

## **SMEs Craft Industry Application of Resource Based View: Capabilities Role of SMEs Performance**

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### **ABSTRACT**

This study examines whether Resource Based View (RBV) theory can be applied in SMEs sector. Superior capabilities are key determinants for sustainable competitive advantage. Not only big firms, but also SMEs need to find what capabilities that determine their competitiveness. This study focused on the internal capabilities of SMEs that may explain their performance. Internal capabilities are translated into innovation, marketing, and learning capabilities. Using survey method collected from SMEs owners/managers, this research examines internal capabilities and performance relationships. Using PLS-SEM, the study revealed that innovation, marketing and learning capabilities are significantly influence SMEs performance. In addition, marketing capability also positively influence innovation capability. This research provides empirical finding that capabilities are also applicable to SMEs in emerging countries. Based on the findings from this study, RBV approach can be used to identify capabilities that determine SMEs performance. With capabilities, SMEs may sustain their competitive advantage.

**Keywords:** innovation capability, marketing capability, learning capability, SMEs performance.

### **1. INTRODUCTION**

The intensifying global competition and market uncertainty have caused business players to search on what determinants ensuring their business performance. High business performance reflects that firm has competitive advantage. In order to have superior performance, firms must find their core competitiveness and execute accurate strategy. Strategic management experts view competitiveness from two perspectives, which are external factors / industrial structure and internal factors / firms specific. Porter (1980) is one of the leading experts in support of external view in explaining firms' competitive advantage. Whereas, since 1990, strategic management researchers have adopted Resource-based view (RBV) and have shifted from industrial approach (external) to firm specific (internal) in viewing sources of competitive advantage. The RBV approach was initiated by Penrose (1959), and has been popularized by Barney (1991).

RBV promotes the important role of resources and capabilities in determining sustainable competitive advantage. So far, research on capabilities was commonly applied in big sized firms, while rarely in small medium sized business (SMES). As in most countries in the world, SMEs play important roles for Indonesia's economy. According to Ministry of Co-operatives and SMEs, out of 59.3 million enterprises operate in Indonesia, only 1.15% were small and 0.1% were

medium-sized enterprises. The other 98.75% were micro-enterprises (OECD, 2018). Due to significant contribution to Indonesian economy, the growth and survival of SMEs is very crucial.

Using RBV approach, this study focuses on the role of internal capabilities in determining SMEs performance. Thus, the main research problem in this study is how internal capabilities explain SMEs performance. Internal capabilities are translated into marketing, innovation and learning capabilities. More specifically, this study examines the effect of innovative capabilities, marketing capability and learning capabilities on SMEs performance. Additionally, marketing capabilities is also analyzed as antecedent factors of SMEs innovative capability.

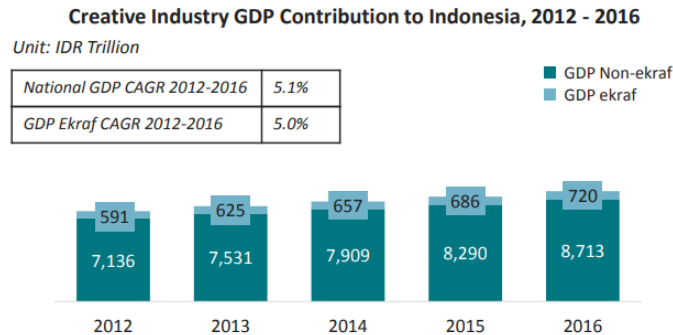
Capability is equally important for SMEs when facing intense competition and dynamic market. It enables the firms to perform better than competitors as well as determines firm's performance (Barney, 1991; Angulo-Ruiza, et al., 2018). In the emerging countries, as one of SMEs sector, craft industry offers promising income due to the increasing popularity of the tourism industry. The tourism and hospitality industry is one of the fastest growing and attractive industry (Kamala & Roostika, 2018). Being directly connected to global competition, SMEs participating in tourism industry directly face global competition. With limited resources, SMEs are very vulnerable to stay competitive. To survive, SMEs can no longer be responsive but they have to be more proactive. In addition, to sustain competitive, SMEs should develop capabilities that are valuable and difficult to copy. According to RBV approach, strengthening intangible assets will give SMEs sustainable competitive advantage. Building innovation, marketing and learning capabilities should facilitate SMEs in strengthening their intangible assets.

Focusing in craft SMEs, this study offers several contributions. First, the previous studies have mostly been conducted in developed countries, and few were undertaken in emerging countries. This study will enrich findings from emerging countries. Kajigelem Cluster as craft center in Bantul Yogyakarta offers an adequate ground to support the generalizability of the RBV approach in wider areas. Studies in emerging market also give practical relevance since emerging markets offer promising future for many companies (Kizologlu, 2015). Second, the focus of this research is given to SMEs craft industry since SMEs represent the success of Nation's economy. The RBV contribution to increase SMEs competitiveness should strengthen the vulnerable SMEs position to survive. Third, this research provides empirical evidence on direct and indirect relationships among internal capabilities relationships to SMEs performance.

## **2. CRAFT INDUSTRY IN BANTUL YOGYAKARTA**

As one of creative industries subsector, handicraft industry has been able to contribute significantly to the Indonesian economy. In 2016, Indonesian creative industry is the 7th largest sector (Ipsos, 2018). Creative industry contributes 7.6% of Indonesia's total GDP. In the global level, Indonesian creative industry is in the top three behind US (11.1% contribution) and South Korea (8.67% contribution) in terms of industry contribution relative to overall GDP. It is expected that in 2019, the contribution will increase to 12%. Table 1 shows Indonesian creative industry contribution to GDP.

Table 1. Creative Industry GDP Contribution to Indonesia



Source: Ipsos, 2018

Yogyakarta is one of the major tourist destinations in Indonesia. It famous with its landscape, heritage and culture (Roostika, 2017). Yogyakarta offers many creative craft products and known for having many creative industries (Roostika, et al., 2015). One of the regions in Yogyakarta where crafts are important source of economy is Bantul. Bantul contributes 80% of Yogyakarta total crafts export (Sujatmiko, 2013). Craft productions in Bantul include pottery, batik hand drawn and stamped, wooden batik, leather goods, bamboo crafts, etc. As small firms, crafts SMEs are very vulnerable to global competition. Government, education institutions and industry should involve in developing SMEs since this industry contributes the biggest employment opportunity. Internally, the SMEs themselves must understand their strengths and weaknesses. SMEs internal capabilities identification can be done by SMEs themselves or with assistant of external partners. These capabilities can be used as assets to survive and grow.

### 3. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

#### 3.1. Organizational Capabilities

The survival and growth of business is determined by the implementation of appropriate strategies. Through appropriate strategies, the businesses will be able to gain their core objectives with more precise formulation and implementation (Prahalad & Hamel, 1990). The RBV approach sees that competitive advantage can be achieved through deployment of resources and capabilities. According to RBV approach, the combination of resources and capabilities could differentiate the firms from others and will allow firms' superior offerings (Agyapong, et al., 2016). Even though initially RBV did not provide distinction between resources and capabilities, however, in later years, distinctions can be identified. Amit and Schoemaker (1993) explain that resources are assets that are owned or controlled by a firm. Whereas, capability is firm's ability to combine resources within organizational processes (Teece, 2007; Angulo-Ruiz, et.al., 2018). Capability according to Day (1994) is complex bundles of skills and collective learning that determine superior coordination of functional activities. Capabilities cover both tangible and intangible resources. Penrose (1959) defined fundamental distinction between resource and capability where resources consist of bundle of potential assets while capability is the bundle of resources to functions itself. The task of the firm is to find and manage capabilities that will provide a competitive advantage. Identifying

capabilities is not a simple work, since the capabilities must be unique (rare, difficult to copy and tacit). Drawing from the RBV approach, the team of resources should create capabilities for superior business performance. Adopting RBV approach for firm's success, this research concentrates on the role of capabilities in crafts SMEs. Specifically, we explore how craft SMEs capabilities would determine SMEs performance in craft industry.

### **3.2. SMEs Performance**

SMEs performance is the ability of the organization to achieve its predetermined objectives (Sampe, 2012). A review of the literature revealed that there were evidences that innovation, marketing and learning capabilities are crucial capabilities in SMEs performance. According to Rosenbusch, et al. (2011), SMEs with strong internal capabilities will gain better competitive edge as compared to its competitors. The RBV provides theoretical foundation in placing capabilities as the internal sources of competitive advantage in SMEs sector. For the purpose of this research, SMEs performance will be defined as an ability of the SMEs to have better market performance than competitors.

### **3.3. Innovation Capability and Performance**

The capacity to innovate is believed to determine SMEs' better capability to develop products/services that match with customers' needs (Rosenbusch, et al., 2011). Innovation has been acknowledged as important capability for SMEs to compete domestically and internationally (Ren, et al., 2015). O'Cass and Sok, (2012) describe that innovation capability is a bundle of interrelated processes in the firm to facilitate development, evolution and execution of product innovation. Another definition is, Innovation capability is the ability of an organization to manage information and knowledge for developing and implementing company's products and services (Wang & Dass, 2017; Zang & Hartley, 2018). According to Rosenbusch, et al. (2011), SMEs could achieve higher competitive advantage when having strong innovation capability since they always strive for superior performance relative to their competitors. Even though SMEs commonly face resource scarcity, SMES have possibility to survive as successful innovators (Rosenbusch, et al., 2011). The reasons is because SMEs are small, thus enabling them to be flexible and responding quicker to the marketplace. Greater flexibilities enable SMEs to be more innovative and perform better, as they respond faster to the market change (Sok. et al., 2013)

Further, study by Sulistyono and Siyamtinah (2016) in SMEs in emerging countries supported the influence of innovation to performance. Other study findings that show similar result in firm level include e.g Keskin (2006); Panayides (2006) and Zang and Hartley (2018). The theoretical model and research conclusion made based on the study of SMEs in developed countries may not always be applicable in the SMEs in developing countries (Najib and Kiminami, 2011). Therefore, researches in SMEs internal capabilities in developing countries are deemed necessary. Specifically, we hypothesize that:

**H1: Innovation capability significantly influences SMEs performance.**

### 3.4. Marketing and Innovation Capabilities

Marketing capabilities have long been recognized as one of the key capabilities to provide superior value to customers (Day, 1994). There have been consistent findings from previous research that marketing capabilities can enhance firms' ability to deploy resources thus supports the achievement for high performance and sustainable competitive advantage (Guo, et al., 2018). Marketing capabilities are evident when employees use accumulated knowledge from clients, markets, suppliers and their environment, to solve market problems (Weerawardena, 2003). O'Cass and Sok (2012) define marketing capability as the capability to manage bundle of interrelated processes for increasing the level for successful target development and the marketing mix execution better than the competitors. Marketing capability according to Angulo-Ruiz, et al., (2018) refer to a firm's capability to combine its marketing resources that are used to increase sales performance and customer satisfaction.

Drawing from the RBV, a firm with marketing capabilities may achieve superior business performance, by ability to offer greater value for its target customers in the forms of higher quality products, an appropriate sales price, better customer services and better marketing mix decisions (Takata, 2016). The capability to learn from the market will create closer relationships to the customers thus serving and responding better. Marketing capabilities are believed to be less susceptible to imitation and replication and have imperfect mobility (Krasnikov and Jayachandran, 2008). To stay sustainable, these capabilities should also fulfil valuable, rare, imperfectly imitable and non-substitutable (VRIN) aspect of competitive advantage. SMEs should have better sustainability when their products offerings are valuable, rare and difficult to imitate. O'Cass and Weerawardena (2010) suggest that marketing capabilities lead to higher brand performance. Strong positive relationships between inside-out marketing capabilities and subjective business performance had been found by Jaakkola, et al., (2010). Marketing capabilities are significant drivers of firm and SMEs performance (Ngo and O' Cass, 2012; Sulistyono and Siyamtinah, 2016; Angulo-Ruiz, et al., 2018; Guo, et al., 2018).

Innovation is widely accepted as being important indicator for SMEs to compete domestically and internationally. Innovation of products or services will be meaningless when it cannot reach commercial success. Thus, despite innovation capability, the company must develop marketing capability for better competing their new product or service in the market. SMEs study in Canada found that innovative capability will be greater when marketing capability is emphasized (Baldwin, 1995). Other than directly influencing business performance, marketing capability also influence innovation capability. The study conducted by Lee and Hsieh (2010) toward competitiveness found significant correlation between marketing and innovation capabilities. Weerawardena (2003) identified the marketing capability influence on innovations capability. The significant influence between these two marketing and innovation variables and further to organization performance have also been explained by Huthala, et al., (2014) study. Therefore:

**H2: Marketing capability significantly influences SMEs performance.**

**H3: Marketing capability significantly influences innovation capability.**

### 3.5. Learning Capability

The role of learning in relation to SMEs performance is equally important as marketing and innovation capabilities. Learning capability is defined as the bundle of interrelated processes to find best training needs, analyze unsuccessful activities, learning firm's past experiences and relevant business knowledge (Sok and O'Cass, 2011). Within an organization, learning capability refers to capability of the organizational in facilitating the organizational learning process in order to outperform the competitors (Deniz, et.al., 2017). Learning activities includes obtaining and sharing information about customer needs, market changes and competitor actions. The knowledge that is learned is used to enhance firm performance. Learning capability has been found to be an important predictor for firm's competitiveness in big size firms as well as SMEs (Jerez-Go'mez, et al., 2005). Having strong learning capability will increase firm's capability to identify the internal situation and respond the external environment better and faster than the rivals. Learning capability is believed to contribute to SMEs a higher opportunity to achieve performance (Sok and O'Cass, 2013; Chiva, et al., 2007). While internally sharing the knowledge better, among the staff learning capability promotes the application of new strategies that enables the firm to work closely to the customers (Sok and O'Cass, 2011). Based on the above discussion, therefore:

**H4: Learning capability significantly influences SMEs performance.**

## 4. RESEARCH METHODS

### 4.1. Survey Design and Data Collection

A self-administered survey was conducted to 120 micro and small family businesses owners. Survey data was collected from Kajigelem, craft centers in Bantul. Kajigelem is a craft cluster comprising of four craft areas. Kajigelem is a brief name for **K**asongan (pottery centre), **J**ipangan (bamboo hand fan), **G**endeng (leather puppet) and **L**emahdadi (wooden batik). Purposive sampling technique was used as most appropriate technique to ensure the sample qualifications covering years of operation, size and location. The reasons why Kajigelem Bantul was chosen as sample were: 1) Kajigelem Bantul contributes to the biggest craft export from Yogyakarta province, 2) Kajigelem is the center of craft industry in Bantul. 3) Craft industry as part of creative industry is one of the targets of national strategic development. Out of 120 questionnaires distributed, 75 questionnaires were usable for quantitative analysis. Respondent response rate was thus 62.5%.

### 4.2. Constructs Operationalization

#### *Marketing Capability*

All of the constructs in this study were measured using single dimensional construct. A five-point Likert scale ranging from (1) 'very disagree' to (5) 'very agree' were used as scaling method. Operational definition for marketing capability in this study is "A set of related processes to facilitate and implement SMEs Development, evolution and execution of marketing mix strategy" (O'Cass and Sok, 2012; Sok, et al., 2013). Marketing capability measures were adapted from Vorhies and Morgan (2005) and Sok, et al. (2013) studies. Six items were used which include: offering effective pricing, market testing market for new creative

products, attracting networks and traders, developing promotion programs, seeking market information and developing creative marketing strategies.

### **Innovation capability**

Innovation capability is operationally defined as “A set of related processes to facilitate and implement SMEs Development, evolution and execution of innovative product” (O’Cass and Sok, 2012; Sok et al., 2013). The innovation capability construct was adapted from Hurley and Hult (1998), Salavou, et al., (2004) and Sok, et al., (2013) and was measured using five items: updating the newest technology, building new products development, developing current product ranges, improving the quality of the products and increasing production flexibility. The owners were asked to indicate the strength of their SMEs with respect to the above items.

### **Learning capability**

Learning capability measures was adapted from Salavou, et al., (2004), Garcia-Morales, et al., (2006) and Sok, et al. (2013). This study follows O’Cass and Sok, (2012) and Sok, et al (2013) learning capability’s operational definition which is “A set of related processes to facilitate and implement SMEs Development, evolution and execution of communication roles, always willing to learn new things and relevant to run business activities”. Five items were employed covering: assessing staff training and need for additional education, improving SMEs skills, learning new and relevant knowledge, evaluating previous unsuccessful activities, and re-evaluating past experiences as lesson learnt.

### **SMEs Performance**

The owners were asked to rate their SMEs performance as compared to their rivals in terms of sales growth, profit growth, productivity growth, success in new products, faster speed to market, increased market opportunities, increased market satisfaction, increased delivery time, improved work methods and processes, and waste reduction. SMEs Performance measures were adopted from Sok, et al., (2013). SMEs performance in this study is operationally defined as “Achievement / effectiveness on programs by organizations in the context of SMEs” (Sok, et al., 2013).

## **5. RESULTS AND DISCUSSIONS**

### **5.1. Results**

#### **Sample Characteristics**

Out from 75 valid questionnaire, 57,3% of the sample was male and 42.7% was female. The age of the customers ranged from below 30 years old, which is 16%; between 31-40 years old is 36%; between 41-50 years old is 32%; and above 50 years old is 16%. Majority of respondents’ educational background is High School graduates accounted for 57.3%. Areas of expertise covered include: the bamboo hand fan SMEs made up 56% of the sample; Kasongan pottery cluster made up 19%; Lemah Dadi with wooden batik made up 13%; and Gendeng with leather puppet is 12%. According the descriptive data, it can be said that majority of the SMEs owners in Kajigelem Bantul is not young entrepreneurs even though

most of the SMEs employ young residents. With limited formal education, trainings opportunities would be the best method to improve the skills of the crafts people. Based on the field observation, we noticed that many crafts SMEs in Kajigelem Bantul continue the conventional models to represent the origin and authentic models. However, since the locations of the clusters near Yogyakarta (a well-known tourism destination) and Yogyakarta also known as education city, SMEs in some degree have developed new designs and innovate their products according to new demands and skills they have acquired from trainings given by government/ education institutions.

### Validity and Reliability Analysis

The data should fulfill the requirement of validity and reliability. PLS-SEM method provide facility in testing the validity and reliability by testing the measurement model. Whereas, the hypothesis should be tested by structural model. This study takes two-step approaches where measurement model is analyzed before further conducting structural model (Chin, 1998). The measurement model is the test focusing on testing the validity and reliability of the measures. The structural model focuses more on the model adequacy and path (Hulland,1999). The two-step approaches were conducted in order to find a good psychometric property measures so that conclusions can be drawn according to the valid data.

The first step of PLS analysis “the measurement model” assesses the individual loading, the Internal Composite Reliability (ICR), the Average Variance Extracted (AVE) and the AVE square root. The first step taken to ensure the validity and reliability of the measures is by checking the individual loading. Table 2. The individual loading of the final PLS processes. The value shown in the outer loading explains the correlation between each item and their corresponding variable. The loading for every item should be higher than 0.5 (Chin, 1998). The higher the loadings indicate the stronger relationships between the items and the corresponding variable. The first run of PLS program, indicated that five indicators were lower than 0.5 thus should be dropped. These items were two items measuring learning capability, two items marketing capability and one item measuring innovation capability. Table 2 shows individual loading after problematics items have been deleted from the measure.

**Table 2. Individual loading after filtering**

	Original Sample (O)	Sample Mean (M)	Standard Deviation (STDEV)	Standard Error (STERR)	T Statistics (O/STERR)
I1 <- Inn Cap	0.6875	0.672	0.1077	0.1077	6.3857
I2 <- Inn Cap	0.5758	0.5613	0.1425	0.1425	4.0403
I3 <- Inn Cap	0.6584	0.6543	0.0845	0.0845	7.7941
I4 <- Inn Cap	0.7488	0.7411	0.0656	0.0656	11.4102
L2 <- Learn Cap	0.8361	0.8327	0.0337	0.0337	24.7863
L3 <- Learn Cap	0.8731	0.8726	0.0243	0.0243	35.9143
L4 <- Learn Cap	0.7513	0.7529	0.0554	0.0554	13.5501
M1 <- Mark Cap	0.701	0.6934	0.0766	0.0766	9.1563
M2 <- Mark Cap	0.7209	0.7179	0.0639	0.0639	11.2727



M3 <- Mark Cap	<b>0.7855</b>	0.7839	0.0528	0.0528	14.8636
M4 <- Mark Cap	<b>0.7303</b>	0.7294	0.0478	0.0478	15.2834
P1 <- Perf SMEs	<b>0.7573</b>	0.7509	0.064	0.064	11.838
P2 <- Perf SMEs	<b>0.7694</b>	0.7648	0.0525	0.0525	14.648
P5 <- Perf SMEs	<b>0.7306</b>	0.7296	0.049	0.049	14.9173
P6 <- Perf SMEs	<b>0.6776</b>	0.6702	0.0955	0.0955	7.0942

**Table 3. AVE, ICR, and Cronbach's Alpha**

	AVE	Internal Composite Reliability	R Square	Cronbachs Alpha	Communality	Redundancy
Inn Cap	0.4496	0.7641	0.2129	0.602	0.4496	0.0848
Learn Cap	0.6753	0.8614	0	0.7579	0.6753	0
Mark Cap	0.5404	0.8244	0	0.7185	0.5404	0
Perf SMEs	0.5396	0.8239	0.6363	0.7212	0.5396	0.1489

The second step requires that researchers check the value of Internal Composite Reliability (ICR). Chin (1998) and Fornell and Larcker (1981) suggest that ICR should be higher than 0.7. Table 3 shows that all ICR values were higher than 0.7 and ranges from 0.7641 (Inn Cap) to 0.8614 (Learn Cap). The reliability of the measures was also shown through Cronbach's alpha where all the values exceeding 0.6 as the rule of thumb. The third step is examining the AVE value. Chin (1998) and Fornell and Larcker (1981) suggest that AVE value should reach at the minimum of 0.5. There is one variable "Innovation capability" in this study where AVE value is less than 0.5 (AVE value is 0.4496). Even though lower than 0.5, innovation capability is maintained since AVE is not the only measures but one among other validity and reliability check. The reason for maintaining innovation capability is also because the questionnaires for innovation capabilities have been assessed by experts in the related marketing and tourism area. The last analysis for validity and reliability is checking the cross loadings and AVE square root.

**Table 4. Cross loadings**

	Inn Cap	Learn Cap	Mark Cap	Perf SMEs
I1	<b>0.6875</b>	0.1341	0.1892	0.436
I2	<b>0.5758</b>	0.2187	0.1432	0.3189
I3	<b>0.6584</b>	0.3825	0.4903	0.3657
I4	<b>0.7488</b>	0.3095	0.3299	0.4779
L2	0.3298	<b>0.8361</b>	0.4405	0.5107
L3	0.3876	<b>0.8731</b>	0.4717	0.5981
L4	0.2731	<b>0.7513</b>	0.6624	0.4962
M1	0.2455	0.4448	<b>0.701</b>	0.3967
M2	0.4527	0.4257	<b>0.7209</b>	0.4508
M3	0.2963	0.4888	<b>0.7855</b>	0.6176
M4	0.3463	0.4975	<b>0.7303</b>	0.5518
P1	0.3693	0.5545	<b>0.7567</b>	0.7573

P2	0.5316	0.4349	0.4637	<b>0.7694</b>
P5	0.5363	0.4737	0.4614	<b>0.7306</b>
P6	0.3111	0.4461	0.2526	<b>0.6776</b>

**Table 5. Correlation and AVE square roots.**

	Inn Cap	Learn Cap	Mark Cap	Perf SMEs
Inn Cap	<b>0.6705</b>	0	0	0
Learn Cap	0.4053	<b>0.8218</b>	0	0
Mark Cap	0.4614	0.6322	<b>0.7351</b>	0
Perf SMEs	0.6008	0.6541	0.6971	<b>0.7346</b>

The results for cross loadings as shown in Table 4 provide evidence on discriminant validity of the measures. Cunningham (2008) explain that the existence of discriminant validity can be seen when the indicators are correlates with their respective construct higher than their correlation with other constructs. When checking the cross loadings, researchers must ensure whether each group of indicators should load higher for its respective construct than indicators of other constructs (Cunningham, 2008). AVE square roots also used as testing for discriminant validity. Discriminant validity via square roots analysis exist when the intercorrelations of the construct higher than the correlations between one construct to other constructs (Chin, 2003; Fornell and Larcker, 1981). Table 5 shows the AVE square root, which values were highlighted. Since all AVES square root testing were all higher than inter-correlation with other constructs, thus the measurement model used in this study was considered satisfactory, providing the evidence of adequate reliability, convergent validity and discriminant validity.

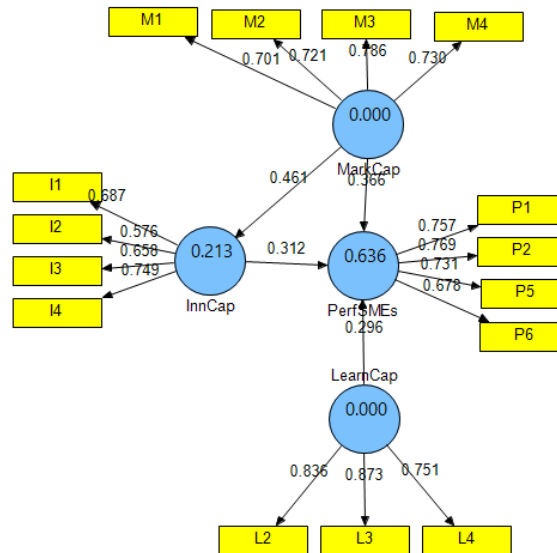
### Assessment for the Structural Model

As shown in Figure 1, R-squared ( $R^2$ ) of all three variables (innovation, learning and marketing) together explains SMEs performance with the value of 63.6%. The rule-of-thumb for the accepted value of  $R^2$  is that the value should be greater than 0.10 (Falk & Miller, 1992). The statistical results show that  $R^2$  in this study were all above 0.10 (63.6% and 213%).

This study proposes a positive relationship between innovation capability and SMEs performance. The structural model shows that H1 is accepted. This was indicated by the path coefficient 0.312 and t-statistics of 3.1596 (Table 6). The positive influence implies that the higher the innovation capability is, the higher the SMEs performance will be. Similarly, H2 and H4 are also accepted. Marketing capability and learning capability are both have positive and significant influence to SMEs performance. These imply that the higher marketing and learning capabilities, the higher the SMEs performance.

Equally important, this study also testing the indirect association between marketing capability to SMEs performance through innovation capability. As proposed in H3, marketing capability positively influence innovation capability. The finding as shown in Figure 1 explains that the path coefficient between

marketing capability and innovation capability is 0.461. The R-squared ( $R^2$ ) explaining marketing capability contribution to innovation capability is 21.3%. This  $R^2$  is bigger than the rule-of-thumb 0.10. Figure 1 shows the research model and results using PLS analysis.



**Figure 1. Research Model and Result**

**Table 6. Total effect**

	Original Sample (O)	Sample Mean (M)	Standard Deviation (STDEV)	Standard Error (STERR)	TStatistics (O/STerr)
Inn Cap -> Perf SMEs	0.3119	0.3128	0.0987	0.0987	3.1596
Learn Cap -> Perf SMEs	0.2965	0.2871	0.0863	0.0863	3.4372
Mark Cap -> Inn Cap	0.4614	0.4686	0.0779	0.0779	5.9207
Mark Cap -> Perf SMEs	0.5097	0.5215	0.087	0.087	5.8555

**5.2. Discussions**

Ren, et al., (2015) argue that innovation is an important SMEs’ capability to compete. In the destination area such as Yogyakarta, tourism market consists of both local and international buyers. In the tourism industry, tourists have different shopping behaviors than general shoppers. SMEs’ Innovation capability in tourism industry is important due to 1) tourists appreciate unique and innovative products/services and 2) tourists in some degree are price inelastic when shopping. This tourism shopping opportunities must be acknowledged by SMEs via innovative offerings. As previously discussed, innovation capability is crucial for SMEs to gain competitive advantage. The reason why innovation capability matters for SMEs is because SMEs are vulnerable from global competition thus, they must be innovative using limited resources. On the other hand, SMEs potential for being more flexible and quicker respond to market should facilitate SMEs to better innovate their offerings.

The H1 (Hypothesis 1) proposing innovation capability and SMEs performance is supported. Previous studies have found similar findings. Some study findings that support innovation capability and firm performance include e.g Keskin (2006), Panayides (2006), and Thornhill (2006). In the SMEs context, the link between innovation capability and improvement in performance has been supported by Sok, et al. (2013) and Sulistyono and Siyamtinah (2016). Innovation capability enables SMEs to translate the needs and wants of the market thus will further impact on the ability to develop products and services matched with market demand. Innovative SMEs are characterized by products/services creativity, fast adoption to new things and able to translate market needs into commercial offerings. Rosenbusch et al. (2011) have underlined the role of innovative capability as the foundation of performance and sources of competitive advantage. These imply that to survive, innovation capability is crucial.

Majority of crafts owners in Kajigalem Bantul cannot be said as young entrepreneurs. However, they employ many young employees. These employees are often quite innovative considering that they are more technologically engaged. In their local workshop, many conventional crafts\ products are displayed. The conventional crafts products are still favorable since tourists are seeking for something that uniquely representing the destination. Even though many of SMEs products in Kajigalem are conventional, they are open for innovation and accept customized orders. In fact, many crafts owners in Kajigalem are highly dependent on big buyers (big traders/exporters) from local and overseas partners. In this situation, they have to be able to translate ever changing products trends demanded by big buyers. In order to fulfill the customized orders, many SMEs are now very much facilitated with technology development. Technology makes many crafts works becoming easier and faster to finish as well as better quality products are offered. Technology also makes SMEs to qualify the standard that big buyers/traders required for national and international market. The existence of technology solves SMEs problems in terms of fulfilling the consistent volume when dealing with national and international partners as compared to when production basis is done manually.

Similar to bigger firms, marketing capabilities in SMEs are shown by executing effective marketing mix strategy. This study found positive influence of marketing capability to performance as stated in H2. Thus, this study supported previous researches on marketing capability and performance relationships such as O'Cass and Weerawardena (2010), Jaakkola, et al., (2010), Ngo and O'Cass (2012), and Sulistyono and Siyamtinah (2016). Marketing capability create SMEs competitive advantage by ability to effectively serve the target customer. Having limited resources, SMEs need to learn about the market, identify the profitable customers, create and maintain target customers and responsive to market change. Marketing capability will be more effective when firms are more market oriented. In a market-oriented firm, all marketing mix activities are taken according to market information and market perspectives. Similarly, SMEs in the tourism industry should be able to translate the needs and wants of craft customers in the destination area. In terms of craft products, SMEs need to offer products that are unique in terms of core function and related emotional attributes such as destination representation as well as customers' involvement to products/services. These had

been practiced in the batik and pottery tourism where visitors are challenged to make batik and pottery.

Online media is commonly used by SMEs as most effective promotional activities. Online promotion has been practiced by many SMEs in Kajigelem, either by joining local government website for SMEs and creative industry or developed their own website. Additionally, local government regularly facilitates SMEs for participating in local and national craft and SMEs exhibitions. Participation in many local, national and international craft exhibitions increases marketing capability and network. Online promotion and participation in exhibition are some of the ways for local SMEs to increase their marketing capability. From online activities and exhibition participations, SMEs learn in building network, doing comparative pricing and developing customer relationships.

The RBV theory believes that firms with marketing capabilities may gain superior performance. Marketing capabilities are difficult to copy thus enable to fulfill sustainable competitive advantage which are valuable, rare, imperfectly imitable and non-substitutable (VRIN concept). From RBV perspectives, craft SMEs should be able to cover the VRIN concept. Without marketing capability, VRIN concept is difficult to achieve since market success should be seen from customers perspectives and not producers' perspectives. The value offering should be translated from customer perspectives. For example, customers expect crafts that are unique and also tell history about the destination. Tourists in their home country will share their travelling experiences and the craft souvenirs could enrich the unique travelling experiences. SMEs should be able to innovatively translate tourists' expectations from the craft products and add value on craft products accordingly.

If wanting sustainable competitive advantage, the products should be rare, imperfectly imitable and non-substitutable. Marketing capability could tell about the status of SMEs offerings, in what degree the unique valuable offerings have been copied by competitors. SMEs should actively gain information from the market. Online market is now also considerably an attractive market, thus SMEs need to be active in monitoring both online and offline market competition. When SMEs products offering are unique, rare, difficult to find and no substitute, combined with effective marketing mix practices, sustainable competitive advantage should possibly be achieved. From marketing capability perspectives, the key is ability to collect information and translate what market wants and then adjusted with SMEs resources to satisfy the customers.

While being important indicator for SMEs to compete, from business perspectives, successful innovation is when the products or services are commercially profitable. This study supports H3, thus also supports marketing capability and innovation capability relationship. The finding of this study thus supports the previous studies on marketing capability positive impact on innovation capability e.g Lee and Hsieh (2010), Weerawardena (2003), and Huhtala, et al., (2014). In order to understand market demand, marketing capability take the first role. Similarly, in the SMEs context, new product development will be useless when market could not absorb it. It is very risky when launching products in the market without testing the market acceptance. With limited capital and other resources, SMEs are benefited from having market knowledge before developing new

products. For example, SMEs exporting to countries with four seasons should adjust the ever-changing demands due to different seasonal trend.

Learning capability is an interrelated process, where open mindedness, sharing and willingness to improve will determine learning success. In the organizational context, learning is not only acquiring new knowledge but also disseminating and taking action accordingly. Learning capability and SMEs performance link has been acknowledged in previous studies eg. Sok and O' Cass (2013) and Chiva, et al., (2007). The structural analysis using PLS in this study supports learning capability positive influence on SMEs performance. With learning capability, SMEs learn and respond to market better, faster and cheaper than competitors. By participating on SMEs skill-based training provided by local government and education institutions, SMEs owners admit the benefits they have received relating to SMEs performance. With learning capability, SMEs should listen to buyers more closely. First hand information from buyers are then being shared and analyzed together, then developed into products offerings. These kinds of offering should better match between SMEs capacities and market demands. As learning capability provides better match with the market, this enhances SMEs competitiveness and market satisfaction. Due to many order-based productions in Kajigelem, thus ability to understand varieties of buyers' product specifications is very crucial. In particular, the ability to maintain satisfaction of regular buyers, big buyers and international buyers determine the survival of craft SMEs.

Learning capability offers SMEs with richer knowledge and skills as wider network are developed. While participating to training and SMEs events, networking with other business partners from different geographical location is created. Here, initial face to face communications are established where trust is built, then future online communication follows. Learning is not only coming from participating on training and learning from past experiences, but often learning is more effective by studying experiences of others whether from partners, online media, books, magazine and television. Learning is not only the domain of young people. Some successful businesses were established by some retirees in building their business success. Learning is the key where these retirees eager to adopt current business models, adopt new technology and adjust current competitive nature. They have to share and work with the young to run their business. They have to be open minded to easily adjust with people from different generations.

Open mindedness and willingness to improve is the key for effective learning. When people are open-minded, they will be open to accept new things or to correct their mistakes. Similarly, collective goals and success will motivate effective sharing and discussions to achieve higher performance. Since learning capability is a process and has to be done within the whole life of business operations, learning capability determines sustainable competitive advantage. In Indonesia, intellectual property rights take long to process legally, while new product innovation is easily copied and is rapidly changed. Often that processing the intellectual property right for new product innovation is not a choice among SMEs. Nevertheless, SMEs must be creative and innovative. The ability to get close to buyers, translate buyers' needs and wants, and satisfy buyers will lock buyers to remain loyal and maintain the relationships. Additionally, buyers often let SMEs to design new creations and they will accept with few additional attributes. This means that SMEs should be proactive in both learning and innovating craft products.

Overall, the findings show the significant effects of innovation, marketing and learning capabilities on SMEs performance. Marketing capability is also important variable that influence innovation capability. These findings provide evidence that in emerging countries and in the SMEs sector, capabilities determine SMEs performance and competitive advantage. The findings from this study should enrich the RBV theoretical contributions in the different situations where previous studies were done mostly in developed countries as well as in bigger size firms. Thus, resource and capability based on RBV theory is applicable for SMEs in emerging countries.

## 6. CONCLUSION AND RECOMMENDATIONS

Craft is one of SMEs sectors that becoming one of Indonesia main creative economy business strengths. Dominated by SMEs, this sector significantly contributes to the increase in nation prosperity, employment and income. This study found the positive significant influences of innovation capability, marketing capability and learning capability to SMEs performance in Kajigelem, Bantul, Yogyakarta. Marketing capability also found to be important variable in determining innovation capability. The vulnerable nature of SMEs to global competition requires SMEs to be adaptive with changing external business environment. Marketing capability helps SMEs to better respond to external opportunities and threats. Marketing capability facilitates SMEs to build innovative capability. Using RBV as theoretical foundation, this study focuses on SMEs capabilities contributions to SMEs performance. Due to SMEs size and background as well as nature of SMEs competition, marketing, innovation and learning capabilities were chosen as key determinants for SMEs performance. Flexibility and fast respond to market change are conditions that SMEs are facing to survive. Marketing capability makes SMEs listen and get closer to buyers while also performing better at marketing mix strategy. Learning capability enforces SMEs to continuously learn from any resources as effective ways to run the business better, faster and cheaper. Innovation capability facilitates sustainable competitive advantage for SMEs where VRIN concept may sustain SMEs competitiveness while also innovation is a key to differentiate from the rivals.

This study is far from being perfect. Many other internal capabilities relevant to craft SMEs should be identified in order to better predict the survival components and competitiveness of craft producers. Within academic sector, this study contributes to enriching the literature review on innovation, marketing and learning capabilities in emerging countries particularly in craft SMEs sector. SMEs have business strategy and internal capabilities that are different from big firms. The important of superior capabilities in bigger firms based on RBV theory is worth to be tested in SMEs sector in Yogyakarta, Indonesia. The results of this study provide evidence that superior capabilities as explained in RBV theory are applicable for SMEs in Indonesia.

For business practitioners, this study contributes to the role of innovation, marketing, and learning capability. Again, due to SMEs vulnerability to global competition in tourism industry, SMEs must be responsive to market changes and stay close with customers. The nature and size of SMEs with higher flexibility necessitates the adoption of innovation, marketing and learning capabilities. Due to commonly SMEs' lacking resources, these capabilities could be effective solutions.

SMEs will appreciate new knowledge when training opportunities are offered. Government and formal institutions must support better access for SMEs information and facilitate programs that may increase SMEs innovation, marketing and learning capabilities. Without government and formal institutions assistances, SMEs survival is difficult and SMEs remain in slow growth.

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