

# Innovation and Dynamic Capabilities among Traditional Market Traders: How it Affect Business Performance

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Keywords: Innovation, Dynamic Capabilities, Business Performance.

Abstract: The purpose of this paper is to report research on dynamic capabilities and innovation-how it affects business performance. The author also examines how the effect of innovation on both dynamic capabilities and business performance, and how dynamic capability impacts on business performance, also as well as how dynamic capabilities as the moderating effect of innovation on business performance. The data collected from an original survey of 840 respondents of the trader in 69 traditional markets around West Java, Indonesia. This research was developed using a survey and literature review as the basis for its development. Structural Equation Modeling was used to evaluate the finding, which means that two stages were used; the first was checking the construct reliability and validity for measuring the model. The second stage was a full model of structural equation modeling to test the hypothesis developed. The finding of these researches described the innovation of traditional market trader has a significant positive effect not only on dynamic capabilities but also on business performance, another finding shows that the dynamic capabilities have a significant positive effect on business performance.

## 1 INTRODUCTION

Traditional market traders that are categorized as Small and Medium Enterprises (SMEs) face challenges from the growing modern markets as well as from competition among the traditional market traders themselves. This is indicated by the development of modern retails such as mini markets, which are considered to threaten the existence of traditional markets in Indonesia (<https://bisniskeuangan.kompas.com>). One reason is the service quality of the traditional market far inferior to the modern market (Najib and Sosianika, 2018). Hanna and Walsh (2002) suggest SMEs must adapt to industrial changes, such as technological progress and the creation of new products so they can survive to operate. Therefore, SMEs must be more innovative in serving their customers, due to the changing preferences of their customers, and the competitors who keep improving their capabilities in the business.

Therefore, the challenge of developing a competency level the dynamic capabilities of traditional market traders is required to be high. Hitt et al. (2001) and Helfat et al. (2007) state that the dynamic capabilities of a company can make a

positive contribution to company performance. Dadashinasab and Sofian (2014) confirm that dynamic capability, in principle, is to reconstruct and enhance the core capabilities of the company in responding to dynamic markets to maintain competitive advantage and maintain performance. Giniuniene and Jurksiene (2015) suggest that the concept of dynamic capabilities is very important in today's research because dynamic capabilities can improve a company's business performance. The main implication of the dynamic capability concept is that the company has competency not only to distribute the utilization of available resources within the organization but also to renew and develop themselves, especially in traditional markets.

On the other hand, in today's competitive business and market environment, Lazonick and O'Sullivan (2000) and Brem and Voigt (2009) argue that the need to continue to innovate and provide new products and services that are better recognized for all company sizes. Because successful innovation is recognized as one of the factors that contribute to the company's competitive advantage (Gunasekaran et al., 2000; How, 2008; Sanz-Valle and Jimenez-Jimenez, 2011), and ultimately has an impact on business performance (Zahra et al., 1999; How, 2008; Talke et al., 2011).

Previous studies related to the relationship between innovation and business performance some mentioned having positive and significant relationships, but others found that there were no positive and significant relationships and even no relationships at all (Geroski and Machin, 1992; Freel, 2000b; Al-Ansari et al., 2013). Freel (2000a) emphasized that he did not find this relationship. Meanwhile, other opinions state that business performance is positively influenced by innovation, and the correlation between innovation and business performance depends on the type of innovation it develops (Otero-Neira et al. 2009; Forsman and Temel, 2011). North and Smallbone (2000) found that there is a relationship between innovation and business performance that is interdependent and mutually. Therefore, the role of dynamic capabilities becomes very important as a mediation that mediates the relationship of innovation with business performance. Research on issues that contribute to the characteristics of SME innovation includes several things, namely; environmental and cultural issues, market strategy issues from the process and type of product, source of ideas, drivers and platforms, and, research and development (Sebora et al., 1994; Hadjimanolis, 1999; Guan and Ma, 2003; Blumentritt and Danis, 2006; Kenny and Reedy, 2006; Laforet and Tann, 2006).

The purpose of this study is to explore the relationship of innovation to dynamic capabilities and business performance. Therefore, this research is organized as follows. First, background and theoretical study are presented, and then a description of the methodology was used. Second, data analysis that followed with a discussion of test results. The final part of this study is the presentation of conclusions.

## 2 LITERATURE REVIEW

### 2.1 Innovation

Innovation is a process that can be repeated in various forms (Damanpour & Schneider, 2006; Dobni, 2008; Goffin & Mitchell, 2010; Norman & Verganti, 2012). According to Freeman and Soete (1997), innovation is related to the involvement of various problems, including; knowledge, capabilities, activities, and organizational processes. Kanter (1983) defines innovation as a form of accepting and implementing the new ideas of the processes, the products, or the services. It basically means that innovation occurs when new elements or new combinations of old

elements are introduced. Therefore, the aim of innovation is to take advantage of the latest conditions and opportunities, formed in the environment and used to frame new values and gain competitive advantage (Porter, 1990; Nonaka & Kenney, 1991; Damanpour & Schneider, 2006; Dobni, 2008).

Several types and activities of innovation include product innovation, process innovation, and market innovation (Sundbo, 2003). Furthermore, Sundbo also (2003) describes product innovation as the introduction of new products to the market; and the process innovation is the introduction of new production processes using new technologies or new work processes; and market innovation is related to the new market behavior of the companies such as new strategies, new marketing, new alliances, and others.

### 2.2 Dynamic Capability

The rise of a dynamic capability view is a reaction response to the not yet covered resource-based view and action-based view as a result of the development of new economic notions and innovations (Mintzberg et al., 2003). On the whole, dynamic capabilities can be built from strategic and operational processes (Güttel & Konlechner, 2009). Strategic processes are mostly related to the ability to feel and take advantage of new opportunities in a vibrant environment (Teece, 2007). Hence, this process determines the establishment of corporate strategies (Güttel & Konlechner, 2009). While in the operational process, more dynamic capabilities relate to reshaping internal or external competencies and establishing operational practices within the company (Güttel & Konlechner, 2009). The study of Hou (2008), Pavlou & Elsayy (2011), Zheng et al. (2011), Wang & Shi (2011), Gathungu & Mwangi (2012), Nedzinskas et al. (2013), and Tiantian et al. (2014) respectively show some similarities and differences in dimensions used in measuring the dynamic capabilities of an organization/company. Lin & Huang (2012) suggest that dynamic capabilities facilitate a company in improving its performance, innovation in products, and the use of sophisticated technology and preparing the company to survive in an ever-changing business environment. Furthermore, Najib et al. (2017) state that dynamic capabilities can be built through sensitivity capability, absorptive capacity, integrative capability, and innovative capability.

## 2.3 Business Performance

Performance is a construct commonly used to measure the impact of strategic orientation. Voola & O'Casey (2010) states that business performance is a major consequence of the responsive market orientation (RMO) and proactive market orientation (PMO). Furthermore, Wheelen & Hunger (2012) argue that performance is the final result of the activities. Thus to measure the dimensions of business performance can be based on the concept of developing dimensions, as suggested by Najmabadi, Rezaeideh & Shoghi (2013) through using performance measurement dimensions consisting of sales growth, return on investment, operating profit margin, return on equity and customer retention. Hussin, Thaheer, Badrillah, Harun, & Nasir (2014) use the dimensions of measuring business performance covering average net profit growth, work value received, the number of contracts received, and the number of contracts renewed. Hyung & Dedahanov (2014) include four aspects of measuring performance, i.e., market share, average growth, success, and profitability. Najib et al. (2017) the dimensions used to measure business performance in measuring business success, including sales growth, market share growth, and profitability.

## 2.4 Innovation, Dynamic Capabilities, and Business Performance

A study has found that innovativeness has a positive relationship with business performance, which includes; profitability, market share, and sales growth (Deshpande et al., 1993). Furthermore, Craig and Dibrell (1994) have proven that innovation is a crucial requirement for business performance, as well as for competitiveness and economic wealth. Similarly, Baldwin and Johnson (1996) show that innovation has a significant influence on various measures of business performance, which include such as ROI (return on investment) and the company's market share. Furthermore, Salavou (2002), based on asset returns, shows that product innovation is a significant determinant for business performance. Innovation helps companies economically, creates competitive advantages, and can positively influence on business performance (Fallah and Lechler, 2008; Talke et al., 2011).

Likewise, there is also a relationship between dynamic capabilities and business performance (Tece et al. 1997; Eisenhardt and Martin. 2000; Makadok 2001; Najib et al., 2017). Furthermore,

Mauludin et al. (2013) argue that dynamic capabilities are needed in formulating strategies in rapidly fluctuating and complicated environments, high innovation demands, and efforts to improve organizational capabilities in order to overcome market dynamics. Dynamic capabilities are organizational routines that must be obtained through learning in a very high style, repetitive or repetitive mastery (Tiantian et al., 2014). Then how far can dynamic capabilities mediate innovation on business performance? Based on the background and theoretical study above, and considering the purpose of this research, a conceptual model is proposed that needs to be tested empirically. In this research, the aim is to examine the relationship between innovation and dynamic capabilities and the relationship between innovation and business performance in traditional market traders. Therefore, some hypothesis can be derived from the research model, as shown in Figure 1:

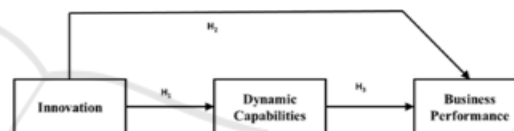


Figure 1: Research Model.

Hypothesis1: The dynamic capabilities of traditional market traders are positively related by innovation.

Hypothesis2: The business performance of a traditional market trader is positively related by innovation.

Hypothesis3: The business performance of a traditional market trader is positively related by with dynamic capabilities.

## 3 METHODOLOGY

### 3.1 Survey Design, Instrument and Sample Characteristic

The purpose of this study is to explore innovative characteristics in traditional market traders and innovation relationships with dynamic capabilities and business performance. Data was collected from traditional market traders in West Java, Indonesia. A five-point Likert scale is designed for questionnaire after a literature review; therefore, the survey instrument for constructing the first variable is an innovation which is adopted from the research of Al-Ansari et al. (2013). The second variable constructs is

a dynamic capability that is developed and adapted from Hou (2008) and Najib et al. (2017). The third variable construct is business-performance, which is adopted and developed from Hyung & Dedahanov (2014) and Najib et al. (2017).

The sample size of this study was 840 respondents of traditional market traders taken from 66 traditional markets around West Java, Indonesia. Table 1 shows the respondents' profile.

Table 1: Respondent Profile

Description	Freq	%	Description	Freq	%
<b>Gender</b>			<b>Outlet Ownership Status</b>		
Male	477	56,8	own property	450	53,6
Female	363	43,2	Rent	390	46,4
	<b>840</b>	<b>100</b>		<b>840</b>	<b>100</b>
<b>Business Experience</b>			<b>Business license</b>		
More than 15 years	286	34,0	License	657	78,2
10 years - 15 years	191	22,7	No License	183	21,8
5 years - 10 years	185	22,0		<b>840</b>	<b>100</b>
Less than 5 years	178	21,2			
	<b>840</b>	<b>100,0</b>			

### 3.2 First Order - Confirmatory Factor Analysis (CFA)

The first order-CFA was carried out to adjust and validate the structural model. The measurement model was developed to see the relationship between the variable constructs examined by using AMOS-22 (Byrne, 2013). After using the modification index to determine the covariance between the variables studied, the suitability of the model to build the variables used in the study includes; innovation, dynamic capability, and business performance. The results show that the variables can be accepted because they have the goodness of fit index, as shown in table 2.

Table 2: Goodness of Fit Index

	An Acceptable Level	Variable Constructs		
		Innovation	Dynamic Capabilities	Business Performance
CMIN/DF	≤ 3	2.672	2.783	2,630
RMSEA	≤ 0,08	0,054	0,076	0,064
GFI	≥ 0,90	0,91	0,905	0,921
AGFI	≥ 0,90	0,92	0,901	0,906
TLI	≥ 0,90	0,912	0,946	0,948
NFI	≥ 0,90	0,90	0,934	0,924
CFI	≥ 0,90	0,923	0,943	0,959
IFI	≥ 0,90	0,923	0,943	0,959
RFI	≥ 0,90	0,916	0,924	0,959

### 3.3 Validity and Reliability

Table 3 shows all loading factors for the constellation of innovation variables. Table 4 for constructing variable dynamic capabilities and Table 5 for constructing business performance variables, all of them were recommended a minimum threshold of 0.30 for our sample size of 840 (Hair et al., 2006). Convergent validity and Average Variance Extracted (AVE) are above 0.50 on all constructs, implying that each construct explains more than 50 percent of the variance in each variable indicator. The discriminant validity was confirmed by the Fornell-Larcker criterion by comparing the square root of the AVE of each construct. The correlation between constructs indicated that, on average, each construct was more strongly related to its measures what the other constructs measures (see table 3, table 4 and table 5 of AVE, Construct reliability and Discriminant validity) (Hair et al., 2006). Pertaining to the model reliability, the Cronbach's alpha and composite values for each construct are above 0.7 of the thresholds (Byrne, 2013).

Table 3: Validity and Reliability Construct Variable: Innovation

Descriptions	Loading Factor	Cronbach's alpha	Average Variance Extracted	Construct Reliability	Discriminant Validity
<b>Business Idea</b>		<b>0,788</b>	<b>0,568</b>	<b>0,871</b>	<b>0,753</b>
We often try new ideas to run our business/business	0,652				
We introduce a number of new products, services, processes, or organizational / management systems	0,833				
We are the first to market new products or services	0,764				
<b>Innovation Types</b>		<b>0,717</b>	<b>0,808</b>	<b>0,808</b>	<b>0,680</b>
We are looking for new ways to do something in running our business/business	0,758				
We are creative in business operation methods	0,561				
We use the latest technology in business	0,706				
<b>Innovation Strategies</b>		<b>0,707</b>	<b>0,816</b>	<b>0,816</b>	<b>0,645</b>
We develop new market segments / sections	0,546				
We use new marketing methods	0,742				
We develop new ways of establishing relationships with customers	0,747				
We spend resources on research and development for new products, services or processes	0,508				

Table 4: Validity and Reliability Construct Variable: Dynamic Capabilities

Descriptions	Loading Factor	Cronbach's alpha	Variance Extracted	Construct Reliability	Discriminant Validity
<b>Sensing Capability</b>		0,858	0,605	0,916	0,778
The capability to understand the dynamics that develop in the market	0,733				
The capability to understand customer needs	0,811				
Capability to feel the dynamics that develop in the market	0,785				
Capability to satisfy customer needs	0,781				
<b>Absorptive Capability</b>		0,865	0,623	0,916	0,789
Capability applies new values/information to the business	0,795				
Capability assimilates/adjusts the value/new information in the business	0,876				
Capability to recognize new information developments in the business environment	0,776				
Capability to recognize new values that develop in the business environment	0,701				
<b>Integration Capability</b>		0,867	0,658	0,829	0,830
Capability to be effective when integrating with the business	0,803				
Capability to apply patterns of integration of interactions in business	0,873				
Capability ability to make an integrated input/suggestion effective	0,811				

Table 5: Validity and Reliability Construct Variable: Business Performance

Descriptions	Loading Factor	Cronbach's alpha	Variance Extracted	Construct Reliability	Discriminant Validity
<b>Sales Growth</b>		0,928	0,762	0,960	0,873
The increase in the types of products sold	0,885				
The increase in the number of products sold	0,893				
The increase in the type of product requested by the customer	0,869				
The increase in the number of products requested by the customer	0,845				
<b>Market Share Growth</b>		0,912	0,728	0,960	0,853
The growth of the market share that is the business market forces	0,766				
The growth of the market share due to the capability of business efficiency	0,868				
The growth of the market share of the number of products sold	0,903				
The growth of the number of the market share of the types of products sold	0,870				
<b>Profitability</b>		0,880	0,649	0,927	0,806
The level of ability to maintain business management efficiency	0,906				
The level of ability to manage the business efficiently	0,910				
Level of ability to generate the profits	0,691				
The increasing income from business	0,686				

## 4 RESULT AND DISCUSSION

Structural Equations Modelling (SEM) describes the relationship between exogenous variables (innovation) and endogenous variables (dynamic capabilities and business performance). The results presented in Figure 2 are the results after moving through the procedure of evaluating the model with first order-CFA.

The model of the structural equation as shown in Figure 2 indicated as a perfect model, as CMIN / DF resulted in 2,835, and also other fit indexes (GFI, AGFI, TLI, NFI, CFI, IFI, and RFI) gave value over 90% that indicated excellent model, as well as the RMSEA value of 0.073, is below 0.08 (Hair, 2006).

Consistent with the research objective, which is to determine the effect of innovation and dynamic capabilities on the business performance of traditional market traders, as shown in Figure 2 and Table 6, there is a significant positive effect of innovation and dynamic capabilities on the business performance of traditional market traders.

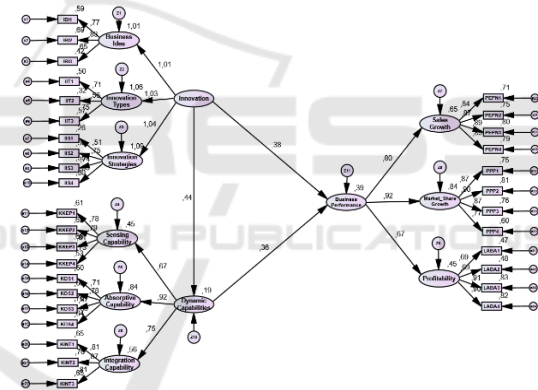


Figure 2: The SEM Diagram of the Effect of Innovation and Dynamic Capabilities on Business Performance

Table 6: Hypothesis Testing Result

Hypothesis	Standardize <sub>t</sub> (Estimated)	SE	CR	P-value
H <sub>1</sub> Innovation → Dynamic Capabilities	,260	,028	9,114	***
H <sub>2</sub> Innovation → Business Performance	,180	,023	7,862	***
H <sub>3</sub> Dynamic Capabilities → Business Performance	,290	,040	7,249	***

Hypothesis testing results in the effect of innovation and dynamic capabilities on business performance as Table 5 shows that: H<sub>1</sub> (innovation is positively related to the dynamic capabilities of



traditional market traders) indicates that the critical value (CR) is 9,114 on the influence of innovation with the dynamic capabilities, with P-Value (probability) is significant with \*\*\*, it means that it is significant by default. Therefore the regression weight on dynamic capabilities foreseen by innovation is significantly different from zero at the 0.05 level (two-tailed). Thus, it implies that  $-H_a$  is rejected, but  $H_o$  is accepted. These results conclude that innovation affects dynamic capabilities. The result shows that the capabilities of traditional market traders which include sensing capability, absorptive capability, and integrated capability must be supported by innovation capability among traders, which includes the ability to develop business ideas, the ability to create various types of innovation, and the ability to plan innovation strategies. Hou (2008) confirms the result of this study that dynamic capabilities are needed to support in dealing with environmental changes, in the form of innovation capabilities, as confirmed by Kim et al., (2018) that innovation is needed in building dynamic capabilities. However, in reality, the traditional markets, despite facing a threat from modern markets, are still the choice of their customers.

$H_2$  (an innovation of traditional market traders is positively related to their business performance) indicated that the critical value (CR) is 7,862 on the influence of innovation with business performance, and P-Value (probability) is significant with \*\*\*, which means that by default is significant. In other words, the regression weight for business performance predicted innovation is significantly different from zero at the 0.05 (two-tailed) level. Thus, it was decided to reject  $H_a$  and accept  $H_o$ . Based on these results, it can be concluded that innovation affects business performance. By innovating can drive business performance, in the form of sales growth, market share growth, and profitability. Therefore, traditional markets need to innovate in the face of current business competition and corporate environments that require continuous innovation, and they should be able to provide such as; new products and product diversification and give the best services (Lazonick and O'Sullivan, 2000; Brem and Voigt, 2009). Another important thing is related to the ability to innovate traditional market traders, because innovation has been believed to be able to improve business performance (North and Smallbone, 2000; Forsman and Temel, 2011; Kim et al., 2017). Innovation that can be done in traditional markets can be done mainly related to changing traditional markets, which are perceived as dirty,

smelly, muddy, narrow hallways, lots of garbage, and irregular arrangement of merchandise.

$H_3$  (dynamic capability is positively related to the business performance of traditional market traders) indicated that the critical value (CR) is 7,862 on the influence of dynamic capabilities with business performance, and P-Value (probability) is significant with \*\*\*, which means that by default is significant. In other words, the regression weight for business performance predicted by innovation is significantly different from zero at the 0.05 level (two-tailed). Thus, it was decided to reject  $H_a$  and accept  $H_o$ . Based on these results, it can be concluded that innovation affects business performance. This result shows the importance of increasing the dynamic capability of traditional market traders in sensing capability, absorptive capability, and integration capability because increasing the dynamic capability of traditional market traders can improve their business performance. Dadashinasab and Sofian (2014) stated that dynamic capabilities could maintain performance, further Giniuniene and Jurksiene (2015) claim it can improve business performance.

This study explores the innovative capabilities and dynamic capabilities of traditional market traders in Indonesia and examines the relationship between innovation and dynamic capabilities on business performance in traditional market traders. This study provides support for previous studies conducted in traditional markets in Indonesia and provides useful insights on the importance of innovation of traditional market traders in developing countries by investigating the extent to which innovation and dynamic capabilities of traditional market traders influence their business performance. The results show that innovation and dynamic capabilities have a positive relationship with the business performance of traditional market traders in Indonesia. The results of this study strengthen and provide empirical support for the view that innovation and dynamic capabilities have a positive impact on business performance and counter the assumption that innovation and dynamic capabilities will consume of the resources and jeopardize of the competitive advantage of traditional market traders, especially in traditional markets in developing countries.

## 5 CONCLUSIONS

The contribution of this research is expected to be able to add to the literature for innovation and dynamic capabilities making available the data from

traditional markets and challenging whether previous research findings are relevant in developing traditional markets. This research reveals some implications. It also has several implications. First, there is an indication that traditional market traders have different views on innovation and dynamic capabilities and show that innovation and dynamic capabilities are statistically significant in relation to business performance in the context of developing traditional market traders in Indonesia. Second, these findings provide more insight into the innovative characteristics and dynamic capabilities of traditional market traders in Indonesia and show that the attention must be paid to innovation and dynamic capabilities, ensuring traditional market traders can achieve much better business performance. Third, this finding might support the policymakers of the traditional market in Indonesia to take the new steps towards national policies that enhance the revitalization of traditional markets not only for the facilities but for business actors themselves who are traditional market traders. Finally, the findings of this study may further encourage traditional market traders to take specific actions to build, lead, and improve their innovative business and dynamic capabilities to achieve better business performance.

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