Business Strategy and Small and Medium Enterprises (SMEs) Performance: The Moderating Role of the Business Environment

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ABSTRACT
Enhancing performance is a crucial approach to ensuring the sustainability of small and medium-sized enterprises (SMEs). The primary focus is on improving SME performance to promote more effective growth. Therefore, the objective of this study is to examine the factors contributing to enhancing SME performance. In empirical research conducted in Indonesia, specifically in South Sumatra Province in 2021, where the contribution to GRDP was only 1.72% compared to other provinces above 10% (Jakarta, East Java, and West Java), the aim is to validate the hypotheses. Through a self-administered survey, 109 eligible questionnaires were collected from SME businesses for this study. Additionally, data analysis employed the Partial Least Square-Structural Equation Modeling (PLS-SEM) technique. The findings of this study indicate the acceptance of the relationship between business strategy and SME performance. Similarly, it is hypothesized that the business environment, acting as a moderator, strengthens the impact of business strategy on SME performance. Insights from this study on the effectiveness of small and medium-sized enterprises (SMEs) in South Sumatra, Indonesia, provide valuable input for future decision-making.

KEYWORDS: Business strategy, Business environment, SMEs performance

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1. INTRODUCTION
Expanding SMEs (Small and Medium-sized Enterprises) currently hold the highest priority for the Indonesian government. The Ministry of Finance has declared that existing government policies have consistently underscored the significance of SME growth in reaching the specified objective. The administration aims to enhance the international productivity and competitiveness of the populace while fostering economic independence through the development of crucial domestic economic sectors, as outlined by Limanseto (2023). Bakhri (2020) recent research indicates that the government should tailor its approach to the expansion of SMEs to align with the local environment. Between 2010 and 2020, SMEs’ contribution to the gross domestic product (GDP) reached its minimum of 3.73%. This decrease was a direct outcome of the global spread of the COVID-19 pandemic across almost every country (Purwoko et al., 2021). As a response, in 2020, the Indonesian government aimed to increase this contribution by 62.36% by 2021. However, in 2021, SMEs only contributed 61.7%, indicating that the target fell short (Rudya, 2022). The contribution of SME exports to the country’s export sector also fell below expectations. In 2021, Indonesia’s SME contribution to exports was lower than that of other ASEAN countries such as Thailand (41.0%) and Malaysia (29.2%). Indonesia trailed behind Singapore (41%) and China (60%) (Grehenson, 2021). Teten Masduki, the Minister of Cooperatives and SMEs, emphasized the economic impact of the COVID-19 pandemic on sustainability, resulting in a decline in SME performance across various regions of Indonesia (Audah, 2022). Between 2020 and 2022, the number of SMEs in South Sumatra decreased by 30%, according to the Governor of South Sumatra. This decline is rooted in evidence suggesting that these businesses need specialized information, skills, and creativity to improve their performance. Small businesses in South Sumatra face significant challenges in their endeavors to enhance performance and achieve greater success (Sasongko, 2022).

SMEs must formulate business strategies to navigate competitive challenges (Baskara, 2022). Business strategy (BS) constitutes a strategic plan at the division level, aimed at establishing and fortifying the competitive position of the organization’s products and services in specific industries or markets (Sugiarti et al., 2022). BS becomes
crucial for organizations navigating intense competition, requiring the implementation of competitive strategies for survival. The strategy implemented is customized to the organization’s competencies and external conditions, enabling managers to identify opportunities to maintain competitiveness and performance (Covin & Slevin, 1991). In their examination of SMEs in West Jakarta, Hartarto and Handoyo (2021) established a noteworthy correlation between business strategy (BS) and SME performance, underscoring that proficient management and execution of BS can elevate the performance of small and medium-sized enterprises. Additionally, various studies exploring the same relationship have been conducted in different Indonesian provinces and beyond. Abdillah et al. (2019) in Central Java, and Rehman and Anwar (2019) in Pakistan found a significant correlation between BS and SME performance. However, Armiani et al. (2021) in West Nusa Tenggara and Ariwibowo et al. (2022) in West Java discovered that it is detrimental and has no correlation. This variation in results across studies in Indonesia and other nations underscores the need for further research. Notably, no research has investigated the relationship between BS and SME performance in the South Sumatra region, highlighting the necessity for additional exploration in this area.

Moreover, the interplay between BS and performance may be shaped by the business environment (Irwanty et al., 2022). The business environment (BE) is described as an external factor that impact business organizations (Santoso, 2023). Wanjiru et al. (2019) stressed that achieving business success in the current competitive era demands more rigorous efforts than in the past, given the proliferation of obstacles like the BE and other factors. As a result, the business environment (BE) stands out as one of the most influential. The investigation by Prescott (1986), established that the business environment does not lend support to the moderation effect between BS and SME performance. Importantly, no previous research has delved into the BE as a moderator between BS and SME performance in Indonesia.

2. LITERATURE REVIEW

This section outlines the definitions of SMEs, with SMEs performance as the dependent variable, business strategy as the independent variable, and the business environment as the moderating variable.

2.1 Small Medium-Sized Enterprise (SMEs)

The definitions of SMEs and the criteria for determining their size are subjects of ongoing debate. There are diverse perspectives on how to evaluate the scale of a small business and the extent to which it should be measured (Suryani et al., 2022). Different institutions emphasize either the number of employees or the revenue of enterprises when defining SMEs. While there is no universally accepted definition of SMEs, the number of employees is commonly employed for its simplicity in data collection and aggregation (Khalily et al., 2019). European Commission (2021) state that the conventional definition of SMEs in numerous countries ranges from one to two hundred fifty employees. Despite international variations in the definition of SMEs, Table 1 outlines the commonly used definitions by various organizations in specific nations.

<table>
<thead>
<tr>
<th>No</th>
<th>Sources</th>
<th>Definitions of Small and medium-sized enterprises (SMEs)</th>
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</thead>
<tbody>
<tr>
<td>1</td>
<td>Organisation for Economic Co-operation and Development (OECD)</td>
<td>Businesses classified as small and medium-sized enterprises (SMEs) operate independently and have a specified maximum number of employees, with this limit varying across jurisdictions. In the European Union, the common threshold for categorizing an SME is typically 250 employees, while in the US, SMEs typically have fewer than 500 employees.</td>
</tr>
<tr>
<td>2</td>
<td>International Finance Corporation (IFC)</td>
<td>Small and medium-sized enterprises generally employ fewer than 50 individuals, possess total assets not surpassing $3 million, and achieve annual sales under $3 million.</td>
</tr>
<tr>
<td>3</td>
<td>The European Commission (EC)</td>
<td>SMEs generally have a staff of less than 250 employees, generate annual sales that do not surpass $67 million, and hold total assets not exceeding $56 million.</td>
</tr>
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</table>

Source: (Imska et al., 2022)

2.2 SMEs Performance

No standardized method exists for evaluating the performance of small businesses, and there is no agreement on the metrics that should be employed (Van de Ven et al., 2023). When an organization endeavours to initiate change, it should transition from receiving input, including information and concepts, to generating a result derived from that input, known as “performance.” Businesses must use resources effectively to achieve their objectives (Idrus et al., 2023). According to Idrus et al. (2023), organizational performance is the ability of an organization to use available resources efficiently and effectively to achieve its goals. Various studies define the effectiveness of SMEs in different ways, and Table 2 outlines alternative definitions of SME performance by other authors.

The research’s dependent variable is SME performance, conceptualized as a unidimensional construct. The attainment of a unidimensional construct happens when a solitary underlying concept elucidates a set of observed variables (Kiyabo & Isaga, 2019). The evaluation of performance is based on subjective criteria (financial and non-financial), involving self-reported activities. In their study, Suliyanto and Rahab (2012) utilized six dimensions: market size,
sales volume, profits, level of complaints, number of employees, and number of clients. This metric is subjectively employed (financial and non-financial). Suliyanto and Rahab (2012) incorporated existing research on SME performance measurement from Lin et al. (2008), which has been frequently employed in prior SME performance assessments. Additionally, it is used to regulate variations in performance based on SME characteristics by implementing suitable performance variables. According to Lin (as cited in Wahyuni & Sara, 2020), business performance refers to the successful attainment of organizational goals. Slater and Narver (2000) cite goals for sales growth, profitability, and market share. This research employs dimensions developed by Suliyanto and Rahab (2012): market size, sales volume, number of complaints, number of employees, and number of consumers. The investigation utilizes the unidimensional construct of SME performance developed by Suliyanto and Rahab (2012).

### 2.3 Business Strategy

The strategy provides management with guidance on achieving organizational goals and bringing the organization's mission and strategic vision to fruition. Crafting a strategy includes establishing objectives, competing with rivals, securing prolonged competitive advantage, and actualizing a strategic management vision for an organization (Hitt, 2011). Table 3 presents different perspectives and definitions of business strategy from various authors.

<table>
<thead>
<tr>
<th>No</th>
<th>Sources</th>
<th>Definitions of SMEs Performance</th>
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</thead>
<tbody>
<tr>
<td>1</td>
<td>Efro et al., (2018)</td>
<td>Performance is the primary objective of every SME firm to maintain competitiveness in the business arena.</td>
</tr>
<tr>
<td>2</td>
<td>Prasetyo and Hasibuan (2019)</td>
<td>Performance is the outcome of the tasks accomplished by an individual, relying on skills, experience, dedication, and time, assigned to them.</td>
</tr>
<tr>
<td>3</td>
<td>Wheelen and Hunger (2015)</td>
<td>An organization’s performance is the outcome of its operational processes and activities, which entail the utilization of both tangible and intangible resources to achieve its objectives.</td>
</tr>
</tbody>
</table>

Table 2: Definitions of SMEs Performance

<table>
<thead>
<tr>
<th>No</th>
<th>Sources</th>
<th>Definitions of Business Strategy</th>
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</thead>
<tbody>
<tr>
<td>1</td>
<td>Sánchez-Henríquez and Páez (2021)</td>
<td>Business strategy is emphasizing the enhancement of a company's products/services' competitive position in the specific industry or market segment served by that division.</td>
</tr>
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<td>2</td>
<td>Bayles (2022)</td>
<td>Business strategy encompasses the strategic initiatives undertaken by an organization to generate value for the organization and its stakeholders, aiming to gain a competitive advantage in the market.</td>
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<tr>
<td>3</td>
<td>Dieffenbacher (2023)</td>
<td>Business strategy is a thorough plan or a sequence of carefully crafted actions designed to attain specific business goals and objectives.</td>
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Table 3: Definitions of Business Strategy

According to Duncan cited by Astuty and Pasaribu (2021) in their research, suggests that the business environment encompasses both the physical and social factors within individual organizations. Efendi (2021) argues that the environment serves as a knowledge stream crucial for defining an organization’s business objectives, significantly influencing managerial thinking. Duncan makes a distinction between internal and external environmental factors (Astuty & Pasaribu, 2021). The internal environment consists of physical and non-physical elements within the organization, such as management, employees, functional units, and staff, impacting individual activities and the development of corporate strategy. Conversely, the external environment includes all physical and non-physical factors outside the organization, involving customers, suppliers, competitors, and socio-political and technological elements influencing individual behaviour and organizational decision-making. The business environment encompasses norms, ethics, a legal and governance framework, and policy conditions that establish the rules for conducting business, positively or negatively impacting market outcomes, investment flows, and productivity factors. These factors can arise from internal or external circumstances, affecting the organization's efficiency and operations (Efendi, 2021). The business environment comprises both internal factors under a company’s control and external factors beyond its control. For this research, only the external environment is considered the business environment (Efendi, 2021). Table 4 provides
various authors’ perspectives on the definition of the business environment.

### Table 4: Definitions of Business Environment

<table>
<thead>
<tr>
<th>No</th>
<th>Sources</th>
<th>Definition of Business Environment</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Wilson (2024)</td>
<td>The business environment (BE) is a term denoting the comprehensive set of internal and external factors influencing business staffing, operations, and sales.</td>
</tr>
<tr>
<td>2</td>
<td>Ahmad (2023)</td>
<td>The business environment represents the combined influence of all external factors affecting a business organization. It includes factors like customers, competitors, organizational structure, market conditions, suppliers, intermediaries, and various others that have a substantial impact on the company’s operations.</td>
</tr>
<tr>
<td>3</td>
<td>Sari (2022)</td>
<td>The business environment constitutes the total combination of individuals, organizations, and external forces that lie beyond the industry’s control but have the potential to impact its production.</td>
</tr>
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</table>

Based on the earlier research of Sobri et al. (2011), the business environment was chosen for its external focus, intending to influence business organizations. Following the conceptualization by Kinange and Patil (2020), the business environment is a multidimensional construct with at least three components or dimensions. The research findings suggest that the business environment is a multidimensional construct characterized by dynamism, hostility, and complexity (Kwiotkowska, 2018). According to Abd Aziz and Mohd Yasin adopted a business environment with three dimensions (market turbulence, technology turbulence, and competitive intensity) based on the research by Kohli and Jaworski (Priyantha Kaluarachchige et al., 2021). The instruments used to measure the business environment in this investigation are multidimensional constructs. The hypotheses are:

**H2:** Business environment (BE) moderates the relationship between Business strategy (BS) and SMEs performance (SP).

### 3. METHODOLOGY

The study employed a quantitative approach to enable the generalization of findings to the entire population. Respondents, including founders, co-founders, those inheriting family businesses, individuals purchasing businesses (not from family), and those hired or promoted by organizations, were selected through simple random sampling. The research focused on SMEs in South Sumatra, Indonesia, with a total population of 943,342 registered SMEs in 2022 (Putri, 2023). Sample size determination was conducted using G*Power, indicating that 109 samples met statistical thresholds (Faul et al., 2013). Considering response rates from previous studies, such as Himawan (2019) with 11.3%, Riyoko (2022) with 28.3% in Central Java, and Dristia (2018) with 43.7% in Yogyakarta, the research aimed to distribute 218 questionnaires. Ultimately, 200 questionnaires were received, and 109 responses were considered usable for analysis.

In evaluating the variable, indicators for SME performance were obtained from Suliyanto and Rahab (2012). These indicators consist of five items: broader market, sales volume, level of complaints, number of employees, and number of customers. The measurement exhibits high reliability, with a Cronbach Alpha of 0.948.

Business strategy includes six dimensions: low-cost strategy, product differentiation strategy, service differentiation strategy, niche strategy, innovation strategy, and marketing differentiation strategy. Participants were requested to respond to 28 items related to business strategy, addressing specific dimensions such as low-cost strategy (5 items), product differentiation strategy (5 items), service differentiation strategy (4 items), niche strategy (4 items), innovation strategy (5 items), and marketing differentiation strategy (5 items). The measures for business strategy were adapted from Beal, Michael Porter, and Hashim and Zakaria (Farida & Setiawan, 2022). The reliability of this measure is high, with a Cronbach Alpha of 0.974.

The Business Environment (BE) is a multidimensional concept with three dimensions: market turbulence, technology turbulence, and competitive intensity. To assess this construct, 17 items were developed by Abd Aziz and Mohd Yasin (Priyantha Kaluarachchige et al., 2021). These items are distributed across the broader business environment and specific dimensions—market turbulence (6 items), technology turbulence (5 items), and competitive intensity (6 items). The measure exhibits high reliability, with a Cronbach Alpha of 0.961. The Likert scale was employed for measurement, utilizing a 5-point range from 1=strongly disagree to 5=strongly agree for assessment purposes.
To analyze the data, the research utilized SmartPLS 4.0.9.2 software for partial least squares structural equation modeling (PLS-SEM). The choice to utilize PLS-SEM as the analysis method was guided by the recommendation of Usman Shehzad et al. (2023), in alignment with the research model of this study. The analysis adhered to the two-stage PLS-SEM approach, which involves the measurement model and the structural model, as detailed by Usman Shehzad et al. (2023).

4. RESULTS

The validity and reliability of items in the measurement model are assessed through considerations such as item loadings, convergence validity (CV), composite reliability (CR), and average variance extracted (AVE) (Table 5). This model illustrates the relationship between observable data and latent variables, and the estimate of the latent variable is calculated as the sum of its manifest variables within the measurement model.

Table 5: Outer Loadings

<table>
<thead>
<tr>
<th></th>
<th>BE</th>
<th>BS</th>
<th>SP</th>
</tr>
</thead>
<tbody>
<tr>
<td>BE</td>
<td>0.724</td>
<td>0.754</td>
<td>0.794</td>
</tr>
<tr>
<td>BS</td>
<td>0.786</td>
<td>0.790</td>
<td>0.772</td>
</tr>
<tr>
<td>SP</td>
<td>0.707</td>
<td>0.795</td>
<td>0.757</td>
</tr>
</tbody>
</table>

Table 6: Validity and Reliability

<table>
<thead>
<tr>
<th>Cronbach's alpha</th>
<th>Composite reliability (rho_a)</th>
<th>Composite reliability (rho_c)</th>
<th>Average variance extracted (AVE)</th>
</tr>
</thead>
<tbody>
<tr>
<td>BE</td>
<td>0.961</td>
<td>0.965</td>
<td>0.617</td>
</tr>
<tr>
<td>BS</td>
<td>0.974</td>
<td>0.975</td>
<td>0.584</td>
</tr>
<tr>
<td>SP</td>
<td>0.948</td>
<td>0.952</td>
<td>0.828</td>
</tr>
</tbody>
</table>

Table 7: Discriminant Validity

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<tr>
<th></th>
<th>BE</th>
<th>BS</th>
<th>SP</th>
</tr>
</thead>
<tbody>
<tr>
<td>BE</td>
<td>0.785</td>
<td>0.745</td>
<td>0.764</td>
</tr>
<tr>
<td>BS</td>
<td>0.793</td>
<td>0.700</td>
<td>0.910</td>
</tr>
</tbody>
</table>

After establishing the reliability of measurements, it is crucial to present supporting evidence for the theoretical model, as illustrated in Figure 1. According to Hair et al. (2021), structural models define the relationships among the presumed latent variables in the research. To estimate structural models, specific criteria must be considered and followed. The evaluation of structural models includes examining standard errors, p-values, t-values, coefficient of determination (R-square), and path coefficients (Hair et al., 2021).

Table 8, displayed below, illustrates the direct relationship between variables. Each direct path shows significance with a p-value less than 0.05, as indicated by the data. Table 9 outlines the mediating role of the business environment (BE) in the relationship between business strategy (BS) and SMEs performance (SP). The results suggest that the pathways BE x BS -> SP, illustrating the moderating role, are statistically significant (p < 0.05).

Hair et al. (2021) proposed that if R^2 falls between 0.02 and 0.12, it indicates poor predictive strength, if it falls between 0.13 and 0.25, it indicates moderate...
Table 8: Direct Relationship

|                  | Original sample (O) | Sample mean (M) | Standard deviation (STDEV) | T statistics (|O/STDEV|) | P values |
|------------------|---------------------|-----------------|---------------------------|-----------------------------|----------|
| BS -> SP         | 0.545               | 0.547           | 0.085                     | 6.390                       | 0.000    |

Table 9: Relationship of Moderation Results

|                  | Original sample (O) | Sample mean (M) | Standard deviation (STDEV) | T statistics (|O/STDEV|) | P values |
|------------------|---------------------|-----------------|---------------------------|-----------------------------|----------|
| BE x BS -> SP    | -0.176              | -0.185          | 0.084                     | 2.110                       | 0.035    |

5. FINDINGS AND DISCUSSIONS

After constructing the measurement model, the study advanced to assess the structural model. The research utilized the standard bootstrapping procedure with 500 bootstrap samples and 109 cases to determine the significance of the path coefficients (Hair et al., 2013; Hair et al., 2021). The specific results are outlined below:

Hypothesis 1: Business strategy (BS) positively correlates with SMEs performance (SP). The bootstrapping PLS-SEM output indicates a significant, strong, and positive association between business strategy (BS) and SMEs Performance ($\beta = 0.545$, $t = 6.390$, $p < 0.05$). Consequently, Hypothesis 1 receives support.

These findings imply that the effectiveness of SMEs’ business strategy is linked to their performance. A strong business strategy enables organizations to generate creative ideas, and explore opportunities for market penetration and risk-taking, ultimately positioning themselves as market leaders through the implementation of long-term strategies and objectives. The results underscore that SMEs in South Sumatra, Indonesia, have embraced business strategies as a fundamental aspect of their business activities, emphasizing the relevance of business strategy for both large organizations and SMEs. Additionally, the results highlight the diversity in the adoption of distinct business strategies across various organizations. The study reveals that small and medium-sized enterprises (SMEs) in the region have implemented six distinct business strategies (low-cost strategy, product differentiation strategy, service differentiation strategy, niche strategy, innovation strategy, and marketing differentiation strategy), aligning with recommendations from the literature and previous studies.

The research findings support the notion that SMEs in different industries tend to adopt different business strategies, consistent with prior research (Latifah et al., 2021; Farida & Setiawan, 2022).

Hypothesis 2: The business environment (BE) moderates the relationship between Business strategy (BS) and SMEs performance (SP). H2 is supported, and the relationship is statistically significant ($\beta = -0.176$, $t = 2.110$, $p < 0.05$).

Therefore, the results suggest that the business environment moderates the relationship between business strategy and SMEs performance, affirming Hypothesis 2. The objective of H2 was to explore the moderating influence of the business environment on the correlation between business strategy and SME performance. The results indicate a positive relationship supporting H2. Specifically, when the business environment is favorable, the link between business strategy and SME performance is advantageous. However, in an unfavorable business environment, the relationship between business strategy and SME performance remains unaffected. The findings imply that the business environment reinforces the association between business strategy and the performance of small and medium-sized enterprises (SMEs). This aligns with previous research illustrating that the business environment moderates SME performance (Mishra & Yadav, 2021). The study concludes that organizations aiming to improve profitability should consistently monitor environmental factors and align them with their chosen strategies to achieve significant SME performance.

6. CONCLUSIONS

This study delves into the performance of small and medium-sized enterprises (SMEs) in the South Sumatra region, investigating the influence of business strategy as an independent variable, business environment as moderating variable, and the SMEs performance as independent variable. The business strategy variable significantly and robustly impacts SME performance. Considering the moderating effect of the business environment, the connection between business strategy
and SME performance is confirmed. These findings carry practical implications and insights for policies aimed at enhancing business research. Notably, small businesses engaged in business orientation can leverage this discovery. The results of the study will aid stakeholders in identifying factors that affect the performance of small businesses, empowering them to enhance success levels in South Sumatra, Indonesia. The study suggests that small business owners, particularly in the processing industry, should keep their business strategies up-to-date to improve overall performance, with a specific focus on processing enterprises. Furthermore, it is recommended that small business owners integrate organizational culture into their operations, as this is anticipated to contribute to improved organizational performance.

REFERENCES


