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The Role of Dynamic Capabilities as a Mediating Factor in Enhancing the Innovative Performance of SMEs: Integrating Transformational Readiness, Digital Literacy, and Strategic Agility

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Abstract

This study examines the mediating role of dynamic capabilities in the relationship between transformational change readiness, digital financial literacy, strategic agility, and the innovative performance of SMEs in East Java. Integrating the Dynamic Capability Theory and Institutional Logics perspective, the research provides a comprehensive understanding of innovation drivers in SMEs within a distinctive local ecosystem context. Employing an explanatory quantitative approach, the study conducted a survey of 125 digitally transformed SMEs in East Java. Data were analyzed using Structural Equation Modeling (SEM) with AMOS software to test measurement and structural models, along with mediation analysis using Sobel Test. Research instruments were validated through confirmatory factor analysis (CFA) and reliability testing. The results indicate that transformational change readiness, digital financial literacy, and strategic agility significantly influence dynamic capabilities formation. However, dynamic capabilities function not as full mediators but as complementary factors that strengthen the direct effects of independent variables on innovative performance. The integration of Dynamic Capability Theory and Institutional Logics reveals that SME innovation in East Java is predominantly driven by community logic and local collaborations rather than pure dynamic capabilities. This study contributes theoretically by developing an integrative model that combines dynamic capability and institutional logic approaches, while offering

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novel insights into dynamic capabilities implementation among SMEs in specific socio-cultural contexts.

Keywords: Dynamic Capabilities, Innovative Performance, East Java SMEs, Transformational Change Readiness, Strategic Agility

INTRODUCTION

In an era characterized by digital disruption and increasing environmental uncertainty, Small and Medium-Sized Enterprises (SMEs) are confronted with complex challenges in sustaining competitiveness through innovation (Larios-Francia & Ferasso, 2023; Aggarwal & Joshi, 2024; Octasylva et al., 2022). The innovative performance of SMEs depends not only on internal resources but also on their adaptive capacity to respond effectively to external changes (Díaz-Pelaez et al., 2024; Wolor et al., 2024; Latifah et al., 2021). Nevertheless, prior studies have predominantly examined factors such as transformational change readiness, digital financial literacy, and strategic agility in isolation, without adequately considering the dynamic mechanisms linking these variables to innovative performance.

Dynamic Capabilities Theory provides a relevant theoretical lens for understanding how organizations integrate, build, and reconfigure resources to generate innovative value (Knudsen et al., 2024; Findsrud, 2020; Muneeb et al., 2023). However, this perspective often overlooks the role of institutional logics that shape SME behavior through norms, regulations, and industry practices (Fauzi & Sheng, 2022; Mishra & Kiran, 2025; Utama et al., 2024). Integrating Dynamic Capabilities Theory with Institutional Logics offers a novel perspective on how SMEs manage the tension between internal flexibility and external institutional demands (Liboni et al., 2022; Pascucci et al., 2024).

SMEs in East Java constitute the backbone of the regional economy, contributing approximately 60.3% of the Gross Regional Domestic Product (GRDP) and absorbing 96.9% of the workforce (BPS East Java, 2023). However, amid rapid digital transformation and post-pandemic uncertainty, only 12% of SMEs in the region have successfully achieved sustainable innovation (Department of Cooperatives and SMEs of East Java, 2023). This phenomenon indicates a significant gap between the potential and adaptive capabilities of SMEs in responding to disruptive environmental changes.

Several specific challenges are faced by SMEs in East Java, including low transformational readiness, unequal digital financial literacy, and fragmented strategic agility. A preliminary survey involving 150 SMEs in Surabaya, Malang, and Sidoarjo

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revealed that 68% of business actors still rely on traditional management practices and demonstrate resistance toward structural transformation. Meanwhile, the adoption of technologies such as cloud accounting and AI-driven marketing has become increasingly critical. Although 89% of SMEs have adopted e-payment systems, only 23% possess adequate knowledge of digital financial principles such as crowdfunding and digital cash flow management (Regional Financial Services Authority of East Java, 2023). This limitation constrains the effective optimization of resources for innovation. Furthermore, SMEs operating in creative industries such as batik and culinary businesses tend to be more adaptive than small-scale manufacturing enterprises. Such fragmentation highlights the need for a contextualized capability-based approach.

This study emerges from these theoretical and empirical gaps by proposing an integrative approach that positions dynamic capabilities as a mediating mechanism between strategic factors namely transformational change readiness, digital financial literacy, and strategic agility and SMEs' innovative performance. The findings are expected not only to enrich academic insights but also to provide practical recommendations for SMEs and policymakers.

Based on the aforementioned background, this study is designed to address several major research questions concerning the determinants of innovative performance among SMEs. First, this study aims to examine the direct effects of transformational change readiness, digital financial literacy, and strategic agility on SMEs' innovative performance. Second, the study investigates whether dynamic capabilities function as a mediating mechanism in the relationship between these independent variables and innovative performance. Furthermore, this research seeks to explore how the integrative perspective of Dynamic Capabilities Theory and Institutional Logics can explain variations in SMEs' innovative performance across different institutional contexts.

In line with these research questions, the study has several primary objectives. The first objective is to analyze the effects of transformational change readiness, digital financial literacy, and strategic agility on SMEs' innovative performance. The second objective is to examine the mediating role of dynamic capabilities in bridging the relationship between these variables and innovative performance. The final objective is to develop a novel theoretical model integrating the perspectives of Dynamic Capabilities and Institutional Logics to explain how SMEs achieve strategic adaptation and innovative advantage amid dynamic external environments.

Theoretically, this study contributes to the enrichment of the dynamic capabilities literature by incorporating institutional dimensions as additional explanatory variables

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while also proposing a new conceptual framework within the context of SME development. Practically, the findings are expected to serve as a strategic reference for SME actors and policymakers in formulating innovation-oriented strategies and policies through the strengthening of dynamic capabilities in the era of digital disruption.

An analysis of previous studies reveals several important findings relevant to the present research context. Numerous studies have confirmed the relationship between digitalization, dynamic capabilities, and business performance, particularly in SMEs. For instance, Martínez-Peláez et al. (2023) and Indriastuti and Kartika (2022) demonstrated that dynamic capabilities mediate the relationship between digitalization and business performance. However, these studies primarily focused on financial performance and did not extensively investigate the mechanisms driving innovation. Meanwhile, Al Jabri et al. (2024) expanded the discussion by examining the interaction between dynamic capabilities, organizational agility, and digital transformation. Nevertheless, their focus on large companies in the United Arab Emirates limits the applicability of their findings to Indonesian SMEs.

Regarding digital financial literacy and transformational leadership, Chang and Octoyuda (2024) found that transformational leadership and learning agility are critical factors in digital technology adoption. However, their study did not integrate institutional influences such as local regulations and social norms. In contrast, Mishra and Kiran (2025) identified digital financial literacy as an antecedent of dynamic capabilities, although their approach remained conceptual and lacked empirical validation in more specific contexts such as East Java.

Furthermore, several studies have attempted to integrate Dynamic Capabilities Theory and Institutional Logics. Mele et al. (2024) and Sarwar et al. (2024) proposed knowledge-based approaches to developing dynamic capabilities as the foundation for digital transformation. However, these studies did not address the tension between market logic and community logic, which characterizes Indonesian SMEs. On the other hand, Abdurrahman et al. (2024) applied the TOE (Technology–Organization–Environment) framework in the banking sector, yet the model has not been fully adapted to SMEs with limited resources.

Innovation and entrepreneurial orientation have also been extensively discussed in the literature. Octasylva et al. (2022) and Bhatti et al. (2022) emphasized the importance of innovation and big data analytical capabilities in improving SME performance. Nevertheless, both studies neglected transformational readiness as a triggering factor in the innovation process.

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A review of previous studies reveals several research gaps that establish the originality of this study. One major gap concerns the limited integration between Dynamic Capabilities Theory and Institutional Logics. Many studies, such as those conducted by Al Jabri et al. (2024) and Bhatti et al. (2022), adopted only the dynamic capabilities perspective without considering institutional pressures shaping SME behavior, particularly in East Java, where local wisdom and collaboration with regional state-owned enterprises play significant roles. Another gap lies in the fragmented analysis of mediation effects. Most previous studies, including those by Indriastuti and Kartika (2022) and Octasylva et al. (2022), examined the mediating role of dynamic capabilities only partially and did not compare the relative mediating strength among transformational change readiness, digital financial literacy, and strategic agility. Research on SMEs in East Java has also largely focused on macroeconomic analysis rather than micro-level investigations examining the interaction among strategic factors within local agro-industrial ecosystems. In addition, the existing literature predominantly employs quantitative approaches such as PLS-SEM without providing qualitative insights into how SME actors interpret and implement dynamic capabilities in daily business practices.

This study seeks to address these research gaps through the development of an integrative model combining Dynamic Capabilities Theory and Institutional Logics. The proposed model will be employed to analyze how SMEs in East Java manage the duality between digital demands representing market logic and institutional constraints reflecting community logic. Moreover, this study aims to comprehensively examine the mediating mechanism of dynamic capabilities in the relationships between transformational change readiness, digital financial literacy, strategic agility, and innovative performance. Consequently, a more comprehensive understanding of the mediating role of dynamic capabilities, whether as a full or partial mediator, is expected to emerge. From a practical perspective, this study is intended to formulate strategic recommendations for enhancing SMEs' innovative performance based on empirical findings in East Java. These strategies include strengthening collaboration with regional state-owned holding companies such as the Jawa Timur Industrial and Trading Company as well as developing locally contextualized digital financial literacy training programs based on practical business cases.

LITERATURE REVIEW

Dynamic Capabilities Theory emphasizes that organizations must possess the ability to integrate, build, and reconfigure both internal and external resources in order to

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respond effectively to rapidly changing business environments (Miśkiewicz, 2021; Kurtmollaiev, 2020). In the context of SMEs, such capabilities are particularly crucial given their limited resources and organizational constraints (Bhatti et al., 2022; Mishra & Kiran, 2025; Tarihoran et al., 2023; Arraya, 2024). The framework of dynamic capabilities encompasses three primary dimensions: sensing, which refers to the ability to identify market opportunities at an early stage; seizing, which involves the capability to capitalize on opportunities through appropriate resource allocation; and transforming, which reflects the ability to continuously adapt and redesign business models. Recent research by Mele et al. (2024) further extends this theory by emphasizing that digitally based knowledge has become a fundamental foundation for the development of dynamic capabilities, particularly within the context of SME digital transformation. Consequently, dynamic capabilities are no longer solely dependent on structural flexibility and adaptive speed but also on digital technological mastery and the organization's ability to strategically internalize digital knowledge.

Institutional Logics Theory provides a conceptual framework for understanding how organizational actions and practices are shaped by systems of values, beliefs, and normative rules embedded within institutional environments (Milosevic et al., 2023; Haveman et al., 2023; Anderson-Gough et al., 2022). In the context of SMEs in East Java, this theory is particularly relevant for explaining the interaction between market logic, which emphasizes efficiency, innovation, and adaptation to the demands of the digital economy, and community logic, which reflects local values such as mutual cooperation, community loyalty, and social entrepreneurial orientation. The tension between these two institutional logics frequently generates strategic dilemmas for SME actors in determining the direction of business transformation. The integration of Institutional Logics Theory and Dynamic Capabilities Theory, as proposed by Furnari (2020), provides an opportunity to understand how SMEs not only develop dynamic capabilities to respond to external changes but also navigate institutional pressures rooted in local norms and cultural values. This integrated approach enables a more holistic analysis of organizational adaptation processes, where innovation and transformation are driven not only by market competition but also by social structures and collective values embedded within local business communities.

Transformational Change Readiness refers to the extent to which an organization is comprehensively prepared to respond to disruptive changes (Soetjipto et al., 2024; Henricks et al., 2020; Michelotto & Joia, 2024). Such readiness extends beyond structural and procedural dimensions to include cognitive, affective, and behavioral aspects.

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Cognitive readiness refers to the understanding of individuals and organizations regarding the urgency and direction of change. Affective readiness reflects positive or negative attitudes toward transformation, while behavioral readiness indicates tangible commitment through adaptive actions. Within the SME context, Octasylva et al. (2022) highlighted that readiness for change is influenced more significantly by charismatic leadership figures capable of inspiring and motivating employees than by formalized management systems. This finding reflects the distinctive characteristics of small organizations, which often rely heavily on personalized leadership. Therefore, understanding transformational change readiness is essential for analyzing SMEs' adaptive capacity in response to external dynamics, particularly in the context of digitalization and increasing competitive pressures in the digital economy era.

Digital Financial Literacy refers to the ability of individuals or business actors to understand, utilize, and manage digital financial instruments effectively and responsibly (Kumar et al., 2023; Choung et al., 2023; Angela et al., 2020). This literacy encompasses knowledge of digital financial products, skills in managing technology-based transactions, and awareness of risks associated with digital financial systems. In the context of SMEs, particularly in regions such as East Java, digital financial literacy has become increasingly important alongside the growing adoption of electronic payment technologies. Data from the Financial Services Authority (OJK, 2023) indicate that although the majority of SMEs (89%) have adopted e-payment systems, only a small proportion (23%) truly understand the fundamental principles of digital cash flow management. This disparity reflects a gap between technological utilization and deeper conceptual understanding, which may affect the effectiveness of financial decision-making and long-term business resilience. Accordingly, digital financial literacy extends beyond technical competence to encompass strategic capabilities in managing finances adaptively amid changes in the digital economic ecosystem.

Strategic agility refers to an organization's ability to anticipate market changes, respond rapidly, and learn from experience in order to maintain competitiveness in dynamic business environments (Satar et al., 2024; Rožman et al., 2023; Yildiz & Aykanat, 2021). Strategic agility involves flexibility in decision-making as well as effective adaptability to external changes. In the context of SMEs, particularly within community-based business ecosystems, strategic agility is often realized through improvisational practices that leverage local networks rather than systematic data-driven analytical approaches. This perspective is consistent with the findings of Setini et al. (2025), which demonstrate that SMEs rely heavily on social interactions and informal collaboration as

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primary resources for responding rapidly to market challenges. Such an approach enables SMEs to remain agile and responsive despite limitations in resources and technology. Therefore, strategic agility in SMEs is not merely associated with speed and flexibility but also reflects collective intelligence emerging from local network relationships, which serve as an essential foundation for coping with uncertainty and market changes.

Innovative performance represents a critical indicator reflecting SMEs' ability to create added value through product, process, and business model innovation (Dewi et al., 2025; Hakim, 2023; Panya & Petchsawang, 2025). Innovative performance can be assessed through three principal dimensions: innovative products, which involve the introduction of new offerings to the market; innovative processes, which focus on improving operational efficiency; and innovative business models, which encompass novel ways of creating and delivering business value. In the context of SMEs in East Java, comparative studies reveal that innovation activities are predominantly characterized by cultural adaptation, such as the digitalization of batik motifs, rather than radical or disruptive technological innovation. This form of innovation illustrates how SMEs utilize cultural heritage as a strategic resource while simultaneously accommodating gradual market transformation. Such cultural adaptation not only enhances SME competitiveness but also strengthens local identity and long-term business sustainability. Accordingly, the innovative performance of SMEs in East Java places greater emphasis on sustainability-oriented and socio-culturally relevant innovation than on advanced technological breakthroughs.

RESEARCH METHOD

This study employed an explanatory quantitative approach using a survey method to examine the relationships among variables specified in the proposed theoretical model. This approach was considered appropriate because it enables the systematic and measurable investigation of causal relationships among independent, mediating, and dependent variables.

The data utilized in this study consisted of both primary and secondary data sources. Primary data were collected through the distribution of structured questionnaires to SME actors in East Java, while secondary data were obtained from official reports published by the East Java Office of Cooperatives and SMEs.

The population of this study comprised all SMEs in East Java that had undergone digital transformation processes. A purposive sampling technique was applied based on

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several criteria, namely SMEs that were legally registered, had utilized digital technology for at least one year, and operated actively within the East Java region. Based on these criteria, a total of 125 respondents were deemed eligible to participate in the study.

This study examined five principal variables. First, transformational change readiness was measured through indicators related to adaptability to change, human resource readiness, and management support. Second, digital financial literacy was assessed based on understanding of digital financial products, capability in managing digital transactions, and knowledge of digital financial risks. Third, strategic agility was measured through responsiveness to market changes, operational flexibility, and the ability to predict business trends. Fourth, dynamic capabilities were represented by the ability to integrate resources, the capacity to reconfigure business models, and organizational learning speed. Finally, innovative performance was measured through the number of new products or services introduced, improvements in business processes, and the ability to adopt emerging technologies.

Data collection was conducted using questionnaires based on a five-point Likert scale. To enrich contextual understanding, structured interviews were also conducted with selected respondents.

The collected data were analyzed using the Structural Equation Modeling (SEM) approach with the assistance of AMOS software. The analysis included instrument validity and reliability testing, measurement model evaluation through Confirmatory Factor Analysis (CFA), structural model assessment, and hypothesis testing. To examine the mediating effects among variables, path analysis and the Sobel test were employed to determine the significance of mediation effects within the proposed relationships.

The research instruments were also evaluated in terms of validity and reliability. Construct validity was assessed using Confirmatory Factor Analysis (CFA), while instrument reliability was measured based on composite reliability and Cronbach's alpha values to ensure that each construct within the research model demonstrated adequate internal consistency.

RESULT AND DISCUSSION

RESULT

This study involved 125 respondents as the research sample to evaluate the adequacy of the instruments used in measuring the principal constructs. The analysis results indicate that all examined constructs namely Transformational Change Readiness, Digital Financial Literacy, Strategic Agility, Dynamic Capabilities, and SMEs'

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Innovative Performance fulfilled the statistical criteria required for reliability and construct validity testing.

In the Construct Reliability assessment, all indicators within each construct demonstrated composite reliability and Cronbach's alpha values exceeding the minimum threshold of 0.70. These findings indicate that the instruments employed in this study possessed satisfactory internal consistency. Furthermore, the Convergent Validity test, assessed through the Average Variance Extracted (AVE) values, also met the recommended criterion of above 0.50 for all constructs. This result suggests that the indicators within each construct were capable of explaining a substantial proportion of shared variance.

In addition, Discriminant Validity testing using the Fornell-Larcker criterion revealed that the square root values of AVE for each construct were greater than the correlations between constructs. This finding confirms that each construct exhibited adequate distinctiveness and was empirically distinguishable from the others.

Therefore, it can be concluded that all research instruments employed in this study satisfied the required standards of reliability and validity, indicating their suitability for subsequent analysis.

Table 1. Construct Reliability and Convergent Validity Testing

Construct	Construct Reliability	AVE
Digital Financial Literacy (DFL)	0,618055556	0,398611111
Strategic Agility (SA)	0,627777778	0,396527778
Transformational Change Readiness (TCR)	0,60625	0,394444444
Dynamic Capabilities (DC)	0,634027778	0,45625
Innovative Performance of MSMEs (KI)	0,657638889	0,542361111

Source: Output AMOS 24.0, 2025

Table 2. Discriminant Validity Testing

Construct	DFL	SA	TCR	DC	KI
DFL	0,52638889	0,53263889	0,55138889	0,18402778	0,16388889
SA	0,53263889	0,52430556	0,55972222	0,225	0,16458333
TCR	0,55138889	0,55972222	0,52361111	0,25069444	0,20277778
DC	0,18402778	0,225	0,25069444	0,5625	0,15902778
KI	0,16388889	0,16458333	0,20277778	0,15902778	0,61388889

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The path analysis results indicate that Transformational Change Readiness (TCR) exerts a significant effect on Dynamic Capabilities (DC), with a coefficient value of β = 0.331 (p < 0.05), as well as on Innovative Performance, with β = 0.250 (p < 0.05). Similarly, Digital Financial Literacy (DFL) was found to have a significant influence on DC (β = 0.266; p < 0.05), although it did not demonstrate a significant direct effect on Innovative Performance (β = 0.222; p > 0.05). Furthermore, Strategic Agility (SA) also showed a significant effect on DC (β = 0.334; p < 0.05) and on Innovative Performance (β = 0.229; p < 0.05). Meanwhile, DC itself was found to make a significant contribution to Innovative Performance, with a coefficient value of β = 0.214 (p < 0.05).

Table 3. Causality Testing Among Variable

Construct	Estimate	S.E.	C.R.	P Value
DC <--- DFL	0,184722222	0,072222222	2.560	0.010
DC <--- SA	0,231944444	0,082638889	2.813	0.005
DC <--- TCR	0,229861111	0,077777778	2.961	0.003
KI <--- TCR	0,173611111	0.097	2.580	0.010
KI <--- SA	0,159027778	0,070833333	2.247	0.025
KI <--- DFL	0,154166667	0.088	2.534	0.011
KI <--- DC	0,148611111	0,070138889	2.116	0.034

Source: Output AMOS 24.0, 2025

The results of the mediation analysis using the Sobel Test indicate that Dynamic Capabilities (DC) do not serve as a mediating variable in the relationship between Transformational Change Readiness (TCR) and Innovative Performance, as evidenced by the Sobel test value of 1.721, which falls below the critical threshold of 1.96. A similar pattern was observed in the relationship between Digital Financial Literacy (DFL) and Innovative Performance (Sobel = 1.691), as well as in the relationship between Strategic Agility (SA) and Innovative Performance (Sobel = 1.631), both of which failed to reach statistical significance.

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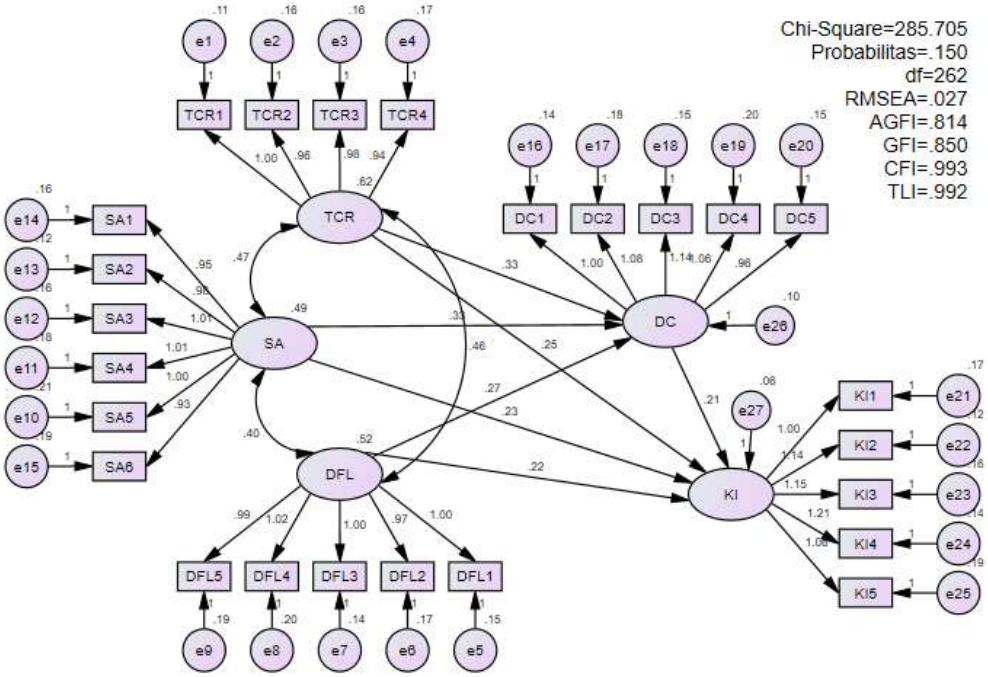


Figure 1. Research model

DISCUSSION

The findings of this study provide new contributions toward addressing several important research gaps that remain insufficiently explored in the existing literature. One of the primary contributions lies in the inconsistency of the mediating role of Dynamic Capabilities (DC) within the SME context compared to large corporations. While previous studies, such as those conducted by Indriastuti and Kartika (2022) and Al Jabri et al. (2024), demonstrated that DC functions as a full mediator in the relationship between digitalization and organizational performance, the present study reveals that, among SMEs in East Java, DC operates merely as a complementary variable. This discrepancy may be explained by the limited resources of SMEs, which tend to rely heavily on community-based local networks to support innovation, as well as by the complexity of local institutional environments, where government initiatives such as the Smart Province 5.0 program encourage reactive innovation rather than innovation driven through systematically developed dynamic capabilities. These findings suggest that institutional logic exerts a stronger influence than market logic in shaping SMEs' innovative behavior.

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From a theoretical perspective, these findings challenge the universality of Dynamic Capabilities Theory in the context of developing SMEs and reinforce the argument proposed by Mele et al. (2024) that dynamic capabilities are inherently contextual and require integration with institutional theories to enhance their explanatory relevance. Furthermore, this study reveals the fragmented role of Digital Financial Literacy (DFL) within the innovation model. Although previous studies, including Mishra and Kiran (2025) and Abdurrahman et al. (2024), positioned DFL as a key antecedent in the development of DC, the results of this study indicate that DFL only significantly influences the formation of DC (β = 0.266) and does not directly affect innovative performance. This discrepancy may be attributed to the incomplete internalization of digital financial management principles among SME actors. Data from the East Java Financial Services Authority (OJK East Java, 2023) indicate that although 89% of SMEs have adopted digital payment systems, only approximately 23% adequately understand digital cash flow management. This condition is further aggravated by the underdeveloped supporting ecosystem, including limited access to digital-based financing schemes, such as Digital People's Business Credit (Digital KUR), and inadequate technological infrastructure. Therefore, future studies should consider incorporating digital ecosystem moderators, such as fintech availability and infrastructural support, into the analytical framework.

This study also identifies the dualistic role of Strategic Agility (SA), which, on the one hand, demonstrates a direct influence on innovative performance (β = 0.229), yet, on the other hand, fails to exert a significant indirect effect through DC, contrary to the assumptions proposed in previous studies such as Bhatti et al. (2022). This finding is consistent with the results reported by Sarwar et al. (2024) and can be explained by the distinctive characteristics of SMEs in East Java. Most SMEs operating in creative sectors, such as batik and culinary industries, rely more heavily on agility rooted in local networking systems including collaboration with regional state-owned enterprises than on data-driven digital platforms. Consequently, the form of SA identified in this context is more accurately characterized as improvisational agility, referring to rapid responses to market changes, rather than analytical agility, which depends primarily on systematic data analysis, as commonly observed in large corporations.

Furthermore, Transformational Change Readiness (TCR) emerged as the most dominant variable, influencing both the development of DC (β = 0.331) and innovative performance directly (β = 0.250). These findings support the study conducted by Octasylva et al. (2022) while also providing a new perspective by demonstrating that

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readiness for change within SMEs is not necessarily grounded in formal management systems but is often stimulated by charismatic local leaders, commonly referred to as local heroes. In addition, external interventions, particularly government-led capacity-building programs such as “SMEs Go Digital,” play a crucial role in fostering transformational readiness rather than relying solely on internal initiatives from SME actors themselves.

This study also offers a critical perspective on the limitations of the Resource-Based View (RBV) in explaining SMEs’ competitive advantage. Contrary to the fundamental assumptions of RBV, which emphasize the importance of internal resources, the findings of this study demonstrate that the competitive advantage of SMEs in East Java is largely shaped through institutional collaboration, such as partnerships with regional state-owned enterprises including the Jawa Timur Industrial and Trading Company, which provide access to external resources without requiring SMEs to independently develop such capabilities. Moreover, innovative initiatives among SMEs often emerge not from strategic business calculations but rather from social pressures and community norms, such as the responsibility to preserve local cultural heritage. This finding reinforces the importance of incorporating civic logic as a critical dimension in the development of knowledge-based dynamic capabilities theory, as suggested by Mele et al. (2024).

CONCLUSION

This study reveals that transformational change readiness, digital financial literacy, and strategic agility collectively play important roles in shaping the dynamic capabilities of SMEs in East Java. An important finding indicates that dynamic capabilities do not function as a full mediating variable; rather, they act as a complementary factor that strengthens the direct influence of transformational readiness and strategic agility on innovative performance. The integration of Dynamic Capabilities Theory and Institutional Logics in this study successfully provides a comprehensive explanation of how SMEs in East Java develop innovation through a unique combination of business adaptability and strong attachment to community values and local networks.To optimize these findings, three major policy recommendations are proposed. First, digital financial literacy programs should be strengthened through integration with existing local financial ecosystems. Second, the development of business cluster approaches may facilitate synergy between SMEs and regional enterprises in fostering strategic agility based on local wisdom. Third, new innovative performance indicators should be developed to

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accommodate the dual characteristics of SMEs in East Java, namely as adaptive business actors and as members of communities with strong local cultural values. These recommendations are expected to assist SMEs in East Java in balancing the demands of modern market competition with the sustainability of local values and community-based business practices.

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