

# THE INFLUENCE OF THE BUSINESS ENVIRONMENT ON INNOVATION AND ITS IMPLICATIONS FOR THE MSMEs PERFORMANCE (A STUDY ON AGRIBUSINESS MSMEs IN MAJALENGKA DISTRICT)

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## ABSTRACT

Agrobusiness Micro, Small and Medium Enterprises (MSMEs) are those engaged in processing agricultural products into processed products. This business has an important role in creating added value to primary agricultural products, expanding the scope of marketing areas, expanding and increasing employment opportunities as well as telecommunications and marketing, increasing farmers' income sources as suppliers of agricultural products, and encouraging food security development. The development of Agrobusiness MSMEs in Majalengka District must be a concern for the local government, because it requires equal distribution of program socialization by involving the community, conducting comprehensive MSME assistance, improving synergy and coordination between agencies responsible for distributing assistance and coordination between the Central Government and Local Government. In addition, MSME actors must also improve their performance in running a business by paying attention to factors that affect the performance of MSMEs themselves such as the business environment and innovation. This research is conducted to see how specific business environment factors affect the innovation process in MSMEs and how these innovations then lead to overall performance improvement. While existing studies underscore the importance of creative marketing strategies and adaptation to the environment, no study has yet taken an in-depth look at the relationship between these two factors and how they influence each other. The population of this study is the owners of Agroindustry MSMEs in Majalengka District, the number of which is not known with certainty. The sampling technique used was purposive sampling. The number of samples taken was 148 respondents. Data collection using a questionnaire. Processing techniques use SEMPLS modeling equations. The results showed that the internal and external environment had a significant effect on innovation, and innovation mediated the influence of the internal and external environment on MSMEs performance. Innovation needs to be carried out by MSMEs to improve their performance by utilizing the potential and opportunities of their internal and external environment by encouraging employees to think creatively, share ideas, and create a work environment that supports experimentation and learning. MSMEs must also establish partnerships and collaborations with research institutions, universities and other institutions to access knowledge, technology and resources that can support innovation. As well as building and strong business networks with

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partners, suppliers, and customers to gain insights, feedback, and collaboration opportunities that can accelerate the innovation process.

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## 1. Introduction

Micro, Small and Medium Enterprises (MSMEs) is a business entity that continues to be a concern and is always prioritized by the government. MSMEs have a significant role and potential in national and regional development. This is because these businesses are the backbone of a populist economic system that is not only aimed at reducing the problem of disparities between income groups and between business actors, or poverty alleviation and employment. West Java Province is one of the provinces in Indonesia that has a very large number of MSMEs. In 2021, the number of MSMEs was recorded at 4,634,807 business units. Consisting of 4,154,141 micro businesses, 437,575 small businesses, 38,531 medium businesses and 4,560 large businesses. Labor absorption in micro and small enterprises reached 8.5 million and medium enterprises reached 2.9 million workers. With this number, the contribution of MSMEs to the West Java economy reached 60% in GRDP, 14.17% in exports and 58.18% in investment (BPS, Jawa Barat 2022). Majalengka District as one of the regions in West Java Province also has quite a lot of MSMEs, although not as many as other areas such as Bandung District/City, Garut District, Sukabumi District and Bogor District. In 2021, there were 211,947 MSMEs in Majalengka district. This number is dominated by MSMEs in the culinary business category as many as 75,770 units, food as many as 55,419 units, and services/others as many as 23,942 units. Besides being famous for its agro-industry, Majalengka district is also famous as an Agrobusiness area such as corn, mango, durian and others. Therefore, these Agrobusiness MSMEs are starting to develop at this time.

MSMEs are micro, small and medium enterprises engaged in processing agricultural products into processed products. Agroindustry can be defined as the activity of processing agricultural commodity products, including sub-production. Agroindustry has an important role in creating added value to primary agricultural products, expanding the scope of marketing areas, expanding and increasing employment opportunities as well as telecommunications and marketing, increasing farmers' income sources as suppliers of agricultural products, and encouraging the development of food security (Sari Fauzia, 2015). The development of Agrobusiness MSMEs in Majalengka District must certainly be a concern for local governments. Agrobusiness MSMEs require equal distribution of program socialization by involving the community, conducting comprehensive MSME assistance, improving synergy and coordination between agencies responsible for distributing assistance and coordination between the Central Government and Local Government. In addition, Agrobusiness MSME organizers must also improve their performance in running their businesses. According to Moehariono (2012) performance is a description of the level of achievement of the implementation of an activity program or policy in realizing the goals, objectives, vision and mission of the organization as outlined through the strategic planning of an organization. In improving the performance of Agrobusiness MSMEs, it must pay attention to factors that affect the performance of the MSMEs themselves, such as the business environment and innovation.

The business environment can be defined as conditions that occur that can encourage or hinder growth and development in business activities, or it can be said to be a factor that affects activities within the company. Environmental factors can be influenced internally by the company and externally by the company. The business environment can also affect MSMEs innovation. This is because a good business environment can encourage product innovation, which in turn can improve the performance of MSMEs. Therefore, MSMEs need to pay attention to the business environment they face and carry out appropriate strategies to face competition, such as focusing on added value, understanding the market, product innovation, and capital development.

This research is important because the current business phenomenon is strongly influenced by external dynamics. The complex business environment, especially in the digital era and globalization, affects the ability of MSMEs to innovate. Understanding the factors that influence innovation in the context of the business environment helps MSMEs develop the right strategies to survive and thrive. This research is also relevant because innovation is the key to the success of MSMEs in facing increasingly fierce competition. With innovation, MSMEs can create added value, expand markets, increase efficiency, and reduce risk. In addition, an understanding of the implications of innovation on MSME performance can provide insights for the government and other stakeholders to develop appropriate policies and support to improve the overall competitiveness of MSMEs. This research benefits not only the MSMEs themselves but also the business ecosystem and the regional economy at large.

## 2. Literature Review

The relationship of the business environment to innovation and MSE performance is shown in research conducted by Gendut Sukarno (2019), this study aims to determine efforts to improve the marketing performance of SMEs in Kendensari, Tanggulangin Sidoarjo by paying attention to the environment, product innovation, and creative marketing strategies. The method used is *Structural Equation Modeling* (SEM). The results show that the corporate environment contributes positively to marketing strategy creativity and that there is a positive relationship between product innovation and marketing performance. In addition, this study also highlights the importance of adaptation to the environment and competition in developing products and marketing strategies. Research by Slamet Riyanto (2018); Neli Anggraini, Vicky F (2021); Lino Pereira, Tutri Hanggari (2022), shows that the business environment both internal and external has a significant influence on the performance of MSMEs. The results of this study prove that a good understanding of the business environment will help MSMEs face challenges and take advantage of opportunities to improve their performance, including encouraging competitive advantage and marketing performance. Research by Sulastini, Fariansyah, Husnurrofiq (2021); Muhammad Badar (2022); Eliora Lorensa, Nur Hidayah (2022), shows that innovation has a significant influence on the performance of MSMEs. These results also prove that product innovation, market orientation and social media have a major contribution to the performance of MSMEs.

The studies mentioned show that the business environment, both internal and external, has a significant influence on MSMEs innovation and performance. However, a possible research gap is the lack of focus on integrating these two factors holistically. Some of these studies also highlight the contribution of social media to MSMEs performance through innovation and market orientation. However, no study has specifically addressed how social media as an innovation and marketing platform affects MSME performance in a more detailed way. This study was conducted to see how specific business environment factors influence the innovation process in MSMEs and how these innovations then lead to improved overall performance. While these studies underscore the importance of creative marketing strategies and adaptation to the environment, no study has yet taken an in-depth look at the relationship between these two factors and how they influence each other in the MSMEs industry. This is an interesting area for further exploration.

## 3. Method, Data, and Analysis

This research method is a survey with a descriptive verification approach. The population in this study are owners or managers of MSMEs in Majalengka District. The selected MSMEs are agroindustry-based MSMEs, namely MSMEs that produce processed agricultural products, the number of which is not known with certainty. The sampling technique used was purposive sampling. The considerations used in sample selection are agro-industry-based MSMEs, MSMEs engaged in semi-finished and finished products, and these MSMEs have been operating for  $\geq 3$  years. In connection with the unknown population, the sample size taken in this study using the Hair, et al formula (2010), the

number of samples can be determined from the number of indicator variables multiplied by 5 to 10. In this study, the number of indicator variables was 12. So this study used the minimum sample size taken, namely  $12 \times 10 = 120$  respondents who were considered eligible as samples.

In this study, a questionnaire was used for data collection. Determination of scores in the questionnaire using a Likert scale. According to Sugiyono (2021), the Likert scale is used to measure the attitudes, opinions, and perceptions of a person or group of people about social phenomena. The data processing technique in this study uses the *Structural Equation Modeling* (SEM) modeling equation which is a further development of *path analysis*, because in the SEM method the causal relationship between exogenous variables and endogenous variables can be determined more fully, (Abdullah, 2019). SEM modeling in this study uses *Partial Least Square* (PLS) estimation techniques, because it is not based on many assumptions. The advantages of this PLS method are that the data does not have to be multivariate normally distributed, the sample size does not have to be large, and PLS can not only be used to confirm the theory, but can also be used to predict or explain the presence or absence of a relationship between latent variables.

SEM-PLS data analysis techniques in this study used SmartPLS (Partial Least Square) software version 3.2.8. The procedure or stages of SEM-PLS analysis in this study were carried out as follows:

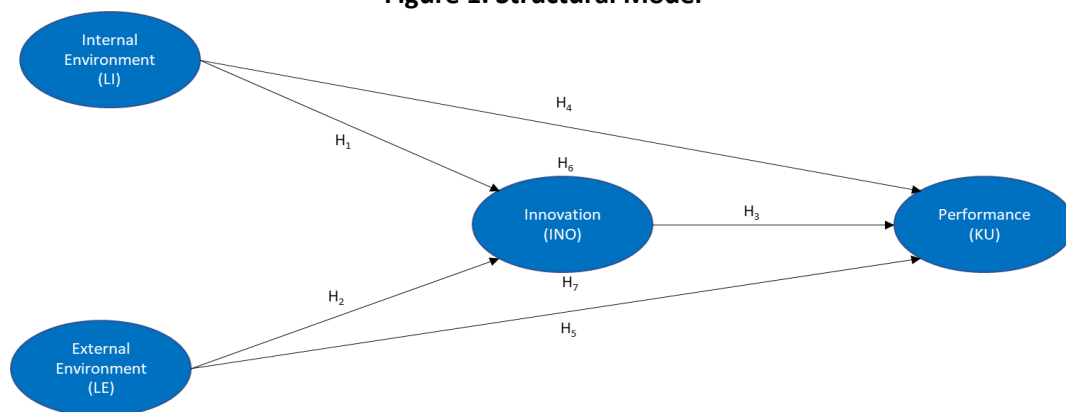
### 3.1 Evaluation of the Measurement Model (*Outer Model*)

The outer model is often called (*outer relation or measurement model*) which defines how each indicator block relates to its latent variable. The measurement model (outer model) is used to assess the validity and reliability of the model. The validity test is carried out to determine the ability of the research instrument to measure what should be measured, (Abdullah, 2019). Meanwhile, the reliability test is used to measure the consistency of the measuring instrument in measuring a concept or it can also be used to measure the consistency of respondents in answering question items in a questionnaire or research instrument.

### 3.2 Structural Model Evaluation (*Inner Model*)

*Inner model*, is a specification of the relationship between latent variables (*structural model*), also known as *inner relation*, describes the relationship between latent variables based on the substantive theory of research. The structural model in this study was evaluated using R-square for the dependent construct, *Stone-Geisser Q-square test for predictive relevance* and *Goodness Of Fit* to assess the overall strength of the structural model. The structural model to be tested can be described as follows:

Figure 1. Structural Model



### 3.3 Hypothesis Test

Hypothesis testing is done through a bootstrapping process and the results are then used by comparing the t-statistic value to the probability value at a *significance level of 5%* = 1.96. If the t-statistic value  $> 1.96$   $H_a \neq 0$  is accepted and  $H_o = 0$  is rejected, meaning that the exogenous variables and / or mediating variables have a significant effect on the endogenous variables. If the t-statistic

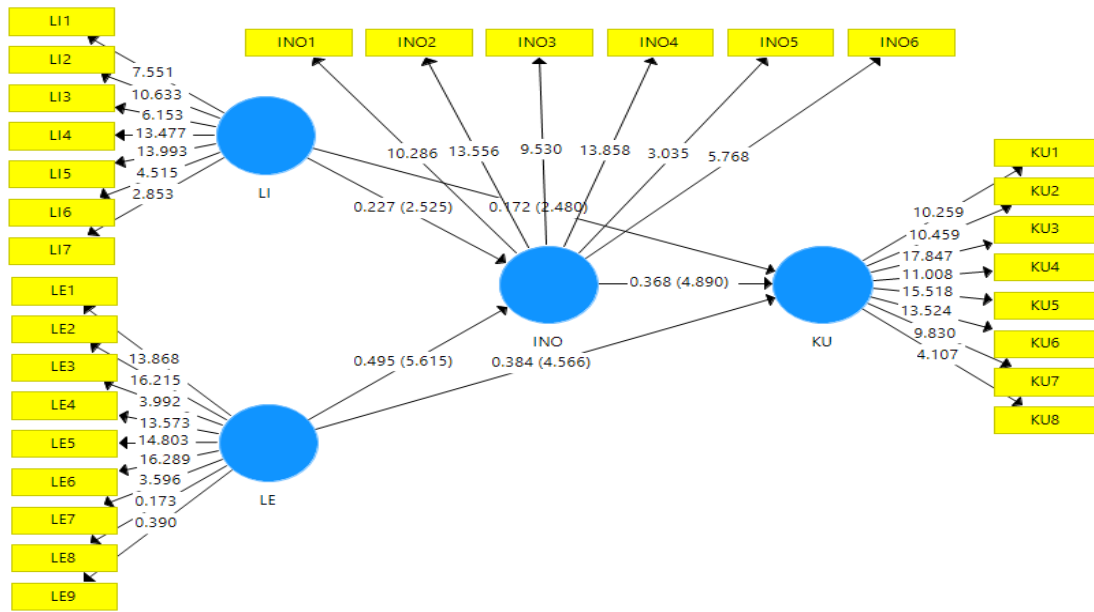
value  $\leq 1.96$  Ha  $\neq 0$  is rejected and Ho = 0 is accepted, meaning that the exogenous variables and / or mediating variables do not have a significant effect on the endogenous variables.

#### 4. Result and Discussion

##### 4.1 Result

Based on the data collected from 148 respondents, the results of the total path coefficient analysis are presented below:

**Figure 2. Total Path Coefficient**



Source: Data processed (2024)

The total path coefficient value presented in the figure above can be accepted if it meets the requirements of the *Goodness of Fit* model, namely the results of the measurement model evaluation (*outer model*) are valid and reliable, and the structural model evaluation (*inner model*) has a healthy *fit*. So that hypothesis testing can be carried out to meet research objectives.

Evaluation of the reflective measurement model at least consists of testing the value of external loading (*cross loading*), validity and reliability tests and convergent validity tests. The results of the measurement model evaluation are presented below:

**Table 1. Evaluation of the Measurement Model (*Outer Model*)**

Variables	Indicator	Cross Loading	Cronbach's Alpha	AVE	CR
Innovation (INO)	INO1	0.740	0.765	0.693	0.787
	INO2	0.724			
	INO3	0.961			
	INO4	0.749			
	INO5	0.960			
	INO6	0.804			
Performance (KU)	KU1	0.861	0.812	0.728	0.854
	KU2	0.767			
	KU3	0.723			
	KU4	0.855			
	KU5	0.707			

	KU6	0.707			
	KU7	0.853			
	KU8	0.800			
External Environment (LE)	LE1	0.729	0.755	0.635	0.721
	LE2	0.756			
	LE3	0.741			
	LE4	0.734			
	LE5	0.775			
	LE6	0.766			
	LE7	0.850			
	LE8	0.720			
	LE9	0.845			
Internal Environment (LI)	LI1	0.805	0.794	0.662	0.789
	LI2	0.700			
	LI3	0.783			
	LI4	0.719			
	LI5	0.720			
	LI6	0.771			
	LI7	0.787			

Source: Data processed (2024)

A decent *cross loading* value is that it should not be  $< 0.5$  (Umi, et al, 2019). In the table above, it can be seen that all latent variables have a *cross loading* value on each indicator  $\geq 0.5$ . This value means that all latent variables consisting of innovation, performance, external environment and internal environment have a strong correlation with their indicators, because they are able to explain the variance in each indicator  $\geq 50\%$ . A reliable measurement model is a model with a Cronbach's Alpha and *Composite Reliability* (CR) value of at least 0.7. In the table above, it is known that all latent variables have Cronbach's Alpha and *Composite Reliability* (CR) values  $\geq 0.7$ . This value reflects that all indicators on each latent variable are reliable or reliable in the measurement model. A suitable measurement model (*fit*), can also be seen from the value of convergent validity which represents that a set of indicators represents and underlies one latent variable. Convergent validity can be measured from the average value of variance extracted (AVE). The AVE value is at least 0.5. The analysis results as presented in the table above, show that all latent variables have an AVE value  $\geq 0.5$ . This reflects that all latent variables are valid, where each latent variable used is able to explain more than half of the variance of its indicators on average.

The structural model basically describes the causal relationship between latent variables in the study. This model shows the hypothesis testing that will be carried out where latent variables affect each other. Evaluation of a good structural model can at least be measured by the coefficient of determination ( $R^2$ ) and predictive relevance ( $Q^2$ ). The results of the structural model evaluation are presented below:

**Table 2. Structural Model Evaluation (Inner Model)**

Variables	R-Square	Q-Square
Innovation	0.430	0.422
Performance	0.634	0.627

Source: Data processed (2024)

In the table above, it is known that the innovation variable has an R value of 0.430. This value reflects that the internal environment and external environment variables have a moderate or sufficient influence to explain innovation by 43%. While the performance variable has an R value<sup>2</sup> of 0.634. This value reflects that the internal environment, external environment and innovation have a substantial or very good influence to explain the performance of MSMEs by 63%. The Q value<sup>2</sup> of the innovation variable is 0.422 and performance is 0.627, the value of the two variables is  $t > 0$ . This value indicates that the observed values have been well reconstructed so that the structural model used in this study has predictive relevance. In other words, the structural model with the data used has an accurate ability to predict the effect of internal and external environments on innovation, as well as the effect of internal and external environments through innovation on MSME performance.

Direct effect is a direct effect that occurs between latent variables on other latent variables without any mediator or intermediary variables between the two. The results of the direct effect test are presented below:

**Table 3. Direct Effect**

	Path Coefficient	T Statistic	P Values	Description
LI -> INO	0.227	2.525	<b>0.012</b>	<b>Accepted</b>
LE -> INO	0.495	5.615	<b>0.000</b>	<b>Accepted</b>
INO -> KU	0.368	4.890	<b>0.000</b>	<b>Accepted</b>
LE -> KU	0.384	4.566	<b>0.000</b>	<b>Accepted</b>
LI -> KU	0.172	2.480	<b>0.013</b>	<b>Accepted</b>

Source: Data processed (2024)

The results show that the Internal Environment (LI) on Innovation (INO) has a t statistic of 2.525 > 1.96 and p values < 0.05, which means that the Internal Environment (LE) has a direct effect on Innovation (INO) so that H<sub>1</sub> is accepted. The External Environment (LE) on Innovation (INO) has a t statistic of 5.615 > 1.96 and p values < 0.05 which means that the External Environment (LE) has a direct effect on Innovation (INO) so that H<sub>2</sub> is accepted. Innovation (INO) on performance (KU) has a t statistic of 4.890 > 1.96 and p values > 0.05, which means that innovation (INO) has a direct effect on performance (KU) so that H<sub>3</sub> is accepted. The Internal Environment (LI) on Performance (KU) has a t statistic of 2.480 > 1.96 and p values < 0.05, which means that the Internal Environment (LI) has a direct effect on Performance (KU) so that H<sub>4</sub> is accepted. Finally, the External Environment (LE) on Performance (KU) has a t statistic of 4.566 > 1.96 and p values < 0.05, which means that the External Environment (LE) has a direct effect on Performance (KU) so that H<sub>5</sub> is accepted.

Indirect effect is an indirect effect that occurs between latent variables on other latent variables through the mediator variable between the two. In this study, the mediator variable is innovation. The results of the indirect effect test are presented below:

**Table 4. Indirect Effect**

	Path Coefficient	T Statistic	P Values	Description
LI -> INO -> KU	0.084	2.232	<b>0.026</b>	<b>Accepted</b>
LE -> INO -> KU	0.182	3.552	<b>0.000</b>	<b>Accepted</b>

Source: Data processed (2024)

The results show that the effect of the Internal Environment (LI) through Innovation (INO) on Performance (KU) has a t statistic of 2.232 > 1.96 and p values < 0.05, which means that Innovation (INO) mediates the effect of the Internal Environment (LI) on Performance (KU) so that H<sub>6</sub> is accepted. The External Environment through innovation (INO) on Performance (KU) has a t statistic of 3.552 > 1.96 and p values > 0.05, which means that Innovation (INO) mediates the influence of the External Environment (LE) on performance (KU) so that H<sub>7</sub> is accepted.

#### 4.2 Discussion

### **The Effect of Internal Environment on Innovation**

The results of the analysis show that the internal environment has a positive and significant effect on innovation. The internal environment of an organization is basically all aspects that exist within the organization itself and can affect the organization's performance, culture, and ability to adapt and innovate. Robbins and Coulter (2020), suggest that the internal environment of an organization includes everything that exists within the organization and can affect its performance and success. This includes organizational culture, organizational structure, human resources, management systems, and business processes implemented in the organization.

The internal environment has a direct and significant influence on innovation because an organizational culture that encourages creativity, experimentation, and controlled risk-taking can be an incentive for employees to create new ideas and implement innovations in various aspects of the business. In addition, the ability of management to identify opportunities, allocate resources wisely, and provide the necessary support for innovation teams can affect the success rate of innovation. In addition, the presence of employees who are trained, knowledgeable, and have intrinsic motivation to innovate can be a major strength for MSMEs in generating creative solutions and overcoming business challenges including organizational structures that are flexible, open, and allow collaboration between units or departments that can facilitate the exchange of ideas and the development of innovation. The results of this study are in line with the results of research by Gendut Sukarno (2019), the company's external environment makes a positive contribution to the creativity of marketing strategies and there is a positive relationship between product innovation and marketing performance.

### **The Effect of the External Environment on Innovation**

The results of the analysis show that the external environment has a positive and significant effect on innovation. The external environment, which includes factors such as economic, technological, social, political, and legal conditions, has a significant impact on the ability of MSMEs to create and adopt innovations. Cantner et al. (2020) stated that the external environment can affect MSME innovation through several mechanisms. One of them is access to resources and information. A supportive environment such as the presence of good information technology infrastructure, access to a wide market, and strong collaboration networks can provide MSMEs with access to new knowledge, technology, and capital needed to innovate. Conversely, a non-conducive environment, such as regulations that hinder business growth or lack of access to capital, can be an obstacle for MSMEs in developing innovations.

Schumpeter (2021), revealed that competition in the external environment as an impetus for innovation. Strong competition in the market encourages MSMEs to look for new ways to differentiate themselves from competitors, develop more unique products or services, and improve operational efficiency to stay competitive. Therefore, a competitive environment can be a stimulus for MSMEs to continuously innovate to maintain or increase their market share. In addition, social and cultural factors also have a significant impact on MSME innovation. Fernández-Mesa and Alegre (2018), show that favorable social conditions such as a thriving entrepreneurial culture, strong collaboration networks between businesses and educational institutions, as well as support from the community and government, can encourage MSMEs to innovate. Conversely, stigma against business failure, lack of social support, or a culture resistant to change can hinder MSME innovation efforts. Technology is also an important factor in the influence of the external environment on MSME innovation.

The use of information technology, such as the internet, mobile applications, and e-commerce platforms, can open up new opportunities for MSMEs to create digital products or services, develop new business models, or improve operational efficiency. In addition, technological developments can also trigger the adoption of innovations, such as cloud computing technology, big data analytics, and artificial intelligence, which can assist MSMEs in improving their performance and competitiveness (Teece, 2019). The results of this study are in line with the results of Gendut Sukarno's research (2019), the company's external environment makes a positive contribution to the creativity of marketing strategies and there is a positive relationship between product innovation and marketing performance.

### **The Effect of Innovation on MSMEs Performance**

The results of the analysis show that innovation has a positive and significant effect on performance. Innovation is basically a process or activity that generates new ideas, products, services, or business processes that provide added value which will certainly bring significant changes in business. Tidd et al. (2017), explain that innovation is a process in which new ideas are discovered, developed, and implemented in products, services, or business processes that provide added value and provide competitive advantages to the organization. Meanwhile, Chesbrough (2019) defines innovation with open innovation theory, which describes collaboration between companies, research institutions, and communities in producing faster and more effective innovations. It can be said that innovation is a dynamic process of creating new ideas and developing ideas and collaboration with various parties to produce innovative solutions and provide competitive advantages for the organization. Innovation is not only important in creating added value, but also in maintaining a superior position in a changing market.

Innovation directly has a significant effect on MSME performance because innovation encourages MSMEs to develop unique products or services that are difficult for competitors to imitate, creating a sustainable competitive advantage. Innovation greatly helps MSMEs to improve operational efficiency, reduce production costs, and increase productivity. Through innovation, MSMEs are encouraged to develop a variety of new products or services, reducing business risk because they do not rely on only one product in one market. Innovation will also encourage MSMEs to be more responsive to changes in market trends, consumer needs, and business regulations. This research is in line with the results of research conducted by Sulastini, Fariansyah, Husnurrofiq (2021); Muhammad Badar (2022); Eliora Lorensa, Nur Hidayah (2022), which also shows that innovation has a significant effect on MSME performance. These results also prove that product innovation, market orientation and social media have a major contribution to the performance of MSMEs.

### **The Effect of Internal Environment on MSMEs Performance**

The results of the analysis show that the internal environment has a positive and significant effect on performance. Internal environments such as leadership, organizational structure and human resources are factors that can affect the efficiency, productivity and ability of an organization to achieve its business goals. Thompson et al. (2021), suggest that a supportive internal environment will help MSMEs to formulate and implement appropriate business strategies, including product development, marketing, and market expansion that are relevant to market needs and organizational competitive advantages.

Elements of the internal environment such as an efficient organizational structure, good supply chain management, and proper use of information technology can improve the operational efficiency of MSMEs, which in turn contributes to the overall performance of the firm. In addition, an internal environment that promotes innovation, creativity, and responsibility for creating new solutions can help MSMEs to differentiate themselves from competitors, develop more unique products, and meet evolving market needs. Another important factor is that a customer service-oriented organizational culture, effective management systems, and well-trained employees will be able to improve MSME performance through service quality in relationships with consumers and customers, which will have a positive impact on customer loyalty and business reputation. The results of this study are in line with the results of research by Slamet Riyanto (2018), showing that the company's internal environment has a significant influence on the performance of MSMEs. The results of this study prove that a good understanding of the business environment will help MSMEs face challenges and take advantage of opportunities to improve their performance including encouraging competitive advantage and marketing performance.

### **The Effect of External Environment on MSMEs Performance**

The results of the analysis show that the external environment has a positive and significant effect on performance. All factors outside the direct control of the organization that can affect business operations, decisions, and performance constitute the external environment. These factors include economic, political, social, technological, and legal conditions that exist in the environment around the

company. Stinchcombe (2021) suggests that the external environment can act as a source of opportunities or threats for MSMEs, depending on how MSME actors can identify and respond to these environmental dynamics.

MSME performance is directly and significantly influenced by the external environment as it affects market demand, consumer needs, and the level of competition in the industry. Changes in market trends, the emergence of new competitors, or competitor strategies will certainly have a positive impact on MSME performance. In addition, changes in government regulations and policies also greatly affect MSME business operations, be it in terms of licensing, taxes, or environmental standards. Fair and conducive legal practices will certainly support the growth of MSMEs. Technological developments, such as digitalization, IoT, or AI, also provide new opportunities for MSMEs to improve efficiency, develop new products, or create innovative business models. The results of this study are in line with the results of research by Neli Anggraini, Vicky F (2021); Lino Pereira, Tutri Hanggari (2022), which show that the external environment has a significant influence on MSME performance. The results of this study prove that a good understanding of the business environment will help MSMEs face challenges and take advantage of opportunities to improve their performance, including encouraging competitive advantage and marketing performance.

### **The Mediating Role of Innovation on the Effect of Internal Environment on MSMEs Performance**

The analysis results obtained show that innovation mediates the influence of the internal environment on MSME performance. This result indicates that innovation has a crucial role as a mediator between the internal environment and MSME performance. The internal environment of MSMEs includes factors such as organizational culture, organizational structure, human resources, management systems, and business strategies that exist within the company. The role of innovation as a mediator in the relationship between the internal environment and MSME performance is crucial because innovation not only helps improve operational efficiency and productivity, but also forms a strong foundation for MSME business growth and sustainability. The study results of Rahman, A., & Ali, M. (2020), show that innovation plays an important mediating role between internal environments such as management systems and internal policies, and the performance of MSMEs in Bangladesh. Data from a survey of MSMEs provides strong empirical support for the positive relationship between innovation and performance in the context of diverse internal environments.

The role of innovation as a mediator is its ability to stimulate a culture of innovation within MSMEs. By encouraging a strong culture of innovation, MSMEs can create a creative work environment, be open to new ideas, and encourage employees to contribute to improving business processes and product development. This can lead to increased productivity, employee motivation, and the ability of MSMEs to adapt to changes in the internal and external environment. In addition, innovation also acts as a mediator in influencing the organizational structure and management system of MSMEs. Through innovations in business processes, information technology, and human resource management, MSMEs can improve operational efficiency, reduce costs, and increase speed in making decisions. Innovation can also assist MSMEs in developing business strategies that are more adaptive and responsive to market changes and competition, thereby improving the competitiveness and overall performance of the firm.

The role of innovation as a mediator between the internal environment and MSME performance is also evident in its ability to optimize the use of human and financial resources. Through innovation in human capital development, MSMEs can improve employee skills and motivation, increase labor retention, and create a work environment that enables greater collaboration and creativity. Innovation can also help MSMEs manage and allocate financial resources more effectively, by identifying profitable investments and reducing waste in operations.

Innovation also has a significant impact on the development of MSME products and services. By continuing to innovate in product development, MSMEs can produce products that are of higher quality, innovative, and in line with market needs. This can increase the attractiveness of MSME products, increase market share, and open up opportunities for business expansion. In addition, innovations in service delivery can also improve customer experience, strengthen customer

relationships, and create a sustainable competitive advantage for MSMEs. However, the role of innovation as a mediator between the internal environment and MSME performance does not happen automatically. MSMEs need to have a structured innovation strategy, investment in research and development, support from visionary management, and a work culture that supports experimentation and learning. In addition, collaboration with research institutes, universities and industry partners can also help MSMEs access the knowledge and resources needed for sustainable innovation.

### **The Mediating Role of Innovation on the Effect of External Environment on MSMEs Performance**

The results of the analysis obtained show that innovation mediates the influence of the external environment on the performance of MSMEs. These results indicate that innovation plays a very important role as a mediator between the external environment and MSME performance. This is evident in various studies, such as the results of research conducted by Sun, et al (2023), this study confirms that innovation plays a significant mediating role in linking environmental factors with MSME performance in Vietnam. This shows that innovation is not only a response to the environment, but also an important link between the external environment and business performance.

The dynamic and changing influence of the external environment such as government policies, market conditions, technology, competition, and other economic factors can be a big challenge for MSMEs as they often have limited resources and less accessibility compared to large enterprises. However, innovation can be the bridge that connects MSMEs to their external environment, helping them adapt, survive, and even thrive amidst such challenges. For example, when there are government policy changes that affect regulations or taxes for MSMEs, innovation can help them find new solutions or develop more efficient strategies to keep operating and maintain profits. Innovation can also help MSMEs adapt their products and services to the constantly changing needs and preferences of the market. By continuously innovating, MSMEs can maintain their competitiveness, even in the midst of intense competition with large enterprises or other global competitors.

Innovation plays an important role in improving the efficiency and effectiveness of MSME operations. By adopting new technologies, production processes can be improved, costs can be reduced, and productivity can be increased. This is particularly important for MSMEs that often have to work with limited resources. For example, the use of information and communication technology (ICT) and social media can help MSMEs increase accessibility, improve customer service, and even open up new opportunities in terms of product marketing and distribution. Thus, innovation not only helps MSMEs survive, but also opens up new opportunities for growth and expansion. In addition, innovation also plays a role in creating added value for MSMEs. By continuously developing innovative products and services, MSMEs can attract new customers, expand their market share, and even increase customer loyalty.

Innovation will help MSMEs differentiate themselves from competitors and create a strong brand image, which in turn can increase market attractiveness and help MSMEs maintain their competitive advantage. However, the role of innovation as a mediator between the external environment and MSME performance does not happen automatically. MSMEs need to have a strong culture of innovation, sufficient resources, and accessibility to knowledge and technology required to develop innovations in a sustainable manner. In addition, support from the government, financial institutions, and the local business ecosystem can also help create conducive conditions for MSMEs to innovate and grow.

## **5. Conclusion and Suggestion**

### **5.1 Conclusion**

The results of this study concluded that: *first*, the internal environment has a positive and significant influence on innovation; *second*, the external environment has a positive and significant influence on innovation; *third*, innovation has a positive and significant influence on MSMEs performance; *fourth*, the internal environment has a positive and significant influence on MSMEs performance; *fifth*, the external environment has a positive and significant influence on MSMEs performance; *sixth*, innovation mediates the influence of the internal environment on MSMEs

performance; and *seventh*, innovation mediates the influence of the external environment on MSMEs performance.

## 5.2 Sugesstion

Innovation needs to be carried out by MSMEs to improve their performance by utilizing the potential and opportunities of their internal and external environment. This can be done by creating a strong culture of innovation within the organization by encouraging employees to think creatively, share ideas, and create a work environment that supports experimentation and learning. MSMEs players must also provide training and development to employees to improve their skills and knowledge in technology, management, and innovation strategies. In addition, MSMEs should utilize information and communication technology (ICT) to improve operational efficiency, collect relevant data for innovation analysis, and facilitate internal collaboration. Equally important, MSME players should establish partnerships and collaborations with research institutions, universities and other institutions to access knowledge, technology and resources that can support innovation. As well as building and strong business networks with partners, suppliers, and customers to gain insights, feedback, and collaboration opportunities that can accelerate the innovation process.

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