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## The effect of leadership and innovation on differentiation strategy and company performance

Hatane Samuel, Hotlan Siagian\* & Stefanie Octavia

*Petra Christian University, Jl. Siwalankerto 121-131, Surabaya, 60236, Indonesia*

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### Abstract

This study examined the effect of leadership and innovation on differentiation strategy and company performance of hotels in Surabaya, Indonesia. The study used quantitative research methods and data was collected by distributing questionnaire to respondents having level of position from supervisor up to CEO within the organization. Descriptive statistical analysis was performed using SPSS, whereas hypotheses testing used SEM (Structural Equation Modelling) and Partial Least Square (PLS). The results showed that leadership affect the performance of hotels, either directly or indirectly through innovation and differentiation as an intervening variable. While leadership does not affect directly differentiation strategy, but it affects indirectly through innovation.

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*Keywords:* Leadership, Innovation, Differentiation, Company Performance

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### 1. Background

Leadership is an important role which affects the success or failure of an organization. The need of good leadership is increasing, especially in facing the global competition. As it might be noticed that globalization supported by advanced technology has allowed the entry of new competitor into different country and at the same time also enabled the introduction of imitation product. As a result, products tend to be more comoditized since there was no more any uniqueness among the product and consequently competition is only based on the price (Kim & Mauborgne, 2005).

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\* Corresponding author. Tel.: +62312983526;  
*E-mail address:* [hotlan.siagian@petra.ac.id](mailto:hotlan.siagian@petra.ac.id)

However, since the financial crisis in the year of 2008 particularly for developing countries, many global companies have been switching their competitive strategy from low cost strategy based on price competition, to differentiation strategy (Gehani, 2013). Moreover, focus on only cost leadership strategy is no longer suitable to accommodate the diverse needs of the customer (Parera & Poole, 1997).

Basically, differentiation is the act of designing a set of meaningful differences to distinguish the company's offerings from competitors' offerings (Kotler & Armstrong, 2003). Companies that use a differentiation strategy consider the first entry into the market as a top priority. Being the first in the market, the company has the discretion to set prices, and exploit the wide market segment in the pursue of achieving high profit and growth. Advantages through differentiation strategy can be achieved through good product quality and emphasis on innovation as the spearhead of the company. According to Porter (1990), innovation is the only way for companies to gain a sustainable competitive advantage and improve performance. Keywords of innovation is creativity in making changes and commercial value. Creativity will be required to exploit an existing product as well as in creating a new product. However, commercial value of the product is also needed in order for a new discovery can be called innovation.

Beside the potential growth, innovation also could bring the company into the market failure causing harm to the company. Such failures might be due to a lack of understanding on the consumers need when innovation does not conform to the market. Leadership supports the creation of innovation through the creation of an environment that fosters creativity, as well as the allocation of resources both in generating accurate market research and the creation of innovations that are acceptable to the market. When leaders see innovation as optional and focus on the company's daily operational (day-to-day operations), the emergence of innovation is inhibited, consequently it results in failure in innovation performance. Therefore, it requires strategic leadership to balance between the short-term and long-term needs of the company, such that both innovation and the company daily operations run well.

Addressing the need of strategic leadership in the hotel industry in Surabaya might be examined from the following data. Since the year 2013 to 2015, the number of hotels in Surabaya has grown highly. In 2014, the number of hotel in Surabaya increased five (5) new hotels which means total industry number of room available increased to 724 rooms while in 2015 an additional of 29 new hotels have been built and ready for services. This growth is predicted to continue in 2016, with additional five new hotels by which, a cumulative of 879 rooms will be available (Prasojo, 2015). This growth is a response to an increasing number of foreign and domestic tourist arrivals in Surabaya. In the period of January-April 2014, the number of foreign tourists who visit Surabaya through the Juanda International Airport increased 1.3 percent compared to the same period in 2013 (Alexanders, 2014). Unfortunately, this growth in number of tourists, did not lead to an increased in occupancy rate of the hotel in Surabaya. On the contrary the occupancy rate has declined since 2013. This situation plus the increase in operating cost such as electricity, food and wages has forced the management of hotels to create a variety of strategies and activities that create a competitive advantage in the pursue of company performance. This study will examine the relationship of leadership, innovation, differentiation strategy and company performance.

## **2. Literatures review**

Leadership is an individual ability to lead and direct a group of people in order to achieve certain goals (Nejad & Rowe, 2009). Strategic leadership is the ability to influence others to voluntarily make everyday decisions in the sense of growth in the short term and long term, as well as the existence of the company (Nejad & Rowe, 2009). Strategic leadership is a combination of the two types of leadership. The most important aspect of strategic leadership is their values and a clear vision, allowing employees to make operational decisions and leaders can focus on the company's strategic decisions. Strategic leaders encourage innovation in the face of environmental change and move forward as well as aware of the capabilities of the organization so as to benefit the company in both the short and long term. This study focus on strategic leadership due to its nature that encourages the creation of innovation which lead to better financial performance achievement. The empirical indicators of strategic leadership used on this research consisted of strategic direction, exploitation and maintainance of core competencies, development of human capital, maintaining of effective corporate culture, emphasizing of ethical practices and establishment of strategic control (Hitt, Ireland, & Hoskisson, 2005).

Differentiation is the act of designing a set of meaningful differences to distinguish the company's offerings from competitors' offerings (Kotler & Armstrong, 2003). A company can differentiate itself in various ways, such as offering

innovative features, launching effective promotions, provide superior service, develop a strong brand name, and so forth (Li & Zhou, 2010). Hilman (2009) states that organizations that use a differentiation strategy tend to establish the differences in various dimensions to make buyers understand the difference between their offerings and competitor. Companies with this strategy tends to offer their products at higher prices than competitors as compensation for its unique features, the cost of the system prompt delivery, quality of service and distribution channels (Hilman, 2009; Porter, 1990). In general, the power of differentiation is scarcity (rare) and costly to imitate is also a source of sustainable competitive advantage. The scarcity will weaken the strength of the buyer due to a lack of or even no alternative products comparable to the company's products. Hence, the empirical indicator differentiation on this research are the introduction of new product / service quickly, offering products / services are different, offering of products / services in a broad range, increased of the time availability of products / services, offering of products / services of high quality, offering of customized, and offering of after sales service and customer support (Auzair & Sofiah, 2011).

Innovation is the management of all activities related to the process of creating ideas, technology development, manufacturing and marketing of a product, process, manufacturing or new equipment (Trott & Paul, 2008). So innovation is a combination of all of these processes (Kotler & Amstrong, 2003). To create innovation, companies need to create an internal environment that facilitate a culture of innovation characterized by flexibility and speed to change for the sake of responding to new opportunities (Urbancova, 2013). Four main criterias of innovation include product innovation, process innovation, market innovation, organizational innovation (Ul Hassan, Shaukat, Nawaz, & Naz, 2013). Innovation performance is how fast, how good the ideas are implemented and how much value is created. In order to bridge the wide range of innovations used in the hotel industry, then innovation is measured by empirical indicators of innovation performance which are: the introduction of new products and services, the percentage of new products in the product portfolio, number of products and services on new projects, innovation in processes and working methods, quality of products and new services, and update of the administrative system and mindset.

According to Koontz & Donnel (1993), organizational performance refers to the ability of a company to achieve such high profits, product quality, a large market share, financial results were good, and the continuity of the company at any given time, and to make it happen it needs relevant strategies. Organizational performance can also be used to see as the extent to which an organization is able to meet the needs of stakeholders and its own needs for survival (Griffin & Ricky, 2003). Camison & Villar-Lopez (2012) states that traditional financial performance is the index most commonly used to measure the performance of the organization by the researchers. Financial ratio analysis can also give a fairly accurate picture of the performance of the company, is useful to compare the performance of several companies with relative different size, and is relevant to use because it is simple, comprehensive, and can be used by all companies (Dess, Gregory, & Lumpkin, 2003). Therefore, the company's performance in this study will use financial performance. The empirical indicator variables are sales growth rate, after tax net income growth, return on sales and profitability (Li & Zhou, 2010; Wang, Jen, & Ling, 2010).

### **3. Hypotheses**

The conceptual model of this study is presented in Fig.1 below. The model suggests the relationship among the research variables: leadership, innovation, differentiation strategy and company performance.

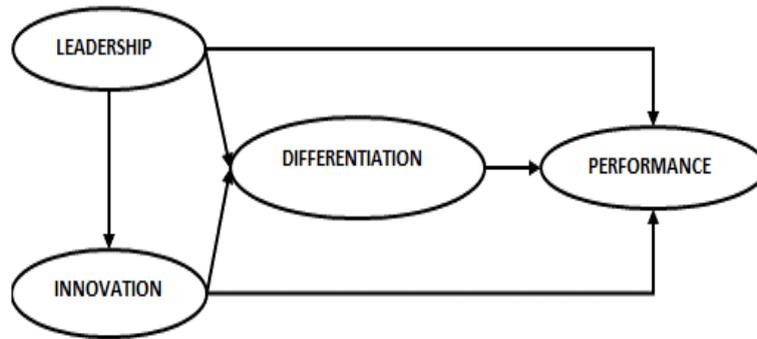


Fig. 1. Research model

Based on the above research model, the following 6 (six) hypotheses are proposed: H1: leadership affects innovation; H2: leadership affects differentiation strategy; H3: innovation affects differentiation strategy; H4: leadership affects company performance; H5: innovation affects company performance; H6: differentiation strategy affects company performance

#### 4. Method

The type of this study is a causal research which is relevant to examine the relationship between latent variable within the model. The population in this study are hotels rated at 3,4 and 5-star hotel located in Surabaya. From 52 hotels in total 40 hotels are selected for this study. The respondents are those who are in charge in the management level of each hotel starting from supervisor up to CEO since they are considered knowledgeable about the company particularly in respect of innovation, corporate leadership system. Data was collected by distributing questionnaire to 52 hotels in Surabaya city. The questionnaire is designed using 5-point Likert type scale (1 = strongly disagree, 5 = strongly agree). To each item statement, the respondents were asked to assess appropriately each statements in accordance with the actual conditions of the hotel. From 52 questionnaires, 47 questionnaires are completed and returned and after further verification 40 questionnaires were considered valid which means the response rate reached 76.92%. The assessment of validity, reliability and descriptive statistical analysis were performed using SPSS whereas hypotheses testing uses SEM (Structural Equation Modelling) and Partial Least Square (PLS).

#### 5. Results

Results of descriptive analysis showed that 45% of respondents have been working for 1 up to 5 years in the hotel. Based on respondent position within the organization, 55% of respondents are manager who is responsible in managing the innovation activities. The other (27%) are supervisor who, by job description, are responsible on daily operation of the hotel. This composition of respondents indicates that majority of respondents (77%) are responsible in decision making and daily operation of hotel. From the point of view of the hotel age, 45% have been in operation for more than six years which indicates that less than half of total sample have experience in competing in the industry. The appropriateness of the model is examined by assessing its goodness of fit (GOF) while the outer model or measurement model is tested by assessing the validity and composite reliability of block indicator of each variable. As shown on Fig.2 (a), leadership was assessed using six items. The result indicated that all indicators are valid except X14 with factor loading of 0.432, less than acceptable minimum limit of 0.5. Meanwhile, innovation, from six subjective item indicators, three of them (X22, X23, X24) are not valid as its factor loading less than 0.5. Consequently, these four indicators were excluded and then model was refined as shown on Fig. 2(b). From further analysis indicated that leadership indicators are all valid since the factor loading exceeds 0.5. Innovation indicators are all valid with factor loading exceeds 0.5. Differentiation strategy was assessed with seven items indicators and all

indicators are considered valid since factors loading exceeds 0.5. Company performance was assessed with four indicators and all indicators are valid based on the factor loading which exceeds 0.5.

Based on the result of inner model analysis, as shown on Table 1, five hypotheses were supported as t-value exceed 1.96. while one hypotheses H2 ( effect of leadership on differentiation) was not supported by the empirical data. As expected leadership has positive and significant influence ( $\gamma = 0.657$  and t-value  $> 1.96$ ) on innovation. H3, Innovation has positive and significant impact on differentiation ( $\beta=0.47$  and t-value  $>1.96$ ). H4, leadership has positive and significant influence on company performance ( $\beta=0.278$  and t-value  $>1.96$ ). H5, innovation has positive and significant influence on performance ( $\beta=0.232$  and t-value  $>1.96$ ). H6, Differentiation has positive and significant influence on performance ( $\beta=0.732$  and t-value $>1.96$ ).

Other result from this analysis is that leadership has no indirect impact on performance through differentiation since the relationship between leadership and differentiation was not significant. Therefore, leadership indirectly influence performance only through innovation

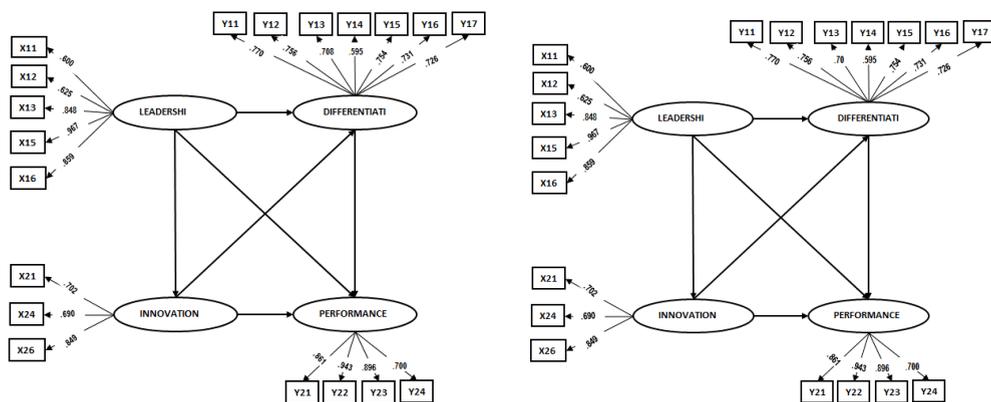


Fig. 2. (a) initial result; (b) refined result

Table 1. Inner model relationship coefficient

Relationship	original sample estimate	Standard deviation	T-Statistic
Leadership → Innovation, H1	0.657	0.084	7.831
Leadership → Differentiation, H2	-0.178	0.298	0.597
Innovation → Differentiation, H3	0.497	0.185	2.691
Leadership → Performance, H4	0.278	0.186	2.092
Innovation → Performance, H5	0.232	0.143	2.054
Differentiation → Performance, H6	0.732	0.148	4.947

### 6. Discussion

The results showed that leadership influence company performance. This is consistent with research conducted by Wang et al. (2010) who argued that when the executive is capable to execute its leadership well, employees will be inspired to actively involve work by which employees job satisfaction will be improved and at the end, they will provide their best work performance to increase the company's performance. The good leadership practices within a company which is represented by two main indicators (two highest factor loading i.e., developing human capital and emphasis ethical practices), facilitate proper allocation of resources and ethical practices to deliver best service to customers in the pursue of customer satisfaction and loyalty. Customer loyalty will certainly improve performance of

hotels in the form of after tax net income growth rate and return on sales, which are the two major indicators having highest factor loading in assessing the company performance.

Innovation represented by the number of new products and services introduced, accompanied by changes in administrative systems and mindset of employees, will be able to enhance the company's performance, especially in the form of efficiency and effectiveness and the increase of hotel revenue and total sales. However, this effect is lower than that of innovation to differentiation strategy. This means that innovation should result in a differentiation of the product or services. Otherwise, its effect on company performance will not be as strong as its effect through differentiation strategy. The results of this study also confirm the literature by Porter (1990) which stated that innovation is the only way for companies to gain a sustainable competitive advantage and improve its performance. This study also supports the argue that innovation can directly affect the company performance (Cheng & Krumwiede, 2011; Jimenez-Jimenez & Sanz-Valle, 2011; Kaliappen & Hilman, 2014)

This study also shows that the effect of leadership on differentiation strategy is not significant. This research differs from research conducted by Prajogo & Sohal (2004) which states that leadership can provide product differentiation for the company. This can be argued because leadership on the hotel cannot directly produce any new product or service to the customers but it can be created through innovation. Therefore, it is necessary to have an intervening variable, innovation, to create differentiation of the product or services of the hotel. The leadership, represented by the two major indicators developing human capital and emphasize ethical practices, cannot create product / service differentiation and assists companies in introducing new product / service quickly.

Leadership of the hotel as presented by two major indicators: developing human capital and emphasize ethical practices are essential in the management of hotel since these issues enable employees to understand how to greet and welcome customers which at the end it will enhance the renewal of the administrative system and mindset and introduction of new products and services. This means that the leader of hotels needs to improve human capital through technical or management training. This study supports the research which states that a person's style of leadership positively affects the performance of employees in creating innovation (Chow & Wu, 2003; Hemlin, Allwood, & Martin, 2008; Prajogo & Sohal, 2004; Shalley & Gilson, 2004; Somech, 2006; West, Borrill, Dawson, Shapiro, & Haward, 2003).

The success of the differentiation strategy to create competitive advantages and produce a good performance greatly depended on the company's success in performing innovation (Kaliappen & Hilman, 2014). Among those innovations are the provision of lot of meeting facility, ladies floor, cooperation with the travel agent, and cooperation with third parties in offering internet access. Hotel also delivered customized offer packages through internet access with separation of prices with the cost of breakfast. Innovation through a number of the introduction of new products and services, accompanied by rapid changes in the administrative system and changing the mindset of employees, will be able to produce variety of products to fulfil the needs of each customer. This study also confirms research which states that innovation can provide a new either method or products that provides increased differentiation strategy to outperform the competition (Al-alak & Tarabieh, 2011; Bilgihan, Okumus, & Kwun, 2011).

The company's ability to produce differentiated product / service, in a short time, will enhance the efficiency and effectiveness of the hotel which enhance hotel total sales and revenue. Beside the introduction of new products, within a short time will also be able to attract consumers continuously in the pursue of increased hotel sales. These results are consistent with the results of research that the company's strategy and competitive advantages affect the performance of the company (Amoako-Gyampah & Acquah, 2008). The study also supports research which states that the differentiation which was built by the organization in the banking industry in Malaysia was able to provide improved performance of the company (Al-alak & Tarabieh, 2011; Mosakowski, 1993; Spencer, Joiner, & Salmon, 2009).

## **7. Conclusion and suggestion**

From this study, it can be concluded that Leadership (indicated by human capital and ethical practices) affect directly the company's performance (demonstrated by the growth rate and return on sales company). Leadership also affect company's performance indirectly through innovation. Leadership does not affect differentiation strategy (indicated by introducing new product / service and offer a different product / service) directly, but it does indirectly through innovation (indicated by the renewal of the administrative system and mindset and introduction of new

products or services). Innovation affect the company's performance either directly, or indirectly, by influencing the differentiation strategy in advance.

Based on the results of this study, researchers suggests the practitioners or the leader to create such an environment that support the emergence of innovations such as the allocation of time, money and resources to do market research, find references and employee empowerment to experimenting. Through the creation of such atmosphere, it can be expected presence of innovation in the sense of differentiation resulting in enhanced company performance. Top management of hotels (3, 4 and 5 star rated) in Surabaya are advised to pay more attention to the human capital development and the emphasis on the company ethical practices through the provision of training and employee development. It should be noted that innovation should also be able to strengthen the differentiation strategy. If innovation does not strengthen the differentiation strategy, its effect on the company's performance could not sustain, because it does not provide a competitive advantage for companies to survive.

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