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Price Negotiation Power of Small and Medium-Sized Enterprises (SMEs)

How should small and medium-sized enterprises (SMEs) reduce their dependency on subcontracting work?

Mizuho Research Institute

<Summary>

While corporate profits are at record levels, the profitability gap between large and small and medium-sized enterprises (SMEs) is widening. Behind this growing gap is the weakness of SMEs in negotiating prices. Based on a poll conducted by Mizuho Research Institute and the Kyoto University Graduate School of Management, this research paper analyzes some common characteristics shared by companies that have price negotiation power, and discusses what can be done to boost this power.

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１．Introduction

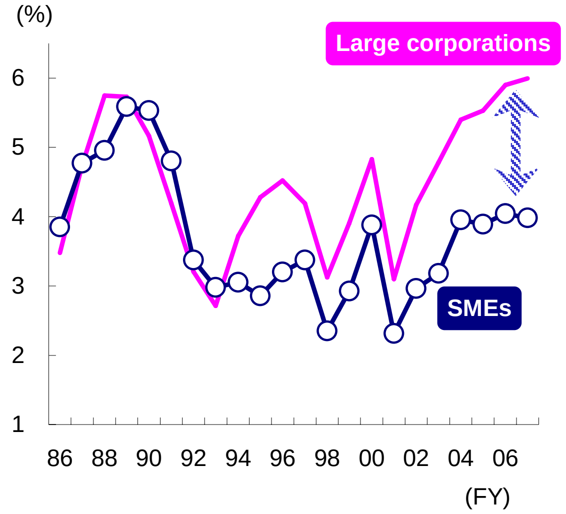
While corporate profits are at record levels, the profitability gap between large and small and medium-sized enterprises (SMEs) is widening. Behind this growing gap is the weakness of SMEs in negotiating prices. Based on a poll conducted by Mizuho Research Institute and the Kyoto University Graduate School of Management, this research paper analyzes some common characteristics shared by companies that have price negotiation power, and discusses what can be done to boost this power.

２．Companies are doing well overall, but the performance gap between large corporations and SMEs is widening

The Japanese economy is continuing to enjoy a prolonged – albeit mild - expansion. The current expansionary period has been in progress for more than 66 months, renewing the postwar record. The driving force is strong corporate performance, especially in the manufacturing sector. According to the *Financial Statements Statistics of Corporations by Industry, Quarterly* of the Ministry of Finance, corporate revenues and profits increased in FY2006 for the fifth consecutive year; ordinary profits were 59.5 trillion yen, roughly 1.5 times the level of FY1989 during the peak of the bubble period. Although the U.S. subprime mortgage problem has cast a cloud over future growth, FY2007 will likely be recorded as another expansionary year. The odds are high that corporate revenues and profits will continue the upward trend for some time.

Despite this sterling corporate performance, however, the profitability gap still remains between large corporations and SMEs. Even in manufacturing, which is outperforming the non-manufacturing sectors, the ratio of operating profits to sales for SMEs is about 4.0%, two-thirds the 6.0% marked by their larger counterparts. Moreover, the ratio of operating profits to sales for SMEs has remained flat since FY2005, further widening the gap between the two camps (**Chart 1**).

Chart 1: Trends in ratio of operating profits to sales



Notes: 1. Figures for FY2007 refer to the actual results for the Apr~Jun quarter

2. Large corporations refer to those with capital of 1 billion yen or over

SMEs refer to those with capital of 10 million to 1 billion yen

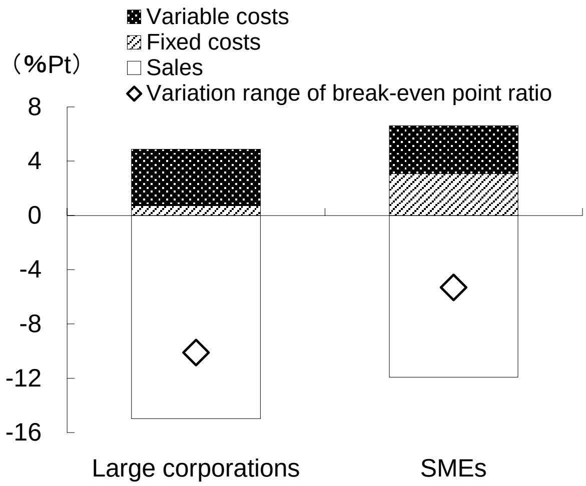
Source: Ministry of Finance, *Financial Statements Statistics of Corporations by Industry.*

３. Behind the widening profitability gap is lack of price negotiation power among SMEs.

One reason why the profitability of small and medium-sized firms lags behind is their weakness in negotiating prices with clients. This leaves them unable to secure sufficient revenues to offset increases in raw materials and personnel costs.

This weakness can be verified by the break-even point ratio, which indicates break-even revenues as a percentage of total revenues: the lower the ratio, the more robust a given company’s profit structure. Looking at trends over the past three years, the ratio has improved 10.1% pt for large corporations, but only 5.3% pt for SMEs. The latter have been unable to keep up with their larger counterparts in achieving revenue to offset higher costs, suggesting a lack of price negotiation power (**Chart 2**).

Chart 2: Factors for fluctuations in break-even point ratio (1Q2004→2Q2007)



Notes: 1. The break-even point ratio is represented as a 4-quarter prior moving average.
2. Large corporations refer to those with capital of 1 billion yen or over
SMEs refer to those with capital of 10 million to 1 billion yen

Source: Ministry of Finance, *Financial Statements Statistics of Corporations by Industry.*

Having said that, while this phenomenon applies in general throughout the SME sector, some individual companies do have technologies, products, or services that give them price-bargaining power equal to (or even higher than) that of their main clients. One of the questions in the poll conducted by Mizuho Research Institute and the Kyoto University Graduate School of Business (*A Survey on the Transaction Structure of SMEs*[1]) asks how sales prices for main clients are determined: 12.0% of the respondents say they set the prices themselves.

We will now analyze the results of the poll in further detail to identify the characteristics shared by companies with price negotiation power, and discuss what can be done to improve the prospects of SMEs.

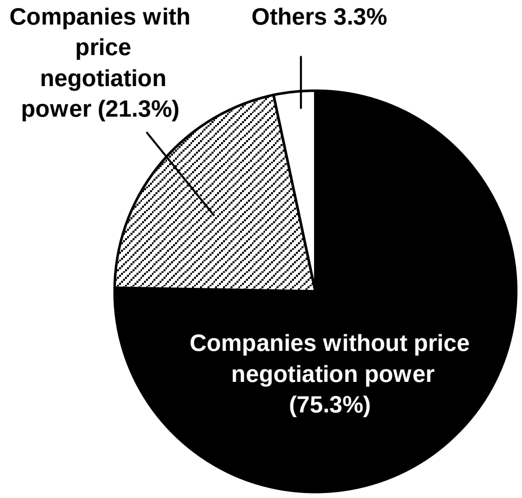
4. SMEs and their price negotiation power

Although, as we saw, 12.0% of respondents to our survey say they determine sales prices, the most common answer (58.6%) among SMEs is that prices are set by agreement between both parties; 26.0% say their main clients determine prices.

[1] The survey polled 6,903 manufacturing companies across Japan in August 2007; 1,283 provided a valid response (the response rate was 18.6%).

While joint agreement does not necessarily mean equal negotiating power, the poll also asks these companies whether they are able to raise prices to offset increases in costs. Only 15.8% say yes. In other words, the majority of companies that say prices are determined by agreement do not actually have much price negotiation power. When combined, the answers “difficult to raise prices” and “main clients determine prices” account for 75.3% of responses to the poll (**Chart 3**).

Chart 3: SMEs and price negotiation power



Note: Whether companies have price negotiation power or not is judged by how sales prices for main clients are determined, and by whether companies can raise prices to offset higher costs. “Others” represents cases in which prices are determined by law or industry customs.

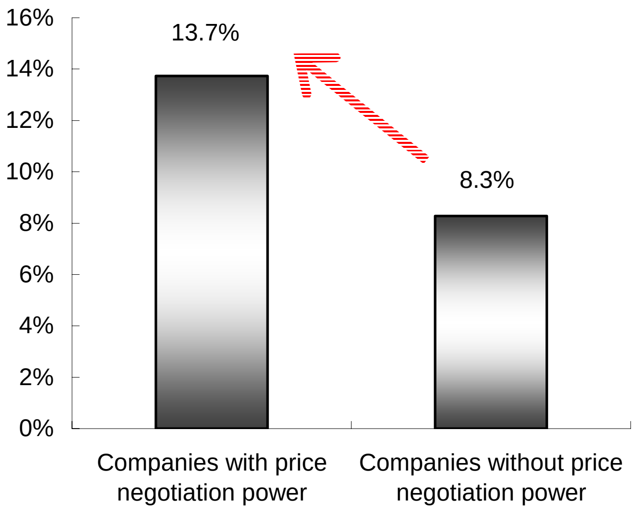
Source: Mizuho Research Institute and the Kyoto University, *A Survey on the Transaction Structure of SMEs*.

Common sense might suggest that the smaller a company the weaker its negotiating power, but in the SME sector, the relative size of a company -- whether based on capital or the number of employees -- does not seem to make any difference when determining price.

As for the type of product, companies manufacturing formed and fabricated materials (e.g., construction materials, dies), raw materials, finished goods, and final products tend to punch above their weight. Companies making parts and semi-finished goods are in a weaker position, though the level varies depending on products. In terms of industry, transportation equipment and electronic parts and devices, largely producing parts or semi-finished goods, ranked somewhat lower in terms of price negotiation power.

Lastly, in terms of dependency upon main clients, the less dependent a company is on particular clients for revenues, the greater its ability to negotiate prices. As we will see, companies with more price negotiation power differentiate their products from competitors' (**Chart 4**). Differentiated products have probably allowed manufacturers to expand their sales channels, reducing their dependency on main clients. In fact, such companies have a larger client base than firms that do relatively poorly in negotiating prices. Reducing dependency on main clients also later gives companies more say in price negotiation with these clients.

Chart 4: Degree of product differentiation and price negotiation power



Note: Proportion of companies that say their products are highly differentiated from their competitors'.

Source: Mizuho Research Institute and the Kyoto University, *A Survey on the Transaction Structure of SMEs*

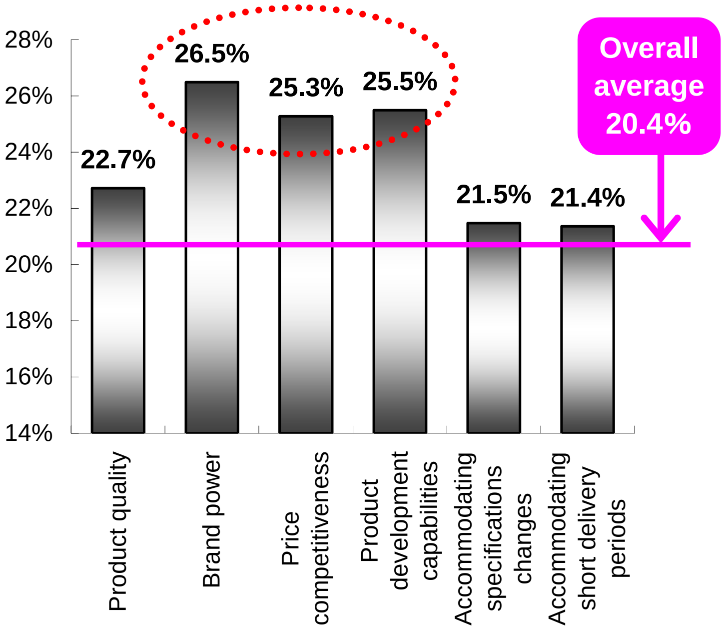
５．Relationship between product differentiation and price negotiation power

What can be done to strengthen price negotiation power? A common answer may be product differentiation, though it is not clear what aspects of products need differentiating, or how much impact product differentiation actually has in negotiations.

The survey asks not only about the degree of differentiation, but also whether the respondents' products have an edge over their competitors'. Specifically, the respondents are asked to rate themselves relative to their competitors, on a scale of 1 to 5, in the following six areas: product quality; brand power; price competitiveness; product development capabilities; accommodating specifications changes; accommodating short delivery periods.

The survey shows that differentiation does not necessarily lead to improved price competitiveness in all of the areas. In brand power, price competitiveness, and product development capabilities, companies with differentiated products tend to have relatively higher price negotiation power; in the other three areas, however, product differentiation does not translate into more price negotiation power (**Chart 5**). It should be noted that, in product quality, accommodating specifications changes, and accommodating short delivery periods – which comprise the top three areas in which companies say they have a competitive edge – differentiation does not lead to higher price negotiation power.

Chart 5: Areas of differentiation and price negotiation power



Note: Proportion of companies with price negotiation power among those that say they have differentiated themselves in these areas.

Source: Mizuho Research Institute and the Kyoto University, *A Survey on the Transaction Structure of SMEs*.

Besides, improving brand power and product development capabilities is easier said than done for SMEs. Price competitiveness would be meaningless, too, if it simply leads to price-cutting competition. Any enhancement of price competitiveness should be a result of improved productivity. To make that happen requires significant amounts of time and investment, a big challenge for resource-strapped SMEs.

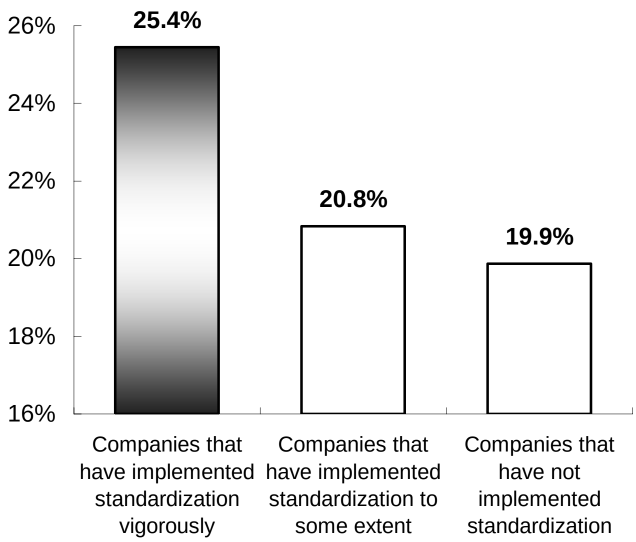
6. Standardization may be a key to operational improvement

What can be done to improve brand power, price competitiveness, and product development capabilities? Naturally, what strategies can be employed will depend on individual companies. In analyzing the survey results, we have focused on the level of standardization each company has implemented.

To many, standardization means simply setting uniform specifications for designs, materials, and parts. However, true standardization should go further to encompass all areas of operation, e.g., reviewing procedures for planning, manufacturing, and sales activities; using transaction history and client information more effectively; creating an organizational structure conducive to standardization; raising employee awareness. Not all these initiatives require large investments; some can be implemented cheaply if management is creative enough.

Some companies may already have standardized their resources and operations. However, the survey shows that while more than 60% of the respondents have undertaken initiatives to set uniform specifications for parts or to modularize them[2]**, only about 17% of the companies surveyed have done so vigorously. Apparently, there remains room for improvement. Standardization and modularization of parts not only reduce costs, but can also be an effective way for companies to differentiate their technologies: separating technologies and expertise into multiple, core technologies will make developing individual technologies more efficient. In fact, the survey has confirmed that price negotiation power tends to be higher among companies that have vigorously implemented standardization and modularization of parts (**Chart 6**). Standardization also improves profitability: the more vigorously companies have implemented standardization, the higher their operating profits (**Chart 7**).

Chart 6: Standardization and price negotiation power



Note: Proportion of companies with price negotiation power.

Source: Mizuho Research Institute and the Kyoto University, *A Survey on the Transaction Structure of SMEs*.

[2] One of the methods of standardization. Unifying the specifications for parts can improve their versatility
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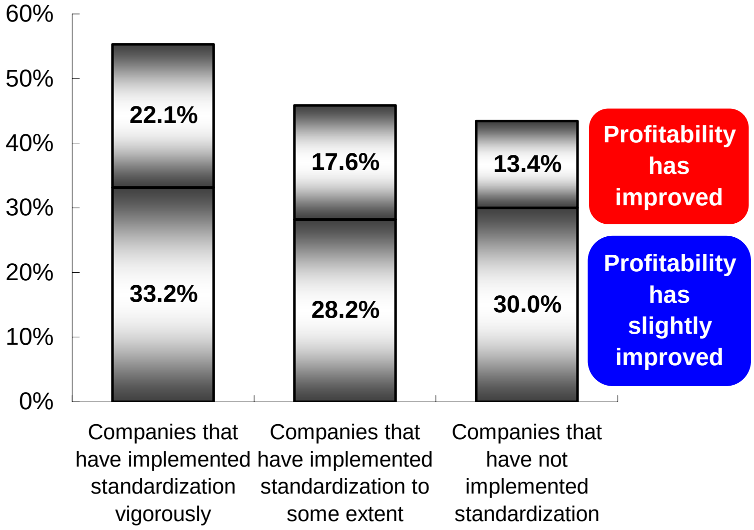
Chart 7: Standardization and profitability



Note: Trends in operating profits over the past 10 years.

Source: Mizuho Research Institute and the Kyoto University, *A Survey on the Transaction Structure of SMEs*.

Accelerating globalization is pressuring the manufacturing sector to shift away from the traditional business transaction structure. Large corporations have been moving toward a procurement structure that allows them to better compete in the global economy. Many SMEs, however, are being held back because they are still largely dependent on affiliate companies and main clients. This slowness to shift gears in the wake of the structural changes wrought by globalization is one of the factors for the profitability gap mentioned earlier. To close this gap, SMEs need to establish new business relationships to reduce dependency on subcontracting work for affiliates and main clients. A good first step might be to review various aspects of operations to see if any can be standardized.

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