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Driving Firm Performance through Product Differentiation Strategy and Service Innovation: Evidence from Nepal's Commercial Banking Sector

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Abstract

Background: In Nepal's commercial banking industry, increased competition has led companies to adopt product differentiation strategies to enhance their market position. However, the impact of these strategies on performance, particularly from an innovation perspective, has not been thoroughly explored. **Objective:** This study explores how product differentiation strategies influence firm performance, placing special focus on the mediating role of service innovation in this connection. **Methods:** This study utilised Smart PLS-SEM analysis to examine the suggested relationships, drawing on data from 105 senior executives from 14 different commercial banks. **Findings:** The analysis reveals that simply differentiating products does not directly enhance the performance. Instead, it significantly boosts service innovation, which in turn positively influences firm performance, thereby confirming the full mediation effect. **Conclusion:** Service innovation plays a vital role in converting differentiation strategies into significant performance improvements. **Implications:** Managers should integrate innovation efforts with strategic differentiation, and policymakers should

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create supportive environments to foster innovation in the Nepalese commercial banking sector.

Keywords: Product differentiation, Service innovation, Firm performance, PLS-SEM.

Introduction

In the rapidly changing landscape of financial services, commercial banks must implement strategies that not only set them apart from their rivals but also deliver significant value to customers and enhance their performance. As outlined in Porter's (1985) competitive strategy framework, differentiation — the provision of unique products or services — is a crucial approach for organisations aiming to boost customer loyalty and secure a robust market presence.

In Nepal's commercial banking sector, this strategic method has become crucial because of increasing competition and heightened customer expectations, which are transforming the industry's dynamics. Although international studies have consistently highlighted the significance of differentiation strategies (Hilman, 2009), implementing these well-established models in the Nepalese context remains a significant and largely unexplored area of research. Bridging this gap advances academic knowledge and offers practical insights for local banks aiming to ensure their long-term growth and sustainability.

Beyond product differentiation, service innovation is crucial to the success of banks. This involves creating and enhancing banking services to adapt to evolving customer demands and shifting market conditions. Such efforts include introducing new products, broadening service offerings, targeting new market segments, and providing tailored solutions for clients. These strategies enable banks to boost customer satisfaction, enhance operational adaptability, and solidify their competitive edge, ultimately contributing to sustained performance and growth of the bank.

Although global research has explored the separate effects of product differentiation and innovation on firm performance (Grawe et al., 2009; Wang et al., 2012; Kaliappen & Abdullah, 2014), studies on the interplay between these factors and their impact on performance outcomes are scarce. This gap is particularly noticeable in the banking industry in Nepal. This study seeks to fill this void by applying internationally recognised theories and frameworks to the Nepalese setting to offer a more comprehensive understanding of how product differentiation and service innovation jointly affect firm performance in emerging markets.

This study was designed to achieve the following four primary goals. First, it aimed to explore how product differentiation strategies affect a firm's performance. Second, it seeks to evaluate the influence of these differentiation strategies on service innovation. Third, it examines the direct impact of service innovation on firm performance. Lastly, the study examines the mediating role of service innovation in linking differentiation strategy to firm performance.

This study aims to provide Nepalese banks with actionable guidance on how to more effectively synchronise their strategic differentiation strategy with innovative practices. Achieving this synchronisation is vital for enhancing their competitive edge and maintaining sustainable

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performance in an increasingly dynamic and challenging market. This research adds value to both the academic literature and practical applications by providing a framework for managers and decision-makers in Nepal's banking industry to enhance their strategies and innovation efforts for sustained success.

Literature Review

Product Differentiation Strategy

Porter (1985) identifies product differentiation as a crucial competitive strategy, along with cost leadership and focus. This strategy involves crafting unique and valuable products and services that set a company apart from its competitors (Armstrong & Kotler, 2003; Porter, 1985). The key components of differentiation include innovation, technology, service quality, and brand identity. These elements work together to foster customer loyalty, justify premium pricing, and reduce customer sensitivity to price changes (Grant, 1991; Porter, 1988). By delivering unique value, companies that pursue differentiation can reduce the bargaining power of buyers and suppliers. Moreover, they can create higher barriers to entry for new competitors and mitigate the threat of substitute products (Dess & Davis, 1984; Fitzsimmons & Fitzsimmons, 2004).

Organisations focusing on differentiation typically dedicate substantial resources to research, marketing innovation, and operational excellence. These efforts are vital for securing unique market positions (Prajogo & Sohal, 2006; Frohwein & Hansjurgens, 2005). Companies bolster their competitive advantage by offering customised product features, leveraging advanced technology, employing creative marketing strategies, delivering outstanding services, and establishing a strong brand reputation (Hilman, 2009). In conclusion, product differentiation is crucial for businesses that aim to maintain a competitive edge. By emphasising unique value propositions, companies can effectively address market challenges and build enduring relationships with customers.

Service Innovation

Innovation is recognised as a vital factor in enhancing an organisation's competitiveness and achieving success. According to Rogers (2003), innovation involves introducing new concepts, actions, or artefacts that are considered novel by individuals or organisations. It encompasses more than just technological advancements, including changes in organizational practices, customer interactions, and business models (Du Plessis 2007).

In the service sector, the concept of service innovation is dedicated to the creation, advancement, and execution of new or substantially improved services that enhance customer value and boost operational performance (Ostrom et al., 2010). This process may involve the introduction of new services, refinement of existing ones, or innovation of delivery channels and customer interfaces to deliver more efficient, accessible, or personalised experiences (Toivonen & Tuominen, 2009).

Service innovation, unlike product or process innovation, focuses on intangibility, co-creation, and interaction, which are crucial for delivering services (Gallouj & Weinstein 1997). In industries such as banking, where maintaining customer relationships and ensuring service

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efficiency are vital, service innovation allows companies to set themselves apart, enhance customer satisfaction, and adapt swiftly to evolving customer demands (Droege et al., 2009). In the banking sector, service innovation can involve the creation of new financial products, diversification of service offerings, pursuit of new customer groups, and customisation of services to address specific market needs. Moreover, digital innovations such as mobile banking, Internet banking, and automated service platforms have significantly altered banks delivery of value to their customers (Toivonen & Tuominen, 2009).

This study investigates the role of service innovation in influencing the performance of commercial banks in Nepal. By examining the impact of new and improved services on organizational outcomes, this study provides valuable insights for bank management and contributes to the broader academic conversation on service innovation in emerging markets.

Firm Performance

The study of firm performance has been a cornerstone of management and strategy research, focusing on how companies achieve their financial, operational, and market-related targets (Venkatraman & Ramanujam, 1986). Initially, research predominantly relied on financial metrics, such as profitability and sales growth, to gauge performance (Wadongo et al., 2010). However, scholars have recognized the limitations of using solely financial indicators, as they often provide a narrow perspective and fail to account for strategic or operational progress (Kaplan & Norton, 1996). Consequently, researchers advocate for a blend of financial and non-financial indicators. Non-financial metrics, including market share, customer satisfaction, innovation capability, and improvements in internal processes, are particularly vital in service industries, where customer loyalty and service quality are key to success (Gonzalez-Benito & Gonzalez-Benito, 2005; Storey & Kelly, 2001; Wu, 2014).

Despite the existence of balanced measurement frameworks, studies emphasize the importance of perceived financial performance—managers' subjective assessments of profitability and financial outcomes compared to competitors (Pitt et al., 1996; McDermott & Prajogo, 2012). While objective financial data are often available in sectors like banking, perceived financial performance remains critical because it captures how managers evaluate their firm's success and competitive position. This study therefore focuses on perceived financial performance as the key outcome, offering insights into how strategic initiatives and innovation efforts shape managerial perceptions of financial success.

Hypothesis development

Product Differentiation Strategy and Firm Performance

Porter (1980, 1985) describes a product differentiation strategy as offering goods or services perceived as distinct by customers. Uniqueness can be achieved through design, quality, innovative features, and customer service. By differentiating their products, companies can command higher prices, enhance customer loyalty, and decrease price sensitivity. Studies have indicated that product differentiation can enhance company performance by increasing profitability and solidifying market position (Adegbite et al., 2016; Adegbite et al., 2019 and others).

Despite extensive research, there is no consensus on this relationship. Certain studies have

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observed no significant influence, especially in scenarios where competitors can effortlessly mimic differentiation or when firms lack the resources to support it (Acquaaha and Agyapong, 2015; Kharub et al., 2015). However, some studies suggest that the effectiveness of differentiation strategies depends on factors like technological capability, managerial expertise, and marketing proficiency (Acquaaha & Agyapong, 2015; Ortega, 2015). Moreover,companies in fiercely competitive sectors may derive greater advantages from differentiation due to the pressing need to stand out (Atikiya, 2015; Demba et al., 2018). Therefore, we propose the following hypothesis:

H1: Implementing a product differentiation strategy significantly enhances the perceived financial performance of commercial banks in Nepal.

Product Differentiation Strategy and Service Innovation

The strategy of product differentiation focuses on offering unique, high-value products that distinguish a company from its competitors. In the banking industry, this often entails creating unique financial services and tailoring customer experiences. To successfully execute this strategy, companies are increasingly turning to service innovation, which involves developing new or improved services to meet customers' changing needs (Frohwein & Hansjurgens, 2005).

Service innovation is a crucial operational strategy that supports and enhances differentiation. Its importance is amplified in competitive markets, where aligning service delivery with market positioning is essential (Gyampah and Acquaah, 2008). Studies have indicated that firms pursuing a differentiation strategy are more inclined to prioritise customer-focused service innovations to prevent strategic misalignment and maintain a competitive edge (Projogo, 2006; Projogo & Sohal, 2006). Based on this theoretical framework, the following hypothesis is proposed:

H2: Implementing a product differentiation strategy significantly enhances service innovation in Nepalese commercial banks.

Service Innovation and Firm Performance

Service innovation is a crucial element in boosting organizational performance. It involves developing or enhancing service offerings that leverage a company's existing strengths to provide increased value to customers (Schilling & Werr, 2009; Chesbrough, 2004). These improvements often facilitate a company's expansion into new markets or the capture of new customer segments (Victorina et al., 2005). Grawe et al. (2009) found a direct and positive link between service innovation and firm performance. This enables organisations to enhance service quality, adapt to evolving customer expectations, and distinguish themselves in competitive markets. Such strategic advancements can bolster a company's position and enhance sustainability.

Previous research shows that service innovation leads to higher profitability, growth, and operational efficiency (Mansury & Love, 2005). This is particularly significant in the banking industry, where ongoing innovation in service delivery is vital for maintaining customer trust and market relevance. Based on these considerations, this study examines the impact of service innovation on the performance of commercial banks in Nepal. Consequently, the following

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hypothesis is proposed.

H3: Service innovation exerts a notably positive influence on the perceived financial performance of commercial banks in Nepal.

Product Differentiation strategy and Firm Performance: Mediating role of Service innovation.
Service innovation is essential for converting product differentiation strategies into enhanced firm performance. This allows banks to create distinctive value-added services that align with their strategic positioning and meet customer needs more effectively (Projogo, 200, Frohwein, 2005). Such alignment boosts competitiveness and enhances operational outcomes of the organisation. As Porter (1980) pointed out, strategy alone is not enough for successful implementation of a strategy. In service-heavy industries, such as banking, innovation ensures that differentiation is not only theoretical but also tangible for the customer. This fosters service excellence and operational significance in the field.

Kaliappen and Hilman (2014) found that service innovation can mediate the link between differentiation and performance, with the indirect impact sometimes surpassing the direct one. This underscores the strategic importance of innovation in achieving differentiation. Based on these insights, this study proposes the following hypothesis:

H4: Service innovation mediates the relationship between product differentiation strategy and perceived financial performance.

Based on the literature review and hypotheses, the following conceptual framework is developed, as shown in Figure 1.

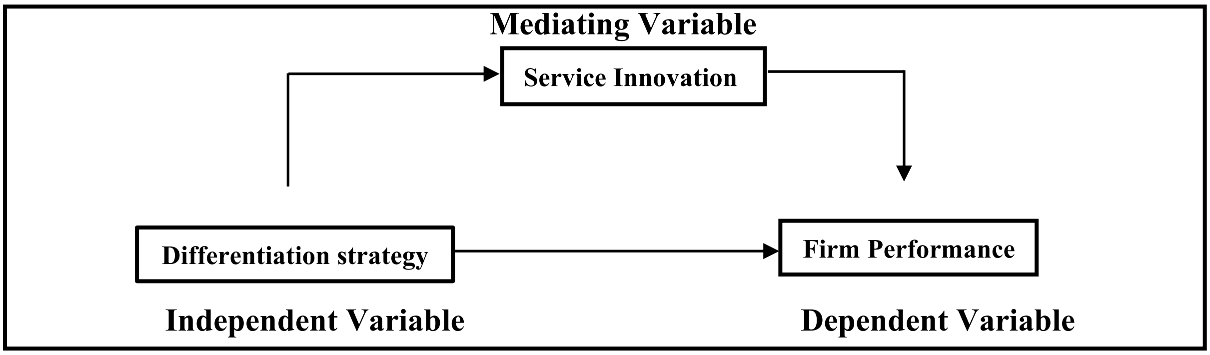

Figure 1: Conceptual framework

Methods

Sample and data collection

This study focuses on Nepalese commercial banks. At the time of data collection, Nepal had 20 licensed commercial banks, from which a representative sample of 14 was selected using stratified sampling to include state-owned, joint venture, and publicly listed banks. A quantitative, cross-sectional survey method was employed using structured questionnaires targeted at senior executives and department heads (HODs), chosen as key informants due to their strategic roles and involvement in decision-making. The sample size was determined using the common guideline of ten respondents per measurement item; with 18 construct items, the minimum required sample size was 180. In practice, 200 physical questionnaires were

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distributed, with 115 returned (a 57.5% initial response rate). After screening for completeness, 105 usable responses were retained, resulting in a final valid response rate of 52.5%. Purposive sampling ensured that respondents had relevant knowledge aligned with the study's objectives. The survey included two sections: demographic information (age, gender, role, experience) and key variables related to product differentiation, service innovation, and perceived financial performance. SPSS version 25 was employed for analyzing descriptive statistics and demographic data, while SmartPLS-SEM version 4 was used for hypothesis testing and evaluating the measurement and structural models, allowing for robust examination of relationships among latent variables.

Measures

This study focuses on three main constructs: product differentiation strategy (independent variable), service innovation (mediating variable), and perceived financial performance (dependent variable). These constructs were measured using validated items drawn from prior research and assessed on a five-point Likert scale, from "strongly disagree" (1) to "strongly agree" (5).The product differentiation strategy was assessed using seven items that reflected the firm's focus on technology investments, premium pricing, product or service enhancements, advertising intensity, reputation-building initiatives, innovative marketing strategies, and the development of new products or services. These items were adapted from the works of Porter (1985), Power and Hahn (2004), Allen and Helms (2006), and Acquaah, ensuring alignment with established theoretical and empirical foundations.

Service innovation, functioning as a mediating concept, was evaluated using four principal indicators that reflect a firm's strategic orientation towards innovation in service delivery and customer engagement. These indicators include the introduction of new products designed to meet evolving customer needs, expansion of product lines to offer a wider array of services, use of new product development to enter and grow in untapped markets, and creation of customised products tailored to specific client demands. These elements were adapted from Schumpeter's (1934) pioneering work on innovation and the OECD's (2005) framework for measuring it. Together, they provide a comprehensive depiction of service innovation as a strategic tool that supports differentiation and enhances firm performance, particularly in the dynamic banking sector context.

Perceived financial performance, the dependent construct, was evaluated using seven items that captured critical financial outcomes, including return on assets (ROA), return on investment (ROI), return on equity (ROE), profit margin growth, market share growth, competitive positioning, and overall financial performance. These measures were drawn from the studies of Parasuraman et al. (1988), Bayol et al. (2001), Moraru (2018), Levesque and McDougall (1996), and Saad Andaleeb and Conway (2006), providing robust indicators of firms' financial health as perceived by senior executives.

Results

In this study, Smart PLS-SEM (version 4) was used to conduct the analysis. The examination was divided into two primary phases: the measurement and structural models. The

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measurement model's findings, which evaluated the constructs' reliability and validity, along with the structural model's outcomes, which examined the hypothesised relationships between the variables, are detailed in the following sections.

Assessment of measurement model

The process of evaluating the measurement model included several essential checks: indicator reliability was assessed by analysing the outer loadings, with values above 0.70 considered satisfactory. Construct reliability was confirmed through both Cronbach's Alpha and Composite Reliability, both of which needed to exceed the 0.70 mark to ensure internal consistency. Discriminant validity was evaluated using the Fornell-Larcker criterion and the HTMT ratio, ensuring that the constructs remained distinct, with HTMT values below 0.90. Finally, multicollinearity was assessed using the Variance Inflation Factor (VIF), where scores under 3.3 indicated no significant multicollinearity issues. Together, these evaluations provide compelling evidence of the reliability, validity, and robustness of the measurement model. The results for all these parameters are presented in Table 1.

Table 1. Results of factor loadings, Alpha, Composite reliability, AVE and VIF.

Construct	Item	Loadings	Cronbach's alpha	Composite reliability	AVE	VIF
Financial Performance	FP1	0.761	0.863	0.895	0.552	2.342
	FP2	0.77				2.325
	FP3	0.771				2.017
	FP4	0.784				1.81
	FP5	0.535				1.649
	FP6	0.734				1.883
	FP7	0.813				2.221
Service Innovation	Inn1	0.74	0.815	0.879	0.645	1.408
	Inn2	0.835				1.943
	Inn3	0.827				1.956
	Inn4	0.806				1.91
Differentiation Strategy	PDS1	0.674	0.795	0.879	0.549	1.529
	PDS2	0.665				1.374
	PDS3	0.806				1.694
	PDS4	0.781				1.592
	PDS5	0.768				1.772

Table 1 outlines the outcomes of the measurement-model evaluation. Most factor loadings were above the advised threshold of 0.70, confirming the reliability of the indicators. However, FP5 was retained because of its theoretical significance, despite its lower loading. The constructs exhibited strong internal consistency, with Cronbach's alpha values surpassing 0.79 and Composite Reliability values exceeding 0.87. Moreover, the AVE values, which ranged from 0.549 to 0.645, established adequate convergent validity for all constructs. Additionally, all VIF values were below the conservative limit of 3.3, indicating that multicollinearity was not

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a concern in this study. In conclusion, the findings robustly support the reliability, validity, and overall strength of this measurement model. The results of the discriminant validity are presented in Table 2.

Table 2. Results of HTMT ratio and Fornell Larcker Criterion

HTMT ratio	Fornell-Larcker Criterion					
	Financial Performance	Service Innovation	Product Differentiation Strategy	Financial performance	Service Innovation	Product Differentiation strategy
Financial Performance				0.743		
Service Innovation	0.575			0.491	0.803	
Product Differentiation Strategy	0.488	0.75		0.423	0.617	0.741

Table 2 displays the HTMT ratios and the results of the Fornell-Larcker criterion, which confirm discriminant validity. All HTMT ratios were below the 0.90 threshold, and the diagonal Fornell-Larcker values exceeded the correlations between constructs. Together, these findings strongly support the validity, reliability, and robustness of the measurement model.

Assessment of the structural model

After confirming the validity of the measurement model, the study proceeded to assess the structural model to examine the proposed relationships among product differentiation strategy, process innovation, and firm performance This evaluation utilized PLS-SEM in SmartPLS 4, employing a bootstrapping method with 5,000 subsamples.

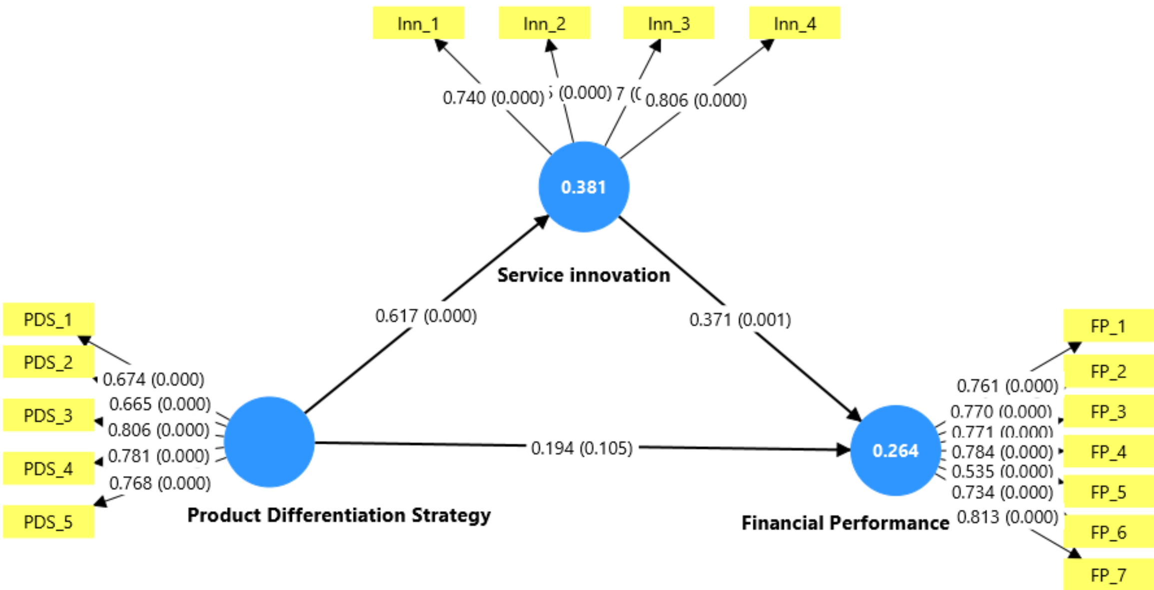

Figure 2. Structural model.

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Table 3 provides a summary of the findings related to the tested direct relationships, as well as the R^2, f^2, and Q^2 values.

Table 4. Results of direct relationship hypotheses, R^2, f^2 and Q^2.

Hypothesis	β (O)	T statistics	P values	R^2	f^2	Q^2
Product Differentiation Strategy -> Financial Performance	0.204	1.622	0.105	0.286	0.048	0.158
Product Differentiation Strategy -> Service Innovation	0.624	10.822	0.000	0.392	0.668	0.365
Service Innovation -> Financial Performance	0.368	3.314	0.001	0.286	0.131	0.158

Table 3 displays the results of the direct relationship analyses. The results indicate that a product differentiation strategy significantly and positively influences service innovation (β = 0.624, p < 0.001); however, it does not have a notable direct impact on financial performance (β = 0.204, p = 0.105). Furthermore, process innovation considerably boosts financial performance (β = 0.368, p = 0.001). The R^2, f^2, and Q^2 values demonstrated moderate explanatory power and effect sizes for the hypotheses tested, affirming the validity of the structural model.

Assessment of Mediating Effect

This study examines the role of service innovation as a mediator in the connection between a product differentiation strategy and firm performance. A mediation analysis was carried out using a bootstrapping approach with 5,000 subsamples to evaluate the direct, indirect, and total effects among the variables. The outcomes of this analysis are shown in Table 4.

Table 6. The results of mediating effect of service innovation on product differentiation strategy and financial performance.

Type of effect	Effect between	Path coefficient	T stats	P value	Remark
Total effect	Product differentiation strategy -> Firm performance	0.433	4.667	0.000	Significant
Indirect effect	Product differentiation strategy -> Service innovation -> Firm performance	0.229	3.121	0.002	Significant

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Direct effect	Product differentiation strategy -> Firm performance	0.204	1.622	0.105	Insignificant

Table 4 displays the outcomes of the mediation analysis that evaluates the influence of process innovation on the connection between a product differentiation strategy and firm performance. The analysis indicates that the overall impact of the product differentiation strategy on firm performance is significant ($\beta = 0.433$, $p < 0.001$), and the indirect effect via service innovation is also significant ($\beta = 0.229$, $p = 0.002$). However, the direct impact of the product differentiation strategy on firm performance was not significant ($\beta = 0.204$, $p = 0.105$). As noted by Hair et al. (2019), when both the indirect and total effects are significant but the direct effect is not, this represents a scenario of full mediation. Consequently, the results strongly suggest that service innovation completely mediates the relationship between product differentiation strategy and the firm's performance.

Discussion

This study sheds light on the intricate connections between product differentiation strategies, service innovation, and firm performance in Nepal's commercial banking sector. The findings indicate that while product differentiation does not directly influence financial performance, it significantly encourages service innovation, which subsequently enhances firm performance. This underscores the pivotal role of service innovation as a mediator in translating strategic differentiation into measurable-performance outcomes.

These conclusions are in line with international research (e.g., Frohwein & Hansjurgens, 2005; Projogo, 2006), which highlights that differentiation alone is insufficient without accompanying innovations that improve service delivary and customer value. Furthermore, the findings resonate with those of Kaliappen and Hilman (2014), who demonstrated that service innovation fully mediates the relationship between differentiation strategy and organizational outcomes. By identifying similar patterns in the Nepalese banking context, this study extends the relevance of established theoretical frameworks and offers practical insights for managers in the banking sector. It particularly emphasises the importance of integrating strategic differentiation with ongoing innovation efforts to maintain a sustainable competitive advantage in a dynamic market environment.

Conclusion and Implications

This study examines the combined impact of product differentiation strategies and service innovation on the financial performance of commercial banks in Nepal. The findings reveal that while product differentiation does not directly boost financial results, it significantly enhances service innovation, which in turn leads to better firm performance. The confirmation of a complete mediation effect highlights the pivotal role of innovation in converting strategic initiatives into significant business outcomes.

The findings of this study offer significant theoretical and practical insights for future academic endeavours. For scholars, it enhances the understanding of strategic management by broadening theoretical frameworks, such as those proposed by Kaliappen and Hilman (2014), Frohwein and Hansjurgens (2005), and Projogo (2006), to include the relatively unexplored Nepalese banking sector. Collectively, these studies emphasise the essential connection between differentiation and innovation in achieving organizational success, and this study supports these concepts within a distinct national context. From a practical perspective, the findings indicate that bank managers should not solely depend on differentiation strategies but should actively integrate innovation into their operational plans. By aligning strategic initiatives with continuous service improvements, companies can enhance efficiency, elevate service delivery, and sustain a competitive advantage in Nepal's evolving banking sector. This study provides both theoretical insights and practical recommendations, offering essential guidance for future strategic planning in the banking sector.

Limitations and future research directions

This study offers insights into the interaction between product differentiation and service innovation and their impact on the performance of Nepalese commercial banks. However, it has some limitations.

First, the cross-sectional design of the study, based on data collected at a single point in time, limits the ability to infer causality or observe how relationships between variables change over time. Future research would benefit from adopting longitudinal designs to better capture the dynamic interactions between differentiation strategies, innovation activities, and performance outcomes.

Second, this study uses a quantitative research approach to gather responses from senior banking executives through structured surveys. While this provides measurable and generalizable data, it does not capture deeper qualitative insights that might explain the underlying mechanisms or contextual factors. To gain richer insights, future research could integrate quantitative analysis with qualitative approaches, such as conducting interviews or case studies.

Third, the evaluation of firm performance relies on executives' subjective perceptions. Although useful, this approach may introduce biases compared to actual financial records or operational data. Future studies should incorporate objective performance indicators, such as audited financial statements or market share data. Finally, this study focuses solely on commercial banks in Nepal, which limits the generalisability of the findings to other industries and regions. Expanding future research to include different sectors or conducting comparative studies across countries could offer broader insights and enhance the applicability of the findings to diverse business environments.

Addressing these limitations can provide more robust insights into the links between product differentiation strategy, service innovation practices, and firm performance, offering richer theoretical contributions and more practical recommendations for business leaders and policymakers.

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