

# Enhancing MSME Performance through Dynamic Capabilities and Entrepreneurial Orientation: The Mediating Role of Transformational Leadership

Che Mohd Syaharuddin Che Cob., Hatinah Abu Bakar\*, Wan Marhaini Wan Omar., Mas Ayu Diana Mohd Fauzi

Faculty of Business and Management, Universiti Teknologi MARA Cawangan Kelantan Kampus Machang

\*Corresponding Author

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## ABSTRACT

Micro, Small, and Medium-sized Enterprises (MSMEs) are the foundation of the economy, driving long-term economic growth, job creation, and innovation. They account for most firms in most nations and make considerable contributions to national GDP, export revenues, and community development. Considering dominance in the national economy, the profitability and long-term viability of MSMEs are inseparably linked to the quality of leadership within these businesses. Effective leadership plays a pivotal role in guiding strategic direction, fostering innovation, managing limited resources, and navigating volatile market conditions. Hence, this study aims to achieve two primary objectives: (i) to examine the impact of dynamic capabilities and entrepreneurial orientation on MSMEs performance, and (ii) to ascertain the mediating effect of transformational leadership on the relationship between dynamic capabilities, entrepreneurial orientation and MSMEs performance. A total of 146 responses were returned and found usable for final analysis using the PLS-SEM technique. The findings revealed that there is no significant direct effect between dynamic capabilities and MSMEs performance but there is a significant direct effect on entrepreneurial orientation on MSMEs performance. Furthermore, the results indicate that transformational leadership does not mediate the relationship between dynamic capabilities and entrepreneurial orientation with MSME performance.

**Keywords:** Dynamic capabilities, entrepreneurial orientation, transformational leadership, performance

## INTRODUCTION

Micro, Small, and Medium Enterprises (MSMEs) play a pivotal role in driving economic growth, fostering innovation, and generating employment across both developing and developed economies. As the backbone of many national economies, MSMEs contribute significantly to GDP, stimulate competition, and support local communities by creating diverse job opportunities. Despite their importance, MSMEs often face numerous challenges that can hinder their growth and sustainability, including limited access to capital, technology, skilled labour, and volatile market conditions. The National Entrepreneurship Policy 2030 (Dasar Keusahawanan Negara – DKN 2030) is a comprehensive long-term strategy introduced by the Malaysian government to develop a robust, inclusive and sustainable entrepreneurial ecosystem. Launched in 2019 by the Ministry of Entrepreneur Development and Cooperatives (KUSKOP), the policy aims to position Malaysia as an outstanding entrepreneurial nation by the year 2030. DKN 2030 outlines several core objectives, including creating a progressive and inclusive entrepreneurial society, strengthening the national entrepreneurial ecosystem, producing globally competitive entrepreneurs, and increasing the contribution of entrepreneurship to the national GDP. By 2030, the policy aims to significantly boost entrepreneurship's contribution to the national economy, including increasing the share of MSMEs to GDP to 50%, generating one million new entrepreneurs, and reducing dependency on public sector employment. DKN 2030 aligns with broader national development agendas such as the Shared Prosperity Vision 2030 (WKB 2030) and the New Industrial Master Plan (NIMP 2030). It plays a vital role in building a resilient, innovative, and inclusive economy driven by empowered

entrepreneurs across all segments of society. The National Entrepreneurship Policy 2030 promotes the development of dynamic capabilities, specifically the ability of entrepreneurs and firms to sense opportunities, seize them effectively, and reconfigure resources in response to rapidly changing market environments.

Dynamic capabilities allow businesspeople to create new business models and be more agile in adapting to changes with the resources they have. In addition, balancing external and internal collaboration is necessary to create a flexible and conducive organizational culture (Warner & Wäger, 2019). Dynamic capability allows businesses flexibility to combine and reorganise internal and external competencies respond to the environment in changed quickly (Aan et al., 2023). Dynamic capability strategies are highly aligned to agility, fast response as an adaptability, and malleability of adapt innovation and revolution for facing an environment of constant change, as well as ambidexterity (van de Wetering et al., 2020).

### **Theoretical Underpinning**

The study is theoretically grounded in the integration of the Resource-Based View (RBV) and Dynamic Capabilities Theory (DCT). From an RBV perspective, firms achieve sustained competitive advantage by leveraging internal resources that are valuable, rare, inimitable, and non-substitutable (Barney, 1991; Sun et al., 2024). In this context, Entrepreneurial Orientation (EO), comprising of innovativeness, proactiveness, and risk-taking, functions as a strategic resource that enables MSMEs to exploit market opportunities. However, while RBV explains the value of possessing these resources, DCT extends this logic by emphasizing that firms must continuously sense, seize, and reconfigure their resource base to maintain competitiveness in volatile markets (Açıkdilli & Ayhan, 2013).

The study further posits that Transformational Leadership serves as a vital dynamic capability that mediates the relationship between EO, dynamic capabilities, and MSME performance. Transformational leaders do not merely manage resources; they optimize their allocation and foster a culture of innovation, thereby amplifying the impact of EO on firm outcomes (Sajjad et al., 2023). Consequently, while RBV identifies EO and capabilities as the fundamental building blocks of success, DCT explains how transformational leadership dynamically integrates and reconfigures these assets to drive performance, particularly within uncertain environments. This theoretical synthesis offers a robust framework for understanding how leadership bridges the gap between strategic intent and organizational excellence.

## **LITERATURE REVIEW**

### **Business Performance**

Business performance, particularly within entrepreneurial ventures, is fundamentally an outcome of a firm's capacity to innovate, respond to market fluctuations, and leverage internal capabilities for sustained growth (Mahfud et al., 2020). As noted by Al Mamun et al. (2018), a comprehensive evaluation of performance requires a holistic perspective that integrates both financial metrics—such as revenue and profit margins and non-financial indicators, including customer loyalty, business expansion, and employee satisfaction. In the face of intensifying competition and environmental uncertainty, MSMEs must continuously adapt their strategies, operational processes, and product offerings to maintain a superior market position. Consequently, modern MSME performance is increasingly dictated by the synergy between internal capabilities, strategic orientation, and the agility to navigate external challenges (Ismail et al., 2021). Effective leadership, innovation, and digital adoption have emerged as critical enablers for enhancing MSME performance, particularly within emerging economies. Given the significant contribution of small and medium enterprises to the global economy, the literature emphasizes the need for specialized performance management frameworks tailored to their developmental needs (Ximena et al., 2020). Pereira et al. (2023) further argued that MSMEs derive substantial benefits from customized management systems that align with their lean organizational structures, resource constraints, and inherent strategic flexibility. Furthermore, recent research underscores that the synergy between entrepreneurial orientation and dynamic capabilities favorably impacts MSME performance by bolstering operational agility, innovation capacity, and long-term sustainability (Mahfud et al., 2020; Shamsudeen et al., 2022)

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## Dynamic Capabilities and Business Performance

Dynamic capabilities refer to a firm's ability to purposefully create, extend, or modify its resource base to respond to rapidly changing environments. These capabilities enable organizations to sense opportunities and threats, seize market opportunities, and transform or reconfigure internal competencies and structures to maintain competitiveness (Pezeshkan et al., 2023). According to Graham and Moore (2021), dynamic capabilities inform the firm's perceptions of a technological innovation's characteristics—such as complexity, compatibility, and relative advantage—which ultimately guide the adoption decision. This implies that firms with well-developed sensing, seizing, and reconfiguring abilities are more likely to engage in timely and strategic technology adoption. Past researchers agreed that dynamic capabilities serve to enhance the likelihood of organisational success within the currently prevailing context (Bailey & Breslin, 2020). A study done by Shamsudeen et al. (2022) found that dynamic capabilities significantly enhance the performance of micro-enterprises in emerging economies by enabling firms to respond proactively to environmental turbulence. In a similar vein, Eikelenboom and de Jong (2019) confirmed that Dutch SMEs with stronger dynamic capabilities are more innovative and achieve higher sales growth. Additionally, Jalali and Sardari (2021) highlighted that the integration of dynamic capabilities into strategic planning processes is positively associated with firm resilience and long-term sustainability in small firms. Hence, this hypothesis is proposed:

*H1: Dynamic capabilities have significant effect on business performance.*

## Entrepreneurial Orientation and Business Performance

Over the past three decades, entrepreneurial orientation has been widely recognized as a central construct in entrepreneurship and management research, attracting significant scholarly attention (Covin et al., 2019; Gupta, 2015). Adriani and Thaib (2024) examined how entrepreneurial orientation influences various indicators of company performance, including satisfaction and global competitiveness. The research suggests that a strong entrepreneurial orientation enables firms to be more responsive to market dynamics, leading to improved performance outcomes. Amalleshwari and Jeevitha (2024) demonstrated that entrepreneurial orientation contributes to sustainable business performance, underscoring entrepreneurial orientation critical role in ensuring long-term organizational success. Likewise, Hanna (2024) revealed that specific components of entrepreneurial orientation, such as innovativeness and competitive aggressiveness, positively impact innovative co-branding collaborations, ultimately leading to improved business performance outcomes. These findings collectively emphasize entrepreneurial orientation that can drive both sustainability and performance enhancements in business contexts. Hence, this hypothesis is proposed:

*H2: Entrepreneurial orientation has significant effect on business performance.*

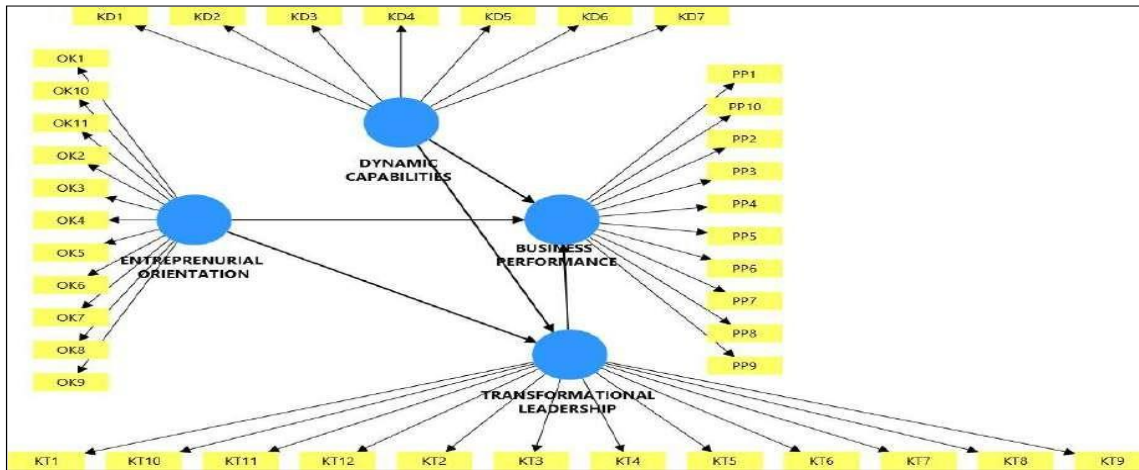
## Transformational Leadership as a Mediator

Transformational leadership induces the process of follower transformation in the sense that leaders can influence employees to embrace group goals through collective identification and value internalisation and build self-efficacy to adjust to the change (Siangchokyoo et al., 2020). Anwar et al. (2023) found that transformational leadership significantly enhances employees' job performance by fostering a higher level of organizational commitment. Nguyen et al. (2023) concluded that transformational leadership contributes to performance through mediating variables such as organizational commitment and knowledge sharing, particularly in emerging economies. According to Van Dun and Kumar (2023), managers' transformational leadership behaviour plays a crucial role in helping employees to recognise the advantages, overcome their worries, and develop confidence in the new technology. Transformational leadership has been shown to mediate the relationship between entrepreneurial orientation and firm performance, as it enables leaders to channel strategic orientation into visionary leadership that motivates teams to pursue innovation and long-term goals (Al-Mamary & Abdulrab, 2017). In small and medium-sized enterprises (SMEs), the lack of formal leadership development may weaken the emergence of transformational leadership behaviour, thereby limiting its role as an effective mediator (Puspitawati et al., 2020). Thus, these hypotheses are proposed:

H3: Transformational leadership mediates the relationship between dynamic capabilities and business performance.

H4: Transformational leadership mediates the relationship between entrepreneurial orientation and business performance.

Figure 1: Research Framework

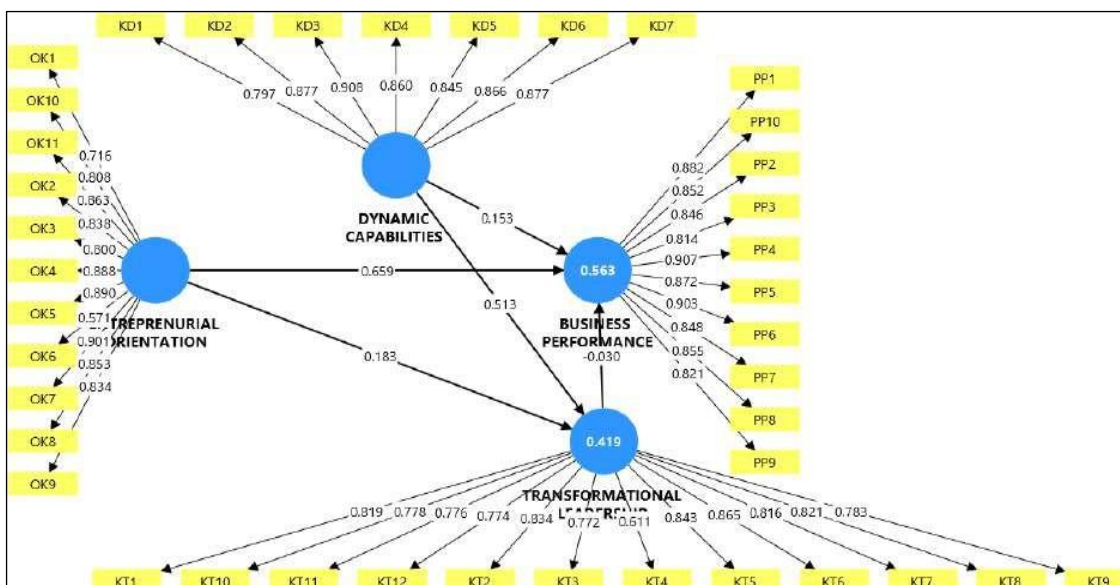


## METHODOLOGY

In order to evaluate the influence of dynamic capabilities and entrepreneurial orientation on MSMEs performance and ascertain the role of transformational leader as a mediator, primary data were obtained through a Google survey form utilizing an established questionnaire. The questionnaire was distributed to MSMEs located across various districts in Kelantan, Malaysia. Business owners and managers were singled out since they are the primary sources of information about the company. The survey instrument was adopted and adapted from a few selected published questionnaires and measured using a 5-point Likert scale ranging from strongly disagree to strongly agree. The measurement of dynamic capabilities was based on the instrument developed by Adhiatma et al. (2022). Entrepreneurial orientation was assessed using the scale originally proposed by Miller and Frisen (1982), while business performance was measured using indicators adapted from Wiklund (1999). Lastly, transformational leadership was measured using the scale developed by Bass and Avolio (2004).

## FINDINGS

Figure 2: Measurement Model



**Table 1: Measurement Result**

<b>Constructs</b>	<b>Items</b>	<b>Loadings</b>	<b>CA</b>	<b>CR</b>	<b>AVE</b>
Dynamic Capabilities	KD1	0.780	0.942	0.950	0.743
	KD2	0.864			
	KD3	0.911			
	KD4	0.855			
	KD5	0.851			
	KD6	0.877			
	KD7	0.888			
Transformational Leadership	KT1	0.818	0.946	0.954	0.629
	KT2	0.832			
	KT3	0.774			
	KT4	0.601			
	KT5	0.840			
	KT6	0.863			
	KT7	0.822			
	KT8	0.820			
	KT9	0.789			
	KT10	0.778			
	KT11	0.776			
Entrepreneurial Orientation	OK1	0.713	0.949	0.955	0.673
	OK2	0.833			
	OK3	0.796			
	OK4	0.885			
	OK5	0.893			
	OK6	0.561			
	OK7	0.905			
	OK8	0.859			

	OK9	0.839			
	OK10	0.811			
	OK11	0.866			
Business Performance	PP1	0.882	0.961	0.961	0.740
	PP2	0.846			
	PP3	0.814			
	PP4	0.906			
	PP5	0.872			
	PP6	0.903			
	PP7	0.848			
	PP8	0.855			
	PP9	0.821			
	PP10	0.852			

Based on the results of measurement model analysis, all constructs—Dynamic Capabilities, Transformational Leadership, Entrepreneurial Orientation, and Business Performance—demonstrate high levels of reliability and accuracy. The Cronbach’s Alpha (CA) and Composite Reliability (CR) values for all variables exceed 0.90, significantly surpassing the required threshold of 0.70 (Hair et al., 2019). These scores indicate that the survey questions consistently measure the intended concepts and possess high internal consistency (Nunnally & Bernstein, 1994).

Besides that, the Average Variance Extracted (AVE) for every construct is well above the 0.50 benchmark (Fornell & Larcker, 1981). This confirms that the model successfully represents the fundamental meaning of each variable, as the construct explains more than half of the variance of its indicators.

Regarding the specific indicators of KT4 (0.601) and OK6 (0.561), these items are kept in the study despite having scores below the ideal 0.70 mark. According to Hair et al. (2019), items with scores between 0.40 and 0.70 should only be removed if doing so significantly improves the overall reliability and AVE of the model. Given that the overall scores for Transformational Leadership (0.629) and Entrepreneurial Orientation (0.673) are already very strong, these specific items do not weaken the model. Furthermore, Hulland (1999) maintained that retaining these items is essential for supporting content validity, thereby ensuring a comprehensive representation of the construct. Since the overall quality of the data remains high, these items are considered both statistically acceptable and important for a thorough analysis.

Table 2: Heterotrait-monotrait ratio (HTMT)

Construct	Business Performance	Dynamic Capabilities	Entrepreneurial Orientation	Transformational Leadership
Business Performance				
Dynamic Capabilities	0.588			

Entrepreneurial Orientation	0.774	0.686		
Transformational Leadership	0.417	0.662	0.536	

In order to assess the measurement model, discriminant validity was examined. Following the recommendation of Henseler, Ringle, and Sarstedt (2015), the heterotrait-monotrait ratio of correlations (HTMT) was employed as a more robust approach for evaluating discriminant validity. The HTMT criterion involves comparing the HTMT values against established threshold levels. According to existing literature, a threshold of 0.85 is generally accepted (Clark & Watson, 1995; Kline, 2011), while Voorhees et al. (2016) suggested that a threshold of 0.90 can also indicate the absence of discriminant validity concerns. As shown in Table 2 above, all HTMT values fall below the recommended threshold, confirming that discriminant validity has been adequately established.

**Hypothesis Testing dan Discussion**

Table 3: Result Relationships

Relationship	Beta	Standard deviation	T statistics	P values	Result
Dynamic Capabilities → Business Performance	0.153	0.105	1.455	0.146	Not Supported
Entrepreneurial Orientation → Business Performance	0.659	0.078	8.432	0.000	Supported
Dynamic Capabilities → TL → Business Performance	-0.015	0.046	0.338	0.736	Not Supported
Entrepreneurial Orientation → TL → Business Performance	0.006	0.020	0.277	0.781	Not Supported

**\*TL: Transformational Leadership.**

The significance of hypotheses was assessed using path coefficients and the bootstrapping technique. The results revealed that the relationship between dynamic capabilities with business performance was not supported ( $\beta=0.153$ ,  $t=1.455$ ,  $p > 0.00$ ). Meanwhile, the study found that the relationship between entrepreneurial orientation and business was significant ( $\beta=0.659$ ,  $t=8.432$ ),  $p > 0.00$ ). As such, H1 was not supported but H2 was supported. Regarding transformational leadership as a mediator, the analysis revealed that transformational leadership did not significantly mediate the relationship between dynamic capabilities with business performance ( $\beta=-0.015$ ,  $p > 0.00$ ) and entrepreneurial orientation ( $\beta=-0.006$ ,  $p > 0.00$ ). Thus, H3 and H4 were not supported.

**CONCLUSION AND FUTURE RESEARCH AGENDA**

The result shows that the direct effect of dynamic capabilities on performance was not statistically significant, indicating that these capabilities alone may not be sufficient to drive performance improvements in MSMEs. In contrast, entrepreneurial orientation was found to have a significant and positive impact on business performance, strengthening its role as a critical strategic posture in competitive environments. Moreover, the analysis found that transformational leadership did not significantly mediate the relationships between dynamic capabilities or entrepreneurial orientation and MSME performance. The insignificant mediating role of transformational leadership may be attributed to the limited presence of transformational leadership behaviour among SME leaders. The non-significant effect of dynamic capabilities on MSME performance advocates that these capabilities, while important, do not directly improve business outcomes in smaller firms. This may be because dynamic capabilities such as adapting to market changes or reconfiguring internal resources function

more as support mechanisms rather than direct performance drivers. In the MSME context, where resources are limited and structures are informal, these capabilities must be activated through concrete strategic actions, such as launching innovative products, responding quickly to customer demands, or effectively applying knowledge.

Entrepreneurial orientation was found to have a significant and positive impact on business performance, reaffirming its role as a vital strategic posture in today's competitive and uncertain business environments. Particularly for MSMEs operating with limited capital (resource-constrained) settings, entrepreneurial orientation enables firms to make strategic decisions that maximize impact despite financial limitations, such as prioritizing high-potential opportunities, leveraging affordable innovations, or entering niche markets ahead of competitors. The analysis indicates that transformational leadership did not significantly mediate the relationship between dynamic capabilities and business performance, nor between entrepreneurial orientation and business performance. In many small firms, leaders often lack formal training in leadership practices and tend to prioritize operational tasks over strategic vision or employee development. This leadership gap limits the ability of transformational leadership to serve as an effective conduit through which strategic capabilities influence performance. As such, the findings suggest that transformational leadership may not function as a behavioral mechanism to translate dynamic capabilities or entrepreneurial orientation into improved outcomes within the SME context—likely due to limited leadership development opportunities and structural constraints commonly found in smaller enterprises. Given the findings that dynamic capabilities alone do not significantly enhance MSMEs business performance, while entrepreneurial orientation has a direct positive effect, future research should explore contextual moderators that may strengthen or weaken these relationships. For instance, studies could examine whether industry dynamism, organization age, or institutional support (e.g., government policies, access to financing) influence how dynamic capabilities translate into performance, particularly in resource-constrained settings.

Additionally, since transformational leadership did not mediate the DC–performance or EO–performance links, further investigation is needed to determine whether alternative leadership styles (e.g., transactional, servant, or adaptive leadership) or informal leadership behaviour (e.g., owner-manager agility) plays a more critical role in MSMEs. Another avenue involves exploring complementary mechanisms beyond leadership, such as organizational culture, employee empowerment, or digital capabilities, that may better explain how DCs and EO drive performance. Qualitative research could also uncover why TL fails to mediate in MSMEs—whether due to lack of leadership training, structural constraints, or misalignment with small-firm dynamics. Finally, longitudinal studies could assess whether the impact of DCs and EO evolves as MSMEs grow, suggesting that dynamic capabilities may become more relevant at later stages of firm development. By addressing these gaps, future research can provide actionable insights for MSMEs on how to effectively leverage strategic resources and leadership practices for sustained competitiveness.

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