



The Digital Transformation: Exploring Innovation's Impact on SME Competency and Sustainability in the Digital Age

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ABSTRACT

This research investigates the role of innovation in diving the business competency and relational competency on the sustainability of SMEs in the digital era. We use data from shared questionnaires distributed to 152 owners of small and medium businesses in clusters located in East Java Indonesia. To estimate the hypothesized relationships, this reset used PLS-SEM. The result showed the business competency has no direct effect on firm sustainability, it does have a significant impact on firm sustainability through innovation. These results suggest that when developing appropriate policies for SMEs, the role of innovation is as a potential intermediary in boosting business capabilities toward the sustainability of SMEs, and it must be considered rightly to address the challenges associated with enterprise internationalization. In short, the development of innovation for the right business competency is critical for SMEs to compete on a global scale. In this study, we recommend that SMEs prioritize innovation as a key intermediary in enhancing business competency for long-term sustainability. Policies should support innovation-driven business models, sector-specific innovation needs, and provide financial incentives for R&D and technology adoption. Collaboration with innovation hubs and promoting digital literacy are crucial for fostering a culture of innovation. Networking opportunities should also be encouraged to strengthen relational competency, enabling SMEs to compete globally.

Keywords: Business competency, Innovation, Micro small medium enterprises, Relational competency

JEL Classification: O310, O340, O350, M210

1. INTRODUCTION

Over the last few decades, the world has changed much more rapidly. The revolutionary era is marked by the massive development of the digital economy, artificial intelligence, big data, robotics, and the most surprising phenomenon is the phenomenon of disruptive innovation [1];[2]. Numerous studies in the literature have demonstrated that disruptive innovation has the potential to destroy an existing system. And this is entirely due to the rapid advancement of information technology [3]. Retail shops that are going out of business because of the presence of e-commerce, traditional taxis that have lost most of their income because of the presence of online transportation services, are just a few of the victims of the birth of this disruptive innovation. The advancement of information and communication technology has resulted in significant changes in many areas of life, including business [4]; [5].

Increasing the sustainability, competitive advantage and company performance by promoting SMEs in cluster is still regarded as a common phenomenon. This strategy aims to maximize the geographical concentration of SMEs in the East Java cluster. In addition to other advantages, clusters are expected to develop innovation capabilities that will improve company performance. Clustered industries, according to [6], simplify the successful integration of SMEs in productivity development and global distribution system. Other experts, including [7]; [8]; [6], have emphasized the importance of grouping SMEs.[6]; [9] suggests that knowledge-based innovation is required to achieve this product innovation.

The ever-changing environment in the age of disruption generates new products that drive sufficient innovation capabilities to respond to these advances. So that, firms must deliberately innovate to achieve a competitive advantage, and sustainability both locally and globally. From a strategic standpoint, [10] emphasizes the importance of culture, structure, systems, and processes in the development of innovation. As a result, businesses are encouraged to develop processes that involve continuous data collection and information exchange [11].

Efforts to improve performance, on the other hand, are not solely dependent on the technical aspects of the right strategy. In terms of relational competency, SMEs require cooperation among themselves as well as

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I. Zutiasari et al. (eds.), *Proceedings of the 4th Business Innovation Sustainability and Technology International Conference (BISTIC 2024)*, Advances in Economics, Business and Management Research 307,

https://doi.org/10.2991/978-94-6463-576-8_15

networking with other institutions. [12]demonstrates that relational competency and linking play an important role in increasing SME clusters in developing countries such as Vietnam and Ethiopia. However, social dimensions such as distribution, business collaboration, receive little attention. [13]demonstrate that relational competency has an impact on resource activation, partner coordination, and information flow. According to [14]; [15], [13] the interaction between relational competency and performance reflects SMEs' collaborative action in gaining collective efficiency [16]. In these circumstances, relational skills can be regarded as the most valuable relational competency for SMEs [12]; [17]. This collaborative effort is expected to boost their performance.

Some researchers, including [18]; [19]; [20]; [21]; [22] and [23] investigated the performance of SMEs operating in East Java clusters. However, these studies still leave gaps in the literature that must be filled. These studies clearly do not reveal the role of innovation as a moderating variable in clustered SMEs' performance. It is crucial that this connection should be investigated. This affair prompted the researchers to expand by investigating the role of innovation in pushing the business competency and relational competency on business. As a result, the intention of this study is 1) to test the effect of business competency on SMEs' performance 2) to investigate the influence of the relational competency on SMEs' performance 3) to examine the role of innovation in encouraging the business competency toward SMEs' performance; and 4) to investigate the role of innovation in driving the relational competency on SMEs' performance.

This study confirms the importance of innovation in helping businesses improve the performance of SMEs in a destructive era. The study's first endowment is raising awareness among SMEs about relational competency and benefits of innovation competency. Second, this study adds to the literature in terms of innovation, business strategy, relational competency, and the sustainability of SMEs in the disruptive era and it can be developed with other research by reflecting on innovation ability.

2. MATERIALS AND METHODS

2.1. Samples

The population of this study consists of 200 small and medium-sized enterprises (SMEs) located in East Java, Indonesia, across various industry clusters, including shoes, furniture, batik, leather bags, food processing, and ceramics. These clusters are concentrated in regions such as Madura, Mojokerto, Sidoarjo, Pasuruan, and Malang. The sampling method used was a survey-based approach, where 200 questionnaires were distributed to business owners across these industries. A total of 152 valid responses were collected, after discarding 8 incomplete questionnaires. The distribution of respondents was as follows: 20% from the leather shoe industry, 20% from furniture, 13% from food processing, 13% from ceramics, 11% from wood processing, 11% from batik, and 14% from the leather bag industry. This sampling strategy ensures representation across key SME clusters in the region, providing a balanced perspective on the industries studied. The analysis was conducted using PLS-SEM, a method suitable for examining complex relationships between unobservable variables, implemented through SMART-PLS 3.0 software.

2.2. *Data collection and technique analysis*

This study's data was gathered through the survey method. 152 of the 200 surveys distributed were returned. Eight questionnaires were discarded during the data sorting stage due to missing values. As a result of the survey conducted for this study, 152 valid. There were 20% from the leather shoe industry, 20% from the furniture industry, 13% from food processing companies, 13% from the ceramic processing industry, 11% from wood processing, 11% from batik, and 14% from the leather bag industry. This sampling strategy ensures representation across key SME clusters in the region, providing a balanced perspective on the industries studied. The analysis was conducted using PLS-SEM, a method suitable for examining complex relationships between unobservable variables, implemented through SMART-PLS 3.0 software.

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Partial least squares structural equation modeling (PLS-SEM) is used in this study because it is widely used by researchers in economics and other fields to examine the causal relationship and influence between unobservable variables. PLS-SEM has also been adopted in many research areas, such as management information systems, accounting, and operations management such [24]; [25]; [22]; [26] PLS-SEM enables researchers to test measurement models alongside structural models, allowing academics to use more complex research models that include both mediating associations [27]. We use the SMART-PLS 3.0 software in this paper

2.4. Data

Table 1 The sample size calculation is based on the sampling technique

Regions	Manufacturing SMEs	The sample size calculation
Mojokerto	Leather Shoes	30
Pasuruan	Furniture	30
Malang	Food Processing	19
Malang	Ceramic Processing	20
Malang	Wood Processing	16
Madura	Batik Handicraft	16
Sidoarjo	Leather Bags	21
Total		152

Source: primary data

Table 2. The profile of respondents

Category	Frequency	%
Gender of SMEs		
Male	99	65%
Female	53	35%
Periods of Firms Establishment		
1991-2000	19	13%
2001-2010	43	28%
2011-2020	54	36%
2021-2022	36	24%
Number of employees		
1-4 (micro enterprises)	68	44,7%
5-19 (small enterprises)	61	40,1%
20-99 (medium enterprise)	23	15,1%

Source: primary data

2.5. Definition Variable and Measure

Relational competency refers to a company's intangible assets for communicating, coordinating, and managing business interactions among its relationships. The relational competency consists of two dimensions, that are relational of society, and the relational of employee. The measurement is using interval through (5) five-point rating to scale approach was used for measurement (1 to 5). In this study, the indicator of relational of society was the firm's relationship with its alliance partner marked by mutual respects, mutual trust, high reciprocity, and be marked by personal friendship. The indicator of the relational of employee was related to close interaction with its employee, mutual trust with employee, reciprocity with employee and commitment with employee.

Business competency is competencies that reflect a variety of strategic orientations in responding to external conditions. it refers to a company's skills or knowledge that supports a distinct value proposition to customers. Uniqueness does not only refer to being distinguishable, but it can also refer to being unique in terms of cost. In this research, business competency consists of two dimensions, that are human capital, and production capital. The measurement is using interval through (5) five point (1 to 5). The indicator of human capital in this research related to domain skills, creativity, thinking, developing new concepts, and ability in overcoming the crises. The indicator of production capital was related to product quality, renewing working equipment, and working method.

Innovation is defined as the ability to improve and manage existing technology, capability, and knowledge in order to create new ones. The measurement is using interval through (5) five point (1 to 5). In this study, the indicator of innovation was related to the frequency of firm's ability to transform knowledge and ideas into new products, new process, and new services for the benefit of the company. And the performance of SMEs is defined as the firm's achievement over a specific period. The measurement is using interval through (5) five points scale approach (1 to 5). The indicator of SMEs performance consists of the growth of sales, the increase sales value profit increase, and the increased production.

3. RESULTS AND DISCUSSION

To achieve the research objectives and hypothesis testing, there are two tests carried out in the study, namely the outer model and the inner model, which are as follows:

3.1. The outer Model

The appraisalment of outer model through loading factor is applied to specify the validity of the indicators in formatting a latent variable, by seeing at the convergent validity value of the indicators in the model. Each indicator should conform the convergent validity, that has an absolute loading factors of > 0.5, if there is an indicator that does not conform the criteria, the indicator is removed from the model. The appraisalment of the outer model can also be checked from the value of the average variance extracted and the composite reliability. The following is the result.

Table 3. The output of the outer model

constructs	The convergent validity		The reliability		
	λ	significant	AVE	CR	
<i>Relational of Society</i>			0.582	0.769	0.848
RS01	0.711	***			
RS02	0.805	***			
RS03	0.798	***			
RS04	0.735	***			
<i>Relational of Employee</i>			0.765	0.899	0.928
RE01					
RE02	0.859	***			
RE03	0.905	***			

RE04	0.841	***			
	0.887	***			
<i>Human Capital (HC)</i>			0.810	0.766	0.895
HC01					
HC02	removed				
HC03	removed				
HC04	0.888	***			
	0.912	***			
<i>Production Capital (PC)</i>			0.660	0.744	0.853
PC01	0.799	***			
PC02	removed				
PC03	0.819	***			
PC04	0.820	***			
<i>Innovation (IN)</i>			0.722	0.810	0.886
IN01	removed				
IN02	0.828	***			
IN03	0.920	***			
IN04	0.796	***			
<i>SMEs Performance (SP)</i>			0.736	0.880	0.918
SP01					
SP02					
SP03	0.905	***			
SP04	0.820	***			
	0.770	***			
	removed				

Source: SEM-PLS, processed (2023)

Table 3 showed indicators with cross loadings less than 0.6 were excluded from the analysis, as suggested by [28]. As a result, only two indicators, “HC01” and “HC02,” were included in the data analysis for the dimension of human capital. This elimination is also applied to all indicators with a cross loading of less than 0.6. Then the appraisalment of the outer model can also be seen from the discriminant validity value, namely by looking at the value of the relationship between indicators and variables. The criterion is an indicator with a higher correlation value than other variables must influence the variable. The following is the result.

Table 4. The summary of the discriminant validity.

	BC	HC	IN	PC	RE	RS	RC	SMEs
BC	1.000							
HC	0.707	0.900						
IN	0.441	0.335	0.850					
PC	0.770	0.535	0.261	0.812				
RE	0.448	0.299	0.147	0.277	0.873			
RS	0.514	0.278	0.189	0.320	0.594	0.763		
RC	0.454	0.158	0.061	0.167	0.402	0.409	1.000	
SME	0.408	0.248	0.403	0.281	0.440	0.336	0.403	0.858

Source: SEM-PLS, processed (2023)

3.2. The inner model

The structural model or inner model can be evaluated by using R2 for the dependent variable and the coefficient value on the path (®) for the independent variable which is then assessed for its significance based on the T statistic value of each path. It must be above 1.96 for the two-tailed hypothesis, above 1.64 for the one-tailed hypothesis, and for hypothesis testing there is an alpha of 5 percent. Here are the results of the inner model:

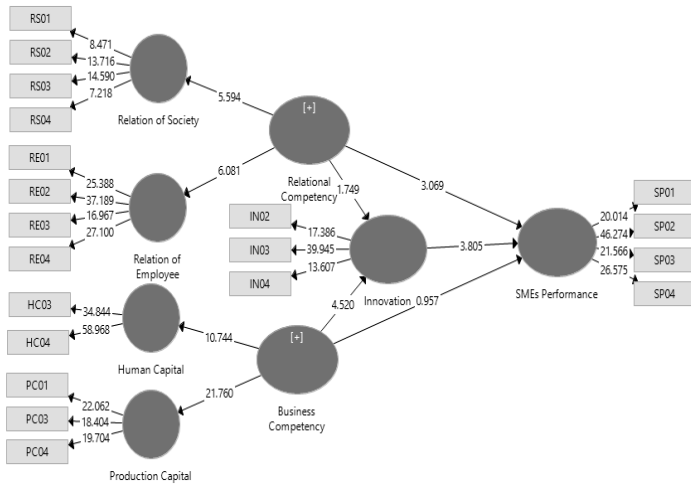


Figure 1. the structural model result
Source: SEM-PLS processed (2023)

Table 5 Hypothesis testing

Category	@	Mean	S.D.	t-statistics	p-values	results
H ₁ BC => IN	0.521	0.528	0.118	4.401	0.000	Received
H ₂ BC => SP	0.109	0.103	0.111	0.986	0.325	Not received
H ₃ RC => IN	-0.176	-	0.098	1.786	0.075	Not received
		0.181				
H ₄ RC => SP	0.334	0.346	0.099	3.367	0.001	Received
H ₅ BC => IN => SP	0.174	0.180	0.062	2.801	0.005	Received
H ₆ RC => IN => SP	-0.059	-	0.040	1.459	0.145	Not received
		0.063				

Source: SEM-PLS, processed 2023

(note: BC=business competency; RC=relational competency; IN=innovation; SP=SMEs performance)

Assessment of Hypotheses Result

The results from **Table 5** show a detailed analysis of how business competency (BC), relational competency (RC), innovation (IN), and SME performance (SP) are related. Below is a breakdown and discussion of the hypotheses tested using SEM-PLS:

H1: BC => IN

@ = **0.521**, **p-value = 0.000** (Accepted). **Interpretation:** Business competency has a strong positive influence on innovation. A higher level of business competency leads to increased innovation among SMEs. This means that the ability of a business to develop strategies, manage resources, and understand markets directly enhances their innovation capabilities. Since the p-value is highly significant (p < 0.001), the relationship is statistically robust.

H2: BC => SP

@ = **0.109**, **p-value = 0.325** (Not Accepted). **Interpretation:** Business competency does not have a direct significant effect on SMEs' performance. Although business competency is essential for operational success, its direct impact on performance appears minimal in this study. This suggests that while businesses may be competent, other factors—such as innovation—are more critical in determining overall performance.

H3: RC => IN

@ = **-0.176**, **p-value = 0.075** (Not Accepted). **Interpretation:** Relational competency has no significant effect on innovation. The negative @ coefficient suggests that an increase in relational competency might slightly reduce innovation, although the effect is not statistically significant. Relational skills, such as maintaining good partnerships and networks, are perhaps not enough on their own to drive innovation within SMEs.

H4: RC => SP

@ = **0.334**, **p-value = 0.001** (Accepted). **Interpretation:** Relational competency has a positive and significant effect on SMEs' performance. This means that SMEs that invest in building strong relationships with customers, partners, and suppliers are more likely to improve their performance. The statistical significance of this relationship (p < 0.05) highlights the importance of networking and maintaining external relationships for SMEs' success.

H5: BC => IN => SP

$\beta = 0.174$, $p\text{-value} = 0.005$ (Accepted). **Interpretation:** This hypothesis demonstrates that innovation mediates the relationship between business competency and SME performance. While business competency alone does not directly impact performance (H2), it significantly contributes to performance when channeled through innovation. In other words, innovation acts as a bridge that connects the capabilities of a business to its overall success, highlighting the importance of fostering innovation in business strategies.

H6: RC => IN => SP

$\beta = -0.059$, $p\text{-value} = 0.145$ (Not Accepted). **Interpretation:** Relational competency, when mediated by innovation, does not significantly affect SME performance. This suggests that while relational skills are valuable for direct performance improvement (H4), they do not effectively translate into performance gains through innovation. The mediation effect of innovation is not strong enough in this context.

3.5. DISCUSSION

The primary goal of the research is to use structural equation modeling techniques to ensure that innovation variables play a significant role in mediating the business competency and relational competency on SME sustainability. According to the diffusion of innovation theory [29]; [30] the success of a business is determined by individual creativity and social experience, which leads to innovation in the form of products, services, processes, organizational management, and marketing that can support business value and competitiveness. In this study, business competency is divided into two dimensions: human capital and production capital. Human capital refers to expertise, creativity, the ability to think creatively, and problem-solving ability. Production capital refers to product quality, prioritizing customer tastes, renewing work methods, and updating work equipment. This study's findings show the relational competency directly affects the sustainability of SMEs. This result can be seen by the $p\text{-value} = 0.001$ and $\beta = 0.334$. The finding implies that increasing relational competency will promote the long-term viability of SMEs. This demonstrates that, even in a disruptive era, SMEs' relational competencies, such as mutual respect, mutual trust with employees, commitment, and personal friendship, were still able to increase their capacity. This increase has influenced increased business processes and has encouraged SMEs to be more sustainable. This finding supports the previous researches such as [12]; [31]; explained that the quality of the business owner's attention to employees, easy access to information for employees, the intensity of employee involvement in work planning, and the presence of a familiar atmosphere in the organization all contribute directly to an increase in production and service, thereby helping to attract new customers and then increasing demand. Furthermore, the company's ability to quality relationships contributes directly to an increase in production and service [32]; [13].

Furthermore, the empirical results show innovation influenced significantly in mediating business competency on the firms, which showed with $p\text{-value} = 0.005$ and $\beta = 0.174$. It indicates that if SMEs actors increase their capacity in the fields of business competency included creativity thinking skills, new concepts, the quality of the products, and renewing of working methods, they will be easier to utilize the innovation in their business, thereby creating and producing added value in the production, which means that the sustainability for SMEs will be better. This result in line with the theory of creativity [33] that the greater a person's knowledge base, skills, and curiosity, the more ideas, trends, new concepts, and combinations they can achieve, which leads to the development of innovative new products and services that lead to higher levels of productivity. This finding also supports the previous studies such as [34]; [35] that innovation capability has a partial mediator effect on business orientation dimensions and export performance, and that SMEs can gain a competitive advantage by improving market-driven innovation capability, [36]; [37] that SMEs should take the advantage of business capability and make an innovation for their products/services to make their business sustainable.

4. CONCLUSIONS

This study investigates the impact of business competency and relational competency on the long-term viability of SMEs in East Java, Indonesia. Using PLS-SEM, the study investigates the direct and indirect (via innovation) effects of business competency and relational competency on the performance of SMEs. The research hypothesis testing results show that the variable of innovation plays an important mediating role in the relationship between business competency and the sustainability of SMEs. These findings build on previous research, which was mostly published in Western Asian countries. As a result, existing research and practice in small industries show that product and service quality innovation, organizational management, and operating processes must be considered as important elements in supporting business actors in the disruptive era. Future studies propose that business actors can practice creative thinking skills, make new concepts more quality, and working method renewal on a regular basis, they will find it easier to incorporate innovation into their operations. As a result, positive outcomes can lead to long-term sustainability and improvement of organizational competitiveness and performance in the face of global competition and economic uncertainty. This study also makes several recommendations for future research. First, several indicators of business competency and relational competency should be considered in future studies because they can predict similarities and differences in the abilities and expertise of business actors on the relationship between interesting variables. Second, a larger sample size should be used because it can better represent the population under study. Third, because they are widely discussed in the SMEs literature, specific dimensions of business competencies such as human capital and production capital should be highlighted. Finally, other motivations for innovation, such as managerial and technological innovation, should be considered because they are widely acknowledged as critical connecting variables between supporting business competencies in dynamic organizations.

This study is limited in several ways. First, it does not explore all potential indicators of business and relational competency, which may provide a more comprehensive understanding of their influence on SME sustainability. Second, the sample size of 152 SMEs, while informative, may not fully represent the broader population, limiting the generalizability of the findings. Third, the study focuses primarily on innovation as a mediating variable but does not delve into other critical factors such as human capital, production capital, and other dimensions of business competency, which may also play significant roles. Lastly, the study overlooks managerial and technological innovation as potential motivations, which are widely recognized in the literature as critical factors in enhancing business competencies and organizational performance. Future research should address these limitations to provide more robust conclusions.

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