

Chapter 1

INTRODUCTION

1.1 Background of the study

For many decades, both the small and medium enterprises (SMEs) have played essential roles in the global economy, mainly for their contribution to generate job opportunities, poverty alleviation, and value added advantages (Nagai, 2007; Hashim, 2000, in Shankar, 2010; Agyapong, 2010; Mukhamad *et al.*, 2011; Salleh, 1991; Meghana, 2005; Vandenberg, 2006). In addition, scholars have found that firm participation in international trade would bring benefits for the growth of economy. The growth of exports would improve productivity and increase the inflow of capital from overseas. This would, in turn, improve the economic growth (Franco, 2012). Similar findings were found by Michael *et al.*, (2009) that export activities were correlated with economic growth and improved the welfare of people. Vuks (2007) studied the exports in 12 Central and Eastern European (CEE) economies during the period of 1996 - 2004 and found that when export potential increased, the capability of knowledge and technology, information of export markets, and connection with the supply chain of exporters also improved. These would encourage foreign direct investment (FDI). Similar studies on the benefits of internationalization can be found in studies conducted by Andong Zhu, and David (2011), and Priyanga (2009).

Since engaging in exports bring significant benefits for SMEs, many research findings conclude that participating in internationalization for SMEs would effect significantly on the growth of firms. For their capability in generating job availabilities, value added, and poverty alleviation (Nagai, 2007; Hashim, 2000, in Shankar, 2010; Agyapong, 2010;

Mukhamad *et al.*, 2011; Salleh, 1991; Meghana, 2005; Vandenberg, 2006). Engaging in internalization would also provide SMEs to be recognized among their competitors and better opportunities to enter new markets (Ungson *et al.*, 1997).

Furthermore, enhancing a firm's performance in the export trade continuously strengthens its standing and allows SMEs for better performance (Kaleka, 2010). Other ideas, as suggested by Karagozoglou, and Lindell (1998), showed that export activities strengthened the competitiveness between the SMEs in the long run. This is because the global operations increase the firm's exposure to the diverse environment and its competency (Vieira, 2009).

The importance of export participation to the overall firm's performance has motivated researchers and scholars to look further into the leading factors that would advance export performances. Leonidou (1996), and Zou, and Stan (1998) found that characteristics and competencies, as well as marketing strategies of firms were most closely interrelated with the performance of export. Interestingly, another study conducted by Ogbeuhi *et al.*, (1994) indicated that the failure of export occurred due to the ineffectiveness and inefficiency in the performance of distribution channel. Furthermore, Shaoming (1998), in his empirical findings of determinant factors in enhancing the performance of export, asserted that distribution channel contributed to be one of the determining factors among them.

However, as the characteristic of an established distribution channel is usually difficult to change (Ramaseshan, & Patton, 1994) and realizing the crucial role of distribution channel on a firm's performance, studies on the relationship among channel members; i.e. suppliers,

manufacturers, distributors, and agents were found to lead better channel performance. Furthermore, Leonidou (1989), Heide (1994), and Morgan, and Hunt (1994) recommended that the inappropriate management of relationships between producers and importers could cause malfunction, which, in turn, would affect the operating performance of the firms. Another similar indication was found by Frazier *et al.*, (1989), which showed that misunderstanding that happened among channel members would not strengthen their relationships, but rather reduced the quality of strategy used that could ease performance. Generally, the driving force of a dealer's need of maintaining a channel relationship was primarily triggered by the contributions of manufacturers to the dealer's benefit. Other several similar topics and findings with reference to channel member relationship can be found in studies carried out by Anderson *et al.*, (1997), Kim (2001), Long (2003), Jennifer (2008), Jiu (2009), Bret (1995), and Rose, and Shoham (2004).

In terms of channel members' arrangement, Rialp *et al.*, (2002) examined the integration of structural channels over firms in Spain, which were engaged in exporting, and they invented obvious evidences that established linkage to importers via distribution decision that could enhance the export process. In respect to other channel arrangement studies, Mcnaughton (2002) shared his result that indicated the aim of multiple distribution channel establishment was merely motivated by serving foreign markets. Kumar *et al.*, (2000) suggested that decentralization of channel members was recommended. An efficient integration of supply chain would play a more critical role in sustaining competitiveness (Kim, 2010). Similar topics were also addressed by Weigand (1989, 1991), Ramaseshan, and Patton (1994), and Zdenko (2011), and the results were all found to lead towards the performance of channel members.

As innovation is believed to designate the main drive for firms to pursue higher competitiveness and better performance, there were findings that had led innovation to remain diverse upon firm performance. Besides, Roper *et al.*, (2001), Pla-Barber *et al.*, (2007), Moini (1995), Wagner (2001), Wakelin (1998), Ozçelik *et al.*, (2004), and Galende *et al.*, (2002) found that innovation was closely associated with firm performance, while Mandy (2010), on the other hand, found that there was no significant relationship between innovation and firm performance. Interestingly, Geroski *et al.*, (1993), and Eitan Naveh *et al.*, (2006) indicated that the effect of process and administrative innovation was led to different ways as far as firm performance was concerned.

In addition, it has been found that the existence of SMEs is essential in the global economy and innovation has been long thought as the determinant factor for the growth of SMEs. However, previous findings of innovation on SMEs performance also indicated mixed results. A study by Freel, and Robson (2004) on the impact of novel and incremental innovation on SMEs in Scotland and Northern England found a negative relationship between product innovation (both incremental and novel) and growth in sales or productivity, at least within a short term. Similar results were also found by Wolff and Pett (2006) on small firms. It was indicated that process improvement did not explain growth of sales. Further findings on service sectors of SMEs innovation were found by Daniel (2011). It was proven that ambidextrous innovation was positively correlated with firm performance. However, another similar study by Mandy (2010) found that there was no significant relationship between distinctive capabilities, innovativeness, and strategies on the export performance of SMEs. In Indonesia, a recent study by Mukhamad *et al.*, (2011)

on domestic oriented food sectors indicated that innovation in product and marketing process explained business performance, while Rosli *et al.*, (2012) asserted that product innovation had a significant impact on firm performance among Indonesian SMEs.

Other than that, in terms of the distribution channel of innovation, a study by Heide *et al.*, (1994) found that the success of an exporter (manufacturer) in a developing country was much associated with how the behavioural relationship with foreign importer was managed; the use of information technology in distribution channel, for instance, internet was empirically found to smoothen the progress of the internationalization process of SMEs and to enhance firms in building relationship with other distribution channels within the same distribution chain (Fern'andez, 2006). Information technology (IT) employed by supply chain members was also indicated to encourage channel member coordination and also had a positive impact on the effectiveness and efficiency. The use of IT also directly promoted a precise type of coordination activity, in which, it would be able to achieve both strategic and operational benefits within the channel (Nada, 2008). Other empirical studies also had the same indication that using inventory and scheduling integration methods in distribution channels helped firms to enhance efficiency (Varimna, 2009).

Furthermore, a similar study conducted by Martina *et al.*, (2009) also assured that the use of IT could create efficiency in tracking returnable packaging and transport units. Product configurators in technology, which had the capability of customizing a wide range of products, would generate an efficient and effective way of presenting the products to customers (Fabricio, 2004). Gunasekaran *et al.*, (2010), in his study on Turkish and Bulgarian SMEs in the food and beverages sector, also indicated similar findings, whereby

implementing IT practices and supply chain strategies in SMEs would raise the level of competitiveness.

1.2 Problem statement

Considering the essential role of distribution channel for firm performance, there are many previous studies that can be found related to this topic. In terms of distribution channels, each channel member normally has distribution channel activities which have already been in existence since the time of the ancient Egyptians; the only thing new is the way it is done (Glaskowsky, 1970; Waidringer, & Eng, 2001). The activities are functioned to guide the product flow from producers to consumers or importers. Most previous studies were conducted on the organizational relationship behaviours (Leonidou, 1989; Moore, 1991; Heide, 1994; Morgan, & Hunt, 1994; Jennifer, 2008; Jiu, 2009; Bret, 1995; John, 2006) and governance arrangement among the channel members (Weigand, 1989, 1991; Kim, 2010; Zdenko, 2011; Rialp, 2002; Mc Naughton, 2002). These studies were found to give information on better channel performance, whilst studies related to handling of the goods' flow (the activities) towards its end users in the context of export-oriented SMEs of the agriculture-based industry have been extremely limited.

Albeit several case studies, empirical evidences depicting the relationship between innovation (this includes distribution channel innovation) and firm performance are varied. This means that while some studies have shown that innovation was closely associated with firm performance (Pla-Barber, & Alegre, 2007; Moini, 1995; Hirsch, & Bijaoui, 1985; Love, 2001; Ozçelik, & Taymaz, 2004; Roper, & Love, 2002; Wakelin, 1998), other studies, however, have found that the effect of process innovation produced different results when

associated to firm performance (Geroski, & Machin, 1993; Mark, 2004; Lin *et al.*, 2007; Eitan, 2006; Mandy, 2010; Gunday *et al.*, 2011). Some other studies have found that process innovation in the distribution channel did not boost sales growth in smaller firms (Wolff & Pett, 2006). These diverse results were due to the weaknesses of past studies in identifying the mediating role of distribution channel performance in the relationship between distribution channel innovations and firm performance.

Therefore, in order to fill the literature gap, besides examining the impacts of innovation in distribution channel activities that lead to firm performance, this study also examined the mediating effects of distribution channel performance in terms of effectiveness and efficiency between the relationship of innovation in distribution channels and firm performance of export-oriented agriculture-based SMEs.

1.3 Research questions

The findings that were addressed earlier indicated that the effectiveness and efficiency of distribution channel play a significant role in export performance. Furthermore, previous studies have also clearly shown that firm performance was driven by how channel members improved the competitiveness of information sharing and coordination, misunderstanding avoidances, sales and profit production, trusting and holding commitment performance, as well as how they arranged both formal and non formal channels, channel members formation, and so on. While the impact of a firm's innovation includes innovation in distribution channels and the driver of performance is found to be diverse, there are extremely limited studies on how the activities of distribution channel

innovations lead to firm performance in the context of SMEs. Therefore, several research questions were developed, as in the following:

RQ1: What types of innovations in distribution channel activities that would affect distribution channel performance in terms of effectiveness and efficiency?

RQ3: Does distribution channel performance in terms of effectiveness mediate the relationship between distribution channel innovation and firm performance?

RQ4: Does distribution channel performance in terms of efficiency mediate the relationship between distribution channel innovation and firm performance?

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1.4 Objectives of the study

1.4.1 General objective of the study

Motivated by the lack of studies on the impact of innovation in distribution channel activities in the context of SMEs, and furthermore, being stimulated by diverse findings of studies on innovation, including in distribution channel upon firm performance, and to fill the literature gap, the general objective of this study was to identify the determinant factors of innovation in distribution channel activities that lead to positive firm performance in export oriented SMEs.

1.4.2 Specific objectives of the study

Several specific objectives derived from the research questions are as in the following :

Objective 1: To identify the types of innovation in distribution channel activities that would affect distribution channel performance in terms of effectiveness and efficiency performance.

Objective 2: To examine the mediating effect of distribution channel effectiveness on the relationship between distribution channel innovation and firm performance.

Objective 3: To examine the mediating effect of distribution channel efficiency on the relationship between distribution channel innovation and firm performance.

Objective 4: To examine the mediating effect of distribution channel effectiveness and efficiency on the relationship between distribution channel innovation and firm performance.

1.5 Scope of the study

In order to capture how innovation in distribution channel affects firm performance; this study captured the Indonesian SMEs that processed raw materials to produce products originating from the agriculture sector. This study focused on the internal factors of distribution channel innovation activities within the SMEs. The SME is defined by referring to the number of employees (ASEAN SMEs, 2011; European Urban, & Regional Studies, 2001; HaBrookshire, & Dyer, 2008; Menegkop, & UKM Law No. 9 on Small and

Medium Enterprises Indonesia, 1995). Besides, as far as this study was concerned, the SMEs were export-oriented small and medium scale enterprises in Indonesia and were involved in the production process activities with less than 100 employees (Menekop, & UKM Law No.9 on Small and Medium Enterprises of Indonesia, 1995), most of which were concerned with wooden, handicraft, clothing, and other agriculture-based industries. Innovation in distribution channels was emphasized on the activities, wherein agility and responsiveness of human resources between SMEs and other distribution channels members were considered similar. The flow of products began when the transactions were completed.

1.6 Contributions and significances of the study

As addressed earlier, the role of distribution channels has become one of the determining factors for export-oriented SMEs to enhance firm performance in order to gain competitiveness. Studies conducted on governance and behaviour among channel members (suppliers, producers, distributors, agents, and consumers) showed an increase in channel performance. At any rate, relevant studies on the producers or manufacturers' distribution innovation activities in the context of export-oriented agriculture-based SMEs industries are hardly found. Therefore, in terms of knowledge, as mentioned in the literature, by adopting innovation in distribution activities, this study examined the innovation in distribution channel activities that led to firm performance, especially in export-oriented agriculture-based SMEs in the manufacturing sector.

The impact of innovation on firm profitability seems to be positively obvious even though some empirical studies have shown differing results. According to Geroski *et al.*, (1993),

product and production process innovations had different effects on firm profitability. Hence, for entrepreneurs or stake holders, this study might shed some light in comprehending how innovation in the distribution channel of SMEs leads to firm performance, especially in terms of export and how the innovation could strengthen their channel members' performance. This, in turn, it becomes one of the crucial factors in accessing the international market.

It has been commonly believed that the role of SMEs in the global economy is becoming more important and should be considered. As their numbers place them in the highest proportion, hence their abilities to contribute to employment absorbance are the highest. SMEs also have deep impact in adding value to goods and services in almost all sectors. Although value is added to SMEs, they have more uniqueness and diversity as compared to the larger enterprises due to the high human resource skill involvement in production. As innovation is one of the main factors in improving the performance of SMEs, other related institutions, such as the government, is therefore, expected to share this responsibility, as lack of technology and innovation are some of the weaknesses that hold SMEs back from achieving their competitiveness. Therefore, this study suggested some directions to the government and/or other related institutions in identifying how innovation in distribution channels of the export-oriented agriculture-based SMEs in the industrial and manufacturing sector might enhance firm performance.

1.7 Organization of the study

This study is organised into eight (8) chapters in order to address and unfold all issues and contents of the study. Chapter 1 begins with the common characteristics of SMEs, their definition, and contributions to the national and/or global economy and then, continues to address the series of issues within the topic. Moreover, in order to make this chapter easily explicable, the subsections in the chapter further explain the related issues and an empirical flow of previous findings in respect to the topic in question. Based on the literature review available, it attempts to state the gap, which is coherent with the current issues, as well as previous findings from relevant studies. The objective of this chapter is to present how a problem statement briefly emerges and leads to the research questions and objectives of the study, in which it would be expected to enrich the available literature or provide new knowledge. Thereafter, the general picture of SMEs in Indonesia is addressed in Chapter 2. Chapter 2 describes the view of SMEs in Indonesia; their definition, their contributions to the Indonesian national growth, their characteristics, and the main problems hindering their development. The objective of this chapter (Chapter 2) is to describe how SMEs in Indonesia, as in other parts of other world, exist, survive and have significant contributions to the economy. Next, Chapter 3 focuses on the main groups of variables involved in the study, namely: concept of SMEs in global, distributional channel, innovation, and firm performance. Issues relevant to the main groups are addressed in this chapter. Another objective of this chapter is to explain theoretically rather than empirically, of the relevant variables that are supported in the next following phase of the study. Chapter 4 is the one chapter that shall picture the conceptual framework of the study. The chapter begins by exploring the linkages of each variables involved in this study to distribution and firm performance. In this chapter, all relevant previous empirical findings of product

distribution channel, innovation, distribution performance, firm performance, and other control variables, such as environment hostility, firm size, firm age, and industrial sector on firm performance are addressed. Based on the empirical literature provided, the conceptual frame work and hypotheses were built in order to achieve the objectives of the study. Various concepts, theories, and relevant variables are also addressed so as to support the addressed literatures. The study then continues to Chapter 5, which explains the research methodology employed. Chapter 5 describes how the quantitative research methodology, as conducted by other researchers based on the conceptual framework, was conducted to achieve the said objectives. The methods of collecting and analysing the primary data of SMEs are also explained accordingly. Some tools of data analysis are addressed in this chapter. Chapter 6 presents the findings obtained from the quantitative procedures in order to go further in the parametric tests. In this chapter, respondents' profiles and correlation results are among the variables that are addressed. These findings are then used to support certain specific questions and hypotheses posed earlier. Hierarchical regression was also used so as to examine the mediator effect of distribution channel performance between the relationship of distribution innovation and firm performance. Continuing to Chapter 7, the author revisits the research objectives and then discusses them in the same chapter. Finally, based on previous discussions, the final conclusion was drawn with several suggestions of future studies, several implications of the study, and research recommendations made and these are constituted in Chapter 8.