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## Innovation Capability, Entrepreneurial Orientation, and Competitive Advantage on SME Performance: Evidence from Handicraft SMEs

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### | ABSTRACT

*This study examines the direct influence of innovation capability, entrepreneurial orientation, and competitive advantage on the performance of small and medium sized enterprises (SMEs) in the traditional handicraft industry of Lombok, Indonesia. Employing the Resource Based View (RBV) and entrepreneurship theory, the research investigates how firm-level capabilities and strategic orientations contribute to organizational performance. Data were obtained from 96 SMEs through questionnaires and analyzed using Partial Least Squares Structural Equation Modeling (PLS-SEM). The findings show that innovation capability and entrepreneurial orientation do not have a significant direct effect on SME performance, whereas competitive advantage has a strong positive effect. These results suggest that although innovation and entrepreneurial spirit are essential for long-term sustainability, their benefits materialize primarily through the creation of competitive advantage. This paper contributes to SME literature by confirming the pivotal role of competitive advantage in achieving superior performance in resource constrained contexts.*

### | KEYWORDS

*Innovation capability; Entrepreneurial orientation; Competitive advantage; SME performance*

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## 1. INTRODUCTION

Small and medium-sized enterprises (SMEs) play a vital role in job creation, reducing unemployment, and improving community welfare. In the city of Mataram, SMEs possess significant potential to drive local economic development, particularly within the handicraft sector rooted in local wisdom and cultural heritage. One of Lombok Island's flagship products is the ketak handicraft (Alim et al., 2022), made from natural fibers of the *Lygodium circinnatum* plant, a type of fern that grows abundantly in the forests of West Nusa Tenggara, especially Lombok (Murdani, 2020). These handcrafted products ranging from woven baskets and storage containers to household accessories are highly appreciated in both domestic and international markets.

The ketak craft industry forms an integral part of Lombok's creative economy, contributing to the tourism and trade sectors. Despite its high economic potential, the sustainability of SMEs in this field faces persistent challenges (Ahyat et al., 2020). According to data from the Cooperative and SME Office of Lombok, many entrepreneurs in the ketak craft sector struggle to maintain production stability and product marketing. Data from the Mataram Cooperative and SME Office (2023) indicate that approximately 50 SMEs are registered as ketak craft producers; however, only about 25% have managed to remain competitive in the market over the past five years. Meanwhile, a survey by the University of Mataram (2022) revealed that 60% of ketak SMEs experienced stagnation due to limited capital, innovation, and access to global markets (Arniya et al., 2023).

Although Lombok attracts a large number of tourists each year, ketak SMEs have yet to fully leverage this potential. According to the Central Bureau of Statistics (BPS, 2023), the contribution of ketak handicrafts to the tourism sector remains around 3%, significantly lower than that of other industries such as culinary and accommodation (Dinas Pariwisata, 2023). Access to adequate financing remains another major obstacle. Many banks and formal financial institutions impose stringent requirements such as asset-based collateral and large initial capital that are difficult for small entrepreneurs to meet (Murniati et al., 2019). As a result, many rely on personal savings or informal loans with high interest rates, further limiting their growth capacity.

Despite growing recognition of ketak crafts in domestic and international markets, global market penetration remains limited. BPS (2022) data show that exports of ketak products fluctuated, with a 12% decline in 2022 compared to the previous year. This decline is largely attributed to weak international distribution networks and insufficient promotion in global markets. Furthermore, most ketak SMEs continue to rely on traditional production techniques, resulting in low efficiency and productivity. Manual production processes take longer and limit output volume (Septiana et al., 2019). The lack of modern technological adoption hinders scalability and quality improvement (Hartono & Hartomo, 2016). While the artisans demonstrate exceptional craftsmanship in traditional ketak weaving, their managerial and marketing skills remain limited. Many SMEs are still managed conventionally, without the use of digital technologies for marketing or financial management (Permen Koperasi dan UMKM, 2018). In today's digital era, leveraging e-commerce and social media platforms has become crucial for expanding market reach and achieving business sustainability.

## **2. LITERATURE REVIEW**

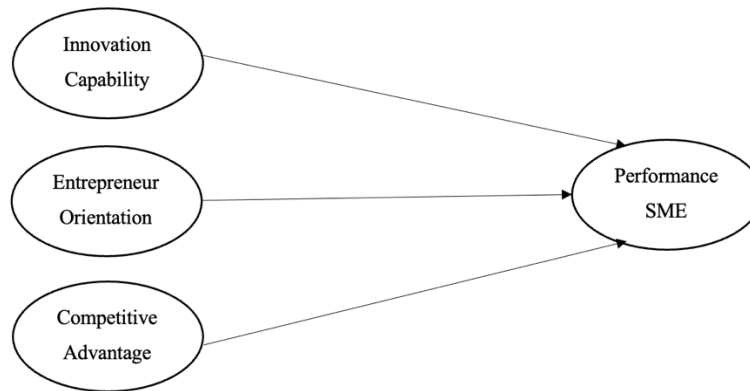
In examining the performance of ketak handicraft SMEs in Lombok, several factors have been identified as key determinants of business success. Among these, innovation capability and entrepreneurial orientation have become central themes in contemporary SME research. Numerous prior studies have shown that both innovation capability and entrepreneurial orientation play critical roles in enhancing competitiveness and overall firm performance. However, gaps remain in understanding how these factors interact to influence competitive advantage and SME performance in local handicraft industries particularly in regions with limited access to capital and markets such as Lombok.

Innovation capability refers to an organization's ability to continuously generate and implement new ideas, processes, or products that improve performance, competitiveness, and adaptability to environmental change (Ferreira et al., 2020). Wong and Thawee (2023) found that firms with strong innovation capability tend to enhance their competitive advantage through new product creation and market adaptation. Nevertheless, the application of this concept in traditional handicraft industries where resources and technology are limited remains underexplored. Farida and Setiawan (2022) demonstrated that innovation capability significantly affects SME performance across various sectors; yet, within traditional craft-based industries that rely heavily on manual skills, the linkage between innovation and performance remains insufficiently examined.

Entrepreneurial orientation (EO) represents the attitude, process, and behavior adopted by organizations or individuals to identify and exploit business opportunities proactively, innovatively, and with calculated risk-taking (Kusa et al., 2024). EO reflects strategic decision-making patterns that promote value creation through innovation, risk-taking, and competitive action. According to Hamdi et al. (2023), EO plays a pivotal role in developing competitive advantage through entrepreneurial risk, proactiveness, and innovativeness. However, the implementation of EO in SMEs operating in

local markets with limited global exposure remains poorly understood. Tajeddini et al. (2023) found that EO has a direct and positive effect on SME performance, particularly in technology-based sectors, but similar empirical evidence in traditional craft industries such as the ketak craft of Lombok remains scarce.

Competitive advantage (CA) is defined as a firm's ability to create greater value for customers compared to its competitors (Porter, 1985), while SME performance refers to the firm's capacity to achieve its objectives and generate desired results across operational, financial, and market dimensions (Djiu et al., 2024). SME performance is typically measured through both financial and non-financial indicators reflecting effectiveness, efficiency, and growth. Barney (1991) argues that competitive advantage, developed through innovation, resource utilization, and organizational capability, ultimately enhances firm performance. Nonetheless, limited research has investigated how these relationships manifest in resource based traditional craft sectors such as Lombok's ketak handicrafts, which rely on locally sourced natural materials and artisanal skills.



**Figure 1. Research Model**

### **3. RESEARCH METHOD**

The present study employs a quantitative research approach, emphasizing the statistical measurement and analysis of variables to test the proposed hypotheses. The research design used is explanatory, aiming to identify causal relationships among variables through empirical observation. Data were collected from a representative sample of ketak handicraft SMEs in Lombok using a structured survey questionnaire. This method allows for systematic and objective data gathering that aligns with the study's objectives and relevance (Sugiyono, 2019).

The data collection process was carefully planned to ensure precision, reliability, and validity. Questionnaires were designed to measure key constructs relevant to this research, including innovation capability, entrepreneurial orientation, competitive advantage, and SME performance. The questionnaire was distributed online using digital survey platforms such as Google Forms, allowing broader outreach and flexibility for respondents to provide feedback at their convenience.

The population of this study comprises all ketak handicraft SMEs located in the central production hubs across West Lombok, Central Lombok, and East Lombok. Given that the total number of SMEs in this sector is relatively large and not precisely known, surveying the entire population was not feasible. Therefore, a sampling technique was employed to select a representative subset of respondents. Using the Slovin formula, the sample size was determined to

be 96 SMEs, which ensures adequate representation and statistical reliability for subsequent analysis.

#### 4. RESEARCH RESULT

In this study, instrument validity testing in the Partial Least Squares (PLS) model was conducted through convergent validity and discriminant validity assessments. Convergent validity was evaluated using Factor Loadings and Average Variance Extracted (AVE).

Table 1. Factor Loading

Items	Competitive Advantage	Result
CA_1	0,970	Valid
CA_2	0,981	Valid
CA_3	0,972	Valid
EO_1	0,952	Valid
EO_2	0,949	Valid
EO_3	0,901	Valid
IC_1	0,912	Valid
IC_2	0,925	Valid
IC_3	0,931	Valid
P_1	0,974	Valid
P_2	0,968	Valid
P_3	0,974	Valid

Referring to Table 1, all indicators for the variables *innovation capability*, *entrepreneurial orientation*, *competitive advantage*, and *SME performance* have loading factor values greater than 0.7, which indicates high validity. Thus, all items were declared valid and accurately reflect their respective constructs.

Table 2. AVE

	Average variance extracted (AVE)	Result
Competitive Advantage	0,950	Valid
Entrepreneur Orientation	0,873	Valid
Innovation Capability	0,851	Valid
SME Performance	0,945	Valid

As shown in Table 2, the AVE values for *innovation capability*, *entrepreneurial orientation*, *competitive advantage*, and *SME performance* all exceed 0.5, confirming that the constructs have met the criteria for convergent validity. Each variable demonstrates adequate explanatory power for its indicators, validating that the measurement model appropriately represents the latent constructs examined in this study.

The hypothesis testing using the Partial Least Squares (PLS) approach was carried out by examining the T-statistic and P-value of each variable to evaluate their effects and levels of significance. The bootstrapping procedure was applied to assess the robustness of the model estimates and to determine whether the hypothesized relationships were statistically significant. This process involved testing the direct effects among variables to validate the effectiveness of the

constructs proposed in the research framework. A relationship is considered significant if the T-statistic value exceeds 1.96 or the P-value is less t

Table 3. Hypothesis Test

	Sample mean	P values
Competitive Advantage -> SME Performance	0,667	0,000
Entrepreneur Orientation -> SME Performance	0,082	0,576
Innovation Capability -> SME Performance	0,245	0,071

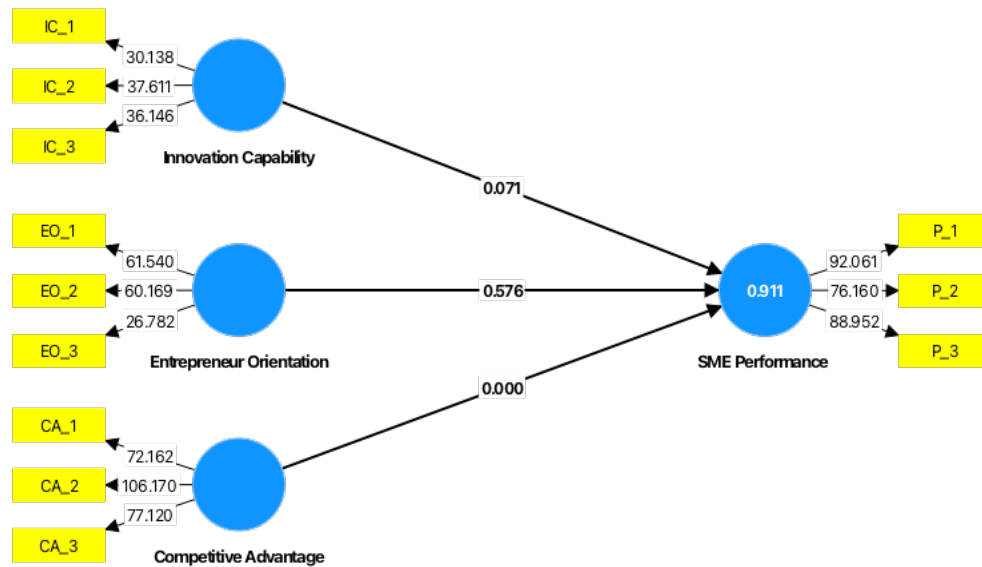


Figure 2. Research Result Model

### H1: Innovation capability influences SME performance

Based on the results of hypothesis testing, the variable innovation capability toward SME performance obtained a P-value of 0.071, which is greater than the 0.05 significance threshold. Therefore, H1 is rejected, indicating that innovation capability does not have a significant effect on SME performance among ketak handicraft entrepreneurs in Mataram. This suggests that innovation capability alone has not yet translated into measurable performance improvements, possibly due to limited technological adoption and resource constraints within traditional craft-based SMEs.

### H2: Entrepreneurial orientation influences SME performance

The test results show that entrepreneurial orientation toward SME performance produced a P-value of 0.576, exceeding 0.05. Consequently, H2 is rejected, implying that entrepreneurial orientation does not significantly affect SME performance among ketak artisans in Mataram. This outcome indicates that although entrepreneurial orientation reflects proactive and innovative behavior, it may not directly contribute to business success without adequate capital, marketing access, or strategic management capacity.

**H3: Competitive advantage influences SME performance**

The relationship between competitive advantage and SME performance yielded a P-value of 0.000, which is less than 0.05. Therefore, H3 is accepted, confirming that competitive advantage has a significant positive effect on SME performance among ketak handicraft entrepreneurs in Mataram. This finding emphasizes that SMEs with superior differentiation, product quality, and market positioning achieve higher performance levels. Competitive advantage serves as a crucial mediating mechanism that transforms internal resources and entrepreneurial capabilities into tangible outcomes.

**5. DISCUSSION****Innovation Capability and SME Performance**

The results of this study indicate that innovation capability does not have a significant effect on SME performance among ketak handicraft artisans in Mataram. This finding suggests that although artisans possess the ability to innovate, such innovations are not always implemented consistently or aligned with market demands. In traditional craft industries like ketak, customer preferences tend to emphasize cultural authenticity and aesthetic value rather than modern innovation. Consequently, innovations undertaken by artisans may not directly translate into improved business performance.

Moreover, the small-scale nature of operations and limited resources such as capital, technology access, and managerial skills serve as major barriers. Many SMEs prioritize daily operational survival and sales continuity over long-term investments in innovation that carry uncertain outcomes. This finding aligns with the study of Wongsansukcharoen and Thaweepaiboonwong (2023), who noted that innovation does not always yield significant performance results, particularly for SMEs operating in local markets with limited purchasing power.

**Entrepreneurial Orientation and SME Performance**

The results also show that entrepreneurial orientation (EO) does not have a significant effect on SME performance among ketak artisans in Mataram. This finding reinforces the notion that while EO encompasses innovation, proactiveness, and risk-taking, its direct impact on performance may be constrained by local market conditions. In traditional craft industries, business success is often determined more by operational effectiveness such as cost management, customer relations, and product quality consistency than by entrepreneurial attributes.

Artisans frequently face constraints related to limited financial resources, technology, and market access, making it difficult to fully leverage EO to improve performance. Furthermore, consumer preferences for traditional craftsmanship and cultural authenticity often outweigh appreciation for innovative or entrepreneurial approaches. Thus, even when artisans display proactive behavior or creative strategies, these efforts may not directly lead to higher revenue or business growth.

This result highlights the need for stronger external support, such as targeted entrepreneurship training, technology adoption programs, and assistance in accessing new markets. Without these supporting mechanisms, entrepreneurial orientation alone may not translate into measurable performance improvements. This outcome contrasts with the findings of Hamdi et al. (2023), who argued that EO is crucial for building long-term competitiveness that ultimately enhances SME performance.

### **Competitive Advantage and SME Performance**

The findings further reveal that competitive advantage has a significant and positive effect on SME performance among ketak artisans in Mataram. This suggests that competitive advantage enables artisans to offer products with superior quality, competitive pricing, unique designs, and strong customer service. Within the traditional ketak handicraft sector, these advantages allow SMEs to meet market needs more effectively, resulting in higher sales, profit margins, and sustainable business growth. One of the most important aspects of competitive advantage is product differentiation. Artisans who produce ketak crafts with distinctive designs, high artistic value, and premium-quality materials are more likely to attract consumer attention, both domestically and internationally. This differentiation enhances customer loyalty and expands market share, leading to improved business performance.

In addition, operational efficiency such as maintaining low production costs while ensuring high quality also contributes significantly to competitiveness. By achieving cost efficiency, SMEs can offer competitive prices without sacrificing profit margins, thereby strengthening business sustainability. This finding is consistent with Djiu et al. (2024) and Farida & Setiawan (2022), who emphasize the importance of effective marketing strategies as part of competitive advantage. Ketak SMEs that capitalize on their strengths in branding, customer engagement, and business partnerships are more likely to achieve increased revenue and long-term growth.

### **6. CONCLUSION**

Although innovation is essential, the findings indicate that innovation has not yet had a direct impact on the performance of ketak SMEs. This may be due to inconsistent implementation, limited resources, and market preferences that value traditional aesthetics over modern innovation. Similarly, while entrepreneurial orientation is considered important, its effect on SME performance was found to be insignificant. This could be attributed to barriers such as limited capital, technology, and market access, as well as customer preferences that emphasize traditional values rather than entrepreneurial approaches. In contrast, competitive advantage was proven to have a significant effect on SME performance. Superior quality, competitive pricing, unique design, and strong customer service enable artisans to improve sales, customer loyalty, and business growth. Operational efficiency and product differentiation emerge as key success factors for sustaining competitiveness in the traditional craft industry.

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