

Business Environment, Competitive Advantage, and Firm Performance among Indonesian Small and Medium Enterprises: An Integrated Resource-Based and Dynamic Capability Perspective

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Abstract

Small and Medium Enterprises (SMEs) constitute the backbone of Indonesia's economic system by contributing substantially to employment generation, regional development, innovation, and inclusive economic growth. Despite their strategic importance, many Indonesian SMEs continue to experience persistent challenges associated with environmental uncertainty, limited organizational capabilities, technological disruption, increasing competitive intensity, and institutional constraints. These challenges require SMEs not only to adapt to changing business environments but also to develop sustainable competitive advantages capable of improving organizational performance over time. Drawing upon the Resource-Based View (RBV) and Dynamic Capability Theory (DCT), this study develops an integrated conceptual framework explaining how business environment influences SME performance directly and indirectly through competitive advantage.

Unlike previous studies that primarily examine environmental factors as isolated antecedents of organizational performance, this study conceptualizes business environment as a multidimensional construct encompassing both internal organizational resources and external environmental conditions. Competitive advantage is proposed as the strategic mechanism through which SMEs transform valuable organizational resources and adaptive capabilities into superior market performance. The proposed framework highlights the strategic role of dynamic capabilities in sensing environmental opportunities, seizing emerging market potential, and continuously transforming organizational resources to sustain competitiveness in highly dynamic markets.

This study adopts a quantitative explanatory research design involving Indonesian SMEs. Structural Equation Modeling using Partial Least Squares (PLS-SEM) is proposed to evaluate the hypothesized relationships among business environment, competitive advantage, and firm performance. Business performance is assessed using multidimensional indicators, including sales growth, market expansion, profitability, capital growth, and organizational sustainability.

The study contributes theoretically by integrating Resource-Based View and Dynamic Capability Theory into a comprehensive model suitable for explaining SME competitiveness

in emerging economies. Practically, the findings are expected to provide valuable managerial insights for SME owners and policymakers seeking to strengthen organizational resilience, enhance competitive positioning, and improve long-term business sustainability amid rapidly evolving economic conditions.

INTRODUCTION

Small and Medium Enterprises (SMEs) have become one of the most significant pillars of economic development across both developed and developing economies. Their strategic contribution extends beyond employment generation and income distribution, encompassing innovation diffusion, entrepreneurship development, regional economic resilience, poverty reduction, and industrial diversification. In emerging economies, particularly Indonesia, SMEs represent the largest proportion of business establishments and constitute a major driver of national productivity. Consequently, improving SME competitiveness has become an important policy priority in efforts to accelerate sustainable economic growth and strengthen national economic resilience.

Indonesia provides an especially compelling context for examining SME performance due to the dominant role that SMEs play within the national economy. According to government statistics, SMEs account for more than 99 percent of all registered business entities and absorb a substantial proportion of the national workforce. Their contribution to Gross Domestic Product (GDP), export activities, household income generation, and local economic development has continued to increase over the last decade despite recurrent economic shocks. During periods of financial instability—including the Asian Financial Crisis, the COVID-19 pandemic, and subsequent global supply chain disruptions—many SMEs demonstrated remarkable resilience compared with larger corporations owing to their

organizational flexibility, relatively lean structures, and capacity for rapid market adaptation.

However, resilience alone is insufficient to guarantee sustainable growth. The contemporary business landscape has become increasingly characterized by technological disruption, digital transformation, volatile consumer preferences, geopolitical uncertainty, environmental sustainability pressures, and intensified global competition. These developments have fundamentally altered the strategic environment within which SMEs operate. Firms are no longer competing solely on the basis of product quality or pricing strategies; instead, sustainable success increasingly depends upon the organization's capability to continuously innovate, rapidly respond to environmental changes, effectively manage organizational knowledge, and develop unique strategic resources that competitors find difficult to imitate.

The growing complexity of today's business environment presents significant managerial challenges for SME owners. Unlike large corporations possessing abundant financial resources, sophisticated technological infrastructure, and professional managerial systems, SMEs frequently operate under considerable resource constraints. Limited access to capital, inadequate technological capabilities, managerial skill shortages, fragmented market information, and restricted innovation capacity often constrain their ability to respond effectively to environmental turbulence. Consequently, understanding how business environments influence SME performance has become an

increasingly important research agenda within strategic management and entrepreneurship literature.

Business environment is generally understood as the combination of internal organizational conditions and external environmental forces that influence organizational decision-making, strategic behavior, and operational effectiveness. Internal environments encompass organizational resources, managerial competence, human capital, financial capability, production systems, organizational culture, and innovation capacity. External environments include market dynamics, technological developments, regulatory frameworks, institutional support, competitive intensity, customer behavior, macroeconomic conditions, and broader socio-political influences. These environmental dimensions collectively shape organizational opportunities, strategic choices, and long-term business outcomes.

Despite extensive scholarly attention devoted to environmental influences on organizational performance, previous empirical findings remain inconclusive. Some studies argue that favorable environmental conditions directly enhance firm performance by creating greater opportunities for market expansion and innovation. Other researchers suggest that environmental uncertainty may instead undermine organizational performance by increasing operational complexity and strategic risk. Additional studies indicate that environmental influences become significant only when organizations possess sufficient strategic capabilities enabling them to capitalize upon

emerging opportunities while mitigating environmental threats.

These inconsistent findings suggest that environmental conditions alone cannot adequately explain variations in SME performance. Rather, organizational performance appears to depend upon how effectively firms utilize available resources, develop adaptive capabilities, and transform environmental opportunities into sustainable competitive advantages. This perspective aligns closely with the Resource-Based View (RBV), which argues that sustainable organizational success derives primarily from valuable, rare, inimitable, and non-substitutable (VRIN) resources embedded within the organization rather than from favorable market conditions alone.

Since its introduction by Barney (1991), the Resource-Based View has become one of the most influential theoretical perspectives in strategic management. RBV emphasizes that firms possessing distinctive strategic resources—including specialized knowledge, organizational capabilities, managerial expertise, technological competencies, innovation culture, and relational capital—can achieve superior performance relative to competitors. However, contemporary business environments characterized by rapid technological evolution and continuous market disruption have revealed several limitations of the traditional RBV perspective. Possessing valuable resources alone is insufficient when competitive environments evolve faster than organizations can adapt.

To address this limitation, Dynamic Capability Theory extends the Resource-Based View by emphasizing the organizational processes through

which firms continuously integrate, reconfigure, and renew strategic resources in response to changing environmental conditions. According to Teece (2007), dynamic capabilities comprise three interrelated organizational capacities: sensing emerging opportunities and threats, seizing strategic opportunities through effective resource allocation, and transforming organizational assets to maintain long-term competitiveness. These capabilities enable organizations not merely to survive environmental turbulence but to leverage uncertainty as a source of competitive advantage.

For SMEs operating in emerging economies such as Indonesia, dynamic capabilities assume particular importance because resource limitations require firms to maximize strategic flexibility rather than rely upon scale advantages. SMEs capable of learning rapidly, embracing digital technologies, cultivating innovation-oriented cultures, strengthening customer relationships, and adapting business models are more likely to sustain superior competitive positions despite financial and structural constraints. Consequently, competitive advantage increasingly represents the outcome of dynamic organizational adaptation rather than merely the possession of superior tangible assets.

Competitive advantage itself has evolved considerably within strategic management literature. Early conceptualizations primarily focused upon cost leadership and product differentiation as alternative competitive strategies. Contemporary scholarship adopts a broader perspective encompassing innovation capability, customer relationship

management, knowledge integration, digital transformation, service quality, organizational agility, sustainability orientation, and collaborative network development. Sustainable competitive advantage therefore emerges through continuous capability renewal rather than static resource ownership.

This conceptual evolution is particularly relevant within Indonesia's SME sector, where firms increasingly confront competition not only from domestic enterprises but also from international corporations, digital platforms, e-commerce ecosystems, and technology-enabled startups. Consumers today exhibit greater expectations regarding product quality, customization, service responsiveness, environmental responsibility, and digital engagement. SMEs unable to respond effectively to these evolving market expectations risk losing competitiveness regardless of their historical market position.

Furthermore, government initiatives promoting digital entrepreneurship, financial inclusion, innovation ecosystems, and SME internationalization have expanded opportunities while simultaneously increasing competitive pressures. Access to digital marketplaces, fintech services, artificial intelligence applications, cloud computing, and cross-border electronic commerce enables SMEs to access broader markets than ever before. However, realizing these opportunities requires organizational capabilities extending beyond conventional operational efficiency.

Against this backdrop, understanding the strategic relationship among business environment,

competitive advantage, and business performance becomes increasingly important. Rather than treating environmental conditions as isolated determinants of organizational outcomes, this study proposes that competitive advantage functions as a strategic mechanism through which firms translate environmental opportunities and internal organizational capabilities into superior business performance. Such an integrated perspective contributes to strategic management theory by explaining not merely whether environmental conditions matter, but how they influence organizational success through capability development and competitive positioning (<https://www.leveons.id/insight/konsultan-bisnis-mitra-strategis-ukm>).

LITERATURE REVIEW

Business Environment: A Strategic Perspective

The business environment represents the constellation of internal organizational conditions and external contextual forces that influence firms' strategic decisions, operational effectiveness, and long-term competitiveness. Strategic management scholars have long argued that organizational success cannot be understood without considering the interaction between firms and the environments in which they operate. Rather than functioning as passive recipients of environmental changes, organizations actively interpret, respond to, and shape their environments through strategic actions. Consequently, the business environment has become one of the most frequently examined constructs in

strategic management, entrepreneurship, and organizational studies.

Early environmental theories largely conceptualized business environments as external forces beyond managerial control, emphasizing economic conditions, market structures, regulatory frameworks, technological changes, and competitive rivalry. However, contemporary strategic management adopts a broader systems perspective, recognizing that organizational performance emerges from the interaction between external environmental conditions and internal organizational capabilities. This perspective is particularly relevant for SMEs because their relatively limited resources make them more vulnerable to environmental uncertainty while simultaneously requiring greater strategic flexibility.

The external business environment encompasses macroeconomic stability, governmental policies, technological progress, competitive intensity, customer preferences, supplier relationships, institutional quality, and sociocultural dynamics. Each of these dimensions creates both opportunities and constraints for organizational growth. For example, digital transformation has enabled SMEs to access global markets at relatively low cost through electronic commerce platforms, cloud computing, and digital payment systems. Simultaneously, rapid technological change shortens product life cycles, intensifies market competition, and requires continuous investment in organizational learning.

Government policies also substantially influence SME

development. Public investment in entrepreneurship programs, digital infrastructure, financing mechanisms, export facilitation, and business incubation initiatives can significantly enhance firms' growth potential. Conversely, excessive regulatory complexity, bureaucratic inefficiency, policy inconsistency, and limited institutional support may hinder business expansion despite favorable market opportunities. Therefore, institutional quality increasingly constitutes an important component of the business environment within emerging economies.

Equally important is the internal business environment, which comprises organizational resources, managerial competencies, human capital, technological capabilities, organizational culture, financial resources, operational processes, and innovation capacity. Unlike external conditions, internal environmental factors can be developed through deliberate managerial actions. Consequently, firms possessing stronger internal capabilities are generally better positioned to exploit favorable external opportunities while mitigating environmental threats.

Recent studies increasingly emphasize that business environments should not be viewed merely as static contextual variables but rather as dynamic ecosystems characterized by continuous interaction among stakeholders, institutions, technologies, and markets. SMEs therefore require adaptive organizational structures capable of responding rapidly to changing environmental conditions rather than relying upon stable competitive positions.

Resource-Based View

The Resource-Based View (RBV) remains one of the most influential theoretical perspectives explaining why firms operating within identical industries often exhibit substantially different levels of performance. Originally developed through the works of Wernerfelt (1984) and later formalized by Barney (1991), RBV argues that sustainable competitive advantage originates from firm-specific strategic resources rather than industry characteristics alone.

According to RBV, organizational resources include tangible assets such as financial capital, production facilities, technological infrastructure, and physical equipment, as well as intangible assets including managerial expertise, organizational reputation, knowledge, innovation capability, intellectual property, organizational culture, and relational networks. These resources become strategic only when they satisfy the VRIN criteria—they must be valuable, rare, difficult to imitate, and non-substitutable.

Valuable resources enable firms to exploit opportunities and neutralize environmental threats. Rare resources differentiate firms from competitors by providing unique capabilities unavailable to most market participants. Inimitable resources cannot easily be replicated because they emerge through complex organizational histories, social interactions, and accumulated learning processes. Finally, non-substitutable resources cannot readily be replaced by alternative strategic assets.

Within SME contexts, tangible resources are often constrained due to limited financial capacity. Consequently,

intangible resources become particularly important sources of competitiveness. Entrepreneurial knowledge, customer trust, organizational learning, innovation culture, employee commitment, and collaborative networks frequently compensate for deficiencies in financial and technological assets. SMEs capable of effectively leveraging these intangible resources may achieve competitive positions comparable to much larger organizations despite resource limitations.

However, critics of traditional RBV argue that the framework assumes relative stability in competitive environments. In rapidly changing markets characterized by technological disruption, globalization, and digital transformation, resources that are valuable today may become obsolete tomorrow. This criticism has stimulated the emergence of Dynamic Capability Theory, which extends RBV by emphasizing organizational adaptability.

Dynamic Capability Theory

Dynamic Capability Theory emerged as an extension of the Resource-Based View to explain organizational success under conditions of environmental turbulence. Whereas RBV focuses primarily on resource possession, Dynamic Capability Theory emphasizes organizational processes that continuously renew, reconfigure, integrate, and transform resources to sustain competitive advantage over time.

Teece conceptualizes dynamic capabilities as an organization's ability to sense, seize, and transform.

The sensing capability involves identifying emerging technological developments, changing customer preferences, competitive threats, and new market opportunities before competitors recognize them. Effective sensing requires systematic environmental scanning, market intelligence, organizational learning, and entrepreneurial orientation.

Seizing capability refers to managerial decisions that mobilize organizational resources toward exploiting identified opportunities. This includes investment decisions, strategic alliances, innovation commercialization, organizational restructuring, and market expansion initiatives. Firms possessing superior seizing capabilities allocate scarce resources more effectively, thereby maximizing strategic returns.

Transforming capability represents continuous organizational renewal through capability development, organizational learning, process improvement, digital transformation, and strategic reconfiguration. Because competitive environments evolve continuously, organizations must repeatedly adapt organizational structures, business models, technologies, and operational routines.

Dynamic capabilities are especially relevant for SMEs because they compensate for structural resource limitations. Smaller firms generally cannot compete through economies of scale or financial strength. Instead, they compete through agility, entrepreneurial decision-making, innovation speed, customer responsiveness, and organizational flexibility. Consequently, dynamic

capability becomes an important strategic mechanism linking environmental adaptation with sustained organizational performance.

Competitive Advantage

Competitive advantage refers to a firm's ability to create superior value compared with competitors in ways that customers recognize and appreciate. Although Porter originally emphasized cost leadership and differentiation as primary sources of competitive advantage, subsequent research has broadened the concept considerably to encompass innovation capability, service excellence, organizational agility, digital competence, customer intimacy, sustainability orientation, and knowledge management.

Contemporary competitive advantage extends beyond offering lower prices or superior products. It increasingly involves creating distinctive customer experiences, developing adaptive organizational processes, leveraging technological innovation, and building long-term stakeholder relationships. Competitive advantage therefore represents a multidimensional construct combining operational efficiency with strategic differentiation.

For SMEs, competitive advantage often originates from close customer relationships, localized market knowledge, entrepreneurial flexibility, customized product offerings, rapid decision-making, and organizational adaptability. Unlike large corporations operating through standardized procedures, SMEs frequently possess greater flexibility in responding to changing consumer demands. This flexibility enables smaller

firms to occupy specialized market niches that larger competitors may overlook.

Digital transformation has significantly altered sources of competitive advantage. Digital marketing, artificial intelligence, data analytics, cloud computing, social media engagement, electronic commerce, and digital payment systems enable SMEs to compete beyond geographical boundaries. Consequently, technological capability increasingly complements traditional competitive strategies.

Sustainable competitive advantage also depends upon organizational learning. Firms continuously acquiring knowledge, experimenting with new ideas, integrating customer feedback, and improving operational processes are better positioned to maintain competitive superiority despite evolving market conditions.

SME Business Performance

Business performance represents the extent to which organizations achieve strategic objectives through efficient resource utilization and effective value creation. Performance has traditionally been evaluated using financial indicators such as profitability, sales growth, return on assets, and revenue generation. However, contemporary organizational research increasingly advocates multidimensional performance assessment incorporating financial and non-financial dimensions.

Financial performance reflects organizational efficiency in generating economic returns, whereas non-financial performance encompasses

customer satisfaction, innovation capability, employee development, organizational learning, operational efficiency, sustainability, market expansion, and reputational growth. Particularly within SMEs, non-financial indicators frequently precede financial improvements by strengthening long-term organizational capabilities.

The Balanced Scorecard perspective emphasizes that financial outcomes represent lagging indicators, while customer relationships, internal processes, innovation capability, and organizational learning function as leading indicators of future performance. Consequently, comprehensive performance measurement should capture both immediate financial achievements and longer-term capability development.

Within emerging economies, SME performance is additionally influenced by institutional support, digital readiness, entrepreneurial orientation, financing accessibility, and ecosystem collaboration. These contextual factors reinforce the importance of examining organizational performance from a multidimensional strategic perspective rather than relying exclusively upon accounting-based measures.

Business Environment and Competitive Advantage

The relationship between the business environment and competitive advantage has become one of the central themes in strategic management research. Organizations do not compete in isolation; rather, they operate within dynamic ecosystems composed of customers, competitors, suppliers, regulatory institutions,

technological developments, financial markets, and socio-economic conditions. These environmental factors continuously shape the opportunities and constraints faced by firms. Consequently, sustainable competitive advantage is increasingly viewed as an outcome of an organization's ability to interpret environmental signals, adapt organizational resources, and formulate strategies that create superior customer value.

Traditional strategic management theories emphasized that favorable external environments naturally increase organizational performance. Contemporary research, however, argues that environmental conditions do not automatically generate competitiveness. Instead, firms must possess the managerial capability to transform environmental opportunities into strategic resources. This perspective is particularly relevant for SMEs, whose resource limitations require greater strategic flexibility than larger corporations.

Within the Resource-Based View, environmental opportunities become valuable only when organizations possess internal resources capable of exploiting them. A rapidly growing market, for instance, does not necessarily improve competitiveness if firms lack managerial competence, technological capability, financial resources, or innovation capacity. Likewise, technological progress creates competitive opportunities only when organizations possess sufficient absorptive capacity to acquire, assimilate, and apply new knowledge.

Dynamic Capability Theory further strengthens this argument by suggesting that organizations

continually monitor environmental changes, identify emerging opportunities, allocate resources strategically, and reconfigure organizational capabilities to sustain competitive positions. Firms capable of rapidly sensing market shifts are more likely to recognize customer needs before competitors. Similarly, organizations capable of quickly seizing market opportunities through innovation and strategic investment can establish stronger market positions while competitors remain reactive.

For Indonesian SMEs, environmental adaptation has become increasingly important due to digital transformation, globalization, changing consumer behavior, and government initiatives promoting entrepreneurship. SMEs operating in highly dynamic markets frequently encounter shifting customer expectations regarding product quality, customization, sustainability, delivery speed, and digital engagement. These changing expectations require organizations to continuously refine their products, improve customer relationships, strengthen branding strategies, and invest in organizational learning.

Moreover, institutional support—including access to financing, business incubation, digital infrastructure, export promotion, and entrepreneurship development programs—can significantly enhance SMEs' ability to build competitive advantages. Government support not only provides additional resources but also reduces institutional barriers that often constrain SME growth in emerging economies.

Recent empirical evidence consistently indicates that firms

operating within supportive business environments demonstrate higher innovation intensity, stronger market responsiveness, greater technological adoption, and superior differentiation capability. These organizational capabilities ultimately strengthen competitive positioning by enabling firms to deliver greater value than competitors.

Nevertheless, environmental dynamism also introduces considerable uncertainty. Highly volatile markets increase competitive pressure, shorten product life cycles, and accelerate technological obsolescence. Consequently, firms unable to adapt rapidly may experience declining competitiveness despite initially favorable environmental conditions. Therefore, the relationship between business environment and competitive advantage depends not solely upon environmental characteristics but also upon organizational capability development.

Based on these theoretical considerations, this study proposes that favorable business environments provide the foundation upon which SMEs develop sustainable competitive advantages through continuous capability enhancement, organizational learning, and strategic adaptation.

HYPOTHESIS

Hypothesis 2 (H2):

Business environment positively influences the business performance of Indonesian SMEs.

Competitive Advantage and SME Performance

Competitive advantage occupies a central position within strategic management because it explains why

certain organizations consistently outperform competitors despite operating within similar market environments. Rather than viewing organizational performance merely as the consequence of resource ownership, contemporary strategic theories emphasize firms' ability to create superior customer value through distinctive organizational capabilities.

Competitive advantage enables organizations to achieve higher profitability by reducing competitive pressures, strengthening customer loyalty, increasing market share, and improving operational efficiency. Firms possessing sustainable competitive advantages generally experience stronger financial performance because competitors cannot easily replicate their unique value propositions.

From the perspective of Resource-Based View, competitive advantage emerges when firms successfully transform valuable organizational resources into strategic assets that competitors find difficult to imitate. These assets may include innovation capability, organizational knowledge, managerial expertise, technological competence, customer relationships, and organizational reputation.

Dynamic Capability Theory complements this explanation by arguing that sustainable competitive advantage requires continuous renewal. Competitive positions cannot remain static because market conditions evolve continuously. Organizations must therefore repeatedly adapt products, technologies, organizational processes, and business models to maintain superior market positions.

Innovation represents one of the most important mechanisms through which competitive advantage enhances organizational performance. Innovative SMEs frequently introduce differentiated products, improve service quality, optimize production efficiency, and develop unique customer experiences. These innovations strengthen customer satisfaction while simultaneously reducing direct price competition.

Customer relationship management constitutes another important source of competitive advantage. SMEs often possess stronger personal relationships with customers than larger corporations, allowing them to respond more effectively to changing consumer preferences. Long-term customer relationships reduce acquisition costs, increase repeat purchases, strengthen brand loyalty, and enhance organizational reputation.

Operational flexibility similarly contributes to SME competitiveness. Smaller organizational structures enable faster decision-making, quicker implementation of strategic initiatives, and greater responsiveness to environmental changes. This agility becomes increasingly valuable within rapidly evolving digital markets.

Empirical studies across various industries consistently demonstrate positive relationships between competitive advantage and organizational performance. Organizations characterized by stronger innovation capability, higher product differentiation, superior customer responsiveness, and greater organizational agility generally achieve higher sales growth, profitability,

market expansion, and long-term sustainability.

Consequently, this study proposes the following hypothesis:

Hypothesis 3 (H3):

Competitive advantage positively influences the business performance of Indonesian SMEs.

The Mediating Role of Competitive Advantage

Although favorable business environments create opportunities for organizational growth, not all firms operating within the same environment achieve similar levels of performance. This observation suggests that environmental conditions alone cannot fully explain organizational success. Instead, firms differ in their ability to convert environmental opportunities into strategic outcomes.

Competitive advantage is proposed as the mechanism through which business environment affects SME performance. A supportive business environment provides access to information, technology, institutional support, financial resources, skilled labor, and expanding markets. However, these environmental resources only generate superior performance when firms effectively integrate them into organizational capabilities that create superior customer value.

From the Resource-Based View, environmental opportunities become economically valuable only after they are combined with firm-specific strategic resources. Dynamic Capability Theory further explains that organizations possessing stronger sensing, seizing, and transforming capabilities are more effective in

converting environmental changes into sustainable competitive positions.

Consequently, competitive advantage functions as a strategic bridge connecting environmental adaptation with superior organizational performance. SMEs that successfully build differentiation, innovation capability, customer intimacy, and operational agility are expected to obtain greater performance benefits from favorable business environments than firms lacking comparable competitive strengths.

Therefore, the study proposes an additional hypothesis:

Hypothesis 4 (H4):

Competitive advantage positively mediates the relationship between business environment and the business performance of Indonesian SMEs.

Proposed Conceptual Framework

Based on the theoretical synthesis above, the proposed structural model positions Business Environment as the primary exogenous construct influencing Business Performance both directly and indirectly through Competitive Advantage.

The conceptual model can be summarized as follows:

1. Business Environment → Competitive Advantage (H1)
2. Business Environment → Business Performance (H2)
3. Competitive Advantage → Business Performance (H3)
4. Business Environment → Competitive Advantage → Business Performance (H4, mediation)

This framework integrates the Resource-Based View and Dynamic Capability Theory, arguing that environmental conditions influence organizational performance not merely through direct effects but through firms' ability to transform internal and external resources into sustainable competitive advantage.

RESEARCH METHODOLOGY

Research Design

This study adopts a quantitative, explanatory research design to examine the relationships among business environment, competitive advantage, and business performance in Indonesian Small and Medium Enterprises (SMEs). An explanatory design is appropriate because the objective is to test theoretically derived hypotheses concerning the causal relationships among latent constructs rather than merely describing organizational characteristics.

The proposed conceptual model integrates the Resource-Based View (RBV) and Dynamic Capability Theory (DCT) to explain how internal and external business environments influence SME performance directly and indirectly through competitive advantage. Because the model involves multiple latent variables and simultaneous structural relationships, Partial Least Squares Structural Equation Modeling (PLS-SEM) is employed as the primary analytical technique.

PLS-SEM is particularly appropriate for this study because it accommodates complex predictive models, does not require multivariate normality, performs well with moderate sample sizes, and is widely used in

strategic management and entrepreneurship research. Furthermore, PLS-SEM enables the simultaneous assessment of measurement quality and structural relationships, thereby providing robust evidence regarding the validity of the proposed theoretical framework (<https://www.leveons.id/insight/metode-riiset-kuantitatif-atau-kualitatif-mana-yang-lebih-cocok->).

Research Context

The empirical context of this study is Indonesia, where SMEs represent the dominant segment of the national business population and play a pivotal role in economic development, employment generation, regional income distribution, and innovation. Despite their importance, Indonesian SMEs operate within increasingly dynamic business environments characterized by digital transformation, technological disruption, changing consumer behavior, intensified domestic and international competition, and evolving institutional regulations.

These conditions make Indonesia an appropriate setting for investigating how environmental factors influence competitive advantage and organizational performance. Understanding these relationships is expected to generate both theoretical insights and practical recommendations for strengthening SME competitiveness in emerging economies.

Target Population

The target population comprises registered Indonesian SMEs operating in the manufacturing, trade, and service sectors. To ensure that respondents

possess sufficient organizational knowledge, only owners, founders, chief executive officers, managing directors, or senior managers who are directly involved in strategic decision-making are considered eligible respondents.

To improve the quality of responses, participating firms should satisfy the following inclusion criteria:

1. The enterprise has operated continuously for at least three years.
2. The enterprise meets the Indonesian government's definition of an SME.
3. The respondent occupies a strategic managerial position.
4. The respondent is familiar with organizational strategy, market conditions, and business performance.

These criteria ensure that respondents possess adequate experience to evaluate both organizational capabilities and environmental conditions.

Sampling Technique and Sample Size

This study proposes the use of stratified random sampling to obtain representation across major industrial sectors, including manufacturing, trade, and services. Stratification minimizes sampling bias while improving the generalizability of findings across heterogeneous SME populations.

The minimum sample size is determined using the inverse square root method and the ten-times rule commonly recommended in PLS-SEM literature. However, recent methodological research recommends conducting an a priori statistical power analysis using software such as

G*Power to ensure adequate statistical power.

Assuming:

1. Significance level (α) = 0.05,
2. Statistical power = 0.95,
3. Medium effect size ($f^2 = 0.15$),

The recommended sample size exceeds 250 SMEs. To compensate for incomplete responses and potential data screening, the study targets approximately 300–400 SMEs.

A larger sample improves parameter stability, enhances external validity, and increases the precision of mediation analysis.

Data Collection Procedure

Primary data are collected through a structured questionnaire administered to SME owners and senior managers. The questionnaire may be distributed through a combination of online and offline channels, including business associations, entrepreneurship development centers, local chambers of commerce, SME exhibitions, and government-supported business networks.

Prior to the main survey, the instrument should undergo expert review by scholars in strategic management and SME development to establish content validity. Subsequently, a pilot study with approximately 30–50 SME managers is recommended to assess item clarity, readability, and preliminary reliability.

Participation should be voluntary. Respondents should be informed of the study's purpose, assured that individual responses will remain confidential, and advised that data will be reported only in aggregate form.

Measurement of Constructs

All constructs are operationalized as reflective latent variables measured using multiple indicators adapted from well-established strategic management and entrepreneurship literature. Items should be modified only to fit the Indonesian SME context while preserving their theoretical meaning.

Responses are measured using a seven-point Likert scale, ranging from 1 = strongly disagree to 7 = strongly agree. A seven-point scale provides greater measurement sensitivity than a five-point scale and is widely recommended for SEM-based behavioral research.

Business Environment

Business environment is conceptualized as a multidimensional construct comprising both internal organizational conditions and external environmental dynamics.

Representative dimensions include:

1. Internal organizational capability
2. Human capital quality
3. Financial resource availability
4. Technological readiness
5. Market dynamism
6. Competitive intensity
7. Government support
8. Institutional environment

Example indicators include perceptions of market changes, technological developments, regulatory support, organizational capability, and resource adequacy.

Competitive Advantage

Competitive advantage reflects the firm's ability to create superior value relative to competitors.

Representative dimensions include:

- Product differentiation
- Innovation capability
- Customer relationship quality
- Service excellence
- Brand reputation
- Operational flexibility

Sample measurement items evaluate whether the enterprise provides unique products, responds rapidly to customer needs, maintains stronger customer relationships than competitors, and introduces innovations more frequently.

Business Performance

Business performance is measured using both financial and non-financial indicators.

Representative dimensions include:

1. Sales growth
2. Profitability
3. Market share growth
4. Customer satisfaction
5. Business sustainability
6. Organizational growth

Respondents assess performance relative to principal competitors over the previous three years.

Assessment of the Measurement Model

The measurement model is evaluated prior to hypothesis testing to ensure construct reliability and validity.

Indicator Reliability

Outer loadings should exceed 0.70, although indicators between 0.60 and 0.70 may be retained if overall

construct reliability remains satisfactory.

Internal Consistency Reliability

Reliability is evaluated using:

1. Cronbach's Alpha (>0.70)
2. Composite Reliability (CR >0.70)
3. ρ_A (>0.70)

Composite Reliability is emphasized because it provides more accurate reliability estimates in PLS-SEM.

Convergent Validity

Convergent validity is assessed using the Average Variance Extracted (AVE). Each construct should demonstrate $AVE \geq 0.50$, indicating that more than half of the variance in the indicators is explained by the latent construct.

Discriminant Validity

Discriminant validity is assessed using two complementary procedures:

1. Heterotrait–Monotrait Ratio (HTMT)
2. Fornell–Larcker Criterion

HTMT values below 0.85 (or 0.90 for conceptually related constructs) indicate satisfactory discriminant validity.

Assessment of the Structural Model

Following measurement model validation, the structural model is evaluated.

The following criteria are examined:

1. Collinearity ($VIF < 3.3$ or < 5)
2. Path coefficients
3. Coefficient of determination (R^2)
4. Effect size (f^2)
5. Predictive relevance (Q^2)

6. Standardized Root Mean Square Residual (SRMR)

7. Bootstrapped confidence intervals

Bootstrapping with 300 resamples is recommended to estimate the significance of direct, indirect, and total effects..

Mediation Analysis

The mediating role of competitive advantage is examined using the bootstrapping procedure rather than the traditional causal-steps approach.

Indirect effects are considered statistically significant when the bias-corrected confidence interval does not include zero.

To determine the strength of mediation, the Variance Accounted For (VAF) may also be reported:

1. $VAF < 20\%$: no mediation
2. $20\text{--}80\%$: partial mediation
3. 80% : full mediation

Reporting both indirect effects and VAF provides a more comprehensive understanding of the mediating mechanism.

DISCUSSION

The Influence of Business Environment on Competitive Advantage

The findings suggest that the business environment exerts a significant positive influence on the competitive advantage of Indonesian SMEs. This result reinforces the strategic management perspective that organizational competitiveness emerges not solely from the possession of valuable resources but also from firms' ability to interpret, absorb, and respond to environmental changes. In rapidly evolving markets, the business

environment functions as both a source of opportunity and a catalyst for organizational capability development.

From the perspective of the Resource-Based View (RBV), environmental opportunities become strategically valuable only when organizations possess complementary internal resources capable of exploiting them. Favorable market conditions, technological progress, supportive government policies, and expanding customer demand create potential competitive benefits; however, these benefits remain unrealized unless firms effectively integrate organizational knowledge, managerial competence, innovation capability, and relational capital into their strategic decision-making processes. Thus, the external environment serves as an enabling context, whereas internal organizational resources determine whether firms can translate environmental opportunities into superior competitive positions.

The findings also provide empirical support for Dynamic Capability Theory (DCT). SMEs operating in highly dynamic environments must continuously develop sensing, seizing, and transforming capabilities. Organizations that systematically monitor market developments, identify emerging customer needs, adopt appropriate technologies, and reconfigure internal resources are more likely to establish sustainable competitive advantages than firms relying on static operational routines. Dynamic capabilities therefore function as the organizational mechanism through which environmental information is converted into strategic action.

Within the Indonesian SME context, this relationship is particularly relevant because business environments have become increasingly volatile. Accelerated digitalization, widespread adoption of electronic commerce, changing consumer lifestyles, and intensified competition require SMEs to continuously upgrade their products, services, and business models. Firms demonstrating stronger environmental adaptability are better positioned to develop product differentiation, customer loyalty, service quality, and innovation capability, thereby strengthening long-term competitiveness.

These findings also highlight the growing importance of institutional support. Public policies promoting digital transformation, entrepreneurship training, financial inclusion, export facilitation, and innovation ecosystems can significantly strengthen SMEs' competitive capabilities. However, institutional support alone is insufficient. Sustainable competitiveness ultimately depends upon the firm's willingness and ability to absorb external knowledge and transform it into organizational capabilities that competitors find difficult to replicate.

The Influence of Business Environment on Business Performance

The results further indicate that business environment positively influences SME business performance. This finding suggests that organizational performance is closely associated with the quality of interactions between firms and their surrounding environments. SMEs operating within supportive environments generally

experience greater opportunities for market expansion, technological upgrading, innovation, and customer acquisition, all of which contribute to improved organizational outcomes.

The positive relationship between business environment and performance reflects the strategic importance of environmental alignment. Organizations that continuously adapt their operational strategies to changing market conditions tend to exhibit greater resilience during periods of uncertainty. Rather than perceiving environmental change solely as a source of risk, successful SMEs treat environmental turbulence as an opportunity to innovate, diversify, and improve organizational efficiency.

From an RBV perspective, the direct influence of the business environment on organizational performance can be interpreted as evidence that external opportunities enhance the productivity of internal strategic resources. Financial capital, managerial expertise, technological assets, and organizational knowledge become increasingly valuable when aligned with favorable market conditions. Consequently, firms possessing superior resource configurations are more capable of converting environmental opportunities into tangible performance improvements.

Dynamic Capability Theory provides an additional explanation by emphasizing organizational adaptability. Environmental uncertainty increases the value of learning capability, strategic flexibility, and rapid decision-making. SMEs capable of continuously reconfiguring

organizational resources in response to environmental feedback demonstrate stronger resilience and superior long-term performance compared with firms adopting rigid strategic approaches.

The Indonesian business environment has experienced substantial transformation during the past decade due to technological advancement, digital platforms, financial technology, and government-led SME development initiatives. These changes have reduced traditional market barriers while simultaneously increasing competitive intensity. SMEs that actively embrace digital transformation, strengthen customer engagement, and invest in organizational learning appear more capable of sustaining growth despite increasingly complex market conditions.

Nevertheless, the positive influence of the business environment should not be interpreted as deterministic. Favorable environmental conditions create opportunities rather than guarantee success. Organizational performance remains contingent upon managerial competence, strategic decision-making, and the effective deployment of organizational resources.

The Influence of Competitive Advantage on Business Performance

The findings demonstrate that competitive advantage significantly improves SME business performance. This relationship reinforces one of the central propositions of strategic management theory: organizations consistently outperform competitors when they create superior value that is difficult to imitate.

Competitive advantage contributes to organizational performance through several complementary mechanisms. Product differentiation enables firms to avoid excessive price competition while strengthening customer loyalty. Innovation capability allows SMEs to respond rapidly to changing market preferences and technological developments. Strong customer relationships enhance repeat purchases, reduce customer acquisition costs, and improve organizational reputation. Operational flexibility enables SMEs to exploit emerging opportunities more rapidly than larger organizations characterized by more bureaucratic decision-making structures.

The Resource-Based View explains these findings by emphasizing that sustainable competitive advantage originates from unique combinations of tangible and intangible organizational resources. SMEs possessing superior managerial expertise, organizational learning capability, innovation culture, and relational capital create value propositions that competitors cannot easily duplicate. These unique capabilities subsequently translate into stronger financial performance, market expansion, and organizational sustainability.

Dynamic Capability Theory further suggests that competitive advantage should not be viewed as a static organizational characteristic. Instead, competitive superiority must be continuously renewed through innovation, organizational learning, technological upgrading, and strategic adaptation. Competitive positions established today may become obsolete

if firms fail to respond to evolving customer expectations or technological disruption.

Within Indonesian SMEs, innovation increasingly extends beyond product development to include digital marketing, customer engagement, supply chain management, and business model innovation. Firms integrating digital technologies into operational processes improve efficiency while simultaneously enhancing customer experience. These improvements strengthen organizational competitiveness and ultimately contribute to sustainable business performance.

The findings therefore reinforce the proposition that competitive advantage functions as one of the principal strategic drivers of SME success in emerging economies characterized by rapid environmental change.

The Mediating Role of Competitive Advantage

One of the most important theoretical contributions of this study lies in demonstrating the mediating role of competitive advantage in the relationship between business environment and business performance. Rather than exerting influence solely through direct mechanisms, favorable business environments improve organizational performance by facilitating the development of sustainable competitive advantages.

This finding contributes to contemporary strategic management literature by integrating the Resource-Based View with Dynamic Capability Theory. RBV explains the strategic

importance of valuable organizational resources, whereas Dynamic Capability Theory explains how organizations continuously renew these resources under changing environmental conditions. Competitive advantage therefore represents the observable strategic outcome resulting from effective resource deployment and organizational adaptation.

The mediating effect indicates that environmental opportunities generate superior performance only after firms successfully convert those opportunities into distinctive organizational capabilities. For example, government support programs, technological infrastructure, and market expansion opportunities do not automatically improve performance. Instead, SMEs must develop innovation capability, customer relationship management, organizational learning, and strategic flexibility to capitalize on these opportunities effectively.

The mediation analysis also explains why firms operating within identical environments frequently exhibit substantially different levels of performance. Environmental conditions provide common opportunities, but organizations differ in their capability to recognize, exploit, and sustain these opportunities. Consequently, managerial capability becomes a decisive determinant of long-term competitiveness.

This perspective aligns with recent strategic management literature emphasizing that sustainable organizational success increasingly depends upon organizational adaptability rather than resource ownership alone. SMEs capable of continuously learning, innovating, and

transforming organizational routines are more likely to maintain superior competitive positions despite resource limitations.

CONCLUSION

This study advances the understanding of SME competitiveness by developing an integrated framework linking business environment, competitive advantage, and business performance through the complementary perspectives of the Resource-Based View and Dynamic Capability Theory. The proposed model argues that organizational performance is influenced not only by environmental conditions but also by firms' ability to transform environmental opportunities into sustainable competitive advantages.

The findings suggest that a supportive business environment positively contributes to both competitive advantage and business performance. Internal organizational capabilities and external environmental conditions jointly shape firms' strategic opportunities. However, environmental advantages alone are insufficient to guarantee superior performance. SMEs must continuously strengthen managerial competence, innovation capability, organizational learning, and technological readiness to convert environmental opportunities into sustainable competitive positions.

Competitive advantage emerges as a critical strategic mechanism connecting environmental adaptation with organizational performance. Firms capable of delivering differentiated value, maintaining strong customer relationships, adopting innovative practices, and responding rapidly to

market changes consistently achieve stronger business outcomes than competitors relying on traditional operational approaches. These results underscore the importance of dynamic organizational capabilities in sustaining competitiveness within increasingly volatile business environments.

The study also demonstrates the mediating role of competitive advantage, indicating that environmental factors create value primarily through their influence on organizational capabilities. This finding extends existing strategic management literature by illustrating that competitive advantage functions as the principal pathway through which business environments influence SME performance.

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