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# THE MEDIATING ROLE OF ORGANIZATIONAL CAPABILITY IN SMES' BUSINESS PERFORMANCE

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**ABSTRACT:** Firms in developing economies operate under persistent pressure from volatile competition, inflationary dynamics, infrastructural constraints, and regulatory rigidity. This study advances the literature by positioning organizational capability as an endogenous mediating mechanism that explains how external environmental conditions are converted into firm-level performance outcomes in a traditional manufacturing B2B context. Using a quantitative design, data were collected from 212 embroidery SMEs through random sampling and analyzed using descriptive and inferential techniques. The analysis indicates that organizational capability conditions the extent to which environmental pressures are associated with variations in business performance, suggesting that firms with stronger internal capabilities are more able to coordinate resources, process information, and align differentiated offerings with customer demands.

**Keywords**:Business Environment; Organizational Capability; Business Performance; SMEs

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## INTRODUCTION

Fundamental organizational performance is determined by organizational capabilities such as "routine" or "process" operations (Eisenhardt & Martin, 2017). Alegre and Chiva argue that superior organizational learning capabilities result in enhanced innovation performance (Alegre & Chiva, 2008). Entrepreneurs can strategically realign and integrate financial, human, and relational resources to foster greater innovation capacity, thereby generating competitive advantages and enhancing organizational performance (Hirunyawipada & Zolfagharian, 2015). According to Meinhardt et al. (2018), Business environment is constantly changing and has a continuous impact on organizational activities. Therefore, organizations need to actively analyze and adapt to maintain competitiveness and achieve success.

A positive business environment can enhance operational strategies, which in turn improve operational performance. However, direct impact business environment on operational performance can be negative or insignificant unless mediated by effective operational strategies (Masudin et al., 2024). Business environment, characterized by factors such as access to finance, human capital, electricity, and internet, significantly affects firm performance (Qiang et al., 2021). Elements like ease of doing business, government policies, and infrastructure play crucial roles in shaping business outcomes (Dehghan Shabani & Parang, 2019). Concerning this phenomenon, the author is curious as to the extent to which the business environment influences the performance of the embroidery industry in Bandung.

Bandung is one of the Western Java cities, known as the Paris of Java. Bandung is also known as the culinary tourism and fashion capital of Indonesia. The SMEs City of Bandung is responsible for as much as 80 percent of the contribution to the PDB of Bandung. In 2018, there were approximately 4,043 industrial units dispersed across the urban area of Bandung City. 74 percent (2,987 units) of the total industrial units are small industry, while 26 percent are large industry (1056 units). Among urban industries, the textile and textile products, food and beverage, and printing sectors demonstrate the most extensive presence across the city. (Disdagin *Kota Bandung*, 2019).

The Textile Industry and Textile Products (TPT) are one of the sectors that play a significant role in the national economy due to their substantial contribution. The rise in population was followed by an increase in average income per person, which resulted in an increase in the amount of clothing purchased. This demonstrates that the expansion of the TPT industry has tremendous potential due to the fact that it is one of the fundamental requirements of human beings. The embroidery business is a segment of the Textile, Printing, And Textile Processing (TPT) industry. The outbreak of COVID-19 has intensified business competition while simultaneously reducing the purchasing power of the general population. Consequently, the offender is expected to be able to defend his actions. TPT industry is prioritized in the Making Indonesia 4.0 Industry Roadmap, it has the potential to contribute up to 18.67% in 2019. The contribution of the TPT industry decreased between 2020 and

2021 due to the spread of COVID-19. In spite of this, the number of border businesses in Bandung has increased along with the COVID-19 outbreak.

## THEORETICAL REVIEW

*Business Environment*

The business environment plays an important role in maintaining the economic and social stability of a country. The development of this environment can help reduce economic and social problems, especially in countries undergoing economic transition, and create conditions that support sustainable economic growth. Consequently, improving the quality of people's lives is also influenced by progress in the business environment.

This improvement is largely driven by economic dynamics which, if managed effectively, will encourage business activity and economic development. On the other hand, a management system is needed that can positively influence the business environment, increase the number of business actors, implement efficient economic instruments, and build productive relationships between the state and the business sector (Kyuregyan, 2025).

The business environment includes various factors that affect the effectiveness and smoothness of a company's operations. The main goal of a business organization is to maximize opportunities and overcome challenges that arise in the work environment. Therefore, analysis of the business environment is crucial for a company to survive and thrive in its industry. Managers need to understand the work culture of the organization before developing a superior business strategy. The ability to face competition is an important basis for designing a strategy, because every step taken depends on understanding competitors (Upadhyay & Sachdeva, 2024). Conventional management systems are no longer able to cope with the dynamics of environmental change. A company's performance is largely determined by its ability to respond to challenges arising from increasingly uncertain, complex, and turbulent external conditions. Therefore, companies need to continuously monitor, analyze, and evaluate their external environment (H.K. Ho, 2014)

Environmental business indicator need to be considered. Carvalho et al. (2016) have identified complexity, dynamism and munificence. Chen et al. (2017); Harrington & Kendall (2005); Rueda-Manzanares et al. (2008) supported the supports the same indicators. Complexity refers to the number and diversity of factors in the environment that Rosenbusch et al. (2007)  Dynamism is the rate and unpredictability of change within the environment. Dynamism can increase the likelihood of firms adopting environmentally responsible behaviors, especially in firms with low levels of organizational slack. It also influences strategic orientations, with dynamic environments encouraging more entrepreneurial approaches. However, its direct impact on performance is often non-significant. Harrington & Kendall (2005); Rueda-Manzanares et al. (2008); Rosenbusch et al. (2007); Hartmann & Vachon (2018); Gul (2019) Munificence refers to the availability of critical resources in the environment that support firm growth and stability. Munificence positively impacts firm performance by

providing abundant resources that firms can leverage to improve their environmental management capabilities. It also moderates the relationship between business orientations and innovativeness, with more munificent environments enhancing the impact of entrepreneurial orientation on innovation. Following the study there is the hypothesis:
*H1: The business environment influences business performance*

*Organizational Capability*

Research findings on the relationship between organizational capabilities and performance, particularly in the context of innovation, information technology, and communication. They also emphasize the importance of technology-enabled information management capability and its role in developing other firm capabilities for improved performance (Lukhmanov & Tsakalerou, 2026; Nwabueze & Mileski, 2018). Organizational capability refers to the ability of an organization to effectively utilize its resources to achieve strategic goals and enhance performance (Inan, 2024). Meanwhile Kemper & Brettel (2015); Inan (2024); Fujimoto et al. (2022); Hajar (2012); Bamel & Bamel (2018) explain organizational capability indeed encompasses the sum of all process value added (steady flow) and the effective management of production resources. This capability is built on the efficient flow of materials and information, dynamic reconfiguration of resources, and strategic management of both technical and social resources. The integration of these elements enables organizations to achieve sustained competitive advantage and enhanced performance.

In the article Talib & Keung (2024) organizational capabilities are expected to influence organizational performance directly. The article investigated the impact of organisational capabilities on the research and development (R&D) project innovation performance. Indicator used technological marketing, customer relationship management, and management capabilities. Another source Muthuveloo et al. (2021) reviews about the findings indicated that organisation capabilities have a significant influence on organisation performance, and it is contributed by eight dimensions comprises of technology capability, dynamic capability, marketing capability, innovation capability, information technology capability, knowledge management capability, learning capability and management capability.

Nwabueze & Mileski (2018) explain communication capability is about effective communication crucial for maintaining performance success, especially in a multicultural and competitive global environment. Emphasized the importance of effective communication in building and maintaining performance success, as well as its impact on customer satisfaction, innovation, employee motivation, and crisis response. Talib & Keung (2024) highlight the significance of marketing capability in influencing organizational performance, particularly in the context of R&D project innovation performance. Mithas & Ramasubbu (2011) and Pinho & Ferreira (2017) Information technology capabilities play a fundamental role in process innovation and organizational performance. The abstracts suggest that IT capabilities contribute to firm

performance by developing other firm capabilities for customer management, process management, and performance management. Lukhmanov & Tsakalerou (2026) explain the capability of organizational innovation is essential for achieving higher competitive performance. The abstracts discuss the determinants of organizational innovation capability and its impact on organizational performance, emphasizing the importance of innovation-enabling technologies in improving market position and financial performance. Widjaja et al. (2020) Information technology and innovation in information technology have been found to affect organizational performance. The abstracts indicate that the usage of information technology can improve organizational performance, particularly in publicly listed companies.
*H2: Organizational capability influences the business performance.*

*Business Performance*

Business performance is a multifaceted concept often seen as an indicator of an enterprise's results and effects (Rajnoha & Lesníková, 2016). It encompasses the ability to adapt to environmental changes, leverage opportunities, and achieve better outcomes. Performance is typically measured through various dimensions, including financial results, customer satisfaction, internal processes, and learning and growth. Additionally, it is crucial to consider both financial and non-financial indicators to get a comprehensive view of business performance (Yüksel & Dağdeviren, 2010).

Banker et al. (2004) explain the Balanced Scorecard (BSC) is a strategic management tool that integrates financial and non-financial performance measures to provide a holistic view of organizational performance. It evaluates performance across four key dimensions: 1) Financial perspective measures related to financial performance, such as profitability, return on investment, and revenue growth; 2) Customer perspective used indicators of customer satisfaction, retention, and market share; 3) Internal business process metrics that assess the efficiency and effectiveness of internal processes; and 4) Learning and Growth measures related to employee satisfaction, innovation, and organizational learning
*H3: organizational capability influences business performance.*

Organizational capabilities play a crucial moderating role in the relationship between the business environment and business performance. By enhancing strategic responsiveness, fostering innovation, and enabling agility, these capabilities help firms leverage environmental opportunities and mitigate risks, leading to improved performance (Alaskar, 2023; Felipe et al., 2020). All hypotheses are displayed in Figure 1, as well as the following hypothesis.
*H4: Organizational capability moderates the influence of the business environment on business performance.*

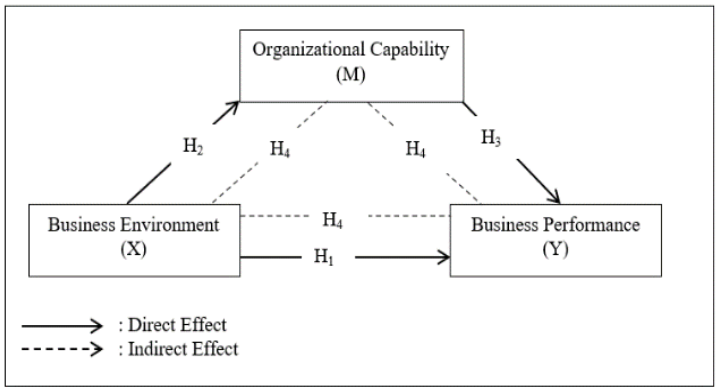


Figure 1. Research Model

## RESEARCH METHOD

*Research Design*

This research study employs descriptive and associative methods of inquiry. In this study, descriptive research clarifies the characteristics and functions of the variables, specificall the business environment and organizational capabilities. This study was conducted in the city of Bandung, Indonesia, and the entrepreneur of Bandung embroidery industry was the subject of the study. Data collection techniques include the dissemination of questionnaires and interviews. This study utilizes primary data in the form of tabulations of respondents' questionnaire responses. This study employs the variables business environment, organizational capability, and business performance as independent variables. The operational variables used are : a) Business environment variable among them production cost, availability of resources, product availability, taste change, consumer preferences, environmental changes, consumer needs, consumer tastes, increasing competence, technological changes, socioeconomic issues Carvalho et al. (2016); b) Organizational capability variable among them content consistency, Support and Recovery, Service advantage, Competitive advantages, customer satisfaction, Personnel Capability, Equipment Capability, Development and introduction of new products, services, new procedures or processes, Information Networks, and External Environment (Muthuveloo et al., 2021); c) Business performance variable among them profit growth, asset growth, customer complaint, customer loyalty, new customer, use of raw materials, production procedures, employee competency, labor turnover (Sreenath & Bagodi, 2017).

*Research Stages*

This quantitative research is conducted systematically to measure and analyze the relationship between variables with numerical data. The first stage begins with identifying the problem, which is formulated into research objectives and questions. Next, a theoretical study is conducted to support conceptual understanding and to develop a framework for thinking and hypotheses. After

that, the researcher determines the research method, including the type of data, population and sample, data collection techniques in the form of questionnaires, and instrument validity and reliability tests. The data collected are then analyzed using descriptive and inferential statistics to test the formulated hypotheses. The results of the analysis are discussed in the discussion section, by linking the findings to relevant theories. This research is then closed with conclusions and suggestions, as well as the preparation of a final report containing all stages in a structured manner.

*Population And Sample Research*

This research study population is Bandung SMEs embroidery specialists, Indonesia. This sample consists of 212 SMEs embroidery. In this study, a simple random sample was used to represent all elements of the population under consideration, and each element had an equal chance of being selected as a subject (Sekaran & Boogie, 2016).

*Data Analysis*

These research study data analysis techniques use of the Structural Equation Model-Partial Least Square (SEM-PLS) with the SmartPls 3 program. Two measurement models comprise the research design: the outer model and the inner model. The reliability, discriminant validity, internal consistency, and convergent validity of indicator values are considered when evaluating external models. Using a determination coefficient, the internal model is evaluated.

## RESULTS

As in Table 1, the business environment variable falls into the advanced category (4,37) with a score about 4,01-5,00. This indicates that the embroidery entrepreneur in Bandung city, Indonesia, has access to a favorable business environment that fosters the growth of the company despite a number of external challenges.

Table 1. The Illustration of Variable Research

| No | Variable | Sub Variable | Average | Category |
|---|---|---|---|---|
| 1 | Business Environmental | Environmental Muniicience | 4.56 | 4.37 |
| | | Environmental Dynamism | 4.45 | Advanced |
| | | Environmental Complexity | 4.20 | |
| 2 | Organizational Capability | Communication Capability | 4.54 | Advanced |
| | | Marketing Capability | 4.12 | |
| | | Technological Capability | 3.44 | |
| | | Innovative Capability | 4.14 | |
| | | Informational Capability | 4.53 | |
| 3 | Business Performance | The Finansial Perspective | 2.78 | Moderate |
| | | Customers' Perspective | 3.55 | |
| | | Perspective on The Internal Business Process | 3.41 | |
| | | Perspective on Development | 2.85 | |

*Outer Model Measurements*

According to Figure 2 of the PLS algorithm above, the outer loading indicator value is X1.1, X1.2, X2.2, X2, X3.3, M3.1, M3.2, M4.3, Y2.1, Y2.2, Y2.3, Y4.1 > 0.5. Consequently, each latent variable has been able to explain the variance of each indicator that measures > 0.5, indicating that the indicator's variable must be identified.

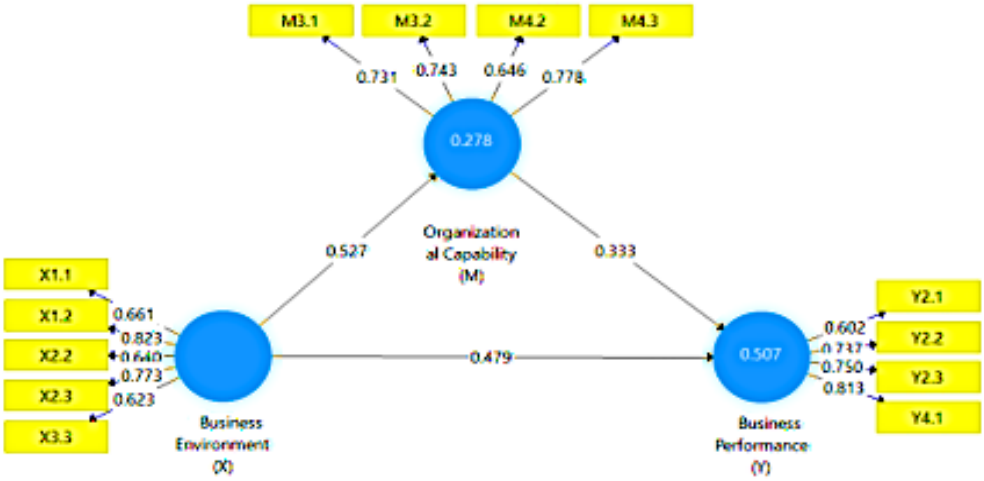


Figure 2. PLS Algorithm

Table 2 of the discriminant validity values reveals that the correlation value of the Fornell-Lacker criterion for each indicator of each construction is the highest when compared to the correlation values of the other constructions. Therefore, every construction already possesses good discriminant validity or can be considered valuable.

Table 2. The Discriminant Validity Values

| Construct | Business Environment (X) | Organizational Capability (M) | Business Performance (Y) |
|---|---|---|---|
| Business Environment (X) | 0.708 | | |
| Organizational Capability (M) | 0.527 | 0.726 | |
| Business Performance (Y) | 0.654 | 0.585 | 0.730 |

Table 3 reveals the level of internal consistency demonstrates that all constructions satisfy the reliability criterion. This is supported by the fact that both of the Composite reliability and Cronbach's alpha are greater than 0.60, indicating a high level of internal consistency.

Table 3. The Internal Consistency Values

| Construct | Cronbach's Alpha | Composite Reliability |
|---|---|---|
| Business Environment (X) | 0.747 | 0.833 |
| Organizational Capability (M) | 0.706 | 0.816 |
| Business Performance (Y) | 0.705 | 0.818 |

The AVE value in the table 4 above indicates that the square root value of the three AVE constructs exceeds the minimum criterion of 0.50. This means that the measure of convergent validity is good or meets the criteria for convergence validity.

Table 4. The Convergent validity Values

| Construct | Average Variance Extracted (AVE) |
|---|---|
| Business Environment (X) | 0.502 |
| Organizational Capability (M) | 0.527 |
| Business Performance (Y) | 0.532 |

*Inner Model Measurement*

As in table 5, it can be concluded that the coefficient of determination or Adjusted R-square ($R^2$) organizational capability (M) values of 0.271, or 27.10%, and business performance (Y) values of 0.498, or 49.80%, represent the contributions of organizational capability and business performance variables.

Table 5. The Coefficient of Determination Values

| Construct | R Square | R Square Adjusted |
|---|---|---|
| Organizational Capability (M) | 0.278 | 0.271 |
| Business Performance (Y) | 0.507 | 0.498 |

The larger the endogenous structure that can explain the dependent structure and the more complex the structural equation, the greater the R-squared adjusted value. From this adjusted R-square, the following formula can be used to calculate the value of $Q^2$:

The value of $Q^2$ $= 1- (1-R_1^2) (1-R_2^2)$ ….(1)

$= 1 – (1-0.271) (1-0.498)$

$= 0.634042$

$= 63.40\%$

Based on the results of the $Q^2$ we estimate that the connection between constructions was 91.47 percent. This shows that the observed values have been correctly reconstructed and that the model is good at making predictions because Q2 is higher than nil which shows that the model is good at predictive relevance.

*Hypothesis Testing*

Using as many as 500 resamples to load the statistical t-value derived from the bootstrapping procedure of 212 respondents. The following results back up the idea that the effect of the business environment on business performance is mediated by organizational capabilities.

Table 6. Testing the Direct Effect Hypothesis

| Paths | Effect | *t*-value | CR | *p*- values |
|---|---|---|---|---|
| Business Environment -> Business Performance | 0.479 | 6.708 | | 0.000 |
| Business Environment -> Organizational Capability | 0.527 | 10.382 | 1.96 | 0.000 |
| Organizational Capability -> Business Performance | 0.333 | 3.957 | | 0.000 |
| Business Env. -> Org. Capability->Business Performance | 0.175 | 3.488 | 1.96 | 0.001 |

## DISCUSSION

The results reported in Table 6 demonstrate that the business environment exerts a significant direct influence on business performance, confirming that external pressures such as market competition, regulatory rigidity, and macroeconomic instability remain decisive forces shaping firm outcomes in developing economies. This finding aligns with prior evidence that environmental turbulence constrains strategic discretion and amplifies operational risk, particularly for small and medium manufacturing enterprises operating with limited buffers (Kyuregyan, 2025; Nwabueze & Mileski, 2018). In such contexts, performance is rarely insulated from external shocks, reinforcing the argument that environmental conditions function not merely as background variables but as active determinants of firm viability (Rajnoha & Lesníková, 2016; Qiang et al., 2021).

More importantly, the significance of organizational capability in the direct-effect model indicates that internal capability structures exert an independent influence on performance, beyond environmental constraints. This result resonates with capability-based and resource orchestration perspectives, which argue that firms convert heterogeneous resources into performance outcomes through coordinated routines, managerial cognition, and information-processing capacity (Hillmann & Guenther, 2021; Kemper & Brettel, 2015). For manufacturing SMEs, particularly in traditional sectors, organizational capability manifests less through technological sophistication and more through adaptive coordination, relational capital, and operational discipline (Rosenbusch et al., 2007; Widjaja et al., 2020). The findings thus extend prior studies by empirically situating organizational capability as a performance driver even under adverse environmental conditions.

The pattern observed in Table 6 also supports emerging scholarship that positions organizational capability as a stabilizing mechanism in volatile business environments. Studies on resilience and adaptive capacity emphasize that firms capable of sensing environmental signals and reconfiguring internal processes are better positioned to sustain performance under uncertainty (Hillmann & Guenther, 2021; Hartmann & Vachon, 2018). In manufacturing SMEs, this capability often materializes through informal coordination, experiential learning, and incremental innovation rather than formalized systems (Masudin et al., 2024; Inan, 2024). The present findings echo this logic by showing that capability strength directly corresponds with performance outcomes, even before accounting for indirect or mediating pathways.

From a contextual standpoint, the embroidery manufacturing industry presents a particularly relevant setting for examining these relationships. As a labor-intensive and demand-sensitive B2B sector, embroidery SMEs are exposed to price volatility, buyer power asymmetries, and shifting design preferences, all of which intensify environmental pressure (Kyuregyan, 2025). The significant direct effects identified in Table 6 suggest that firms operating in such environments cannot rely solely on favorable market conditions but must actively cultivate organizational capabilities that enable responsiveness, differentiation, and operational efficiency (Talib & Keung, 2024; Liu & Zhang,

2024). This observation reinforces earlier arguments that competitive advantage in traditional manufacturing sectors is increasingly capability-driven rather than scale-driven (Rueda-Manzanares et al., 2008; Pinho & Ferreira, 2017).

Taken together, the evidence from Table 6 implies that business performance emerges from the joint operation of environmental forces and internal organizational capabilities, with neither acting in isolation. While the business environment imposes structural constraints, organizational capability determines how effectively firms absorb, interpret, and respond to these constraints (Makhloufi et al., 2024; Sreenath & Bagodi, 2017). Rather than neutralizing environmental pressures, capability appears to recalibrate their impact on performance, suggesting a conditional and dynamic relationship. This interpretation advances existing empirical work by clarifying that organizational capability is not merely a residual internal factor but a central mechanism shaping firm outcomes in resource-constrained industrial settings (Hardiana & Ridho'i, 2022; Qiang et al., 2021).

## FURTHER STUDY

Based on the results of data analysis, the impact of the business environment on business performance can be mediated by organizational capabilities both directly and indirectly. Organizational capability is one of the driving forces in obtaining a competitive advantage for a business, i.e., the ability to effectively manage resources and information that can help the organization focus on satisfying customer demands with its distinctive products and services. So, the SMEs embroidery in Bandung must be able to manage organizational capabilities well. If this is done well and efficiently, the SMEs embroidery can bring together its people and other resources to respond to changes in the business environment and provide value to customers and other stakeholders.

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