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The Role of Dynamic Capability and Product Innovation to Increase Competitive Advantage

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Abstract—This study aims to determine dynamic capability and product innovation in determining competitive advantage in SMEs woven fabric industries (endek) in the Klungkung Regency, Bali Province. The research approach used is descriptive analysis with a quantitative approach using the Smart PLS programme. The population in this study is the owner of a woven fabric business (endek) in the Klungkung Regency, Bali Province. The results showed that dynamic capability could directly determine the product innovation and competitive advantage of woven fabric SMEs (endek) in the Klungkung Regency, Bali Province. However, product innovation can produce a competitive advantage for woven fabric SMEs (endek) in the Klungkung Regency, Bali Province. The research results also show that product innovation is a mediator in the influence of dynamic capability on competitive advantage.

Keywords: Dynamic capability, product innovation, competitive advantage

Introduction

Small and Medium Industries (IKM) have an important role in a country's economic growth. One of its roles is increasing Gross Domestic Product (GDP) and employment. Empowering small and medium industries is one effort to increase the empowerment of people's economy-based businesses. This is one of the programs to increase economic growth and community welfare. Figure 1 provides information related to the development of the GDP of SMIs in the processing industry from 2018 to 2023.

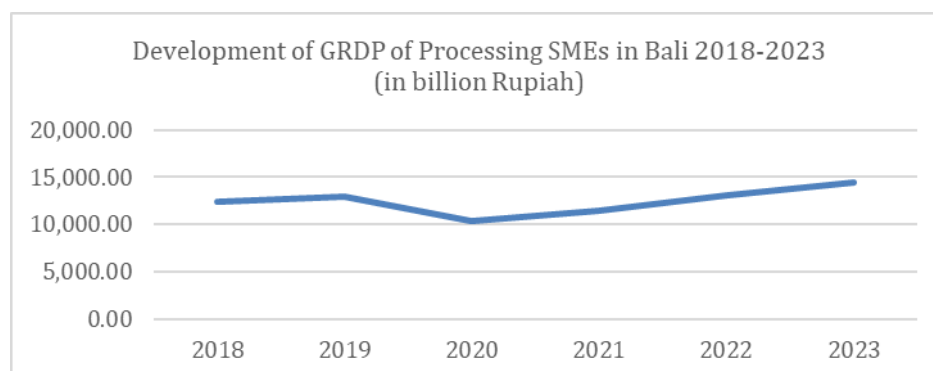


Figure 1. Development of GRDP of Processing SMEs in Bali 2018-2023
Source: Central Bureau of Statistics Bali Province, 2020

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Figure 1 shows that the development of GRDP in the SMI category of the processing industry in the last six years has increased, except that in 2020, it decreased from the previous year. One reason is the impact of the COVID-19 pandemic.

However, in general, SMEs have limitations in terms of resources, including human resources and capital, that can affect business development and weak business networks. This triggers SMEs to lose out to large industries. This means that the challenge faced by handicraft SMIs is to maintain competitiveness amid increasingly fierce competition and limited resources.

One of the leading SMEs that is also experiencing these problems is the endek weaving SMI in Bali. Endek weaving SMIs in Bali that produce traditional and handmade products have high market demands on product design and functionality. The condition of endek weaving SMIs in Bali, which are processed with Non-Machine Weaving Tools (ATBM), is currently experiencing competition with the emergence of woven motif products produced by machines, which are certainly cheaper because they can be produced in large quantities in a short time. These conditions require endek weaving SMIs to maximize their dynamic capabilities and increase their competitive advantage with other similar products.

Competitive advantage is an important determinant of its performance and survival (Barnett & McKendrick, 2004; Barney, 2001; Leiblein et al., 2017). A firm is considered to have a competitive advantage over its competitors when it generates above-average profits. This advantage will only last as long as other companies cannot imitate it. This shows the need for strategic renewal so the company remains ahead of the competition. Therefore, where companies gain competitive advantage is one of the most central questions in strategy research (Wang & Gao, 2021). The competitive advantage of SMEs is created from adaptability, which becomes a tool for SMEs to face changes in the external environment. The characteristics of this environmental dynamic are also shown by the era of the Industrial Revolution 4.0, which has the characteristics of increasing digitalization that spreads throughout the world and creates more new competition for MSMEs. This change triggers and requires SMEs to take strategic steps and adjust business strategies (Khouroh et al., 2020).

Competitive advantage can be affected by dynamic ability. Teece et al., (1997) explained that dynamic capability is the ability of companies to integrate, build, and reconfigure internal and external competencies to cope with rapidly changing environments. Research conducted by Khouroh et al., (2020); Li & Liu (2014); Prabowo et al., (2021); Zatia Zatia et al., (2023) also found that dynamic ability can affect competitive advantage.

In addition to affecting competitive advantage, dynamic capabilities can also increase product innovation. Research results of (Firman & Thabrani, 2018; Jiang et al., 2020; Vu, 2020) support the statement that dynamic capabilities can increase product innovation. Product innovation meets market demand, so product innovation is used as a competitive advantage for the company. Then, the results of research by Coccia (2017); Lay Hong et al., (2016); Roespinoedji et al., (2019) show that product innovation can affect competitive advantage. High innovation, both the innovation process and product innovation, will increase the company's ability to create quality products. High product quality will increase the company's competitive advantage and performance (Herman et al., 2018).

Phenomena related to several important roles of SMEs for the national economy, but efforts are needed to overcome the condition of limited resources. So, this research examined the influence of business capabilities and product innovation on competitive advantages in endek woven fabric SMIs in the Klungkung Regency. In addition, this study will examine the mediating role of product innovation on the indirect influence of dynamic ability and competitive advantage.

Literature Study and Hypothesis

Competitive Advantage

The company must own an absolute competitive advantage; in addition to achieving the performance or success of the products produced, it can also maintain its business existence (Ekawati et al., 2016). Competitive advantage is expected to achieve the expected operating profit, increase market share, and satisfy the customers served (Suardhika, 2021). (Kotler & Armstrong, 2012) offer three indicators used to measure competitive advantage: product differentiation advantage, market segmentation advantage, and market entry advantage. Meanwhile, the three indicators used by Herman et al., (2018); Puspaningrum (2017) in their research are having a unique product, having a distinctive and quality product, and competitive product prices. With products increasingly in demand by customers, SMEs will be able to improve their competitive position in the market. In Concept and Hypothesis, Authors should state the concept and hypothesis which used in the research by very short literature survey.

Dynamic Capability

Dynamic capabilities are a firm's ability to integrate, build, and reconfigure internal and external competencies to cope with a rapidly changing environment (Teece et al., 1997). Li & Liu (2014) argue that dynamic capabilities include the capacity to identify needs or opportunities for change, formulate a response, and implement an action. In line with the definition, this research also elaborates dynamic capabilities into three dimensions from a process perspective, namely, the capacity to recognize and make strategic decisions, the capacity to make decisions promptly, and the capacity to implement change (Khouroh et al., 2020; Li & Liu, 2014). Recognizing and making strategic decisions requires developing cognitive maps, recognizing and interpreting stimuli or changes in the framework, and analyze information from the internal and external environment (Neill et al., 2007; Pandza & Thorpe, 2009). Timely decision-making capability is the process of formulating, evaluating, and selecting strategic orientations to promptly adjust to environmental changes (Sharfman & Dean Jr, 1997). Change implementation capability is a form of ability to execute and coordinate strategic decisions and corporate changes involving various organizational and managerial processes, depending on the nature of the specific goals and tasks desired (Harreld et al., 2007; Helfat et al., 2007).

Product Innovation

Innovation is an idea, idea, practice, or object that is realized and accepted as a new thing by a person or group to be adopted for the better (Prajogo, 2016). Product innovation meets market demand, so product innovation is used as a competitive advantage for the company. Innovation creates new ideas and puts them into practice. Innovation is new ideas in the product, so the results are better. In corporate organizations, innovation takes two forms: product innovation, which produces new goods or services or improvements from existing ones; and process innovation which creates new ways of creating things (Sharma et al., 2016).

Hypothesis and Conceptual Framework

Based on the objectives of the research and the results of previous studies, the following hypotheses can be proposed:

H1: Dynamic capabilities can increase competitive advantage

H2: Product innovation can increase competitive advantage

H3: Dynamic capabilities influence product innovation

H4: Product innovation mediates the indirect influence of dynamic capability on competitive advantage

From the description of the hypothesis above, the conceptual framework of research can be presented in Figure 1.

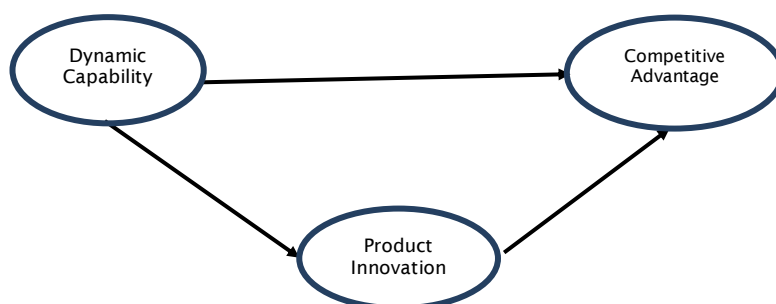


Figure 2. Conceptual Framework
Source: Primary data processed, 2024

Method

This research uses questionnaires as the main research instrument to explain the relationship between business capabilities and product innovation with competitive advantage. The population in this study is all woven fabric SMEs (endek) in Klungkung Regency, Bali Province, which are recorded in the directory at the Bali Provincial Industry and Trade Office in 2022, which is 115 business units. The entire population was determined as a sample in this study (saturated sampling/census). A five-point Likert scale was used to obtain the perceptions of woven fabric (endek) SMI owners/managers related to the variables studied, from strongly disagreeing with a score of 1 to strongly agreeing with a score of 5.

In the research instrument, the measurement of dynamic capability variables uses three dimensions from a process perspective, namely, the capacity to recognize and make strategic decisions, the capacity to make timely decisions, and the capacity to implement change (Khourouh et al., 2020; Li & Liu, 2014). In the product innovation variable, multi-item indicators refer to Abbas et al., (2019): product development, quality development, and product development with technology. For competitive advantage variables, multi-item indicators from (Puspaningrum, 2017), namely uniqueness, quality, and price. The measurement of the business performance variable uses three indicators adapted from (Suardhika & Adriati, 2018): increased sales, improved business operational capabilities, and market development. Before the questionnaire was used on the target, a trial of 35 sample units was conducted. This ensures the calibration of research instruments with validity and reliability tests (Ghozali, 2014).

The results of the questionnaire distribution, the data were collected, and descriptive analysis was carried out to describe the respondent's profile. After that, an inferential structural equation modelling analysis with the SmartPLS v.3.0 program was used to test the hypothesis and the mediation effect.

Result and Discussion

An analysis was carried out on the characteristics of respondents in explaining business capabilities and product innovation to competitive advantages in woven fabric SMIs (endek) in Klungkung Regency, Bali Province. This analysis aims to obtain a picture of respondents' profiles regarding gender, age, recent education, and business interests. The results of the analysis obtained are presented in Table 1.

Table 1. Characteristics of Respondents

Characteristics	Amount	Percentase (%)
Gender:		
Male	20 person	17,4
Female	95 person	82,6
Age:		
25 - 34 years	7 person	6,1
35 - 44 years	38 person	33,0
45 - 55 years	46 person	40,0
> 50 years	24 person	20,9
Recent Education		
SMA/SMK	29 person	25,2
Diploma	37 person	32,2
S1	44 person	38,3
S2	5 person	4,3
Business Interests		
3 - 7 years	22 unit	19,1
8 - 12 years	40 unit	34,8
13 - 17 years	8 unit	7,0
> 17 years	45 unit	39,1
Total	115 unit	100

Source: Primary data processed, 2024

According to the analysis, the characteristics of respondents based on gender indicate that the female owners or managers of woven fabric SMEs (endek) in the Klungkung Regency dominate with a contribution of 82.6 percent. In comparison, the male owners or managers of SMEs only have a distribution of 17.4 percent. This proportion indicates that women are more likely to work in the woven fabric (endek) business in the Klungkung Regency. In addition, the characteristics of respondents based on age show that respondents aged 45-55 years are more numerous, with a distribution of 40 percent. Furthermore, followed by respondents aged 35-44 years (33 percent) and the least aged 25-34 years (6.1 percent). Information from the distribution of respondents based on this age indicates that the woven fabric (endek) SMEs in the Klungkung Regency are mature in managing their businesses. In the characteristics of respondents based on business length, most woven fabric SMIs (endek) in Klungkung Regency have been running a business for more than seven years (80.9 percent). At the same time, the rest are SMEs that have run the business for 3-7 years (19.1 percent). This information illustrates that the woven fabric (endek) SMIs in Klungkung Regency are experienced in the businesses they run.

Hypothesis Testing

This study used SEM-PLS analysis with the SmartPLS v.3.0 programme for hypothesis testing and the role of mediation. The purpose of this analysis method is to predict and explain the effect of dynamic capabilities and product innovation on competitive advantage and test the mediating role of product innovation variables.

Outer Model Evaluation

The results of the convergent validity analysis in Table 2 show that all variable constructs have an outer loading value above 0.5 and an AVE above 0.50. These results indicate that all indicators on each variable studied are good or valid measures (Ghozali, 2014).

Table 2. Convergent Validity Analysis

Variable	Indicator	Outer Loading	AVE
Dynamic Capability	Capable1	0.772	0.555
	Capable2	0.777	
	Capable3	0.764	
	Capable4	0.661	
	Capable5	0.656	
	Capable6	0.791	
	Capable7	0.767	
	Capable8	0.760	
Product Innovation	Innov1	0.809	0.597
	Innov2	0.692	
	Innov3	0.811	
Competitive Advantage	CA1	0.884	0.669
	CA2	0.740	
	CA3	0.823	

Source: Primary data processed, 2024

Furthermore, discriminant validity needs to be tested by comparing the square root of each variable's average variance extracted ($\sqrt{\text{AVE}}$) value with the correlation between latent variables (Ghozali, 2014). As shown in Table 3, all variable constructs have good discriminant because the square root of the average variance extracted ($\sqrt{\text{AVE}}$) value is greater than the correlation coefficient of the latent variable.

Table 3. Discriminant Validity Analysis

Variable	AVE	$\sqrt{\text{AVE}}$	Innov	Capable	CA
Product Innovation	0.597	0.773	0.773	0.610	0.696
Dynamic Capability	0.555	0.745	0.610	0.745	0.711
Competitive Advantage	0.669	0.818	0.696	0.711	0.818

Source: Primary data processed, 2024

Cronbach's alpha and composite reliability analysis are used to test the reliability of variable constructs (Hair et al., 2011). Information from Table 4 shows that Cronbach's alpha and composite reliability values for all variables studied are above 0.70. These results indicate that all variables studied have a good level of reliability (Ghozali, 2014).

Table 4. Reliability Test

Variable	Cronbach's Alpha	Composite Reliability
Product Innovation	0.719	0.815
Dynamic Capability	0.885	0.909
Competitive Advantage	0.750	0.858

Inner Model Evaluation

The inner model is evaluated concerning the predictive relevance of the model (Q2), which measures how well the model generates the observed values. Q2 is based on the coefficient of determination of all dependent variables. The magnitude of Q2 has a value with a range of $0 < Q2 < 1$; the closer to the value 1 the better the model (Hair et al., 2011).

Table 5. Predictive Relevance Model Analysis (Q²)

Variable	R Square (R ²)
Product Innovation	0.373
Competitive Advantage	0.722
Calculation: $Q^2 = (1 - [(1 - R_1^2) (1 - R_2^2)])$	
$Q^2 = (1 - [(1 - 0.373) (1 - 0.722)]) = 0.8257$	

Source: Primary data processed, 2024

The results of the predictive relevance model calculation (Q²) show that the value is 0.8257 and close to the value of 1 (Table 5). These results provide evidence that the structural model is a good fit. The meaning that can be given from the results of this analysis is that the model can explain 82.57 percent of the data. The remaining 17.43 percent is explained by errors or other variables not contained in the model.

Three hypotheses on direct effects will be tested in this study. The hypothesis can be accepted if the path coefficient is positive and the t-statistic value is above 1.96 at a significance level (p-value) of 0.05. The results of hypothesis testing are presented in Table 6 below.

Tabel 6. Direct Effect Hypothesis Testing

Effect	Original Sample (O)	Sample Mean (M)	Standar Deviation (STDEV)	T-Statistic (O/STDEV)	Desc.
Dynamic Capability à Product Innovation	0.610	0.615	0.064	9.505	H ₁ Accepted
Dynamic Capability à Competitive Advantage	0.616	0.619	0.075	8.205	H ₂ Accepted
Product Innovation à Competitive Advantage	0.319	0.317	0.084	3.814	H ₃ Accepted

Source: Primary data processed, 2024

The results of hypothesis testing on direct effects (Table 6) show that dynamic capabilities are proven to have a positive and significant effect on product innovation, so H1 is accepted. This result is indicated by a positive path coefficient of 0.610 with a T-statistic = 9.505 (T-statistic > 1.96). In testing H2, dynamic capabilities positively and significantly affect competitive advantage. This result is indicated by a positive path coefficient of 0.616 with a T-statistic = 8.205 (T-statistic > 1.96). Furthermore, product innovation positively and significantly affects competitive advantage and accepts H3. This result is indicated by a path coefficient of 0.319 with a T-statistic = 3.814 (T-statistic > 1.96).

In testing the indirect effect with the mediating variable of product innovation, an analysis was conducted using the Variance Accounted For (VAF) method (Hair et al., 2011). The results of testing the indirect effect of the research model can be presented in Table 7 below.

Tabel. 7. Indirect Effect Testing Analysis

Effect	Direct Ef-fect	Indirect Effect	Total Ef-fect	VAF (%)	Desc.
Dynamic Capability à Product Innovation → Competitive Advantage	0.616*	0.195*	0.811	24.04	Partial Medi-ation

Source: Primary data processed, 2024

Information that can be conveyed from Table 7 is that product innovation can mediate significantly (T-statistic > 1.96) on the indirect effect of dynamic capabilities on competitive advantage. These results provide clues to accept that H4 and product innovation partially mediate the indirect effect of dynamic capabilities on competitive advantage. The overall analysis results can be presented in Table 8 and Figure 2 based on the results of the analysis that has been carried out.

Tabel 8. Recapitulation of Direct, Indirect and Total Effects

Effect	Direct Effect	Indirect Effect	Total Effect
Dynamic Capability à Product Innovation	0.610 ^s	-	0.610
Dynamic Capability à Competitive Advantage	0.616 ^s	0.195 ^s	0.811
Product Innovation à Competitive Advantage	0.319 ^s	-	0.319

Catatan: S = Significant (T- statistic > 1.96); NS = Not Significant (T- statistic < 1.96)

Source: Primary data processed, 2024

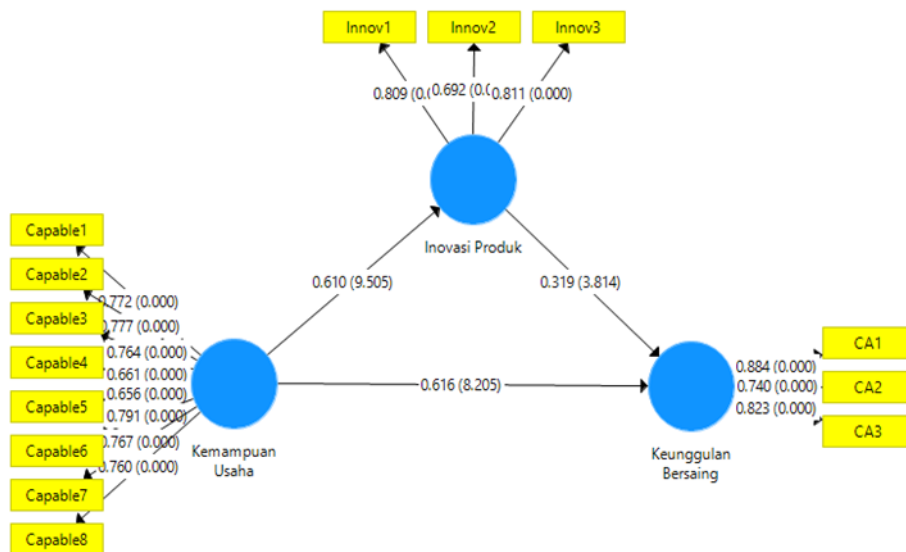


Figure 3. Full Model Smart-PLS (Bootstrapping)

Source: Primary data processed, 2024

This study conveys the findings that the dynamic capabilities that can be developed in woven fabric (endek) SMEs in Klungkung Regency can directly impact their competitive advantage. Dynamic capabilities that increase product innovation will generate a greater competitive advantage.

The Effect of Dynamic Capabilities on Competitive Advantage

The findings of this study prove that dynamic capabilities have a positive and significant effect on competitive advantage. This result means that the increase in capability can increase the competitive advantage of woven fabric SMEs (endek) in Klungkung district, Bali Province. Implementing effective market-oriented strategic efforts to meet market needs can put SMEs in a better position to compete (Winarso, 2020). Based on the analysis, it is known that the ability to recognize market trends, consumer demand, and changes in production technology is the key to making the right strategic decisions. The ability to make timely decisions includes formulating, evaluating, and selecting strategic orientations to adjust to environmental changes quickly and in a timely manner. In a rapidly changing industry such as woven fabric SMEs, making decisions quickly and appropriately is critical. The ability to implement change includes the ability to execute and coordinate strategic

decisions and corporate changes. It involves various organizational and managerial processes depending on the desired objectives and tasks. In the context of woven fabric SMEs, the ability to implement change includes production processes, supply chain management, and marketing strategies. The results of this study are in line with the results of research by Khourouh et al., (2020); Li & Liu (2014); Prabowo et al., (2021); Zatia Zatia et al., (2023) which found that dynamic capabilities have a positive effect on competitive advantage.

The Effect of Product Innovation on Competitive Advantage

The analysis shows that product innovation is proven to have a positive and significant effect on competitive advantage. This result means that product innovation in business activities can increase competitive advantage in woven fabric SMIs (endek) in Klungkung Regency, Bali Province. According to the results of this study, product innovation carried out by woven fabric SMIs (endek) in Klungkung Regency, Bali Province, which prioritizes product quality development, as well as product development and product development with technology, can encourage increased competitive advantage. Product quality development carried out by woven fabric SMIs (endek) aims to improve product quality and multipurpose product benefits. Innovation efforts carried out with the development of product quality will later be able to produce quality products as a form of competitive advantage (Puspaningrum, 2017). The results of this study are in line with the results of research from Coccia (2017); Lay Hong et al., (2016); Roespinoedji et al., (2019), who have found that increasing product innovation can ensure a competitive advantage of the company.

The Effect of Dynamic Capabilities on Product Innovation

The findings show that dynamic capabilities have a positive and significant effect on product innovation. This proves that companies with strong dynamic capabilities to recognize and make strategic decisions help them gather relevant information about the market and customers, enabling SMEs to develop product innovations that align with evolving market needs (Zhang & Wu, 2017). Market sensitivity in making timely decisions enables firms to respond quickly to emerging innovation opportunities, thus accelerating the process of developing and launching new products (Sheng, 2017). In addition, strong dynamic capabilities allow companies to flexibly mobilize internal and external resources to act on opportunities effectively, which increases their success rate in developing and commercializing new products (Yi et al., 2016). The results of this study are in line with research conducted by Firman & Thabrani (2018); Jiang et al., (2020); Vu (2020), who have found that dynamic capabilities have a positive and significant effect on product innovation.

The Effect of Dynamic Capabilities on Competitive Advantage Mediated by Product Innovation

The findings show that product innovation can significantly mediate the indirect effect of dynamic capabilities on competitive advantage. This indicates that high dynamic capabilities can increase the likelihood of product innovation, which in turn increases the competitive advantage of woven fabric SMIs in Bali Province. This confirms the importance of product innovation as one of the main strategies to improve the competitiveness of woven fabric SMIs. Product innovation is considered a mediator between dynamic capabilities and competitive advantage in woven fabric SMIs. This is because product innovation enables firms to create unique added value for customers and differentiate themselves from competitors. By having good dynamic capabilities, woven fabric SMIs can produce product innovations that are relevant to market needs, such as developing new motifs, using innovative materials, or improving efficient production processes. The results of this study are in line with research conducted by (Firman & Thabrani, 2018), which found that product innovation can significantly mediate dynamic capabilities on competitive advantage.

Conclusion

The research findings, as analyzed and discussed, lead to the following conclusions:

Dynamic capabilities have a positive and significant effect on competitive advantage. This result means increased capability can increase the competitive advantage of woven fabric SMEs (endek) in the Klungkung district, Bali Province. Implementing effective market-oriented strategic efforts to meet market needs can put SMEs in a better position to compete

Product innovation has a positive and significant effect on competitive advantage. This result means that product innovation in business activities can increase competitive advantage in woven fabric SMEs (endek) in Klungkung Regency, Bali Province.

Dynamic capabilities positively and significantly affect product innovation. This proves that companies with strong dynamic capabilities to recognize and make strategic decisions help them gather relevant information about the market and customers, enabling SMEs to develop product innovations that align with evolving market needs

Product innovation can significantly mediate the indirect effect of dynamic capabilities on competitive advantage. This indicates that high dynamic capabilities can increase the likelihood of product innovation, increasing the competitive advantage of woven fabric SMEs in Bali Province. This confirms the importance of product innovation as one of the main strategies to improve the competitiveness of woven fabric SMEs.

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