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Necessity entrepreneurs tend to compete on price more often

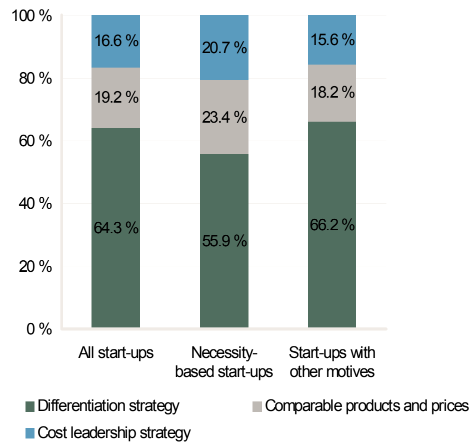
Authors:
Prof Dr Jörn H. Block, University of Trier,
Dr Karsten Kohn, phone +49 (0) 69 7431-4473,
Dr Katrin Ullrich, phone +49 (0) 69 7431-9791, research@KfW.de

Start-ups can enter the market through the price (cost leadership strategy) or the product they offer (differentiation strategy). This strategy choice is influenced by the business start-up motive of the founders as this is closely linked to the available entrepreneurial resources. Accordingly, necessity entrepreneurs tend to pursue a cost leadership strategy and less frequently a differentiation strategy than other entrepreneurs. This harbours particular risks.

The necessity motive often implies less start-up resources

Of the economically active[1] business start-ups founded in the years 2005 to 2007, 19 % were created out of a necessity motive – lack of paid employment opportunities or as a way out of unemployment. Necessity entrepreneurs did not previously design their professional career for self-employment and therefore often possess fewer entrepreneurially relevant resources. They also tend to have less time to prepare their new business and think about a market entry strategy.

Chart: Comparison of competitive strategies of necessity-based start-ups



Note: N=4,568 business start-ups.

Source: KfW/ZEW Start-up Panel, survey wave 2008.

Most start-ups enter the market using a differentiation strategy

When enterprises enter a market, they can do this on the basis of different strategies. The most basic classification of these strategies is by cost leadership (selling for a lower price than the competitor) or by differentiation (offering a better product).

Most entrepreneurs – irrespective of their entrepreneurial motive – seek to succeed in the market through new or improved products (see chart). However, 21 % of necessity enterprises, a disproportionately high rate, enter into competition with established enterprises through the price. Necessity entrepreneurs also pursue an imitative strategy (comparable products and prices) more frequently.

Start-up motive influences choice of strategy

Even taking into account other characteristics of the entrepreneur and the new enterprise, the result remains the same: necessity entrepreneurs offer a lower price as a strategy to set themselves apart from their competitors with higher probability than other entrepreneurs. Moreover, start-up entrepreneurs are more likely to seek cost leadership if they were previously economically inactive.

On the other hand, a new enterprise is more likely to pursue a strategy of differentiation through the product it offers

- when it is innovative,
- the fewer competitors it has,
- when it has employees.

Cost leadership also carries risks

Both strategy options require appropriate resources. While selling for a lower price than the competitors requires lower production costs and high efficiency, a strategy of differentiation requires creativity and courage to offer something new, for example.

Even if cost leadership initially appears to be the simpler strategy for entrepreneurs and hence more easily applicable, it is associated with risks. Established competitors may benefit from size advantages. Moreover, customer preferences may change in the long term, or competitors may find even more efficient production methods.

The right fit as a success factor

Entrepreneurs should align their strategy with the characteristics of their enterprise and the resources available to them. This includes meticulous calculation of the price advantages they want to offer their clients. Even if undercutting the price of rivals initially is a market entry strategy that can be swiftly implemented, the new enterprise must be able to defend it in the long term as well – unless it improves its products and services in the medium term and switches to a differentiation strategy. ■

For the detailed analysis see: Block, J. H., Kohn, K., Miller, D. and K. Ullrich (2012), Necessity entrepreneurship and competitive strategy. Discussion Paper, mimeo.

[1] These new businesses are either listed in the German Commercial Register, have resorted to debt capital, taken up business loans or other resources to become established, or are otherwise actively integrated into the economic process, for instance through intensive customer relations.