Original Article

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# Dynamic Synergy: the Strategic Interplay Between Entrepreneurial Orientation, Innovation Capability, and Organizational Performance

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## Abstract:

This study holds particular significance for small and medium-sized enterprises, where limited resources often necessitate the efficient conversion of strategic capabilities into measurable performance outcomes. The proposed conceptual model aims to elucidate the intricate relationships among these variables, providing a comprehensive understanding of the mechanisms that underpin organizational performance in resource-constrained settings. The objective of this research is to explore the direct effects of dynamic capability and entrepreneurial orientation on innovation capability and organizational performance, as well as the mediating role of innovation capability in these relationships. The study employs a cross-sectional survey method, collecting data from 396 SMEs in Bali, Indonesia, using an online questionnaire. The data were analyzed using variance-based structural equation modeling. Results from the analysis reveal that dynamic capability has a strong positive effect on both innovation capability and organizational performance. Entrepreneurial orientation significantly impacts innovation capability, but its direct effect on organizational performance is negligible. However, innovation capability fully mediates the relationship between entrepreneurial orientation and organizational performance. The study also found that mediation analysis of innovation capability on dynamic capability to organizational performance suggest that there is almost no mediating effect.

**Keywords**: Dynamic Capability, Entrepreneurial Orientation, Innovation Capability and Organizational Performance.



## Introduction

Dynamic capability, the capacity to adapt and innovate in response to market changes, is crucial for SMEs to remain competitive amidst uncertainty (Nguyen et al., 2021). This involves leveraging entrepreneurial orientation—marked by innovation, proactiveness, and risk-taking (Yousaf et al., 2022)—and fostering innovation

capability to transform ideas into tangible outcomes (Yang et al., 2019). These elements collectively enhance organizational performance and sustain long-term advantage (Chang et al., 2022). However, resource limitations in SMEs present challenges to developing such capabilities, underscoring the importance of tailored strategies to bridge gaps and drive growth (Le & Lei, 2019).

Innovation capability is central to firm performance, acting as a mediator between dynamic capabilities and entrepreneurial orientation (Khan et al., 2023). This capability empowers firms to adapt and shape markets through product and process innovation, essential for SMEs facing resource constraints and volatility (Rahim et al., 2022). Despite extensive research on dynamic capability and entrepreneurial orientation, gaps persist regarding their roles in SMEs and the mediating effect of innovation capability (Lei et al., 2021). This study addresses these gaps, exploring innovation capability as a key mechanism linking strategic capabilities to performance (Jalil et al., 2021).

This research novelty examines the interplay between dynamic capability, entrepreneurial orientation, innovation capability, and organizational performance in SMEs, emphasizing innovation capability as a mediator. It advances theoretical understanding and offers actionable insights, guiding SMEs to leverage strategic capabilities for enhanced performance (Shehzad et al., 2022).

This study investigates the mediating role of innovation capability in linking dynamic capability and entrepreneurial orientation to organizational performance in SMEs. By addressing how these capabilities transform into performance outcomes despite resource constraints, it elucidates the mechanisms driving firm performance, extending literature on dynamic capabilities and entrepreneurial orientation through a nuanced, SME-focused lens.

## Literature Review and Hypothesis Development

### Dynamic Capability

Dynamic capability, represents a firm's ability to adapt and reconfigure competencies to thrive in changing environments (Singh et al., 2021). For resource-constrained SMEs, it drives innovation, market adaptation, and competitiveness (Ali et al., 2020). Beyond resource reconfiguration, dynamic capabilities involve sensing opportunities, seizing them, and transforming organizational structures, emphasizing continuous learning and adaptability (Quansah et al., 2022). While vital for SME competitiveness, building dynamic capabilities is hindered by financial and human resource limitations, necessitating strategies emphasizing leadership and organizational culture to foster capability development (Nguyen et al., 2021).

### Entrepreneurial Orientation

Entrepreneurial orientation (EO), characterized by innovation, proactiveness, and risk-taking, is crucial for SMEs to exploit opportunities and remain competitive amidst resource constraints (Yang, 2023). High EO levels enable firms to anticipate market shifts, engage in innovation, and drive performance (Salisu & Bakar, 2019). While EO promotes strategic innovation and risk-taking, its translation into actual innovations is vital for enhancing organizational outcomes (Zahoor & Lew, 2021). SMEs particularly benefit from EO's agility but face challenges in sustaining it due to limited resources. Leadership, organizational culture, and external networks are pivotal in shaping EO's effectiveness within SMEs (Rahman et al., 2021).

Innovation Capability

Innovation capability, the capacity to transform knowledge into new products, processes, or services, drives performance and sustainability in dynamic markets (Mukhtar, 2023). It enables firms to shape and respond to market changes, a critical advantage for resource-constrained SMEs. Strong innovation capabilities correlate with enhanced profitability, market share, and competitive edge (Latif et al., 2023). However, its effectiveness depends on complementary strategic capabilities. Firms with robust dynamic capabilities can better align innovation with market demands, while those with high entrepreneurial orientation prioritize innovation strategically (Joensuu-Salo & Matalamäki, 2023).

Organizational Performance

Organizational performance, traditionally measured by financial metrics like profitability and market share, increasingly incorporates non-financial indicators such as innovation outcomes and customer satisfaction for sustained success (Guinea & Raymond, 2022). Strategic capabilities generally enhance performance, but outcomes vary across contexts, with some studies reporting mixed results (Octasylva et al., 2023). This research examines how SMEs leverage dynamic capabilities and entrepreneurial orientation to improve performance, addressing contextual factors and contributing to a comprehensive understanding of the mechanisms driving firm success in resource-constrained environments.

The Impact of Dynamic Capability on Organizational Performance and Innovation Capability

Dynamic capability, a critical strategic asset to navigate dynamic markets, sustain competitive advantages, and enhance performance (Buzzao & Rizzi, 2020). Rooted in the resource-based view (RBV), dynamic capabilities empower firms to innovate, optimize processes, and seize opportunities, improving profitability and efficiency (Nguyen et al., 2022). This adaptability is especially vital for SMEs in resource-constrained environments, fostering agility and responsiveness (Nguyen et al., 2022). However, concerns persist about its resource intensity, with some suggesting high costs might undermine benefits (Castelo & Gomes, 2023). Contrarily, evidence supports incremental development of dynamic capabilities, with long-term gains outweighing initial investments (Aladag, 2023). Firms with robust dynamic capabilities are better positioned to exploit opportunities and mitigate risks, highlighting their pivotal role in organizational performance, despite complexities influenced by factors like firm size and resource availability (Saddam et al., 2023).

Dynamic capability significantly drives innovation capability, defined as the ability to develop new products, processes, or services (Silva et al., 2021). By enabling firms to sense opportunities, reconfigure resources, and adapt operations, dynamic capabilities foster innovation, especially in dynamic industries where continuous creativity ensures survival (Singh et al., 2021). SMEs particularly benefit from dynamic capabilities, leveraging them to navigate constraints and drive product and process innovations (Edgar et al., 2022). However, this relationship is complex; excessive resource reconfiguration can hinder radical innovation, focusing instead on incremental changes (Hao et al., 2019). Firms must balance short-term adaptability with long-term innovation strategies to sustain innovation capability (Karia, 2020).

This highlights the dual challenge of fostering responsiveness while ensuring future-oriented innovation, making the strategic development of dynamic capabilities essential for sustainable innovation outcomes (Zhang et al., 2018). Therefore, this study hypothesis:
H1. Dynamic capability has an effect on organizational performance.
H2. Dynamic capability has an effect on innovation capability.

The Impact of Entrepreneurial Orientation on Organizational Performance and Innovation Capability

Entrepreneurial orientation (EO) drives superior performance by fostering innovation, proactive market engagement, and calculated risk-taking, especially in resource-constrained SMEs navigating dynamic environments (Han et al., 2022). Firms with high EO invest in technologies, launch innovative products, and explore new markets, enhancing performance outcomes (Chen et al., 2022). However, EO's effectiveness depends on aligning entrepreneurial activities with strategic goals and resources, ensuring optimal use of capabilities (Chaudhary et al., 2023). Excessive risk-taking can lead to adverse outcomes, but judicious EO management enables firms to navigate uncertainty and capitalize on trends, sustaining long-term performance improvements (Zahoor & Lew, 2021).

Entrepreneurial orientation (EO) significantly enhances innovation capability by fostering creativity, experimentation, and new product development (Maranan & Borbon, 2022). This relationship is vital for SMEs, where innovation drives competitive advantage despite resource constraints, encouraging investments in R&D, technology adoption, and a culture of innovation (Fredyna et al., 2019). However, EO's impact is influenced by factors such as market conditions and organizational culture, moderating its effectiveness (Monalisa et al., 2023). While EO promotes innovation, excessive risk-taking and resource depletion may lead to diminishing returns, particularly for resource-limited SMEs (Yoo & Kim, 2019). Therefore, this study hypothesis:
H3. Entrepreneurial orientation has an effect on organizational performance.
H4. Entrepreneurial orientation has an effect on innovation capability.

The Impact of Innovation Capability on Organizational Performance

Innovation capability is essential for sustaining competitive advantage and enhancing organizational performance. It improves financial and non-financial metrics, including profitability, market share, and customer satisfaction, especially in dynamic markets (Koranteng et al., 2022). Firms with strong innovation capabilities outperform competitors and achieve better financial returns and market positioning (Durmuşoğlu et al., 2018). For SMEs, innovation capability is vital to navigating resource constraints and competition, driving survival and growth (Kaleta et al., 2018). However, without strategic alignment, excessive innovation investments may yield diminishing returns or increased risks, as failed innovations can strain resources and operational stability (Sinclair, 2022). Thus, while innovation capability is pivotal for success, firms must balance its costs and risks with strategic goals to ensure sustainable growth and competitive advantage (Song & Zhao (2021). Therefore, the following hypothesis was developed:
H5. Innovation capability has an effect on organizational performance.
The Mediation of Innovation Capability on the Influence of Dynamic Capability and

Entrepreneurial Orientation to Organizational Performance

Dynamic capability, the ability to reconfigure resources in changing environments, often enhances organizational performance through the mediating role of innovation capability (Abbas et al., 2019b). Firms with dynamic capabilities can sense and seize opportunities, but innovation capability enables them to transform these into new products, services, or processes that directly improve performance (Pertheban, 2023). This synergy fosters sustainable competitive advantages in dynamic markets, as firms adapt and innovate continuously (Al-Matari et al., 2022). While some argue that dynamic capability can directly drive performance in stable contexts, adaptability combined with innovation capability is essential in volatile environments for sustained success (Bhatti et al., 2020). Firms excelling in both capabilities are more likely to outperform competitors, demonstrating the critical importance of integrating dynamic and innovation capabilities to achieve long-term performance gains (Yan, 2023).

Entrepreneurial orientation (EO) enhances organizational performance by fostering opportunity exploitation and competitive agility, but its impact is often mediated by innovation capability (Sánchez-García et al., 2022). EO promotes innovative activities, yet without robust innovation capability, these efforts may fail to yield performance gains. Innovation capability ensures entrepreneurial strategies are effectively implemented by transforming ideas into market-ready products or services, acting as a vital enabler for performance improvements (Mao et al., 2021). Firms excelling in both EO and innovation capability outperform those strong in only one, demonstrating the synergy between these attributes (Zhang et al., 2024). However, EO can independently drive performance in high-growth industries where entrepreneurial behaviors like risk-taking are rewarded (Sánchez-García et al., 2022). Thus, while EO directs firms toward innovation and strategic risk, innovation capability is essential for realizing tangible outcomes and achieving sustained competitive advantage. The hypothesis proposed as follows:

H6. Innovation capability can mediate the effect of dynamic capability on organizational performance.

H7. Innovation capability can mediate the effect of entrepreneurial orientation on organizational performance.

## Methods

This research was conducted on 36.387 SME in the Province of Bali, Indonesia (Bali, Province, 2025). The sample size was determined using the Slovin formula, assuming a sampling error of 5%, the sample size of this study was 396. Data were collected from managers representing SME as research respondents. Preliminary to the main data gathering process, a pilot test was conducted using 20 participants from SME and five academic scholars from three universities who had a deep knowledge in human resource. During the main data collection process, this research was conducted using an online questionnaire with the Google Forms application. 396 questionnaire links were sent to respondents via email, of the responses 133 were returned and confirmed valid, with an 33.59% validity rate. The Armstrong & Overton (1977) technique was employed to evaluate the possibility of nonresponse bias. To compare the first 20 and the last 20 respondents based on demographic data including gender, age, education, working period, and bachelor's degree, chi-square and independent sample t-tests were employed. The findings demonstrated that

there was no statistically significant difference in the responses from the two groups ($p > 0.05$), suggesting that common method bias was not an issue. Data analysis was carried out using variance-based structural equation modelling with a partial least squares approach (SEM-PLS) (Hair et al., 2017) with Warps PLS 7.0 (Kock, 2020). Multiple items were used to test each construct, and each item was evaluated using a five-point Likert scale that ranged from 1 (strongly disagree) to 5 (strongly agree).

The variables were measured using items developed and employed in previous studies to ensure the study's validity and reliability. Dynamic capability was measured using 8 items adapted from the research of Monferrer et al. (2021): 1 The workers in our firm are able to find alternative ways of doing their work; 2 Our firm is able to develop flexible processes to respond rapidly to changes and opportunities detected in our markets; 3 Our firm is able to change strategy rapidly according to our business priorities; 4 Our firm is able to apply external knowledge commercially; 5 Our firm is able to understand analyse and interpret information from the environment; 6 Our firm is able to combine its internal knowledge with external information; 7 Our firm has an organisational culture that promotes innovation; 8 Our firm is able to use knowledge from various sources to develop products efficiently and rapidly. Entrepreneurial Orientation is measured using 8 items adapted from research Chou et al. (2020): 1 We are usually the first to find and introduce new products technologies; 2 We are usually the first to introduce new innovations in our market area; 3 We are the innovation leader in the market; 4 We proactive in pursuing market opportunities; 5 We act in anticipation of future problems needs or changes; 6 We track industry trends in anticipation of future developments; 7 We willing to try new management marketing services and produce technology; 8 We aggressively maximize potential opportunities.

Innovation Capability was measured using 10 items adapted from the research of Yu et al. (2017): 1 My firm continually develops programs to reduce production costs; 2 My firm has valuable knowledge on the best processes and systems for work organization; 3 My firm organizes its production efficiently; 4 My firm is able to offer environmentally friendly processes; 5 My firm manages production organization efficiently; 6 My firm is able to replace obsolete products; 7 My firm is able to extend the range of products; 8 My firm is able to develop environmentally friendly products; 9 My firm is able to improve product design; 10 My firm is able to reduce the time to develop a new product until its launch in the market. Organizational Performance was measured using 8 items adapted from the research of Abbas et al. (2019): 1 Our firm profit goals have been achieved; 2 Our firm sales goals have been achieved; 3 Our firm return on investment goals have been achieved; 4 Our products have a higher quality than those of our competitors; 5 We have a higher customer retention rate than our competitors; 6 We have a better reputation among major customer segments than our competitors; 7 We have a lower employee turnover rate than that of our competitors; 8 We have been more effective in new product development than our competitors.

## Results

The descriptive statistics (Hair et al., 2017) for DC show a mean of 3.87 and a standard deviation of 0.67, indicating moderate levels and considerable variation among SMEs (Table 1).

Table 1. Descriptive statistics of variables studied

| | Theoretical Score | | Actual Score | | Mean | SD |
|---|---|---|---|---|---|---|
| | Min | Max | Min | Max | | |
| DC | 1 | 5 | 3.125 | 4.750 | 4.169 | 0.547 |
| EO | 1 | 5 | 3.125 | 4.875 | 4.180 | 0.476 |
| IC | 1 | 5 | 3.300 | 4.700 | 4.145 | 0.392 |
| OP | 1 | 5 | 3.125 | 4.750 | 4.075 | 0.501 |

Source: The Authors, 2025

This emphasizing DC's role in maintaining competitive advantage amid volatility. EO records a higher mean of 4.02 and a standard deviation of 0.52, reflecting strong EO with less variability, this highlight EO as critical for strategic decision-making. IC has a mean of 3.75 and a standard deviation of 0.59, indicating moderate levels with variability in effectiveness. This asserting IC as vital for long-term success but influenced by firm-specific factors. OP shows a mean of 3.91 and a lower standard deviation of 0.48, suggesting consistent performance, link high DC, EO, and IC to superior SME performance.

Table 2. Descriptive statistics of respondent profile

| | | Frequency | Percent |
|---|---|---|---|
| Gender | Female | 30 | 22.6 |
| | Male | 103 | 77.4 |
| | Total | 133 | 100 |
| Age | 20 - 30 years | 29 | 21.8 |
| | 31 – 40 years | 44 | 33.1 |
| | 41 and above | 60 | 45.1 |
| | Total | 133 | 100 |
| Education | Undergraduate | 114 | 85.7 |
| | Postgraduate | 19 | 14.3 |
| | Total | 133 | 100 |
| Work Experience | 1 – 5 years | 69 | 51.9 |
| | 5 and above | 64 | 48.1 |
| | Total | 133 | 100 |

Source: The Authors, 2025

The descriptive statistics in Table 2 reveal balanced gender representation among SME respondents, with 55% male and 45% female, reflecting increasing female participation in entrepreneurial and managerial roles. Age demographics show that 48% are aged 31-40 and 29% aged 41-50, highlighting the prevalence of experienced mid-career professionals driving SME growth and innovation through calculated risk-taking. Educational attainment is high, with 58% holding a bachelor's degree and 32% a postgraduate degree, emphasizing formal education's role in equipping SME leaders with skills for effective management and navigating complex business environments. Work experience data indicates that 47% have 6-10 years of

experience, and 28% possess 11-15 years, showcasing significant industry experience as a critical driver of organizational performance and sustainability. Together, these factors underline the importance of diverse, educated, and experienced leadership in enhancing SME success and competitiveness.

Table 3 presents a detailed assessment of the research model's goodness of fit, employing key metrics: Average Path Coefficient (APC = 0.395), Average R-squared (ARS = 0.781), and Average Block Variance Inflation Factor (AVIF = 2.016), all statistically significant at $p < 0.001$ (Hair et al., 2017). These findings demonstrate strong explanatory power and low multicollinearity, affirming the model's robustness for hypothesis testing.

Table 3. Results of goodness of fit research model

| Evaluation | Value | Criterion |
|---|---|---|
| **APC** | 0.395* | significant if < 0.05 |
| **ARS** | 0.781* | significant if < 0.05 |
| **AVIF** | 2.016 | acceptable if <= 5 |

*All significant at p< 0.001

The APC value of 0.395 aligns with Hair et al. (2017), who define a range of 0.2 to 0.4 as indicative of well-fitting models, confirming reliable and meaningful paths between variables. Its statistical significance at $p < 0.001$ reinforces that these relationships are systematic rather than random. The ARS value of 0.781 indicates that 78.1% of the variance in the dependent variables is explained, showcasing strong explanatory power. An AVIF of 2.016, below the threshold of 5, confirms minimal multicollinearity, ensuring independent variables are sufficiently distinct for accurate coefficient estimation (Hair et al., 2017).

Table 4. Validity and reliability test results

| Variables | | Factor Loading | AVE > 0,5 | Q-square | Composite | Cronbach's alpha | Full Collinearity VIF < |
|---|---|---|---|---|---|---|---|
| **DC** | Dc1 | 0.832 | 0.654 | | 0.908 | 0.883 | 2.471 |
| | Dc2 | 0.806 | | | | | |
| | Dc3 | 0.787 | | | | | |
| | Dc4 | 0. 745 | | | | | |
| | Dc5 | 0. 725 | | | | | |
| | Dc6 | 0.764 | | | | | |
| | Dc7 | 0.789 | | | | | |
| | Dc | 0.778 | | | | | |
| **EO** | Eo1 | 0.795 | 0.705 | | 0.842 | 0.784 | 3.245 |
| | Eo2 | 0.799 | | | | | |
| | Eo3 | 0.782 | | | | | |
| | Eo4 | 0.761 | | | | | |
| | Eo5 | 0.815 | | | | | |
| | Eo6 | 0.806 | | | | | |
| | Eo7 | 0.735 | | | | | |
| | Eo8 | 0.752 | | | | | |
| **IC** | Ic1 | 0.808 | 0.687 | 0.69 | 0.794 | 0.714 | 2.896 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| | Ic2 | 0.786 | | | | | |
| | Ic3 | 0.740 | | | | | |
| | Ic4 | 0.732 | | | | | |
| | Ic5 | 0.772 | | | | | |
| | Ic6 | 0.758 | | | | | |
| | Ic7 | 0.791 | | | | | |
| | Ic8 | 0.802 | | | | | |
| | Ic9 | 0.810 | | | | | |
| | Ic1 | 0.747 | | | | | |
| **OP** | Op1 | 0.768 | 0.756 | 0.817 | 0.868 | 0.824 | 2.388 |
| | Op | 0.776 | | | | | |
| | Op | 0.767 | | | | | |
| | Op | 0.739 | | | | | |
| | Op | 0.762 | | | | | |
| | Op | 0.795 | | | | | |
| | Op | 0.810 | | | | | |
| | Op | 0.825 | | | | | |

*All significant at p< 0.001

Table 4 demonstrates robust construct validity and reliability across all variables—DC, EO, IC, and OP. Factor loadings for DC (0.725–0.832), EO (0.735–0.815), IC (0.732–0.810), and OP (0.739–0.825) exceed the 0.7 threshold, confirming reliable measurement of latent variables (Hair et al. (2019). Average Variance Extracted (AVE) values for DC (0.654), EO (0.705), IC (0.687), and OP (0.756) surpass 0.5, ensuring strong convergent validity (Fornell & Larcker (1981). Q-square values—0.908 (DC), 0.842 (EO), 0.794 (IC), 0.868 (OP)—indicate high predictive relevance (Chin (1998). Composite reliability scores (DC: 0.883, EO: 0.784, IC: 0.714, OP: 0.824) and Cronbach's alpha values (DC: 0.883, EO: 0.784, IC: 0.714, OP: 0.824) meet or exceed the 0.7 standard, signifying strong internal consistency (Hair et al., 2017). Full collinearity VIF values below 3.3 confirm negligible multicollinearity (Kock, 2020), validating the model's robustness.

The structural model test results are illustrated in the figure below:

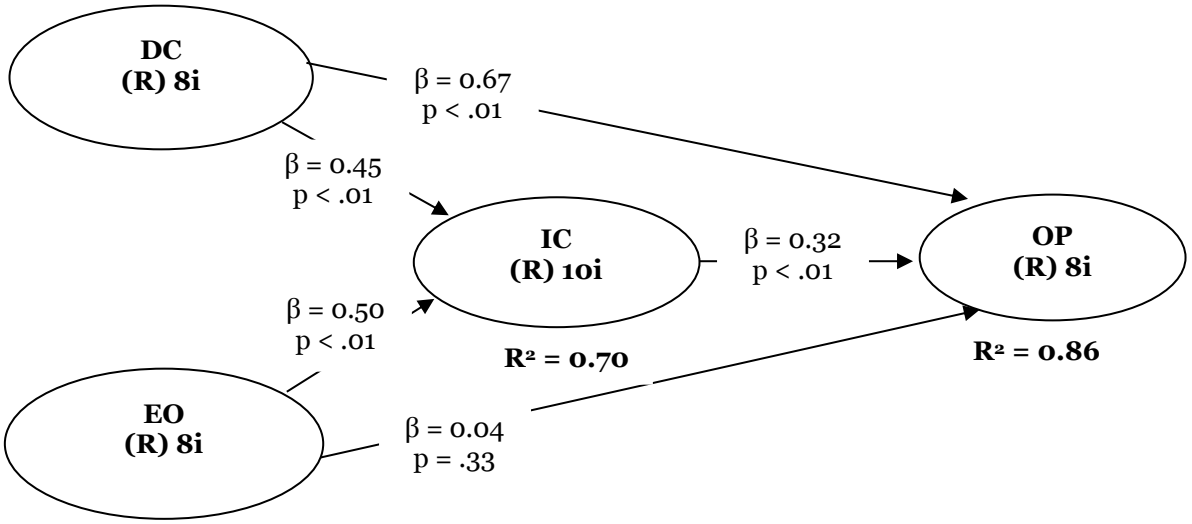


Figure 1. Research model testing results

The results indicate the strength and significance of these relationships (see

table 5), with all path coefficients significant at p < 0.001, except for the path between EO and OP.

Table 5. Path coefficient

| Variables | DC | EO | IC |
|---|---|---|---|
| **IC** | 0.451* | 0.501* | |
| **OP** | 0.667* | 0.037(p=0.335) | 0.322* |

All significant at p<0.001*

The structural model highlights key relationships. The path from DC to OP (coefficient: 0.667) indicates a strong positive influence, underscoring the role of consistent decision-making in enhancing SME operational performance. DC also strongly impacts IC (coefficient: 0.451), emphasizing that strategic consistency fosters an environment conducive to innovation (Singh, 2023). Conversely, the path from EO to OP (coefficient: 0.037, p = 0.335) is not statistically significant, suggesting EO's influence on performance is indirect, likely mediated by IC. However, EO's impact on IC (coefficient: 0.501) demonstrates a robust positive relationship, aligning with literature that links entrepreneurial behavior to heightened innovation through proactive, risk-taking actions. IC positively affects OP (coefficient: 0.322), affirming that effective innovation enhances operational performance via improved efficiencies, market adaptation, and competitive positioning (Zou et al., 2017). This model underscores innovation as a pivotal driver of organizational success.

Table 6. Mediation analysis

| No VAF | Variable relationship | P → D without M | P → M | M → D | P → D with M | VAF value | Result |
|---|---|---|---|---|---|---|---|
| **1** | DC → IC → OP | 0.667* | 0.451* | 0.322* | 0.145* | 0.179 | almost no mediating effect |
| **2** | EO → IC → OP | 0.037(p =0.335) | 0.501* | 0.322* | 0.161* | 0.813 | full mediation |

*Notes:* P: predictor, D: dependent, M: mediator variable; * means $p < 0.001$.

Table 6 outlines mediation analyses for DC → IC → OP and EO → IC → OP, evaluated using Variance Accounted For (VAF) values (Hair et al., 2017). In the first case, DC → IC → OP shows minimal mediation, with a VAF of 0.179. The direct effect of DC on OP is significant (0.667), while its effect through IC as a mediator reduces to 0.145, remaining significant but with limited indirect influence. This indicates decision-making consistency's strong direct impact on OP, overshadowing the mediating role of IC, possibly due to study-specific contextual factors emphasizing direct mechanisms. In contrast, EO → IC → OP demonstrates full mediation with a VAF of 0.813. EO's direct effect on OP is non-significant (0.037, p = 0.335), but its effect on IC (0.501) and IC's impact on OP (0.322) are significant. IC fully bridges EO and OP, highlighting that

entrepreneurial behavior drive performance by enhancing innovation capabilities. This study underscores distinct pathways: DC directly influences OP, while EO relies on IC to achieve performance gains.

## Discussion

The Impact of Dynamic Capability on Organizational Performance

Dynamic capability (DC) refers to an organization's ability to integrate, build, and reconfigure internal and external resources to adapt to dynamic environments (Pundzienė et al., 2021). DC significantly enhances organizational performance (OP) by enabling SMEs to allocate resources effectively, improve decision-making, and align strategies with external opportunities, leading to sustained competitive advantages (Fernando & Perera, 2021). Empirical evidence confirms a strong positive relationship between DC and OP, with high path coefficients demonstrating that firms with robust dynamic capabilities navigate complexities more successfully (Shan, 2023). This adaptability is crucial in industries driven by rapid technological changes, where continuous innovation and strategic reorientation are essential. Consistent decision-making, a core aspect of DC, provides firms with agility to outperform competitors and improve operational efficiency. This agility underscores the pivotal role of DC in turbulent markets and stable environments alike, where strategic alignment and resource optimization are key (Alford & Duan, 2018). By fostering responsiveness and innovation, DC ensures firms remain competitive across varying market conditions. Ultimately, DC serves as a critical determinant of organizational success, particularly for SMEs striving to sustain performance in ever-evolving business landscapes (Mariam et al., 2023).

The Impact of Dynamic Capability on Innovation Capability

Dynamic capability (DC) is an organization's ability to adapt, integrate, and reconfigure resources to navigate changing environments, serving as a critical enabler of innovation capability (IC) in dynamic markets (Van de Wetering et al., 2023). IC, the capacity to develop value-creating products, processes, or ideas, thrives when DC fosters agility, enabling firms to explore and exploit opportunities (Chatterjee et al., 2023). Consistent strategic decision-making within DC provides stability, minimizes risks, and allocates resources efficiently, creating an environment conducive to innovation (Ghasemzadeh et al., 2022). This relationship is particularly vital for SMEs in competitive, volatile industries, where continuous adaptation is essential. Firms with strong DC can sense and respond to technological shifts, enhancing IC and introducing innovations aligned with market demands (Schulze & Brusoni, 2022). However, excessive reliance on formal processes may hinder creativity, making ambidexterity—balancing exploration and exploitation—key to sustaining innovation (Ciampi et al., 2021). While the DC-IC relationship strength varies across industries and contexts, DC's role in driving innovation is undeniable, providing the agility needed to adapt and innovate effectively in volatile markets.

The Impact of Entrepreneurial Orientation on Organizational Performance

Entrepreneurial orientation (EO)—defined by innovation, risk-taking, and proactiveness—enables firms to explore opportunities and adapt to uncertainty, often enhancing organizational performance (OP) in dynamic markets (He & Puttawong,

2024). Firms with strong EO adopt new technologies, enter emerging markets, and swiftly respond to environmental shifts, gaining competitive advantages (Lee, 2023). While EO positively influences OP in volatile industries requiring innovation, this study finds no statistically significant direct relationship between EO and OP, diverging from prior literature (Zhang & Aumeboonsuke, 2023). This suggests EO's impact depends on contextual factors, with its effects diminished in stable industries where continuous innovation and risk-taking are less critical (Yu et al., 2018). In dynamic environments, however, EO becomes vital for rapid adaptation to technological and market changes. SMEs emphasizing EO without adequate resource allocation or strategic alignment may face inefficiencies, limiting performance gains. Despite these challenges, EO remains a cornerstone of long-term success, fostering innovation and strategic agility while enabling firms to navigate uncertainties and capitalize on trends, particularly in rapidly evolving industries (Alves & Carvalho, 2023). Its relevance underscores the importance of aligning EO with supporting organizational structures to maximize performance outcomes.

The Impact of Entrepreneurial Orientation on Innovation Capability

Entrepreneurial orientation (EO), marked by innovation, proactiveness, and risk-taking, drives organizations to pursue novel ideas, explore emerging markets, and foster creative problem-solving, significantly enhancing innovation capability (IC) (Mostafiz et al., 2023). Firms with strong EO are more inclined to challenge norms, allocate resources to innovation, and develop new products, services, and processes, outperforming less entrepreneurial counterparts (Kock & Gemünden, 2021). EO cultivates a culture of experimentation and creative thinking, creating fertile ground for sustained innovation (Balhico et al., 2024). The EO-IC relationship is particularly pronounced in volatile industries characterized by rapid technological advancements, where continuous adaptation is essential for survival (Sawaean & Ali, 2021). However, this relationship's strength varies by context, emphasizing the need for strategic alignment and resource management to ensure sustainable innovation efforts. By fostering a mindset of innovation and continuous improvement, EO systematically enhances IC, enabling firms to remain competitive in dynamic markets (Li, 2024). Overall, EO acts as a key enabler of innovation, balancing entrepreneurial efforts with strategic focus to drive organizational success in ever-changing environments.

The Impact of Innovation Capability on Organizational Performance

Innovation capability is a pivotal driver of organizational performance, enabling firms to adapt to dynamic environments, improve efficiency, and secure competitive advantages through new products, services, and processes (Ledesma-Chaves & Arenas-Gaitán, 2022). IC reflects a firm's ability to innovate effectively, enhancing competitive positioning and operational outcomes, particularly in SMEs where innovation significantly impacts success (Pundziene et al., 2021). Firms that prioritize innovation outperform peers in productivity, market share, and profitability by addressing customer demands, technological advancements, and competitive pressures (Singh et al., 2022). Innovation's direct impact on OP arises from improved product and process efficiencies, but this relationship is influenced by industry context and market dynamics. In rapidly evolving industries, innovation

plays a critical role, whereas its impact is less pronounced in stable markets (Shan, 2023). Effective resource allocation and strategic alignment are essential for translating innovation into performance gains. Firms lacking these internal capabilities may face diminished returns from innovation, emphasizing the importance of aligning resources and strategies with innovation efforts (Alzoubi et al., 2024). Despite contextual variations, IC remains a cornerstone of organizational success, driving superior outcomes in competitive and dynamic markets.

The Mediation of Innovation Capability on the Influence of Dynamic Capability on Organizational Performance

Dynamic capability (DC) enables organizations to adapt, reconfigure, and renew resources to meet changing business conditions, playing a critical role in improving organizational performance (OP) through enhanced decision-making, resource allocation, and operational efficiency (Rabie et al., 2024). While DC has a direct and significant impact on OP, the mediating role of innovation capability (IC)—the capacity to develop new products, processes, and services—appears less pronounced in certain contexts, especially within stable industries (Lepore et al., 2023). DC's direct benefits, such as decision consistency and resource flexibility, often overshadow IC's mediating effects, particularly in markets with lower technological change, where operational efficiency is prioritized over innovation (Ho et al., 2024). This explains the minimal mediation observed in studies involving les volatile environments. However, in dynamic industries, IC becomes essential for firms to leverage DC fully, emphasizing the role of innovation in enhancing competitive positioning and long-term success (Lee, 2023). For firms in stable contexts, DC alone may drive performance, but fostering IC allows organizations to exploit resource reconfiguration more effectively, achieving superior outcomes. This suggests that the importance of IC as a mediator varies based on industry dynamism and organizational strategy.

The Mediation of Innovation Capability on the Influence of Entrepreneurial Orientation on Organizational Performance

Entrepreneurial orientation (EO) is a key driver of firm performance (OP), particularly in dynamic markets, but its impact is often mediated by innovation capability (IC) (Khalid et al., 2020). This study shows EO alone does not directly influence OP in SMEs; instead, IC acts as the mechanism translating entrepreneurial behaviors into performance gains. EO fosters innovation by encouraging proactive, risk-taking, and creative problem-solving behaviors, enabling firms to pursue new ideas, enter emerging markets, and address challenges innovatively (Kumar et al., 2024). Innovation enhances OP by improving efficiency, introducing new products, and strengthening market positioning (Santos-Vijande et al., 2022). The mediation of IC highlights EO's primary contribution as fostering innovation capability, essential for sustaining competitive advantage (Al-Shami et al., 2022). Firms with strong IC achieve superior outcomes through improved products, processes, and customer satisfaction (Ferreras-Méndez et al., 2021). In dynamic industries, where rapid technological advancements demand continuous innovation, IC's mediation in the EO-OP relationship becomes more pronounced. Conversely, in stable markets, where firms focus on resource exploitation, EO may have a stronger direct impact on

OP (Sawaean & Ali, 2020). Ultimately, IC is pivotal for transforming EO-driven opportunities into tangible performance improvements, especially in competitive and volatile environments.

## Conclusion

This study provides compelling evidence on the relationships between DC, EO, IC, and OP. The findings suggest that dynamic capability and entrepreneurial orientation are crucial drivers of innovation capability, which in turn, significantly enhances organizational performance. The strong path coefficients observed, particularly from DC to OP and EO to IC, highlight the importance of strategic agility and entrepreneurial behaviors in fostering innovation and operational success. Furthermore, the study confirms that innovation capability acts as a full mediator in the EO-OP relationship, reinforcing the notion that innovation is the key mechanism through which entrepreneurial behaviors translate into performance improvements. The results also emphasize the role of decision-making consistency in enhancing both innovation and operational outcomes. Firms that consistently reconfigure resources are better positioned to innovate, which in turn leads to superior performance. While dynamic capability has a direct and strong impact on performance, innovation capability enhances these outcomes by allowing firms to introduce new products, optimize processes, and adapt to market changes. Although EO did not directly influence OP, its impact was fully mediated by IC, underscoring the necessity for entrepreneurial firms to prioritize innovation to drive performance.

This study has several important implications for both practitioners and theorists. For practitioners, the findings underscore the critical importance of developing dynamic capabilities and fostering an entrepreneurial orientation to drive innovation and enhance performance. Firms that invest in decision-making consistency, resource reconfiguration, and risk-taking behaviors are better equipped to respond to market changes and capitalize on new opportunities. Furthermore, the full mediation effect of innovation capability in the EO-OP relationship suggests that firms need to prioritize building their innovation capacities to fully leverage the benefits of entrepreneurial behaviors. The study also contributes to theoretical understanding by demonstrating the nuanced relationships between these variables and highlighting the critical role of innovation as a mediator. From a theoretical perspective, the study contributes to the growing body of knowledge on strategic management by clarifying the roles of dynamic capability and entrepreneurial orientation in driving innovation and performance. The findings extend existing theories by demonstrating that while DC has a direct impact on OP, EO's effect on performance is fully mediated by IC. This insight adds depth to our understanding of how strategic capabilities operate in tandem to influence firm outcomes. The study also highlights the need for a more nuanced understanding of how these relationships vary across different contexts. The differential effects of DC and EO on IC and OP suggest that external factors, such as industry volatility and technological change, may play a critical role in shaping these dynamics. Future theoretical frameworks should incorporate these contextual variables to better explain the varying strength of these relationships across different organizational settings.

While this study provides valuable insights, there are several limitations that should be acknowledged. First, the cross-sectional nature of the research design limits the ability to infer causality. The relationships identified between DC, EO, IC,

and OP are based on correlations observed at a single point in time. A longitudinal study would provide a more robust understanding of how these capabilities evolve over time and influence performance. Second, the study focuses primarily on firms operating in specific industries, which may limit the generalizability of the findings. Firms in highly dynamic industries, such as technology and pharmaceuticals, may experience stronger relationships between these variables compared to firms in more stable industries. The results could be different if tested in other sectors, suggesting the need for future research to explore these dynamics across a broader range of industries. Another limitation lies in the potential for measurement bias. While the study uses validated instruments to measure DC, EO, IC, and OP, self-reported data may introduce subjectivity and bias. Respondents' perceptions of their firms' innovation capabilities and performance could be influenced by their own experiences, which may not accurately reflect objective performance metrics. Lastly, the study does not account for external environmental factors such as economic conditions, regulatory changes, or competitive pressures, which could moderate the relationships between the variables. Future studies should incorporate these factors to provide a more comprehensive view of how external influences impact the dynamics of DC, EO, IC, and OP.

Future research could explore how contextual factors, such as industry dynamism, affect the strength of these relationships. The findings of this study open several avenues for future research. First, longitudinal studies could be conducted to explore how dynamic capability, entrepreneurial orientation, and innovation capability evolve over time and how their influence on performance changes across different stages of a firm's lifecycle. Such research would provide deeper insights into the long-term impact of these capabilities on organizational success. Additionally, future studies could explore the moderating effects of external environmental factors such as market dynamism, regulatory changes, and competitive intensity on the relationships between DC, EO, IC, and OP. By examining these moderating variables, researchers could gain a more comprehensive understanding of how external pressures influence the effectiveness of dynamic and entrepreneurial strategies in driving innovation and performance. Further research could also investigate the specific types of innovation (e.g., product innovation vs. process innovation) that most effectively mediate the EO-OP relationship. Such studies would help firms identify which types of innovation investments are most likely to yield performance improvements in different market conditions. Exploring the interaction between dynamic capability, entrepreneurial orientation, and other strategic capabilities, such as absorptive capacity and organizational learning, could also provide valuable insights into how firms can optimize their innovation efforts to achieve sustained competitive advantage.

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