspective and strategic choice approach which have emerged in the literature related to the strategic management. A theoretical framework was built up through organizing the existing theories and findings in studying Chinese SMEs. The framework investigated competitive strategy and business environment influencing Chinese SMEs' performance. Based on data collected from SMEs in China, this study has confirmed the importance of competitive strategy to achieve their competitive advantage. Moreover, there are a negative relationship between competitive pressure and SMEs' performance. The findings of this study have implications for management practice. Specifically, the result of this research may be useful for management practitioners who are involved in the development of Chinese SMEs. The findings that competitive strategy is prime determinants of business performance should be a source of encouragement to managers in Chinese SMEs.

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Table 1. Respondent's particulars

Respondent's particulars	Number of Respondents	Percentage (%)
(a) Respondent's location		
Beijing	10	8.26%
Fujian	5	4.13%
Guangdong	23	19.01%
Hebei	4	3.31%
Hubei	3	2.48%
Jiangsu	22	18.18%
Jiangxi	3	2.48%
Shandong	9	7.44%
Shanghai	11	9.09%
Sichuan	5	4.13%
Tianjin	6	4.96%
Zhejiang	20	16.53%
Total	121	100%
(b) Respondent's position		
President/general manager	25	20.66%
Department manager	32	26.45%
Project manager	33	27.27%
General or senior engineer	31	25.62%
Total number of firms	121	100%

Table 2. Firm size, ownership and age of the respondents

Firm age		Firm size by employment		Ownership	
1-10	46	1-100	31	SOEs	23
10-20	40	100-500	44	Collective	36
20-30	17	500-1000	25	Private	42
30-40	14	1000-2000	14	Joint venture	10
40-50	4	2000-3000	7	Foreign-funded	10
Total	121	Total	121	Total	121

Table 3. Mean, standard deviation and correlation of variables

Variables	Mean	S.D.	1	2	3	4	5	6	7	8
1. Cost	3.82	0.68	---							
2. Differentiation	3.67	0.73	0.28 <sup>b</sup>	---						
3. Innovation	3.59	0.69	0.26 <sup>b</sup>	0.56 <sup>b</sup>	---					
4. Strategic alliance	3.26	0.85	0.28 <sup>b</sup>	0.34 <sup>b</sup>	0.37 <sup>b</sup>	---				
5. Environment dynamism	2.64	0.66	0.49 <sup>b</sup>	0.71 <sup>a</sup>	0.44 <sup>a</sup>	0.20 <sup>a</sup>	---			
6. Competitive pressure	3.39	0.67	0.24 <sup>b</sup>	0.55 <sup>b</sup>	0.48 <sup>b</sup>	0.29 <sup>b</sup>	-0.20 <sup>b</sup>	---		
7. Sales growth	3.39	0.71	0.37 <sup>b</sup>	0.50 <sup>b</sup>	0.41 <sup>b</sup>	0.33 <sup>b</sup>	-0.08 <sup>a</sup>	0.42 <sup>b</sup>	---	
8. Profit growth	3.04	0.79	0.31 <sup>b</sup>	0.29 <sup>b</sup>	0.24 <sup>b</sup>	0.17 <sup>a</sup>	-0.12 <sup>a</sup>	0.34 <sup>b</sup>	0.73 <sup>b</sup>	---

Note. \* P<0.05; \*\* P<0.01

Table 4. Variables and their reliability

Variables	Retained number of items	Reliability (Cronbach's Alpha)
Cost	4	0.83
Differentiation	4	0.80
Innovation	5	0.78
Strategic alliance	4	0.65
Environment dynamism	5	0.77
Competitive pressure	4	0.70

Table 5. The impact of competitive strategy and business environment on SMEs' performance

Independent variable	Dependent variable		
	Model 1a Sales growth	Model 1b Profit growth	Model 1c Overall performance
Cost	0.37**	0.16**	0.27**
Differentiation	0.26**	0.28**	0.29**
Innovation	0.20**	0.09*	0.15*
Strategic alliance	0.16*	0.04	0.10
Environment dynamism	0.11	0.17*	0.15
Competitive pressure	-0.09*	-0.15*	-0.13*
R <sup>2</sup>	0.34	0.20	0.29
Adjusted R <sup>2</sup>	0.31	0.16	0.25
F value	9.91	4.69	7.73