

The Influence of Entrepreneurial Orientation and Innovation on MSME Performance Mediated by Competitive Advantage

Factors Influencing
MSME Performance

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ABSTRACT

In the current dynamic business environment, small businesses face intense competition that requires strong strategic capabilities to survive and grow. This study examines the effect of entrepreneurial orientation and innovation on the business performance of MSMEs through the competitive advantage. A quantitative approach was employed using survey data from 132 MSMEs, analyzed using Structural Equation Modeling–Partial Least Squares (SEM-PLS). The results indicate that entrepreneurial orientation and innovation have a significant positive effect on competitive advantage. Innovation also has a direct positive effect on business performance, while entrepreneurial orientation does not directly influence performance. Competitive advantage plays a critical mediating role, exerting a strong and significant effect on business performance and transmitting the impact of entrepreneurial orientation and innovation to performance outcomes. These findings imply that MSMEs should prioritize innovation-driven strategies and actively leverage entrepreneurial orientation to build sustainable competitive advantages. Policymakers and business development agencies are encouraged to support MSMEs through innovation capacity building and entrepreneurial capability development, as competitive advantage emerges as a key mechanism for enhancing long-term business performance.

Keywords: Business Environment, Business Performance, Competitive Advantage, Entrepreneurial Orientation, Innovation.

INTRODUCTION

Micro, Small, and Medium Enterprises (MSMEs) serve as a key pillar of economic growth in many countries, especially in developing nations like Indonesia (Solikahan & Mohammad, 2019; Mohammad et al., 2019). In developing countries, MSMEs not only play a role in employment but also in employing an abundance of unskilled workers (Ndesaulwa & Kikula, 2016). In Indonesia, MSMEs are the backbone of economic development, especially in economic crises, as well as being a source of community income and providing job opportunities (Susbiyani et al., 2021). This business group also plays a role in alleviating poverty, improving welfare, and empowering low-income groups (Zeebaree & Siron, 2017; Qamariah & Muchtar, 2019).

Despite their significant contribution to the national economy, MSMEs still encounter various internal and external challenges and limitations related to production, management, marketing, human resources, technology, capital, and the overall business environment (Putri et al., 2020). This sector also tends to have a limited capacity to adapt

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to changing market conditions, a weak response to emerging business opportunities, and low creativity in innovation, particularly when competing with imported products (Susbiyani et al., 2021). Although the products produced by MSMEs have great potential to succeed in national and international markets, this business group has weaknesses in the entrepreneurial and management aspects, in addition to access to banking and marketing (Fadhillah et al., 2021). Likewise, the courage to take risks for SMEs in business is still low, and the ability to develop products and creativity to find new business ideas is also low. These various weaknesses and challenges indicate the low business performance and limited competitive advantage of MSMEs in Indonesia.

The performance of MSMEs largely depends on how effectively they allocate scarce resources, such as working capital and labor, to achieve predetermined goals (Mufidah & Eliyana, 2021). Empirical findings reveal that competitive advantage significantly influences MSME business performance (Putri et al., 2020). Competitive advantage refers to a company's capability to compete with others by delivering superior value to customers. It can be developed or strengthened through the implementation of appropriate strategies, particularly by managing human resources effectively and efficiently. Entrepreneurial orientation is one of the key factors that determine business success (Sirivanh et al., 2014; Quantananda & Haryadi, 2015). Likewise, without innovation, companies will experience difficulties in improving their business performance. Innovation and entrepreneurial orientation are factors that can increase competitive advantage (Sutapa et al., 2017). In order to achieve a sustainable competitive advantage, companies must create innovations (Bambang et al., 2021). The high or low competitiveness of MSMEs is also influenced by the ability to innovate (Ismanu & Kusmintarti, 2019). Meanwhile, the company's competitive advantage is the key to business success.

There have been many studies analyzing the relationship between entrepreneurial orientation, innovation, competitive advantage, and MSME business performance. However, in addition to generally using correlation or regression analysis, there is also no agreement among researchers regarding the dimensions of these variables. This study seeks to fill the research gap in the analysis of MSME business performance. First, the research uses an analysis with a structural equation model so that it can determine the effect of exogenous variables on endogenous variables, either directly or indirectly, and their total effect. Second, the research attempts to use the dimensions or indicators of the analyzed variables according to the measurement of companies with the scale of MSMEs. This study aims to examine the improvement of MSME business performance in Cirebon Regency by achieving a competitive advantage through Entrepreneurial orientation and innovation.

LITERATURE REVIEW & HYPOTHESIS DEVELOPMENT

The Effect of Entrepreneurial Orientation and Innovation on Competitive Advantage

Innovation and entrepreneurial orientation are key factors that can enhance competitive advantage (Paulus & Wardhani, 2018; Widiatmo & Retnawati, 2019; Komarudin, 2021). Entrepreneurial orientation serves as one of the main determinants of competitive advantage, alongside advanced technology, high-quality human resources, strong work ethics, creativity, motivation, production efficiency, superior product quality, effective management systems, a well-structured organization, and a strong entrepreneurial spirit (Hatta et al., 2019). A competitive advantage reflects a set of attributes that distinguish a business from its competitors, positioning it uniquely in the market and enabling superior performance (Lestari et al., 2019). Human resources with strong entrepreneurial knowledge have a strategic edge in managing internal and external factors to create distinctive advantages. Entrepreneurial orientation drives sustainable and competitive economic growth within firms, as companies with an entrepreneurial mindset continuously innovate, take calculated risks, and proactively seize opportunities, establishing and sustaining competitive advantage (Kusuma & Rastini, 2017; Rahmadi et al., 2020; Lukiaستی, 2021).

In addition to entrepreneurial orientation, product innovation plays a crucial role in enhancing competitive advantage and achieving high business performance (Setyawati, 2015; De Conto et al., 2016; Alwi & Handayani, 2018; Herman et al., 2018; Sadalia et al., 2020; AlQershi et al., 2020). A company's capacity for innovation determines its level of competitiveness, as it enables entrepreneurs to generate and implement ideas effectively, address market needs, and sustain long-term success. Innovation, whether in products, production processes, technological improvements, or new business models, strengthens competitive advantage, contributes to financial performance, and positions firms to remain competitive in dynamic markets.

H1: Entrepreneurial orientation has a positive effect on competitive advantage.

H2: Innovation has a positive effect on competitive advantage.

The Effect of Entrepreneurial Orientation and Innovation on Business Performance

Entrepreneurial orientation plays a crucial role in enhancing firm performance and is a key determinant of business success, influenced by internal factors such as strategic management, resource utilization, organizational structure, entrepreneurial culture, reward systems, and leader traits, as well as external factors including economic, social, political, and technological conditions (Sirivanh et al., 2014; Quantananda & Haryadi, 2015). Entrepreneurial orientation involves innovation, risk-taking, and proactive actions to gain a competitive advantage and is vital for MSME growth (Vithanage & Udayanga, 2020; Sadalia et al., 2020). It promotes cost efficiency, creativity, innovation, and accuracy in task execution and problem-solving, and empirical evidence shows a positive and significant effect on MSME performance (Irawati & Purnomo, 2019). In rapidly changing environments, firms with strong entrepreneurial orientation are better positioned to improve performance, competitiveness, and sustainability, although some studies report mixed results (Madi et al., 2021; Wardi et al., 2017; Prihandono et al., 2021).

In addition to entrepreneurial orientation, innovation plays a crucial role in determining business performance. It enables companies to develop new products, increase sales, and gain a competitive advantage, particularly in the face of globalization and intense competition (Forsman & Temel, 2011; Permatasari & Praswati, 2024). Innovation, whether organizational, product, or marketing, can enhance growth, profitability, and productivity, allowing firms to differentiate themselves, improve market performance, and compete effectively even if they initially perform poorly (de Oliveira et al., 2018; Mohammad et al., 2019; Herlinawati & Machmud, 2020).

H3: Entrepreneurial orientation has a positive effect on business performance.

H4: Innovation has a positive effect on business performance.

The Effect of Competitive Advantage on Business Performance

Business performance reflects a company's ability to achieve its objectives efficiently and effectively, encompassing both financial and non-financial outcomes such as growth, profitability, and resource utilization (Mason et al., 2015; Lisa, 2019; Restrepo-Morales et al., 2019). Entrepreneurial orientation, competitive advantage, and innovation are key drivers of performance. Entrepreneurial orientation, characterized by proactiveness, risk-taking, innovation, and autonomy, enables firms to seize opportunities, develop new products, and sustain MSME growth (Kharisma et al., 2020; Lukiastuti, 2021). Competitive advantage allows firms to deliver superior value to customers, outperform competitors, and achieve above-average returns. Innovation further strengthens competitiveness, drives new product development, boosts sales, and ensures business excellence, making it essential for MSMEs to maintain market leadership and enhance overall performance (Ismanu & Kusmintarti, 2019; Sulistyono & Ayuni, 2020).

Competitive advantage is central to a firm's performance, reflecting its ability to deliver superior value to customers and outperform competitors (Hacioglu & Gök, 2013;

Zeebaree & Siron, 2017). Competitive advantage can be developed through effective strategies, particularly in human resource management, enabling firms to offer products with greater value, achieve higher returns, increase market share, satisfy customers, and ensure business sustainability (Ambarwati et al., 2020; Murtianingsih, 2021). Empirical studies show that competitive advantage positively influences MSME performance and marketing outcomes (Kiyabo & Isaga, 2020; Prihartono & Ali, 2020; Kencana & Giantari, 2021).

H5: Competitive advantage has a positive effect on business performance.

Competitive Advantage as a Mediating Variable

Innovation and entrepreneurial orientation play vital roles in shaping business performance, particularly when their effects are mediated by competitive advantage. According to Niadi and Wijayanti (2025), innovation significantly enhances business outcomes by fostering differentiation, efficiency, and the development of unique capabilities, which in turn strengthen firms' competitive advantage and consequently improve overall performance. Their study, focusing on MSMEs in Indonesia, highlights that innovative practices act as a strategic lever, effectively bridging entrepreneurial behaviors with sustainable competitive strength and long-term organizational growth.

Similarly, Ayetigbo et al. (2025) show that entrepreneurial orientation indirectly influences firm performance through competitive advantage among SMEs in emerging markets. Firms exhibiting proactive, innovative, and risk-taking behaviors are better able to identify opportunities, adapt to market changes, and outperform competitors, with competitive advantage serving as a crucial mediating factor that converts entrepreneurial actions into measurable performance gains. These findings collectively suggest that businesses capable of integrating innovation and entrepreneurial orientation to cultivate distinctive competencies are more likely to achieve superior and sustainable performance outcomes, reinforcing the strategic importance of both constructs in today's competitive business environment.

H6: Innovation has a positive effect on business performance through competitive advantage.

H7: Entrepreneurial orientation has a positive effect on business performance through competitive advantage.

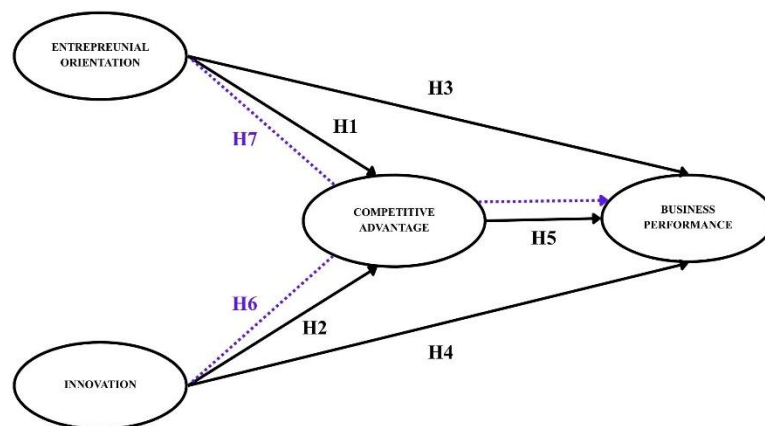


Figure 1. Conceptual Framework

The conceptual framework illustrating the connections between entrepreneurial orientation, innovation, competitive advantage, and business performance is shown in Figure 1. Competitive advantage acts as a mediating factor that amplifies the impact of entrepreneurial orientation and innovation on business performance, while

entrepreneurial orientation and innovation are shown as important drivers that directly affect both competitive advantage and business performance.

RESEARCH METHODS

A quantitative method was employed in this study. A survey approach for MSMEs in two Cirebon Regency subdistricts was used. The owners or managers of MSMEs are the research subjects. With a sample size of 132 MSMEs, this population is restricted to MSMEs that have been in business for at least five years. A Likert scale of 1 to 5 was used as a measurement scale for respondents' responses to each question item on questionnaires that were created based on operational definitions and indicators of each variable.

The following operational definitions and indicators of the variables measured in this study are based on the literature review. First, entrepreneurial orientation is defined as the capacity of individuals or businesses to recognize and seize opportunities through proactive actions, calculated risk-taking, innovation, competitiveness, and acting independently (autonomy) in launching new products and services to win the competition. The indicators of entrepreneurial orientation are proactive actions, innovative, risk-taking, aggressive, and autonomy. Product innovation, process innovation, and market innovation are indications of innovation, which is defined as the generation of concepts, development, discovery, and, ultimately, the launch of new goods, services, or processes. Third, competitive advantage is the aggregation of various things that distinguish companies from their competitors and provide a unique and superior position in the market, with indicators: unique, competitive prices, rarely found, profitability, not easy to imitate, and not easy to replace. Finally, business performance is a measure of the company's success by taking into account the value provided to both internal and external customers, with indicators: growth, efficiency, and profit.

Data analysis was conducted using the Structural Equation Modeling approach with Partial Least Squares (PLS-SEM). The analysis process in PLS-SEM consists of three main stages: model specification, assessment of the outer model, and assessment of the inner model. The analysis process consisted of three main stages: model specification, assessment of the outer model (validity and reliability of measurement items), and assessment of the inner model (path coefficients, hypothesis testing, and significance of relationships) (Hair et al., 2014). This method allows the estimation of direct, indirect, and total effects among entrepreneurial orientation, innovation, competitive advantage, and business performance, making it suitable for analyzing complex relationships in MSMEs.

RESULTS

Based on theoretical and empirical evidence, entrepreneurial orientation and innovation are found to have a positive impact on both competitive advantage and business performance. In addition, competitive advantage itself positively influences business performance. Therefore, entrepreneurial orientation and innovation not only exert a direct effect on business performance but also an indirect effect through competitive advantage. Based on this conceptual framework, the measurement and structural model specifications are illustrated in the diagram presented in Figure 2.

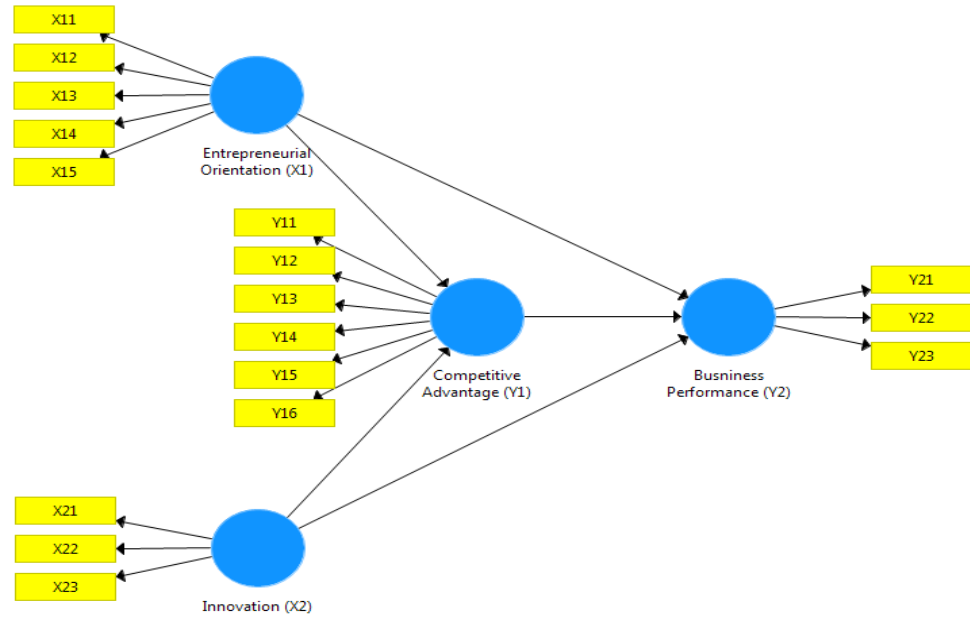


Figure 2. Measurement Model (Outer Model) and Structural Model (Inner Model)

Table 1. Validity Test

Variable	Indicator	Factor Loading	Cronbach Alpha	Composite Reliability	AVE
Entrepreneurial Orientation	X11	0.797	0.83	0.88	0.60
	X12	0.774			
	X13	0.747			
	X14	0.738			
	X15	0.796			
Innovation	X21	0.786	0.76	0.86	0.67
	X22	0.712			
	X23	0.794			
Competitive Advantage	Y11	0.747	0.84	0.89	0.57
	Y12	0.733			
	Y13	0.791			
	Y14	0.723			
	Y15	0.710			
	Y16	0.725			
Business Performance	Y21	0.707	0.78	0.87	0.69
	Y22	0.844			
	Y23	0.801			

The evaluation of the measurement model is conducted to confirm the relationship between latent variables and their respective indicators. This evaluation involves testing the model's reliability and validity. The reliability test in Table 1 results indicate that all constructs in this study demonstrate good reliability. This is evidenced by Cronbach's alpha values exceeding 0.600, composite reliability values above 0.700, and AVE values greater than 0.500. Since all constructs in the measurement model employ reflective indicators, validity testing is carried out through assessments of convergent validity and discriminant validity. Convergent validity examines the correlation between manifest variables within a construct and is evaluated using AVE and outer loading values, with thresholds of 0.500 and 0.700 or higher, respectively. The findings show that all constructs have AVE values above 0.500 and outer loading values exceeding 0.700. These results confirm that the construct measurements in this study have achieved adequate convergent validity.

Table 2. Discriminant Validity

Construct	Entrepreneurial Orientation	Innovation	Competitive Advantage	Business Performance
Entrepreneurial Orientation	0.775			
Innovation	0.42	0.819		
Competitive Advantage	0.46	0.58	0.755	
Business Performance	0.31	0.39	0.52	0.831

Meanwhile, discriminant validity was observed through cross-loadings, that is, item loadings of relevant constructs were higher than item loadings designed to measure all constructs and the Fornell-Larcker Criterion. Testing the discriminant validity of the construct measurement results that the cross-loading value of all constructs with each indicator is higher than 0.700. Based on Table 2, the Fornell-Larcker criterion value for all constructs with each indicator is higher than 0.700. These values indicate that the construct measurement in the study has met discriminant validity.

The structural model evaluation aims to determine the relationships among all latent variables within the model. The quality of this model is assessed based on its predictive capability for endogenous constructs. Parameters used in evaluating the structural model include the coefficient of determination (R^2), cross-validated redundancy (Q^2), and path coefficients.

Table 3. R-Square & Q^2 Test

Variable	R^2 Value	Interpretation of R^2	Q^2 Value	Predictive Relevance
Competitive Advantage	0.214	Weak effect of entrepreneurial orientation and innovation on competitive advantage	0.108	Satisfactory ($Q^2 > 0$)
Business Performance	0.273	Moderate effect of entrepreneurial orientation, innovation, and competitive advantage on business performance	0.139	Satisfactory ($Q^2 > 0$)

The coefficient of determination for the structural model of improving MSME firm performance in Cirebon Regency is shown in Table 3. The competitive advantage R^2 score is 0.214, which suggests that innovation and entrepreneurial orientation have little impact. The R^2 value for firm performance is 0.273, indicating a moderate impact of innovation, competitive advantage, and entrepreneurial orientation. Competitive advantage and company performance have Q^2 values of 0.108 and 0.139, respectively. The predictive significance of the model is good because both Q^2 values are bigger than zero.

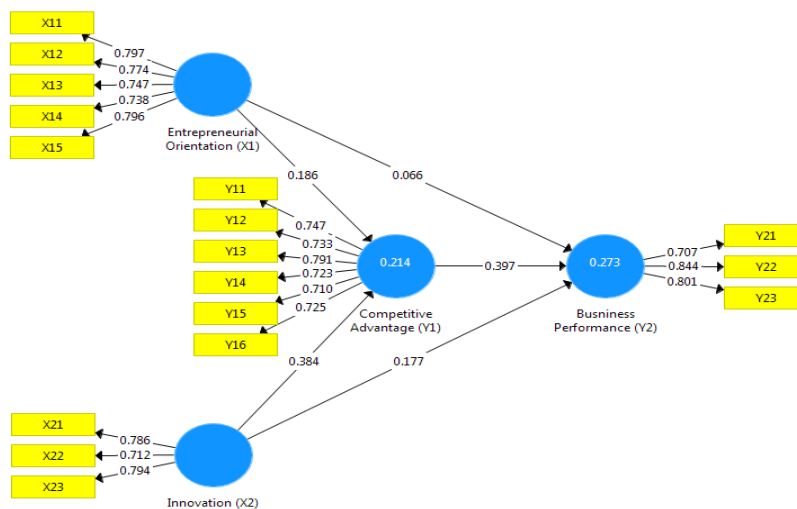


Figure 3. Structural Model of MSME Business Performance Improvement

Table 4. Hypothesis Testing

Path	Original Sample	Sample Mean	Standard Deviation	T-Statistics	p-value
Entrepreneurial Orientation → Competitive Advantage	0.186	0.197	0.072	2.563	0.011
Innovation → Competitive Advantage	0.384	0.392	0.079	4.839	0.000
Entrepreneurial Orientation → Business Performance	0.066	0.083	0.077	0.865	0.387
Innovation → Business Performance	0.177	0.179	0.088	2.017	0.044
Competitive Advantage → Business Performance	0.397	0.397	0.081	4.916	0.000

Based on Table 4 and Figure 3, path coefficient analysis indicates that entrepreneurial orientation has a positive and significant effect on competitive advantage ($\beta = 0.186$; $t = 2.563$; $p = 0.011$), suggesting that stronger entrepreneurial orientation enhances an organization's competitive positioning. Innovation also exerts a positive and significant influence on competitive advantage, with a larger effect size ($\beta = 0.384$; $t = 4.839$; $p < 0.001$), underscoring its critical role in strengthening competitive advantage. However, entrepreneurial orientation does not have a significant direct effect on business performance ($\beta = 0.066$; $t = 0.865$; $p = 0.387$), indicating that its contribution to performance is indirect rather than immediate. In contrast, innovation has a positive and significant direct effect on business performance ($\beta = 0.177$; $t = 2.017$; $p = 0.044$). Furthermore, competitive advantage demonstrates the strongest positive effect on business performance ($\beta = 0.397$; $t = 4.916$; $p < 0.001$), confirming its central mediating role in translating entrepreneurial orientation and innovation into improved business performance.

Table 5. Indirect Effects Test Results

Path	Specific Indirect Effects
Innovation → Competitive Advantage → Business Performance	0.152
Entrepreneurial Orientation → Competitive Advantage → Business Performance	0.074

The findings of the indirect effects test are shown in Table 5. With a value of 0.152, innovation has an indirect impact on business success through competitive advantage. With a value of 0.074, entrepreneurial orientation also indirectly affects firm performance through competitive advantage. These results suggest that competitive advantage acts as a moderator. Thus, through competitive advantage, both innovation and entrepreneurial orientation have an impact on corporate performance. Based on the direct and indirect effects, it can be determined that the total effect of each exogenous variable on the endogenous variables is as shown in Table 6.

Table 6. Total Effect

Variable	Value
Innovation → Business Performance	0.330
Competitive Advantage → Business Performance	0.397
Entrepreneurial Orientation → Business Performance	0.140
Innovation → Competitive Advantage	0.384
Entrepreneurial Orientation → Competitive Advantage	0.186

Table 6 shows that entrepreneurial orientation has a total impact of 0.186 on competitive advantage and 0.140 on business performance. Innovation has a significantly greater overall impact on competitive advantage (0.384) and on company success (0.330). In the meantime, the overall impact of competitive advantage on firm performance is 0.397. These findings demonstrate how innovation and entrepreneurial orientation both directly and indirectly improve corporate performance through competitive advantage. In

general, innovation seems to have a greater influence on creating competitive advantage and enhancing corporate success than entrepreneurial orientation.

DISCUSSION

Entrepreneurial orientation, understood as an organizational attitude, characteristic, or process, is widely recognized as a key determinant of company success. Entrepreneurial orientation encompasses behaviors such as innovation, proactiveness, risk-taking, aggressiveness, and autonomy, serving as a driving force for sustainable and competitive growth (Zeebaree & Siron, 2017; Rahmadi et al., 2020). Firms with strong entrepreneurial orientation consistently develop innovative products and take calculated risks, which can enhance long-term competitiveness. However, in the early stages of business development, these traits may reduce focus on immediate performance outcomes, particularly for MSMEs. This study finds that entrepreneurial orientation positively affects the competitive advantage of MSMEs in Cirebon Regency, with a direct effect of 0.186 (18.6%) and an indirect effect on business performance through competitive advantage of 0.074 (7.4%). These findings align with Kusuma and Rastini (2017), who reported that entrepreneurial-oriented managers are better positioned to build competitive advantage, highlighting the role of entrepreneurial orientation in long-term strategic growth.

Similarly, innovation plays a crucial role in enhancing MSME performance and sustaining competitive advantage. Innovation enables companies to develop new products, improve processes, and respond effectively to market changes (Artz et al., 2010; Herlinawati & Machmud, 2020). This study shows that innovation has a direct positive effect on competitive advantage (0.384 or 38.4%) and an indirect effect on business performance through competitive advantage (0.152 or 15.2%), resulting in a total effect of 0.330 (33.0%). These results support prior research indicating that innovative capacity is essential for maintaining competitive advantage, particularly amid globalization and rapidly changing markets (Forsman & Temel, 2011). Firms that innovate are better able to outperform competitors, sustain profitability, and adapt to shorter product life cycles (De Conto et al., 2016; Efrata et al., 2019). In the context of MSMEs, this underscores the importance of fostering a culture of innovation to enhance both competitive advantage and business performance.

Competitive advantage itself has the strongest impact on MSME business performance in Cirebon Regency, with an effect of 0.397 (39.7%). Competitive advantage represents a company's unique position in the market, allowing it to achieve returns above industry averages and enhancing both operational and marketing performance (Prihandono et al., 2021). This finding confirms previous studies suggesting that firms with sustainable competitive advantage are better able to maintain profitability, expand market share, and improve customer satisfaction (Lestari et al., 2019). Moreover, by leveraging competitive advantage, MSMEs can transform entrepreneurial and innovative efforts into measurable performance improvements.

The results indicate that while entrepreneurial orientation and innovation positively influence business performance, their effects are partially mediated by competitive advantage. Entrepreneurial orientation contributes to competitive advantage and indirectly enhances business performance, but its short-term impact on performance may be limited, particularly for younger MSMEs. In contrast, innovation demonstrates both significant direct and indirect effects, highlighting its critical role in improving performance outcomes. These findings suggest that MSME managers should not only focus on developing entrepreneurial traits but also prioritize innovation as a strategic tool to strengthen competitive positioning and business results (Rahmadi et al., 2020).

In practical terms, fostering entrepreneurial orientation and innovation among MSME managers can enhance the firm's ability to identify opportunities, take calculated risks, and implement creative solutions (Paulus & Wardhani, 2018). At the same time, building a sustainable competitive advantage ensures that these efforts translate into tangible performance improvements, including higher profitability, market share growth, and

long-term sustainability. This study reinforces the theoretical and practical significance of entrepreneurial orientation, innovation, and competitive advantage as interrelated drivers of MSME success, particularly in dynamic and competitive markets.

CONCLUSION

The analysis and hypothesis testing of MSME business performance in Cirebon Regency using Structural Equation Modeling (SEM) indicate that entrepreneurial orientation and innovation play a crucial role in creating a competitive advantage. This competitive advantage, in turn, serves as a key driver for improving MSME business performance. In other words, MSMEs that cultivate entrepreneurial attitudes and foster a culture of innovation are more likely to compete effectively and achieve superior performance outcomes. These findings highlight the importance of a high level of commitment from MSME owners or managers to continuously enhance business performance, ensuring that the enterprise provides significant value to customers. Efforts to improve performance should begin with developing entrepreneurial orientation and encouraging innovation among owners, managers, and employees, which collectively strengthen the firm's competitive positioning.

However, a limitation of this study lies in the operating period of the MSMEs under investigation, which is a minimum of five years. At this stage, many MSMEs are still in the growth phase, meaning that the observed effects of entrepreneurial orientation and innovation on business performance may not fully reflect long-term outcomes. Future research is therefore recommended to focus on more established MSMEs, for example, those that have been operating for at least ten years, to better capture the long-term impact of entrepreneurial orientation, innovation, and competitive advantage on business performance. Additionally, subsequent studies could incorporate other variables, such as managerial capacity or technological support, to gain a more comprehensive understanding of the factors that strengthen the relationship between entrepreneurial orientation, innovation, and MSME performance. The study underscores the critical role of entrepreneurship and innovation as interrelated drivers of MSME success.

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