

Assessment of Financial and Operating performance:

[A Case study on Specialized Financial and Promotional Institution (SFPI)]

A Thesis submitted to St. Mary's University, School of Graduate Studies in partial fulfillment of the requirements for the Award of the Degree of Master of Business Administration (MBA) in Accounting & Finance

By

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St. Mary's University,
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December, 2015

Addis Ababa, Ethiopia

Study On

Assessment of Financial and Operating Performance:

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(SFPI)]**

By:
Andinet Ayenew Feyissa

DECLARATION

I, the undersigned, hereby declare that this thesis entitled “**Assessment of Financial and Operating Performance: A Case study on Specialized Financial and Promotional Institution (SFPI)**” is my original work, prepared under the guidance of Abebaw Kassie (Ph.D.), my thesis advisor. All sources of materials used for the thesis have been duly acknowledged, I further confirm that the thesis has not been submitted either in part or in full to any other higher learning institution for the purpose of earning any degree.

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CERTIFICATION

This is to certify that this Project work entitled “**Assessment of Financial and Operating Performance: A Case study on Specialized Financial and Promotional Institution (SFPI)**” has been submitted to St. Mary's University, School of Graduate Studies is a bona-fide work of Mr. Andinet Ayenew who carried out the research under our guidance. We certified further that, to the best of our knowledge the work reported herein does not form part of any other project report or dissertation on the bases of which a degree or award was conferred on an earlier occasion on this or any other candidate.

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ACKNOWLEDGEMENTS

First and foremost, I give thanks to lord for his guidance, protection, divine provision and brightened direction of my personal and academic journey.

Next, any achievement requires the effort of many people and this thesis is not exceptional. Thus, many individuals have been supportive and instrumental in assisting me with this study; therefore, at least I owe them a debt of gratitude and I have to tell other people about their help.

I would like to express my sincere gratitude to Abebaw Kassie (Ph.D.) my advisor, for their unreserved comments, advice, suggestions and guidance he made on the paper from the inception to the completion of the study. His smooth guidance all the time allowed me to convert the anxiety in to strength.

My special thanks also goes to Arega Seyoum (Ph.D.), my external examiner and Dejene Mamo (Asst.Prof), my internal examiner for their constructive and golden comments, advices and suggestions they gave me at the time of my thesis defense.

My special thanks also goes to Ato Muluken Bekele , operation manager of SFPI for his cooperation by providing the necessary materials without any reserve he gave me at the time of my thesis work.

Finally, I also deserve my special appreciation and heartfelt thanks to my dearest wife w/ro Hamere Getachew for encouragement and valuable support, this success is also yours.

Andinet Ayenew

ABSTRACT

The establishment of sustainable MFI that reach a large number of rural and urban poor who are not served by the conventional financial institutions, such as the commercial banks, has been a prime component of the new development strategy of Ethiopia. Healthy financial and operating performance of microfinance institutions is very important for their well functioning and to serve their clients properly. The motivating philosophy of this paper is that unless MFIs become viable and sustainable financial institutions, they can never fully realize their objective of reaching a greater number of poor people.

In light of this, this paper has attempted to look at the Financial and Operating Performance of SFPI at firm level and compare against the Industry Average from Sustainability and Profitability; Portfolio Quality; Efficiency and Productivity and Outreach level perspectives. Based on judgmental sampling technique five MFIs (SFPI, ACSI, DECSI, OCSSCO and OMO) were selected and taken as industry average. Data for the study were entirely based on secondary sources and various ratios and indicators were used to measure the performance of SFPI. Sixteen years data from 1999 to 2014 were used to see the trend in performance and revealed through tables, figures and ratios.

The major finding of the study indicates that, In terms of outreach SFPI is performing well compared to the industry average particularly a significant result has observed in terms of emphasizing more number of women borrowers. In terms of portfolio quality SFPI has also better than the industry average. In terms of financial Sustainability and Profitability SFPI is in a position to generate sufficient revenue to cover operating costs at the same time its ability to operate and expand without subsidies is possible for this institution. However in terms of productivity and efficiency SFPI is seen to be less efficient and less productive as compared to the industry average. In general SFPI's financial and operating performance was well and sound as compared to the Industry average.

Key words: *MFI, financial & operating performance, SFPI, Industry Average, Outreach, Sustainability & profitability, portfolio quality, efficiency & productivity.*

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ACRONYMS & ABBREVIATION

| | |
|-------|--|
| ACSI | Amhara Credit and Saving Institution |
| AEMFI | Association of Ethiopian Microfinance Institutions |
| CGAP | Consultative Group to Assist the Poorest |
| DECSI | Dedebit Credit and Saving Institution |
| FSS | Financial Self-Sufficiency |
| GNI | Gross National Income |
| GTP | Growth and Transformation Plan |
| I.A | Industry Average |
| MFI | Microfinance Institutions |
| MIX | Microfinance Information eXchange |
| NA | Not Available |
| NBE | National Bank of Ethiopia |
| NGO | Non-Governmental Organization |
| NPL | Non- Performing Loan |
| OCSSO | Oromia Credit and Saving Share Company |
| OSS | Operating Self-Sufficiency |
| PaR | Portfolio at Risk |
| ROA | Return on Asset |
| ROE | Return on Equity |
| SFPI | Specialized Financial and Promotional Institution |
| SSA | Sub-Saharan Africa |
| USD | United State Dollar |
| YGP | Yield on Gross Portfolio |

CHAPTER I

1. INTRODUCTION

1.1 Background of the Study

Ethiopia has an estimated population of more than 90 million. Agriculture is the mainstay of the economy and approximately 83.2% of the country's population live in the rural areas. Ethiopia is one of the least developed countries. The per capita income of the country, though it showed improvement in recent years, is only USD 550 during the current period.

Most of the poor, which mainly argued to be constrained by absences of credit access, participate in some kind of informal sector ranging from small petty trading to medium scale enterprises. (Befekadu, 2007). Poverty and food insecurity are the main challenges and fundamental issues of economic development in Ethiopia. At the same time, famine, disease, civil strife, unwise policies were part of its history. Almost all indicators identify Ethiopia as one of the poorest countries on earth. The major causes of low economic growth and high incidence of poverty in Ethiopia include lack of income, assets, employment opportunities, skills, education, health and infrastructure. (Wolday, 2000) Following the political changes in 1991 the Federal Government of Ethiopia has made subsequent policy changes towards a free market economy and agriculture focused development programs such as the New Extension Program to increase agricultural production and productivity, the Federal and Regional Food Security Strategies designed to increase food and agricultural production and Growth and Transformation Plan.

To meet those objectives the development of financial sectors in the country is important. The financial sector is a component of a nation's economy created by the

ebb and flow of capital in the financial industry. Institutions like banks, insurance companies, investment firms, Microfinance's and so forth are all part of the financial sector. (www.wisegeek.com/financial-sector.htm)

Microfinance is the provision of financial services for the poor people with very small business or business project. Microfinance is the provision of a broad range of financial services such as – deposits, loans, pension services, payment services, money transfers and insurance products – to the poor and low-income households.⁴ Microfinance refers to small scale financial services primarily credit and savings provided to people who farm or fish or herd who operate small enterprises or micro enterprises where goods are produced, recycled, repaired or sold. (Robinson, M. 2001) i.e. Microfinance stands for financial services addressed to the poor as targeted clients with different motives to use such services.

The success of an enterprise to a great extent depends upon its financial and operational performance. Careful and well planned financial management is needed for raising and efficient utilization of resources. In addition, healthy financial and operating performance of microfinance institutions is very important for the achievement of development goals (the purpose for which these institutions are established for) and for the well functioning of the country's financial system as a whole. Hence, it is highly essential to evaluate the financial and operating performance of microfinance institutions.

Performance evaluation of a company is usually related to how well a company can use its assets, share holder equity and liability, revenue and expenses. Financial ratio analysis is one of the best tools of performance evaluation of any company. In order to determine the financial position of the MFIs and to make a judgment on how well the MFIs efficiency, its operation and management and how well the industry has been able to utilize its assets and earn profit.

Performance of an institution shall be measured from the objectives of the organization angle. Microfinance's goal is to eradicate poverty. In the early days when MFIs started, they were financed by donor funds that have a poverty eradication goal. Hence the performance of the MFI was measured on how much MFI reach to the poor (outreach) and impact (how far the lives of those who get financial services are changing as compared to those who don't get these services). But as the MF industry grows in size, the need for increased financing coupled with unpredictability of donor funds activate the issue of building a sustainable MFIs that stand on their own feet. That is; MFIs shall start covering their own cost of operation from their program revenues. Sustainability is loosely defined as the ability of a MFI to cover its operating and other costs from generated revenue and provide for profit. It is an indicator which shows how the MFI can run independent (free) of subsidies. This change in emphasis has created a different perspective on the analysis of performance of the MFIs. (Letenah, E. 2009) Today many key players in the industry use sustainability as one core criteria to evaluate the performance of MFIs in addition to the outreach and impact measures described earlier. For a country like Ethiopia, poverty and food insecurity remains to be one of the biggest policy concerns. Amongst various measures to eradicate it, Microfinance, has provided a ray of hope.

In Ethiopia, several MFIs have established and have been operating towards resolving the credit access problem of the poor particularly to those who participates in the petty business. (*Befekadu, B.*2007). Of those microfinance institutions which are working in Ethiopia, Specialized Financial and Promotional Institutions is one. Specialized Financial and Promotional Institution S.C. was established in 1997 with an authorized capital of Birr 800,000. Out of which Birr 200,000 was subscribed and fully paid. The company is registered as Microfinance institution by the National Bank of Ethiopia as March 1997 under the certificate No.MFI/0034/97 (www.mixmarket.org).

Currently SFPI is providing financial services through 15 branch offices. Up to now, the institution has given total loan amounting to Birr 179 million, and has over 46,000 active clients being served by a total of around 237 employees. (SFPI, 2015 report).

The objectives of SFPI in brief are to provide loan in cash or in kind to target group with meager income, to accept from its clients savings in the form of savings at the expire of fixed period or without limit of time, to provide clients technical advice and to loaners with work methods and market, technical and management advice, creating job opportunity and stimulating the local community. In order to meet the felt needs of the target market, SFPI strongly committed itself to develop a variety of financial products. Currently it has five loan products (Group loan, individual loan, youth loan, MSE and WEDP loan products) and five saving products (compulsory saving, ordinary saving, fixed time deposit, housing fund saving and box saving products). On top of these financial products, SFPI designed credit life insurance product which has been endorsed by the BoDs and expected to be implemented in the 2016 fiscal year. To achieve these objectives the institution should be financially feasible and sustainable.

1.2 Background of the Organization - SFPI

In Ethiopia, several microfinance institutions (MFIs) are established and have been operating towards resolving the credit access problem of the poor particularly to those who participates in the petty business. Of those microfinance institutions which are working in Ethiopia, Specialized Financial and Promotional Institutions (SFPI) is one.

SFPI has been registered 5th in the history of modern microfinance industry in Ethiopia following proclamation number 40/96, and it has been in the microfinance business for about 17 years. It has proven records and success history in the business. Over the years, it has gone through series of evaluations and inspections by various actors: audited by external auditors, rated by international rating agencies and inspected by National Bank of Ethiopia where the institution came to know its strengths,

weaknesses, opportunities and threats. As per the commercial code of Ethiopia General Assembly of shareholders is the highest governing body of the institution who delegates the board of directors to oversee the overall management of the Company and to provide policy directions for the management of the Institution. The management structure consists of General Manager, four departments and three services. Each department has two divisions. Branches are the lower level in the organizational structure and categorized as Branch grades I, II and III based on size of clients.

The Board of Directors is accountable to the General Assembly where the General Manager to whom the three departments and three services are accountable is directly accountable to the board of directors whereas internal control Department is administratively and functionally accountable to General Manager and Board of Directors in that order. Branch offices are directly accountable to the operations department.

SFPI started exercising decentralization in terms of both savings and loan activities. Floating fund is fixed for saving withdrawal based on the level of development of branch offices on top of allowing cash withdrawal from bank issuing cheque with ceiling of signatories which is also subject to the level of development/grades of branch offices. The same is true for loan processing. Branch offices are mandated to disburse loans within a given ceiling that is based on the scale of operation/grade of the branch offices. This has significantly reduced the burden on the head quarter (to have more time to focus on strategic issues) on the one hand and to speed up loan processing (reducing transaction costs) on the other, among others.

The shareholding structure and constitution of Board of Directors of SFPI have significantly contributed in balancing the two missions whereby the institution could be able to enjoy remarkable growth both in terms of outreach and sustainability

indicators. The shareholders of the institution comes from various backgrounds namely financial institutions (Government owned and privately owned Banks as well as private insurance company), civic society, Development oriented local NGOs, individuals with valuable professional backgrounds where SFPI has proved to have adequate support in terms of guidance, supervision and asset protection.

SFPI is currently providing financial and non financial services to the target clients. Financial services mean Short-term working capital loans maturing within a period of less than or up to 18 months. This includes seasonal or term loans. Medium term loans that could be for investment/fixed assets and working capital and maturing within a period of up to 36 months while housing loan term extends up to 60 months. Consumption loans (e.g. to buy basic household items like furniture, to repair a house) to civil servants and other organizations' employees- loan maturing within 24 months or less. Non-Financial Services mean provides training before and after the provision of its financial services to its own clients and such training program may include initial orientation to be provided to the potential client on the objective of the MFI and its operational policies and procedures, initial orientation on the right and responsibilities of the applicants as clients of the MFI and advisory services. (SFPI, 2015 report).

1.2.1 Foundation

Specialized Financial and Promotional Institution (SFPI) is one of the microfinance institutions (MFIs) established immediately after the issuance of Proclamation No. 40/96. The Institution is licensed to operate nationwide. It started operation in Addis Ababa after obtaining a license from the National Bank of Ethiopia in November 1997. The founder shareholders were Ethiopian National Association of Blinds (ENAB), National Women Association for Development (NWAD), Agri-service Ethiopia (ASE), Ethiopian Women Entrepreneurs Association (EWEA) and an individual Mr Hailu Wondafrash. The ownership structure has also been diversified where Commercial

Bank of Ethiopia (owning largest portion of a share), Dashen Bank S.Co, Addis Ababa Women Entrepreneurs Association (replacing Ethiopian women Entrepreneurs Association) and two additional individual shareholders joined the ownership structure of the institution. The number of the shareholders of SFPI which is ten comprises 3 financial institutions (2 banks: Commercial bank of Ethiopia and Dashen Bank & one insurance company: Ethio-Life & General Insurance), 2 Local NGOs (Agri-service Ethiopia and Projynist), 2 Civic societies (Ethiopian National Association for Blinds and Addis Ababa Women Entrepreneurs Association) and three social investors (Ato Ayele Bogale, Ato T/Berhan T/Tsadik and Ato Hailu Wondafrash) who committed resources to contribute towards changing the livelihood of target community. (SFPI, 2015 report).

1.2.2 Vision

The vision of SFPI is to see poor people especially women to be fully accessed to institutional credit and saving services for self-empowerment, poverty eradicated both in rural and urban Ethiopia and emergence of self-reliant and business-minded generation. (SFPI, 2015 report).

1.2.3 Mission

The purpose of SFPI is to enhance the socio-economic empowerment of underprivileged people and entrepreneurs both in rural and rural Ethiopia with special focus to women through increased access to financial and support services while ensuring sustainability of the institution. (SFPI, 2015 report).

1.2.4 Objectives

- To improve food securities at household level both in the rural and urban areas of the region.
- To create job opportunities to the unemployed parts of the population through promoting micro, small and medium enterprises in the region.
- To stimulate the local economy through offering adequate and efficient financial services and builds financially sound and sustainable institution.
- Poverty alleviation by providing both financial and non-financial support services to the target population.

1.2.5 Key Strategies

- Confer priority to agricultural sector in the rural and MSEs in the urban areas.
- Use high community participation for the success of financial services of SFPI.
- Ensure that women get priority for financial services.
- Integrating the SFPI program with whole set of development programs in the region.
- Secure and achieve sustainable financial income required to cover the institution's operational expenses.
- Give prior attentions to saving mobilization.

1.2.6 Target Groups

The target clients of SFPI are the enterprising/active poor men and women who are and would like to be self-employed and are located in both urban and rural areas of the country and cannot access conventional bank loans for various reasons. (SFPI, 2015 report). Such target population can be categorized as follows:

- The active poor who are willing to organize themselves into groups of 3-5 members and these could be those already in business or start-ups.
- Individuals who are already engaged in micro or small enterprise that are production/service oriented and are feasible activities. This could be Individual borrowers of SFPI who have been borrowing as group members but have at one stage outgrown the group lending system and wish to borrow larger amount of loans individually or those who want to take individual loan starting from first loan cycle.
- Cooperatives that are organized around agriculture or other sectors and have legal entity.
- The enterprising youth who have marketable vocational skills and would like to be self-employed.
- People permanently employed by well-established organizations may be considered as targets for consumption loan.
- Entrepreneurs mainly women
- Community members working to come out of poverty
- The poorest of the poor capable of generating income /productive poor/

1.2.7 Ownership

Specialized Financial and Promotional Microfinance Institutions /called SFPI / is a share company established in accordance with the requirements of the National Bank of Ethiopia. (SFPI, 2015 report).The owners (share holders) are ten in numbers:

1. The government owned financial institution Commercial Bank Of Ethiopia
2. The private owned financial institution Dashen Bank S.C
3. The Private owned Insurance company Ethio Life and General Insurance
4. Agri service Ethiopia Local NGO
5. Projynist Local NGO
6. Ethiopian National Association for Blinds

7. Addis Abeba Women Entrepreneurs Association
8. Social Investors (Ato Ayele Bogale , Ato T/Berhan T/Tsadik & Ato Hailu Wondafrash

1.2.8 Area Coverage

When the institution commenced operation in the second half of 1998; SFPI is currently functional in one city administration (Addis Ababa) and two National Regional States (Oromia and Amhara) with 15 branch offices and six sub offices and finalized an assessment to enter in third regional state in south nation and national state. Four branch offices are based in Addis Ababa including head quarter while nine and two branch offices are in Oromia and Amhara National Regional State respectively. SFPI provides different loan and saving products, these loan products are group guaranteed, Individual (MSE operators by conventional lending system), WEDP (Women Entrepreneur Development Project), Youth and Consumption loan products.

Saving products are compulsory saving and different types of voluntary saving products such as passbook saving (ordinary saving), time deposit, housing fund saving and box saving. To have additional saving product, study of child saving product has been finalized and expected to be endorsed by Board of Directors very soon. The number of employees has been increasing overtime and currently reached 255 employees out of which saving credit and saving officers account for over 34%. The client outreach and loan portfolio of the institution reached 50,128 and over ETB 170 million respectively. Women took 55% and 59% of total client and loan portfolio outreach in that order as end of September 30, 2015 and planned to raise women's share of clients to 68% as end of June 30, 2016. (SFPI, 2015 report).

1.2.9 Types of Services

At this time, SFPI is rendering different types of services such as; Credit, Saving Money transfer and Pension payment. SFPI has five loan products namely Individual, Agricultural, Micro & Small enterprise (MSE), youth and Women Entrepreneurship Development Program (WEDP) loan products. Saving products are compulsory saving and different types of voluntary saving products such as passbook saving (ordinary saving), time deposit, housing fund saving and box saving. (SFPI, 2015 report).

1.3 Statement of the Problem

The Ethiopian economy has been state controlled through a series of industrial development plans since the Imperial Government of Haile Selassie. Under state socialism (1974-91), popularly referred to in Ethiopia as the 'Derg regime', Financial institutions were directed to finance some public projects that may not have passed proper financial appraisal (Yesuf, 2010). Following the down fall of the Derg regime a new policy have been proposed and implemented to promote the development of the country. Now, Ethiopia strives to grow and to become under the category of the countries which have middle income societies. Thus; now is the time for Ethiopia to escape from poverty.

So, to achieve such an objective, the financial sector especially the microfinance institutions play an important role by helping the poor who have no access to other financial institutions. In consideration of this, the federal government of Ethiopia has adopted a strategy to support them in their expansion. The establishment of sustainable MFI that reach a large number of rural and urban poor who are not served by the conventional financial institutions, such as the commercial banks, has been a prime component of the new development Strategy of Ethiopia (Wolday, 2000).

Financial and operating performance of a company being one of the major characteristics indicates competitiveness, potentials of the business, economic interest of the company's management and reliability of present and future contractors. Therefore, identification of the MFIs weaknesses and strengths through financial and operating performance indicators has great contribution to the management, shareholders, the public, (customers of the microfinance institutions), the regulators (the government bodies) and the economy as a whole. The objective of almost all of the microfinance institutions in Ethiopia is poverty alleviation. To achieve this objective microfinance institutions should be financially viable and sustainable. Regardless of the increasing trust on microfinance to reduce poverty in Ethiopia there has been amazingly a lot of work undertaken to evaluate their performance. But, there is also a fear among interested parties in the industry that MFIs could not stay in the market to serve the poor without the immense support of government, donors and others (Alemayehu, 2008).

Most of the prior studies focus on assessment of the impact of MFIs on poverty alleviation, impact of MFIs on women's empowerment, the role of microfinance on agricultural productivity, and impact of microfinance institutions on children's education. But, in the area of Financial and Operating Performance of MFIs in SFPI is not thoroughly researched. Thus, this paper has attempted to look at the Financial and Operating Performance of SFPI as a whole and compare against the Industry Average (I.A.)¹ based on the following parameters of measuring financial performance:

1. Sustainability with respect to financial, operational or institutional and Profitability,
2. Portfolio Quality
3. Efficiency and Productivity
4. Outreach level

¹ For the purposes of this paper, Industry Average (I.A) were defined as the summation of SFPI, ACSI, DECSI, OCSSCO and OMO then divided by five:

Thus, the motivating philosophy of this paper is that unless MFIs become viable and sustainable financial institutions, they can never fully realize their objective of reaching a greater number of poor people. It is therefore, important to assess the institutional-level financial and operating performance of SFPI and compare to the Industry Average.

1.4 Research Questions

The purpose of this project was to analyze the performance of SFPI at firm level. So far, most research tried to assess the impact of microfinance on poverty, women empowerment, income generation, agricultural productivity, etc. But this paper was trying to assess whether Specialized Financial and promotional institution is financially and operationally sound or not by addressing the following questions:

1. What is the extent of SFPI outreach level?
2. How well is the institution's efficiency and productivity?
3. What is the condition of the portfolio quality?
4. Can SFPI provide microfinance services sustainably?

1.5 Objectives of the study

1.5.1 General objective

The general objective of the study is focusing on the assessment of financial and operating performance of SFPI.

1.5.2 Specific objectives

The study has the following specific objectives:

1. To assess the outreach level of SFPI and compare with the Industry Average.

2. To measure the efficiency and productivity level of SFPI and compare against the industry average.
3. To evaluate the portfolio quality of SFPI and compare with the Industry Average.
4. To see the institution's financial viability in comparison with the Industry Average.

1.6 Significance of the Study

The most important contribution of this research work is its ability to show practically the way company's performance is measured. In addition to this the study is expected to have importance to different parties. Like, managers of the institutions, shareholders, regulators (government bodies), and so forth. In general; the study will have the following expected significances:

1. To provide input for further researchers in relation to Financial and Operating Performance.
2. To give input to the concerned institution to re-examine previous procedures and investigate a new procedure.
3. To provide some insight about the strength and weakness of SFPI as compared to the Industry Average.
4. To serve as a reference material for both academicians and practitioners.
5. It will also be useful for policy makers in making amendment of the structure of microfinance.

1.7 Scope of the Study

This research is confined only to the assessment of the operational and financial performance of SFPI Microfinance Institution (MFI) for the period covering from 1999 to 2014. Nonetheless, it would have been much better and exhaustive for the study had

there been a chance of accommodating all MFIs found in Ethiopia. However, to make the study manageable and to evaluate the problem in detail, the researcher is forced to delimit the study to incorporate SFPI and comparing against the industry average.

However; it has to be noted that the performance analysis of SFPI was include impact studies and adjustments for inflation, in-kind subsidies, cost of funds, and varying accounting practices across institutions as there is no available data about the impact of MFIs on the lives of the poor, subsidies and cost of subsidies from the data source the researcher has used.

1.8 Limitation of the Study

Although there are 35 microfinance institutions in Ethiopia, the study was limited to SFPI's sixteen years Financial and Operational performance. That is; since this study was based on one company only, the findings might not be representative of the whole sector. In addition to this, the study was entirely based on secondary sources and lack of primary data due to time, finance and information constraint can have a limitation on the findings of the study. Finally, the conclusions and recommendations were based on the data analysis; hence they are valid only to the extent of the validity of the data. Except the above mentioned limitations, the study is believed to represent the factual financial performance of the institution.

1.9 Organization of the Study

For the sake of convenience, the sequence of the study is divided in to five chapters. Accordingly; the first chapter is introductory which consists background of the study, background of the organization SFPI, statement of the problem, research questions, and objectives of the study, significance of the study, scope of the study and limitation of the study. The second chapter presents review of the empirical and theoretical

literatures on the performance measurements of microfinance institutions. The third chapter provides research methodology. The fourth chapter provides discussion and analysis. Finally, chapter five concludes the result of the study and forward relevant recommendations based on the findings.

CHAPTER II

2. LITERATURE REVIEW

2.1 THEORETICAL LITERATURE REVIEW

2.1.1 What are Microfinance Institutions?

Microfinance (MF) is seen as one of the most efficient instruments to promote economic development and to fight poverty in poorer countries. Numerous microfinance institutions (MFIs) all over the world have proven that financial services can be offered on a sustainable basis with high outreach.

Microfinance institutions (MFIs) provide a range of financial services to poor households. Their worldwide growth in numbers has had a positive impact by providing the poor with loans, savings products, fund transfers and insurance facilities. This has helped create an encouraging socio-economic environment for many of these developing countries households.(Mamiza, Michael, & Shams ,2009).

Microfinance refers to the provision of financial services primarily savings and credit to the poor and low income households that don't have access to commercial banks (Arsyad, 2005). (Legerwood, 1999) defines it as the provision of financial services (generally saving and credit) to low income clients. Microfinance is the provision of financial services for the poor people with very small business or business project. Microfinance is the provision of a broad range of financial services such as –deposits, loans, pension services, payment services, money transfers, and insurance products to the poor and low income households.

(www.bsp.gov.ph/regulations/attachments/2001/circ272)

Microfinance refers to small scale financial services primarily credit and savings provided to people who farm or fish or herd who operate small enterprises or micro enterprises where goods are produced, recycled, repaired or sold. (Robinson, 2001).

Microfinance institutions (MFIs) are relatively small financial institutions that have traditionally provided small loans (micro credit) to low income citizens with the objective of helping them to engage in productive activities (micro enterprise). The nature of these institutions is quite different from traditional financial institutions (such as commercial banks). MFIs are significantly smaller in size, limit their services towards poor households and often provide small collateral or free group loans. (Mamiza, Michael, Shams 2009).

Thus, MFIs are different from traditional financial institutions because they only provide services to low income customers and often provide loans without collateral.

According to Woller et al. 1999; Murdoch 2000 MFIs are different from commercial banks in their two main operational objectives. First, they act as financial intermediaries to poor households. This is known as the 'institutionist paradigm'. This means MFIs should generate enough revenue to meet their operating and financing costs. Second, they have a social goal. This is known as the 'welfarists paradigm' which includes a focus on poverty alleviation and depth of outreach along with achieving financial sustainability.(M.kabir,2009). In broader understanding, Alemayehu conceived that services given by microfinance institutions include loans, savings, insurance and pensions; however, some microfinance institutions also provide credit cards, payments services and money transfer services (Alemayehu, 2008).

2.1.2 Evolution of Microfinance

Traditional banking sector cannot reach millions of poor for whom small loans could make huge differences. There are several reasons for this. Most of the poor are rural, and they are much dispersed. They have low education levels, if at all. As a result,

administrative cost of supplying loans to the poor population is extremely high. Another issue that makes it difficult to serve these customers through traditional banking is that the poor does not have any assets to use as collateral. As a result, the poor had access to loans only through local moneylenders at exorbitantly high interest rates. (www.sesric.org/imgs/news/image/definitionMicro.do)

Micro-credit financing starts with the assumption that the poor is willing to pay high interest rates to have access to finance. In general, the system uses the social trust as the collateral. Although there are different micro-credit financing models, the borrowers in the pioneering models are usually members of small groups. Loans are given to individuals, but an entire group is responsible for the repayment. Hence, the borrower who does not fulfill his commitment to repay back will lose his/her social capital. Micro-credit institutions report that their repayment rates are above the commercial repayment rates, sometimes as high as 97%. Today, there are millions of poor people around the world who turn to be entrepreneurs through the micro-credit sector (Alemayehu, 2008).

The year 1974 is a landmark in the history of microfinance development. It was by then that Professor Muhammad Yunus, a Bangladeshi economist introduced the idea of providing the poor with small loans. While he was on a field trip to an impoverished village with his students, he met a woman and interviewed her. She was making a living from the sale of stool (prepared from bamboo). From the interview he understood that the woman was making only a penny margin of profit for each stool. Then he reasoned that the woman would raise herself above subsistence level if she were given the loan with a more advantageous rate: then, he did it from his own pocket. In 1983 he formally established the Grameen Bank (meaning “village bank”). (www.globalenvision.org/library/4/537/)

Thus, the limitations of financial institutions in providing the poor with credit have become the driving forces behind the emergence of MFIs. Nowadays, microfinance institutions are growing to provide the poor with financial as well as technical assistance. The accomplishment of MFIs is, therefore, a manifestation of a paradigm shift that defeated the old notion that the poor are not “creditworthy.” (Bamlaku, 2006).

Generally, the field of microfinance was pioneered by specialized non-governmental organizations (NGOs) and banks. They challenged the conventional wisdom of the 1970s and discovered that with new lending methods, the rural poor repaid loans on time. These new methods included providing very small loans without collateral at full-cost interest rates that were repayable in frequent installments. They demonstrated that the poor majority, who are generally excluded from the formal financial sector, can, in fact, be a market niche for innovative banking services that are commercially sustainable. As a result, current microfinance has made a major shift from subsidized microfinance projects of the past, which ended up serving few people, to the development of sustainable financial institutions specialized in serving the low-income market. Today there are a growing number of successful microfinance institutions (MFIs) worldwide. These are primarily local institutions that are reaching a significant number of poor people and that are becoming commercially viable. (www.undp.org/evaluation/documents/essential on microfinance).

2.1.3 History of Microfinance in Ethiopia

The Ethiopian economy has been state controlled through a series of industrial development plans since the Imperial Government of Haile Selassie. Under state socialism (1974-91), popularly referred to in Ethiopia as the ‘Derg regime’, Financial institutions were directed to finance some public projects that may not have passed proper financial appraisal (Yesuf Legas, 2010).

Following the political changes in 1991 a subsequent policy changes has been made towards a free market economy, agriculture focused development and to liberalize the financial sector. To this effect, Proclamation No. 84/94 was issued, which allows private domestic investors to participate in banking and insurance activities, which were previously monopolized by the government. However, the issuance of this proclamation alone did not totally solve the financial problem of the economically active poor people in rural and urban areas (Seifu, 2002).

Another Proclamation, No. 40/96 was issued to solve the problem of the delivery of financial services to the poor. Following the issuance of this proclamation different NGOs have shifted themselves into microfinance institutions raising the number of MFIs in Ethiopia to 35 in 2015. Consequently, the microfinance industry of Ethiopia showed a remarkable growth in terms of outreach and sustainability. Furthermore, the National Bank of Ethiopia issued a new directive on May 2002 to improve the regulation limits on loan size (Br. 5000), repayment period (one year), and lending methodology (social collateral) (Bamlaku, 2006).

Thus, formal Microfinance industry in Ethiopia was started in 1994/5. In particular, the Licensing and Supervision of Microfinance Institution Proclamation of the government encouraged the spread of Microfinance Institutions (MFIs) in both rural and urban areas as it authorized them among other things, to legally accept deposits from the general public (hence diversify sources of funds), to draw and accept drafts, and to manage funds for the micro financing business (Getaneh, 2005). Currently there are 35 microfinance institutions in Ethiopia, licensed and registered by NBE, following the issuance of proclamation No. 40/96.

The proliferation of microfinance institutions could indicate the emphasis given to the strategy to fight against poverty in the country. Microfinance initiatives are policy instruments (prime components of the new development strategy). They can create an

enabling environment for the poor to increase output and productivity by inducing technology adoption, improving input supply, and increasing income, reducing hunger and thereby reducing poverty (Wolday, 2001).

2.1.4 Interest Rates in the Ethiopian Microfinance Institutions

The interest rates of MFIs were revised four times by the NBE. Initially, the NBE issued Directive No. MFI/09/96 that sets the lending and saving interest rates of MFIs. According to this directive, the lending interest rate of MFIs should not be higher than 2% above the maximum lending interest rate charged on loans extended by formal banks. Thus, the maximum lending interest rate was set at 12.5% per annum. The interest rate on savings and time deposits shall not be less than 1% higher than the minimum interest rate paid on such deposits extended by formal banks. In May 1998, the NBE increased the maximum ceiling of the lending interest rate of MFIs to 15.5 percent per annum (Directive No. MFI/10/98). However, both directives did not state whether the lending interest rate was flat rate or declining rate. In June 1998, the NBE removed the ceiling of the lending interest rate of MFIs. It has clearly stated that the board of directors of each MFI can set its own lending interest rate (Directive No. MFI/11/98 and Directive No. MFI/13/2002).

Initially, the minimum interest rate on savings and time deposits was 7% per annum. Directive No. MFI/12/98 was issued to reduce the minimum interest rate on savings and time deposits from 7% to 6% per annum. However, in 2002 (Directive No. 13/2002) the NBE reduced the lower ceiling of saving interest rate for formal banks and MFIs to 3%. The minimum saving interest rate for the MFIs was increased to 4% in 2007. (NBE Directive no 19/2007 vol 72, no 202). The recent adjustment interest rate on deposits and loans under Directive no NBE/INT/11/2010 was issued on December 1, 2010 states that deposit interest rate on demand deposit is freely determined by each bank, however the minimum interest rate on saving and time deposit is 5%. Besides to

this the lending rate on loans and advances is freely determined by each bank. Currently interest applicable by SFPI is for saving deposit interest rate is 6%, for fixed time deposit 8.5%, for lending rate from 16% up to 24% (SFPI, 2015 report).

2.1.5 Capital Adequacy Ratio of Microfinance Institutions

Technically, capital adequacy is a measure of an institution's capacity to absorb loan losses and still have adequate fund to maintain regular financial services. The rule of the thumb is that capital should be commensurate with the volume and risk involved in business and adequate to absorb losses related to defaults in loan portfolio and other operational losses. (Wolday,2008) Directive No. MFI/16/2002 of NBE states that MFIs should maintain at all times a minimum capital ratio of 12 percent (ratio of risk-weighted assets to total capital). MFIs are also required to submit quarterly report on capital position within three weeks after the close of each quarter. However, this directive is only applicable to MFIs, which are re-registered, i.e., MFIs whose total deposits equal or exceed Birr one million (107,067 USD). Even for the re-registered MFIs at various stages, capital adequacy ratios should have been based on size, experience and financial sustainability.

However recently new Directive no MFI/27/2015 cited that minimum initial paid up capital required to obtain a micro financing business shall be Birr 10 million shall be fully paid in cash and deposited in a Bank in the name and to the account of microfinance under formation but the existing micro finance institution whose paid up capital is below Birr 10 million shall raise their paid up capital to the said amount within seven years from the effective date these directive in line with the time frame of Birr one million by June 30, 2015, Birr 1.3 million by June 30, 2016, Birr 1.6 million by June 30, 2017, Birr two million by June 30, 2018, Birr five million by June 30, 2019, Birr seven million by June 30, 202, Birr ten million by June 30, 2021 (NBE Directive MFI/27/2015).

2.1.6 The Schools of Thought on Microfinance Institutions (MFIs)

The Schools of thought on how to deliver financial services to the poor are the minimalist, institutionalist, self-sustainability, the integrated service delivery, welfarist and poverty approaches. (Bhatt & Tang, 2001).

The institutionalist approach centers on “financial deepening” of building sustainability to serve those excluded from services of conventional banks. Achieving FSS and the number of clients served (in other terms breadth of outreach) are at the heart of the institutionalist approach. Institutionalists do not agree on directly targeting the very poor. Targeting the very poor is costly that hinder FSS. On the other hand, welfarists argue that it is possible to realize breadth and depth of outreach with poverty targeted services. (Adeno, 2007).

For welfarists, the net social benefits derived from serving a limited number of very poor clients are better than serving large numbers of not-so-poor clients. (Woller & Woodworth, 2001) · To have the same effect on social welfare, the self-sustainable lender must have 15 to 125 times the breadth of the poverty lender. (Schreiner, 2002).

The institutionalist and welfarist approaches have practical inferences on differences in the devise for service delivery, institutional structures and financing, and segregation of the potential clients to be served. (Woller & Woodworth, 2001) Their basic difference lies at focusing on the institutional sustainability on the part of institutionalists but social benefits of welfarists. Hence, institutionalists give main concern to the business; welfarists focus on clients. As to welfarists change in the life of clients would be brought through provision of both financial and non-financial services with the aid of subsidies.

2.1.7 Key Principles of Microfinance

- ❖ *The poor need a variety of financial services, not just loans.* Just like everyone else, poor people need a wide range of financial services that are convenient, flexible, and reasonably priced. Depending on their circumstances, poor people need not only credit, but also savings, cash transfers, and insurance (www.cgap.org).
- ❖ *Microfinance is a powerful instrument against poverty.* Access to sustainable financial services enables the poor to increase incomes, build assets, and reduce their vulnerability to external shocks. Microfinance allows poor households to move from everyday survival to planning for the future, investing in better nutrition, improved living conditions, and children's health and education (www.cgap.org).
- ❖ *Microfinance means building financial systems that serve the poor.* Poor people constitute the vast majority of the population in most developing countries. Yet, an overwhelming number of the poor continue to lack access to basic financial services. In many countries, microfinance continues to be seen as a marginal sector and primarily a development concern for donors, governments, and socially-responsible investors. In order to achieve its full potential of reaching a large number of the poor, microfinance should become an integral part of the financial sector (www.cgap.org).
- ❖ *Financial sustainability is necessary to reach significant numbers of poor people.* Most poor people are not able to access financial services because of the lack of strong retail financial intermediaries. Building financially sustainable institutions is not an end in itself. It is the only way to reach significant scale and impact far beyond what donor agencies can fund. Sustainability is the ability of a microfinance provider to cover all of its costs. It allows the continued operation of the microfinance provider and the ongoing provision of financial services to the poor. Achieving financial sustainability means reducing transaction costs, offering better products and services that meet client needs, and finding new ways to reach the unranked poor (www.cgap.org).
- ❖ *Microfinance is about building permanent local financial institutions.* Building financial systems for the poor means building sound domestic financial intermediaries

that can provide financial services to poor people on a permanent basis. Such institutions should be able to mobilize and recycle domestic savings, extend credit, and provide a range of services. Dependence on funding from donors and governments – including government-financed development banks – will gradually diminish as local financial institutions and private capital markets mature (www.cgap.org).

- ❖ *Microcredit is not always the answer.* Microcredit is not appropriate for everyone or every situation. The destitute and hungry who have no income or means of repayment need other forms of support before they can make use of loans. In many cases, small grants, infrastructure improvements, employment and training programs, and other non-financial services may be more appropriate tools for poverty alleviation. Wherever possible, such non-financial services should be coupled with building savings (www.cgap.org).
- ❖ *Interest rate ceilings can damage poor people's access to financial services.* It costs much more to make many small loans than a few large loans. Unless micro lenders can charge interest rates that are well above average bank loan rates, they cannot cover their costs, and their growth and sustainability will be limited by the scarce and uncertain supply of subsidized funding. When governments regulate interest rates, they usually set them at levels too low to permit sustainable microcredit. At the same time, micro lenders should not pass on operational inefficiencies to clients in the form of prices (interest rates and other fees) that are far higher than they need to be (www.cgap.org).
- ❖ *The government's role is as an enabler, not as a direct provider of financial services.* National governments play an important role in setting a supportive policy environment that stimulates the development of financial services while protecting poor people's savings. The key things that a government can do for microfinance are to maintain macroeconomic stability, avoid interest-rate caps, and refrain from distorting the market with unsustainable subsidized, high-delinquency loan programs. Governments can also support financial services for the poor by improving the business environment for entrepreneurs, clamping down on corruption, and

improving access to markets and infrastructure. In special situations, government funding for sound and independent microfinance institutions may be warranted when other funds are lacking (www.cgap.org).

- ❖ *Donor subsidies should complement, not compete with private sector capital.* Donors should use appropriate grant, loan, and equity instruments on a temporary basis to build the institutional capacity of financial providers, develop supporting infrastructure (like rating agencies, credit bureaus, audit capacity, etc.), and support experimental services and products (www.cgap.org).
- In some cases, longer-term donor subsidies may be required to reach sparsely populated and otherwise difficult-to-reach populations. To be effective, donor funding must seek to integrate financial services for the poor into local financial markets; apply specialist expertise to the design and implementation of projects; require that financial institutions and other partners meet minimum performance standards as a condition for continued support; and plan for exit from the outset (www.cgap.org).
- ❖ *The lack of institutional and human capacity is the key constraint.* Microfinance is a specialized field that combines banking with social goals, and capacity needs to be built at all levels, from financial institutions through the regulatory and supervisory bodies and information systems, to government development entities and donor agencies. Most investments in the sector, both public and private, should focus on this capacity building (www.cgap.org).
- ❖ *The importance of financial and outreach transparency.* Accurate, standardized, and comparable information on the financial and social performance of financial institutions providing services to the poor is imperative. Bank supervisors and regulators, donors, investors, and more importantly, the poor who are clients of microfinance need this information to adequately assess risk and returns. ([www.aecid.es/export/sites/default/keyprincMicrofinance CG-eng](http://www.aecid.es/export/sites/default/keyprincMicrofinance%20CG-eng)) (www.cgap.org).

2.1.8 Microcredit and Traditional Banking

A microcredit is a small amount of money loaned to a client by a microfinance institution and it is used by the client to start or develop their business activities. To date the most commonly variable microfinance product is microcredit. Microcredit is normally provided for working capital and sometimes for the purchase of fixed assets. Microcredit can be offered, often without collateral, to an individual or through group lending (Wenner, 2009).

- Group lending:-also, known as solidarity lending, is a mechanism that allows a number of individuals to provide collateral or a guarantee a loan through a group payment pledge. The incentive to repay is based on peer pressure; if one person in a group defaults, the other members make up the payment amount.
- Individual lending:-in contrast, focuses on client and does not require other people to provide collateral or guarantee a loan.

2.1.9 Difference between Microfinance Institutions and Banks

Microfinance institutions differ from conventional banking institutions in the following ways: (www. Evers et al 2010).

1. Lending practice
2. Institutional setting
3. Promotional policies

The following table illustrates the difference between microfinance institutions and banking institutions.

Table 2.1 Differences of Traditional banking & MFI

| Difference | Traditional banking | Microfinance for microenterprise |
|-----------------------|--|--|
| Lending practice | <ol style="list-style-type: none"> 1. Collateral needed 2. Appraisal based on business plan and financial records 3. Repayment enforced by legal action (collateral, guarantee) 4. Asset based lending 5. Difficult procedures lead to high transaction costs for small loan | <ol style="list-style-type: none"> 1. Peer pressure or alternative collateral accepted 2. Appraisal takes in to account other criteria like motivation, recommendation by social network 3. Positive enforcement of repayment (stepped or sequential loans, peer pressure) 4. Cash flow based lending 5. Special techniques to reduce administrative costs |
| Institutional setting | <ol style="list-style-type: none"> 1. Formal financial institutions ruled by the central bank legislation 2. Staff are professional bankers 3. Centralization of decisions-makings | <ol style="list-style-type: none"> 1. Different legal statuses are possible e.g. foundation, trust, limited company, NGO, cooperatives. 2. Staff often have a non- banking background 3. Decentralization of decision- makings. |
| Promotional policies | <ol style="list-style-type: none"> 1. Banks wait for clients to ask for credit, clients are approached in a formal way and have to defend their credit requests in front of bank staff 2. Clients are self confident enough to visit the bank and know how to present themselves 3. Promotions of banking services in general is done through the media and word of mouth | <ol style="list-style-type: none"> 1. The need for credit is systematically identified, constants are more informal, group meeting are used to exchange experiences and gain self confidence 2. Clients do not have the confidence to approach a bank 3. Clients recruit new client (self selection) and partner networks (enterprise agencies, social works) refer potential clients |

Source: Evers et al (2010).

2.1.10 Performance Measurements in Microfinance

2.1.10.1 Sustainability and Profitability

Financial sustainability (profitability) – refers to whether the MFI is profitable enough to maintain and expand its services without continued injections of subsidies. (www.undp.org/evaluation/documents/essentialonmicrofinance).

The financial sustainability of MFIs is important as the poor benefit most if they have access to financial services over time rather than receive, for example, just one loan but denied future loans because the MFI has disappeared, or is illiquid because repayment rates are low, or funds promised by donors or governments have not materialized.

Two levels of financial sustainability can be measured. One is a lower level of achievement in which the MFI reaches operational self-sustainability (OSS) meaning that operating income is sufficient to cover operating costs, including salaries and wages, supplies, loan losses, and other administrative costs.

Financial self-sustainability (FSS) is a higher standard because it means that the MFI can also cover the costs of funds and other forms of subsidies received when they are valued at market rates. Achieving this level is important because it means the MFI would still break even if all subsidies would be withdrawn. However, this does not always assure long-term institutional sustainability. In addition, the MFI must earn enough income to build capital reserves required for growth and as protection against future shocks. Measuring financial sustainability requires that MFIs maintain good financial accounts and follow recognized accounting practices that provide full transparency for income, expenses, loan recovery, and potential losses. Many MFIs cannot meet this standard. (Yesuf, 2010). Most widely indicators of Sustainability and Profitability include: Adjusted return on equity, Adjusted return on assets, Operational self-sufficiency & Financial self-sufficiency. (Seifu, 2002).

Table 2.2 Financial sustainability and profitability ratios, their formulas and their explanations

| No. | Ratio Name | Formula | Explanation |
|-----|------------------------|---|--|
| 1 | Return on Equity (ROE) | $(\text{Net operating income} - \text{axes}) / \text{Average equity}$ | Calculates the rate of return on the average equity for the period. Because the numerator does not include non-operating items such as donations, the ratio is frequently used proxy for commercial viability. Usually, ROE calculations are net of profit or revenue taxes. |

| | | | |
|---|----------------------------------|---|--|
| 2 | Return on asset (ROA) | (Net operating income - taxes)/ Average Asset | Measures how well the MFI uses its total assets to generate returns. |
| 3 | OSS | operating revenue/(financial expense + loan-loss provision expense + operating expense | Measures how well an MFI covers its costs through operating revenues. In addition to operating expense, it is recommended that financial expense and loan-loss provision expense be included in this calculation, as they are a normal (and significant) cost of operating |
| 4 | Profit margin | Net operating income/operating revenue | Measures what percentage of operating revenue remains after all financial, loan-loss provision, and operating expenses are paid. |
| 5 | Financial Self Sufficiency (FSS) | Adjusted operating revenue/(Financial expense + loan-loss provision expense + operating expense + expense adjustments | Measures how well an MFI can cover its costs, taking into account a number of adjustments to operating revenues and expenses. The purpose of most of these adjustments is to model how well the MFI could cover its costs if its operations were unsubsidized and it was funding its expansion with commercial-cost liabilities. |

Source: Consultative Group to Assist the Poorest (CGAP):

2.1.10.2 Portfolio Quality

Portfolio quality is a crucial area of analysis, since the largest source of risk for any financial institution resides in its loan portfolio. The loan portfolio is by far the MFI's largest asset and, in addition, the quality of that asset and therefore, the risk it poses for the institution can be quite difficult to measure.

For microfinance institutions, whose loans are typically not backed by bankable collateral, the quality of the portfolio is absolutely crucial. Fortunately, many microfinance institutions have learned how to maintain loan portfolios of very high quality. In fact, leading microfinance institutions typically better at maintaining a

higher portfolio quality than their commercial bank peers in many countries. The most widely used measure of portfolio quality in the microfinance industry is Portfolio at Risk (PaR), which measures the portion of the loan portfolio “contaminated” by arrears as a percentage of the total portfolio.

Although various other measures are regularly used, PaR has emerged as the indicator of choice. It is easily understandable, does not understate risk, and is comparable across institutions. A microenterprise loan is typically considered to be at risk if a payment on it is more than 30 days late. In addition to the Portfolio at Risk indicator, there are other indicators related to portfolio quality and associated risks: Write-Offs and Risk Coverage. (TorJanssen, 2003).

Table 2.3 Portfolio quality ratios, their formulas and explanations

| No. | Ratio Name | Formula | Explanation |
|-----|----------------------------|--|---|
| 1 | PAR ratio | Portfolio at risk (X days)/gross loan portfolio. | The most accepted measure of portfolio quality. Portfolio at risk is the outstanding amount of all loans that have one or more installments of principal past due by a certain number of days. When referring to PAR, an MFI should always specify the number of days. MFIs should indicate whether restructured loans are included in their calculation. Some MFIs automatically include restructured loans in their portfolio at risk. This practice reflects the belief that restructured loans carry higher risk than do current loans. |
| 2 | Write off ratio | Value of loans written off/Average gross loan portfolio | Represents the percentage of an MFI’s loans that have been removed from the balance of the gross loan portfolio because they are unlikely to be repaid. A high ratio may indicate a problem in the MFI’s collection efforts. |
| 3 | Risk coverage ratio | Loan-loss reserve/portfolio at risk>X days | Shows how much of the portfolio at risk is covered by an MFI’s loan-loss allowance. It is a rough indicator of how prepared an institution is to absorb loan losses in the worst case scenario. MFIs should |

| | | | |
|--|--|--|--|
| | | | <p>provision according to the age of their portfolio at risk: the older the delinquent loan, the higher the loan-loss allowance. For example, a ratio for PAR > 180 days may be close to 100%, whereas the ratio for PAR > 30 days is likely to be significantly less. Thus, a risk coverage ratio of 100% is not necessarily optimal.</p> |
|--|--|--|--|

Source: Consultative Group to Assist the Poorest (CGAP):

2.1.10.3 Efficiency and Productivity

Efficiency and productivity indicators are performance measures that show how well the institution is streamlining its operations. Productivity indicators reflect the amount of output per unit of input. These indicators reflect how efficiently the MFI is using its resources, particularly its assets and its Personnel.(Alemayehu, 2008).

Efficiency indicators also take into account the cost of the inputs and/or the price of outputs. Since these indicators are not easily manipulated by management decisions, they are more readily comparable across institutions than the profitability indicators such as return on equity and return on assets. On the other hand, productivity and efficiency measures are less comprehensive indicators of performance than those of profitability.

Microfinance institutions have much lower rates of efficiency than commercial banks because on a dollar per dollar basis microcredit is highly labor intensive: a hundred-dollar loan requires about as much administrative effort as a loan a thousand times larger. In an MFI, administrative costs may be \$15, \$20, or even \$30 for each \$100 in the loan portfolio, so the efficiency ratio is 15%, 20% or 30%, whereas in commercial bank efficiency ratios of 1.5%, 2% or 3% are common. Economies of scale have much less impact on efficiency in MFIs than is usually believed because of the high variable costs of the microcredit technology. If the loan portfolio of an MFI exceeds \$2 to \$3 million, growth does not seem to bring significant efficiency gains and small MFIs can often be

more efficient than their much larger peers. (TorJansson , 2003) This paper includes the following indicators of measuring productivity and efficiency: Operating Expenses, Cost per Borrower, Personnel Productivity, Loan Officer Productivity, average outstanding loan size, and other expense ratios.

2.1.10.4 Outreach level (Coverage and Depth)

Outreach refer to financial services provision to a large portion of the society, termed breadth of outreach, and to the poorest of the poor, also called depth of outreach. (Conning J, 1999) Outreach at glance means the number of client's served by the microfinance institutions. (Befikadu, 2007).

The best measurement of outreach is straightforward. That is the number of clients or accounts that are active at a given point in time. The number of active clients includes borrowers, depositors, and other clients who are currently accessing any financial services. However, Meyer (2002) described as outreach is multidimensional concept. In order to measure outreach we need to look in to different dimensions. The first is simply the number of persons now served that were previously denied access to formal financial services. Usually these persons will be the poor because they cannot provide the collateral required for accessing formal loans, are perceived as being too risky to serve, and impose high transaction costs on financial institutions because of the small size of their financial activities and transactions. Women often face greater problems than men in accessing financial services so number of women served is often measured as another criterion.... Although difficult to measure, depth of poverty is a concern because the poorest of the poor face the greatest access problem. Some measure of depth of outreach is needed to evaluate how well MFIs reach the very poor. Finally, the variety of financial services provided is the criterion because it has been shown that the poor demand and their welfare will be improved if efficient and secure savings, insurance, remittance transfer and other services are provided in addition to the loans that are the predominant concern of policy makers. (Mayer, 2002) Navajas et

al. (2000), cited on Befekadu similarly, indicated that there are six aspects of measuring outreach: depth, worth of users, cost to users, breadth, length and scope. Where, depth of outreach refers to "the value the society attaches to the net gain from the use of the micro credit by a given borrower. This measure is to identify the poor clients. And, worth of outreach to users refers to "how much a borrower is willing to pay for a loan." Similarly, cost of outreach to user refers to "cost of a loan to a borrower." These costs to users might consists of prices like interest rates and various payments that they have to pay, which could be revenue to the lender, and other loan related transaction costs like expenses on documents, transport, food, taxes, etc. Finally, "breadth of outreach is the number of users...length of outreach is the time frame in which a microfinance organization produces loans," and "Scope of outreach is the number of type of financial contracts offered by a microfinance organization."

It is argued that length of a loan matter, because if the microfinance institutions support the poor only in the short run it will hamper the social welfare of the society in the long run. In the case that when the client of the microfinance institution knows that he/she will not receive additional loan in the future they would have no incentive to borrowers to repay their loan. (Navajas, Rodriguez & Meza ,2000).

2.2 EMPIRICAL LITERATURE REVIEW

Below are a summary of prior empirical studies on financial and operating performance of microfinance institutions in the context of different countries.

Crombrughe, Tenikue and Sureda (2007) have carried out performance analysis for a sample of microfinance institutions in India. The methodology used for the study was regression analysis. They investigated three aspects of sustainability: cost coverage by revenue, repayment of loans and cost-control. Their results suggests that the challenges of covering costs on small and partly unsecured loans can indeed be met, without

necessarily increasing the size of the loans or raising the monitoring costs. Their analysis also suggests that to improve their financial results, like a better targeting of the interest rate policy or increasing the number of borrower's periled officers especially in collective delivery models.

Qayyum and Ahmad (not dated) conducted study on efficiency and sustainability of microfinance institutions in South Asia by using non parametric Data Envelopment Analysis (DEA). While conducting DEA analysis using single country data at a time, they found that eight MFIs from Pakistan, six MFIs from Bangladesh and five MFIs from India were at the efficient frontier under variable returns to scale. They considered both inputs oriented and output oriented methods by assuming constant returns to scale (CRS) and variable returns to scale (VRS) technologies. The combined DEA analysis for the three countries, however, resulted in only two MFIs being efficient under CRS and five MFIs under VRS assumptions.

Their analysis further reveals that the inefficiencies of MFIs in Pakistan, India and Bangladesh are mainly of technical nature. The results have an important policy implication that in order to improve the efficiency of the MFIs there is need to enhance the managerial skills and improve technology. This could be done by imparting training.

Alemayehu Yirsaw (2008) has made study on the performance of six Micro Finance Institutions in Ethiopia. From profitability and sustainability point of view, the study found that most of the microfinance institutions were doing well in terms of operational self sufficiency and financial self sufficiency. According to the result of the study as the size of MFIs decreases in terms of gross loan portfolio, operational self sufficiency and financial self sufficiency decreases as well.

From asset and liability management angle, the study found that most microfinance institutions used the highest portion of the assets to their primary activity (making loans to micro entrepreneurs). A low cost of funds results from an MFI gaining access

to deposits and /or borrowings at a reasonable cost. In this respect all MFIs were successful in obtaining funds at an average interest rate below commercial banks lending rate (7%). The study further noted that, medium and large MFIs performed well in obtaining funds as compared to their small counter parts. In the year under the studies investigation, medium and large MFIs had below 50% liquidity ratio represented by current asset over current liability.

From efficiency and productivity point of view the study found that, large MFIs have the lowest operating expense ratio (more efficient) and small MFIs the highest operating expense ratio represented by operating expense over average gross loan portfolio. According to the result of the study as the size of MFIs increases the operating expense ratio decreases as well. That is; Large MFIs spends the least (or are efficient) in personnel and administrative expenses to serve a single borrower. Small MFIs seem to reach poorer clients since the average loan size is the smallest. Generally the study noted that large microfinance institutions were more efficient and productive but Small MFIs seem to reach poorer clients better.

Befikadu B. Kereta (2007) has made study on outreach and sustainability of microfinance institutions in Ethiopia. The paper examines the performance of MFIs in relation to outreach and financial sustainability. The study reviews literatures on core performance indicators of MFIs. The studies literatures noted that MFIs could be examined through three main pillars: outreach to the poor, financial sustainability and welfare impact. However; the welfare impact assessment is not covered in his paper due to time and money limitations. Both secondary and primary data (obtained from questionnaire distributed to representative sample of MFIs) has been employed in his study. In the analysis process, the study has adopted simple correlation and descriptive analysis techniques.

From the outreach angle, he found that individual MFI's outreach has shown increment over the period of the study with different rates of growth, leading the

industry's outreach to rise in the period from 2003 to 2007 on average by 22.9 percent. It is also identified that while MFIs reach the very poor, their reach to the disadvantaged particularly to women is limited (38.4 Percent).

From financial sustainability angle, the study found that MFIs in Ethiopia are hopeful. They are operationally sustainable as measured by return on asset and return on equity and the industry's profit performance is also improving over time. While, dependency ratio measured by the ratio of donated equity to total capital declined, ratio of retained earnings to total capital is raising letting the industry to be financially self-sufficient. Using Nonperforming Loan (NPLs) to loan outstanding ratio indicator, his study found that MFI financial sustainability is in a comfort zone with average NPLs ratio of 3.2 percent for the period from 2005 to 2007.

Arege (2007) the study conducted on three Ethiopian microfinance institutions (Aggar, Harbue and SFPI) shows that ROA and ROE for Aggar microfinance was negative with ROA ratios of -6.66% and -7.11% during the years of 2005 and 2006 respectively. Aggar's ROE for the same years was -9.04% and -13.05%. As per the researchers finding the negative results were due to the huge net loss reported by the firm during the years of 2005 and 2006. ROA for SFPI during 2005 and 2006 was 0.49% and 0.60% respectively. SFPI's ROE ratio was 0.97% and 1.14% for the same periods. But Harbue's ROA during 2005 and 2006 was 0.28% and -2.58% respectively. The firms also have ROE of 0.97% and -3.40 during 2005 and 2006 respectively.

Adeno Kidane (2007) made a study on one of the largest MFIs in Ethiopia Amhara Credit and Saving Institution (ACSI). His result shows that ACSI has served more than half a million clients. Over 1.6 million loans have been disbursed worth Birr 1.5 billion. By 2005, the institution was operationally and financially self sufficient at 119.9 and 115.3% respectively. ACSI is among a few MFIs that are able to achieve the highest efficiency at the lowest cost per borrower. The operating cost was as low as five cents in 2005. ACSI also has a high portfolio quality, as delinquency rates are around 1.9%.

Bamlaku Alamirew Alemu (2006) made a study on micro financing and poverty reduction in Ethiopia the paper examines the impact of Ahmara credit and saving Institute (ACSI) in Ethiopia taking a sample of 500 households from five different zones in Amhara region using both descriptive statistics and econometric tools were employed (such as chi- square, paired T-test and ANOVA) and econometric analysis (Logistic regression), so as to investigate the impact of credit on improving the life of the clients . The study has found out the poor has smoothed their income in the study area. However there is a problem of fungibility in the sense that clients manipulate the loan for their immediate needs which forces the poor to offset long term benefits due to the urgent need for daily survival of lack of business skills to engage into a productive business. Therefore, generally the study noted that the current service of ACSI need to focus on business training skills apart from loan provision to create sustainable micro enterprise and other economic activities to help the poor move beyond day to day survival and plan for their future.

Kassa Teshager (2008) has made a research on microfinance as a strategy for poverty reduction. The paper examines empirical evidence in Ethiopia to check if microfinance is good poverty reduction strategy for this purpose the two cases (ACSI and Wisdom) were analyzed based on Design, outreach, financial performance, sustainability and impact framework. The study found that Microfinance is indeed a strategy for poverty reduction in Ethiopia. However, the contribution of cases depends on their approach. ACSI is efficient, profitable, and sustainable MFI and best reflects the business approach. However, it is less effective in achieving its development mission and reaching the poorest clients in the region. Although Wisdom is financially less efficient, productive and sustainable, its strong link with World Vision Ethiopia helps to work relatively better in its development objectives. The study result shows pressure should have motivated MFI's to serve more poor people with better quality products and conclude that any clients benefited from the two program(ACSI & Wisdom) but they

exclude the poorest segment of the population especially women and youth besides to this the studies shows both case have positive impact on their clients especially in income diversification, health and nutrition, housing and empowerment of the poor and finally addressed that microfinance is not a miracle solution. It is not for everyone and is not solely responsible for poverty reduction. It must also be integrated with other social programs like public works, safety nets and/or community development programs that are flexible to meet the diverse needs of destitute families. Microfinance loans need to be reviewed and adjusted to the contextual needs of the poor, since the poor are not a homogenous group.

Letenah Ejigu (2009) has made a research on performance analysis of sample microfinance institutions of Ethiopia. The paper appraises the performance of Ethiopian MFIs in terms of various criteria by comparing with the Micro banking Bulletin (MBB) benchmark and for some relative ratios comparison among themselves. The MF industry as a whole is challenged by the need to reach the poorest customers and at the same time being financially self sufficient. Although the industry as a whole is growing at a faster pace still the two critical questions of reaching the poor and building a financially sustainable MF industry that walk on their own leg freely are empirical questions. Data for the research were purely secondary taken from the MIX Market website and used one sample t test, one way ANOVA with Scheffe Post Hoc Comparison tests, Kruskal-Wallis test and Pearson correlation coefficients. The result of the study indicates that Ethiopian MFIs in general are poor performers on depth of outreach. They are not reaching the poorest of the poor. They are also poor in terms of the ratio of GLP to assets, allocating a lower proportion of their total assets in to loans. They are also not using their debt capacity properly. The large and smaller MFIs are allocating more loan loss provision expense than the industry average and the related PAR is high for these MFIs. All the MFIs are good at breath of outreach, cost management, efficiency and productivity. They also charge low interest rates. The profitability and sustainability of the MFI depend on

their size. From a simple correlation analysis it is found that there is a tradeoff between serving the poor and being operationally self-sufficient. MF age correlates positively with efficiency, productivity, the use debt financing (commercialization) and OSS. It is also found that the use of debt financing makes firms more efficient and productive.

Giovanni Ferro (2006) has made a research on measuring the performance of microfinance institutions. The paper examines the financial sustainability of an MFI only gives one feature of its performance. As many MFIs primarily exist in order to help the poorest people, one also has to include aspects of outreach in their performance. Hence, MFIs' performance can be termed multidimensional. The study noted that how some statistical tools can offer new insights in the context of MFIs' performance evaluation. Factor analysis is used in a first step to construct performance indices based on several possible associations of variables without posing too many a priori restrictions and also can help construct some synthetic indices of both outreach and self-sustainability. One advantage of factor analysis is that no arbitrary weight needs to be ascribed to each variable, as the "data speak for themselves", in that the weights are computed from the correlation matrix of the chosen variables. One drawback of this technique is that it does not provide information of the absolute level of performance. Cluster analysis was mainly used to better grasp the possibility that some MFIs would form groups across the two scores. The clusters were not very compact and quite unstable across the years, probably also because MFIs come from different countries and are possibly influenced by institutional or macroeconomic factors specific to their countries.

CHAPTER- III

3. METHODOLOGY OF THE STUDY

3.1. Research Design

In any research undertaking, the methodology/research design to be followed is determined by the nature of the problem statement or more specifically by the research objectives. Hence in this study, assessment of the Financial and Operating performance using case study approach was used by the researcher because this research design is the most appropriate for measuring the performance of the microfinance institutions. Therefore; the study is a quantitative and historical (retrospective) research on the bases of case study approach.

3.2 Sampling Method

Sampling is the part of statistical practice concerned with the selection of an unbiased or random subset of individual observations within a population of individuals intended to yield some knowledge about the population of concern, especially for the purposes of making predictions based on statistical inference. Or sampling is the process of selecting a few or sample from the large group or sampling population in order to estimate about the prevalence of unknown piece of idea in the study population. However; the issue of sampling in this paper has little/no significance, as the purpose of the study was to assess Financial and Operating performance of SFPI in comparison with the Industry Average.

Thus; the researcher selected the microfinance institutions based on different criterion: i.e. geographical distributions (to include at least major regions of the country like Addis Ababa, Amhara, Tigray, Oromia, Southern Nations, Nationalities and Peoples) and year of establishment (microfinance institutions which were established during

the year of 1997 G.C) to determine the Industry Average (I.A). This criterion is included to overcome the impact of age difference on performance. As a result; SFPI, ACSI, OMO, OCSSCO and DECSI are the microfinance institutions which were included in this paper. Therefore, these institutions were the sample units for the study. Hence; in selecting the sample elements judgmental sampling technique were employed.

3.3 Methods of Data Collection

The study with the aims of assessing Financial and Operating performance of SFPI, is mainly based on secondary data from the annual financial reports of the institutions such as income statement, portfolio report and the balance sheet of the selected MFIs, data from books, journals, news papers, magazines, reports of various governmental and nongovernmental organizations such as AEMFI (Association of Ethiopian Micro Finance Institutions) for literature review and data from National Bank of Ethiopia and the Mix Market web sites for audited financial statement were used. To increase the reliability of data the researcher has used more recent and sixteen years audited annual financial reports for the microfinance institutions for the period covering from 1999 to 2014 as a source of secondary data in order to assess and close to the fact of the institutional-level financial and operating performance of SFPI and compare against the Industry Average.

The researcher has been used different types of variables to assess Financial and Operating performance of SFPI against industry average. To measure the outreach/coverage the researcher has used number of active borrowers and percent of women borrowers as a variables because assessing the number of clients being served by a MFIs is one of the core performance indicators for a given MFIs. Outreach refers to financial services provision to a large portion of the society, termed breadth of outreach, and to the poorest of the poor, also called depth of outreach. Outreach at glance means the number of clients served by the microfinance institutions.

Depth of outreach is measured by number of active borrowers, the percentage of women borrowers, average loan size, number of loan outstanding, loan portfolio at gross, average loan balance per borrower, number of depositors, and level of deposits. The higher value for all the previous variables indicates that the MFIs are good at reaching the poor and a larger value for percentage of women borrowers indicate a good depth of outreach as women are considered to be poorer than men. Expanding the number of clients being served is an ultimate goal of almost all microfinance institutions. But rapid expansion sometimes proves to be unsustainable, especially during an MFI's early years when it needs to design its products and build its systems. It has very seldom been useful for funders to pressure MFIs for rapid expansion.

To measure sustainability and profitability the researcher has used ROA, ROE, OSS and YGP as a variable because financial viability (Institutional sustainability) is the ability of an entity to cover its costs with revenue generated from operations with no dependence on subsidy. There are two indicators for assessing financial viability or sustainability. These are measures of Operational Self-Sufficiency (OSS) and Financial Self-Sufficiency (FSS). To achieve OSS, the company should increase its revenue from operations and reduce its operating, financing, and loan loss expenses. FSS measures the firm's ability to generate revenue sufficient to cover both direct (operating, financing, and loan losses) and indirect (cost of capital) expenses of doing business.

The cost of capital is adjusted for inflation, expected rate of return by owners, and cost of debt adjusted at market rate. Measure of FSS below 100% indicates dependency on donor funds or subsidies. However; it has to be noted that the performance analysis of SFPI does not include FSS as it needs adjustments for inflation, in-kind subsidies, and cost of funds as there is no available data about subsidies and cost of subsidies from the data source the researcher has used. MFIs aim, at first, to achieve OSS followed by FSS. As the institution matures, there is an expectation that there will be an increase in

financing costs due to more debt in the asset structure to finance the huge portfolio and decrease in operating and loan loss expenses due to efficient management of loan portfolio and reducing operational costs to the lowest possible. Setting adequate interest rate on loans, achieving highest collection rates, aggressive mobilization of savings, and cost-effectiveness and efficiency in operations are policy considerations to achieve sustainability (Ledgerwood, 1999).

Profitability indicators measure financial performance of a firm over a period of time. It is useful for both internal management and external stakeholders to assess profitability of the business. In these ratios net income is stated as return on assets and return on capital. Return on assets (ROA) measures the average net income earned on a single currency owned and indicates the kind of return the assets are generating. Analysis of ROA helps in policy settings to improve revenue generating capabilities, better delinquency management, and the introduction of new products to clients.

High return implies good utilization of assets. It is a measure of the return from a single Birr of loans outstanding. ROE refers to the maximum return available to shareholders. The ROE gives the rate of return earned on net worth or equity invested. Higher return implies pleased shareholders or owners. Investors may decide to invest or divest by referring to the ROE of the firm. The return on portfolio ratio indicates the productivity of the credit operation. On the other hand, portfolio yield measures the percentage of net income earned for every Birr in portfolio. Yield measures ultimate profitability. The higher the ratio, the more profitable each currency lent is. (Barres, 2006). Investors, financiers, and clients would determine their future ties with the institution by examining its profitability. In banks, microfinance and other commercial institutions, the commonest measures of profitability are Return on Equity (ROE), and Return on Assets (ROA).

The highest income source for MFIs is their portfolio where as the major source of expenses are administrative and personnel expenses. SFPI earns financial revenues from loans and other financial services in the form of interest income, penalties, and commissions. Financial revenue also includes income from other financial assets, such as investment income. Its financial activities also generate costs of doing business. These include general operating expenses, financing charges, and loan losses due to default. Profitable institutions generate greater revenue that exceeds total expenses. From the very nature of the line of business, interest income is the major source of income for SFPI.

To measure productivity and efficiency the researcher has used operating expense per loan portfolio, personal expense per loan portfolio, No of active borrowers per staff member, No of active borrowers per loan officer and depositor per staff member as a variable because efficiency and productivity indicators are performance measures that show how well the institution is streamlining its operations. Productivity indicators reflect the amount of output per unit of input. These indicators help to assess the capability of MFIs to generate revenue and resource use ability to wealth maximization. Provision of financial services and products at the minimum cost possible is the maxim of efficient service delivery. Productivity consists of both outreach and efficiency. Productive firms utilize human, financial and other resources effectively and efficiently.

Productivity refers to the conversion of an input into output using a given resource. Efficiency refers to achieving the intended objective at the least resource use possible. Efficiency is the measure of the cost per unit of output. The productivity ratio in the case of MFIs focuses on the capacity of credit officers to serve as many clients as possible. These ratios include number of active borrowers and savers, average portfolio, and total amount disbursed per credit officer or field officer or staff. The efficiency ratios measure the operational costs of service delivery. Operating efficiency

ratio measures the ratio or percentage of operating expenses relative to the portfolio. The lower operating expense ratio indicates the lower expense relative to portfolio outstanding. Usually costs of credit disbursement are higher than costs of accepting saving deposits. The efficiency ratios include operating costs ratio, cost per unit of currency lent, and cost per loan made. Operating cost ratios of 13% to 21% is a good indicator for successful MFIs (Ledgerwood, 1999).

To measure capital structure the researcher has used capital asset ratio, debt to asset ratio, deposit to loan ratio and gross loan portfolio to asset ratio as a variable because MFI finance their activities with funds from various sources, both debt (deposits from clients and borrowings from banks and other financial institutions) and net worth. Measures of financial structure describe these various fund sources and compare them with assets purchased with those funds. Financing structure ratios, also termed as stability ratios, include leverage and capital adequacy measures.

Leverage is the extent in which debt financing is employed compared to equity financing. Leverage ratio is calculated by dividing debt to equity. It shows the amount of debt per Birr invested in capital i.e., the number of times of debt for every Birr of equity. The lower the ratio the safer is the firm. Commercial loans and clients' savings serve as a base for leverage. Leverage impacts on profitability positively up to certain limit. Total debt to total assets ratio shows the percentage of debt in financing the business. Too high debt to equity ratio indicates highly leveraged situation that implies too much debt or too small equity base in the financing structure. On the other hand, too low debt to equity ratio indicates inefficient use of equity. Hence it is advisable to maintain optimal level of debt to equity ratio.

Adequate capital is an incentive for both lending institutions and savers to build confidence in the MFIs in meeting their obligations in the future. Capital is a pillar for expansion, source of security, flexibility, stability, buffer against risk and losses, and a

base for borrowing. Capital adequacy is the amount of capital compared to the overall financial position of the firm. It refers to the optimal level of capital required to take up losses incurred without damaging the institutional sustainability. Capital adequacy measures the stability and solvency of the firm in line with the level of leverage. The desired trend is that the higher the safer. Too low ratio indicates too much debt in the firm's financial structure. Too high ratio is on the other hand an indicator of under-leveraged there by reducing return on equity. As debt financing is cheaper than equity it is advisable to maintain optimal use of debt as much as possible. The sources of funding for SFPI are shareholders equity, retained earnings, donated equity, commercial borrowings, subsidized liabilities, and savings.

To measure the portfolio quality the researcher has used PaR > 30 days, PaR > 90 days, write-off, loan loss rate and risk coverage as a variable since the largest source of risk for any financial institution resides in its loan portfolio. The loan portfolio is by far an MFI's largest asset and, in addition, the quality of that asset and therefore, the risk it poses for the institution can be quite difficult to measure. For microfinance institutions, whose loans are typically not backed by bankable collateral, the quality of the portfolio is absolutely crucial. Fortunately, many microfinance institutions have learned how to maintain loan portfolios of very high quality. In fact, leading microfinance institutions typically are better at maintaining a higher portfolio quality than their commercial bank peers in many countries.

The most widely used measure of portfolio quality in the microfinance industry is Portfolio at Risk (PaR), which measures the portion of the loan portfolio "contaminated" by arrears as a percentage of the total portfolio. Although various other measures are regularly used, PaR has emerged as the indicator of choice. It is easily understandable, does not understate risk, and is comparable across institutions. In addition to the Portfolio at Risk (PAR) indicator, this paper includes three other

indicators related to portfolio quality and associated risks: Write-Off ratio, Loan Loss rate and Risk Coverage.

The major productive asset of SFPI as it is common in other MFIs, is its loan portfolio. Thus, portfolio quality refers to the health of this productive asset and the risks attached to it; mainly delinquency to its loan portfolio. The portfolio quality is detrimental to the institutions current performance as well as future prospect in generating higher revenues and better outreach to the poor. Repayment rates, loan loss, and portfolio quality ratios are indicators used to assess the portfolio quality. The repayment rate indicates the recovery rate of loans due in time. It measures loan repayments collected compared to the total expected amount to be collected over a given period of time. It is important in cash flow projections and monitoring loan repayments. It is hardly possible to evaluate current condition of the portfolio based on repayment rate but has a predictive value based on past experience.

This measurement may be misleading in fast growing, long term portfolio conditions but it has to be noted that the repayment rate is not covered in this paper due to the absence of the sufficient data. The second portfolio quality measurement is portfolio quality ratios. This indicator comprises of three different ratios of the arrears rate, the portfolio at risk (PaR), and the ratio of delinquent borrowers. The arrears rate shows the risk that a loan will not be collected in the future. Arrears are loan amounts overdue from the originally set repayment time and date. In principle a loan late even hours is termed as in arrears. It shows how much of the loan is uncollected on the due date. Some argue that arrears rate does not show the overall risk the total portfolio is exposed to as it indicates only the amount overdue. In fact, it is not the overdue amount only which is at menace but the outstanding amount in total is at risk of loss when its part is overdue.

A better indicator or measure of risk associated with the portfolio is then assumed to be the portfolio at risk ratio that includes any remaining balance of loans infected with arrears including the arrears balance itself. In other terms the calculation takes into account outstanding balance of loan amounts that have past due amounts. It is prudent compared to the arrears rate by considering the total poisoned loan which is in doubt of collection including the past due amount. The PAR helps to see the real picture of the risk of delinquency particularly in credit terms with small loan payments over a long credit period. It should be noted that the definition of the policy of delinquent loans matters the calculations of portfolio quality measures.

Another indicator is based on loan losses. Loan losses are part of the costs of doing business. Ratios can be calculated based on an estimated amount used in businesses as loan loss reserves and an actual amount of loans written off during the period. Loan loss reserves are estimated based on experience over time that the reserve ratio can be an indicator to evaluate the delinquency management over time. The ratio is expected to decrease over time if accompanied with better delinquency management practices. Loan loss reserve ratio rarely exceeds successful micro financing institutions (Ledgerwood, 1999).

The loan loss ratio measures the amount of loans written-off or cancelled from accounting records as uncollectible during a given accounting period when the loans do have little hope of collection in the future. The trend analysis for the loan loss ratio can be made to evaluate the changes over time. As a general indicator, loan losses of above 2% annually show a delinquency problem (Ledgerwood, 1999). MFIs with a vision to stay in the market as a going concern should display to their clients that they will stay in the business for indefinite period of time. Showing sustainability and stability in the business is a decisive factor for clients to repay today in expectation of getting services in the future.

The reason behind failure of short-sighted credit service interventions is that clients default in expectation of no pressure to settle their debt from a project to phase-out. They compare the cost and benefit of defaulting vis-à-vis repaying the loans.

3.4 Methods of Data Analysis and Interpretation

Once the data is collected from secondary sources, it was analyzed through various techniques. First, the collected data was arranged in the manner that it becomes easy for analysis. Secondly, the arranged data was analyzed and interpreted using different statistical tools like, tables, charts, graphs and percentages. Tools like tables, graphs and percentages are commonly used to show the result, effect as well as the relationship between the indicated variables in all measurement applied in this study. In addition to, these statistical tools and techniques of financial analysis such as trend analysis (time series analysis), Industry Average Analysis and ratio analysis were used. To reveal performance of MFIs very well, sixteen years data from 1999 to 2014 were used to see the trend in financial and operating performance of SFPI and compare against the Industry Average (I.A).

3.5 Ethical Issue

There is need to consider a number of different ethical issues and find out what rules there maybe for conducting research at an early stage in the study. The ethical approval to conduct the research will be sought. Several ethical issues were addressed during the course of this research work. Letters were sent to the selected microfinance institutions to seek their consent for their financial statements and they were informed as the purpose of the paper is for the academic fulfillment.

CHAPTER- IV

4. DISCUSSION AND ANALYSIS

As it was indicated in the methodology part of the study, the findings stated below are extracted and analyzed based on secondary sources. In this section the paper presents findings of the study on Financial and Operating Performance of SFPI and comparison with the Industry Average using performance measurements.

4.1 Outreach/Coverage

Outreach refers to financial services provision to a large portion of the society, termed breadth of outreach, and to the poorest of the poor, also called depth of outreach. Outreach at glance means the number of clients served by the microfinance institutions so, to analyze the number of clients being served or covered by SFPI & Industry Average during sixteen years of the study period using the variables number of active borrowers and percent of women borrowers are presented as follows;

Table 4.1 Number of active borrowers

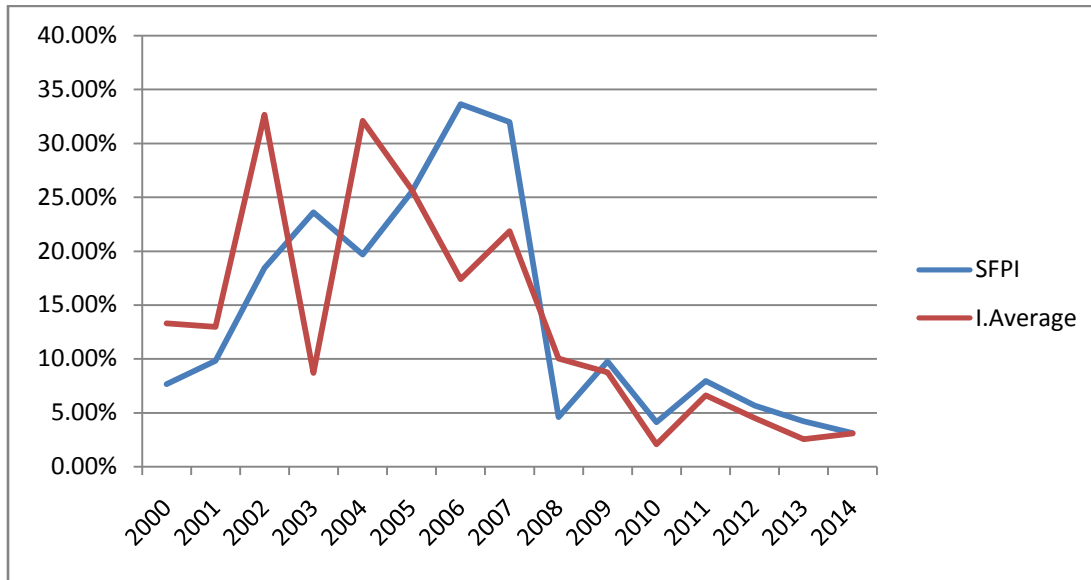
| Indicator /Year | Number of Active Borrowers | | Growth Rate of Active Borrowers | |
|-----------------|----------------------------|------------|---------------------------------|------------|
| | SFPI | I. Average | SFPI | I. Average |
| 1999 | 5,520.00 | 73,932.80 | | |
| 2000 | 5,942.00 | 83,741.40 | 7.64% | 13.27% |
| 2001 | 6,526.00 | 94,593.60 | 9.83% | 12.96% |
| 2002 | 7,728.00 | 125,470.60 | 18.42% | 32.64% |
| 2003 | 9,552.00 | 136,363.40 | 23.60% | 8.68% |
| 2004 | 11,430.00 | 180,109.40 | 19.66% | 32.08% |
| 2005 | 14,345.00 | 226,402.80 | 25.50% | 25.70% |
| 2006 | 19,169.00 | 265,727.20 | 33.63% | 17.37% |
| 2007 | 25,294.00 | 323,729.00 | 31.95% | 21.83% |
| 2008 | 26,459.00 | 356,163.80 | 4.61% | 10.02% |
| 2009 | 29,044.00 | 387,295.60 | 9.77% | 8.74% |
| 2010 | 30,240.00 | 395,254.20 | 4.12% | 2.05% |
| 2011 | 32,645.00 | 421,283.80 | 7.95% | 6.59% |
| 2012 | 34,494.00 | 440,206.00 | 5.66% | 4.49% |
| 2013 | 35,943.00 | 451,353.40 | 4.20% | 2.53% |
| 2014 | 37,060.00 | 465,182.20 | 3.11% | 3.06% |
| Average | 20,711.94 | 276,675.58 | 2.07% | 1.99% |

Source: - Researcher's own computation from MIX Market Inc. website (www.themixmarket.com).

Numbers of active borrowers are the number of individuals who currently have an outstanding loan balance with the microfinance or individuals who are responsible for repaying any portion of the gross loan portfolio. Number of active borrowers of SFPI and the Industry Average is increasing from time to time as can be observed from table 4.1 above and Figure 4.1 below. SFPI's outreach in terms of number of active borrowers has shown increment over the period of the study with different rates of growth.

SFPI has shown a gradual progress in terms of outreach since its establishment. The table given above would illustrate this best. However all over the period of the study the absolute number of active borrowers of SFPI is less than the number of active borrowers of the Industry Average. But comparing the size might not be meaningful in this context so, to get the real effect of outreach we better to compare in terms of the growth of active borrowers of SFPI with growth of Industry average and we found that SFPI is better than industry average especially starting from the year 2009 up to 2014(i.e. the recent data). The average growth of SFPI over the sixteen years period is 2.07% which is better than the industry average of 1.99%. when we compare the growth of active borrowers of SFPI with growth of Industry average especially starting from the year 2009 up to 2014(the recent data) we can find that SFPI is better than industry average. The average growth of SFPI over the sixteen years period is 2.07 which is better than the industry average of 1.99. Therefore; SFPI is performing well as compared to the industry average.

Figure 4.1 Numbers of Active Borrowers by Growth rate



Source: - Researcher’s own computation from MIX Market Inc. website (www.themixmarket.com).

Table 4.2 Percent of women borrowers

| Year | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|--------------|--------|--------|--------|--------|--------|--------|--------|
| SFPI | 56.00% | 68.21% | 71.99% | 69.99% | 69.00% | 60.00% | 54.51% |
| Ind. Average | 35.40% | 38.46% | 34.90% | 35.17% | 36.08% | 33.60% | 33.74% |

| Year | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|--------------|--------|--------|--------|--------|--------|--------|--------|
| SFPI | 66.84% | 50.01% | 55.00% | 55.76% | 56.94% | 56.00% | 55.81% |
| Ind. Average | 37.60% | 41.60% | 44.06% | 44.37% | 45.97% | 46.90% | 46.42% |

| Year | 2013 | 2014 | Average |
|--------------|--------|--------|---------|
| SFPI | 53.50% | 55.57% | 59.70% |
| Ind. Average | 45.09% | 46.66% | 40.38% |

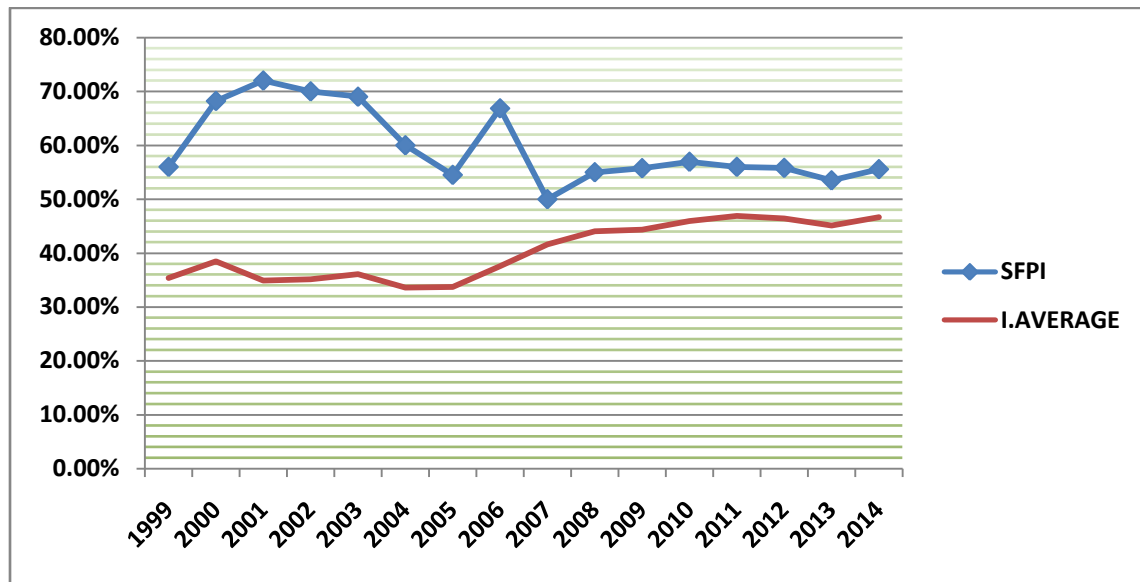
Source: researcher’s own computation from MIX Market Inc. website (www.themixmarket.com)

With respect to the total population in the region and the coverage SFPI currently has managed to address, one could argue that it still needs to go further. The percent of

women borrowers for SFPI was showing a remarkable progress from year to year as we can observe from the above table 4.2 and Figure 4.2 below. So all over the period of the study the percentage of women borrowers of SFPI is more than the percentage of women borrowers of the Industry average. Therefore SFPI is performing well in terms of balancing the gender aspect of its clients compared to the industry average. Besides to this all over the years of the study, women are represented by far more than men. Table 4.2 above and Figure 4.2 below exhibit the percent of women borrowers from the total number of active borrowers of SFPI and Industry Average. The result shows that the percent of women borrowers of SFPI is higher than the percent of women borrowers of the Industry Average all over the periods covered by the study.

One of the disadvantaged groups from economic empowerments point of view are women. The study found that even if credit access to women is still limited in the industry but SFPI is registered remarkable performance in this aspect. At the industry level women credit access share is only 40.38 percent on an average while at the SFPI the percent of women borrowers is 59.70 percent on an average which is by far better than the industry average. Therefore, SFPI has shown a remarkable progress in terms of emphasizing more number of women borrowers in order to balance the gender aspect of its clients and to support the disadvantaged group of the economy. So the industry is required to adjust its policy that increases the percent/the number of women borrowers like SFPI. Since empowering women and serving the active poor are the primary objectives of any microfinance institutions.

Figure 4.2 Percent of women borrowers



Source: - Researcher's own computation from MIX Market Inc. website (www.themixmarket.com)

4.2 Financial Sustainability and Profitability

Sustainability is heavily defined as the ability of a MFI to cover its operating and other costs from generated revenue and provide for profit. Financial sustainability is an indicator which shows how the MFI can run independent (free) of subsidies. However, Profitability indicators measure financial performance of a firm over a period of time. It is useful for both internal management and external stakeholders to assess profitability of the business. So, to analyze the financial sustainability and profitability of SFPI & Industry Average during sixteen years of the study period using the variables ROA, ROE, OSS & YGP are presented as follows;

Table 4.3: Sustainability and Profitability Measures

| Indicator /Year | ROA | | ROE | | OSS | | Yield on Gross portfolio | |
|-----------------|--------------|--------------|---------------|---------------|----------------|----------------|--------------------------|---------------|
| | SFPI | I. Average | SFPI | I. Average | SFPI | I. Average | SFPI | I. Average |
| 1999 | 1.45% | 0.02% | 24.35% | 3.32% | 70.00% | 104.34% | 12.66% | 11.01% |
| 2000 | 1.29% | 0.34% | 31.99% | 7.75% | 53.79% | 108.47% | 15.05% | 12.15% |
| 2001 | 1.16% | 1.65% | 23.86% | 7.53% | 55.36% | 111.09% | 12.98% | 11.81% |
| 2002 | 0.97% | 1.86% | -8.72% | 5.49% | 70.71% | 117.69% | 15.33% | 13.33% |
| 2003 | 1.87% | 3.61% | 1.64% | 6.87% | 106.06% | 140.58% | 21.32% | 15.48% |
| 2004 | 1.49% | 4.03% | 0.97% | 9.16% | 106.06% | 160.84% | 19.55% | 14.62% |
| 2005 | 1.60% | 3.83% | 1.13% | 11.80% | 104.39% | 158.97% | 19.06% | 14.49% |
| 2006 | 3.13% | 4.67% | 5.84% | 15.44% | 126.69% | 171.65% | 18.35% | 13.86% |
| 2007 | 1.36% | 3.19% | 2.80% | 12.34% | 111.27% | 170.02% | 16.40% | 13.19% |
| 2008 | 2.96% | 3.42% | 6.48% | 12.52% | 119.33% | 155.28% | 23.42% | 15.61% |
| 2009 | 3.61% | 3.38% | 15.00% | 13.42% | 121.32% | 147.83% | 24.21% | 15.48% |
| 2010 | 4.75% | 3.73% | 15.07% | 12.83% | 127.26% | 147.00% | 11.78% | 12.81% |
| 2011 | 5.80% | 4.62% | 14.35% | 13.91% | 149.15% | 162.11% | 22.08% | 15.81% |
| 2012 | 5.57% | 4.13% | 17.75% | 14.57% | 152.17% | 163.56% | 22.33% | 15.64% |
| 2013 | 6.72% | 4.46% | 21.00% | 15.04% | 155.18% | 188.79% | 22.83% | 15.28% |
| 2014 | 6.58% | 4.48% | 18.10% | 14.76% | 156.60% | 174.67% | 24.73% | 16.67% |
| Average | 3.14% | 3.21% | 11.98% | 11.05% | 111.44% | 148.93% | 18.88% | 14.20% |

Source: Researcher's own computation from MIX Market Inc. website (www.themixmarket.com).

As depicted on Table 4.3 above, the highest return on assets of SFPI was registered in 2013. A Birr in assets earned around seven cents in 2013 but previously it was declined continuously and reached around one cents in 2002. On an average SFPI had ROA of 3.14% which is lower than the average ROA of the Industry Average, i.e., 3.21%. A Birr invested in equity has generated the highest return on the year 1999, 2000, 2001 and 2013 around 24 cents, 32 cents 24 cents and 21 cents respectively.

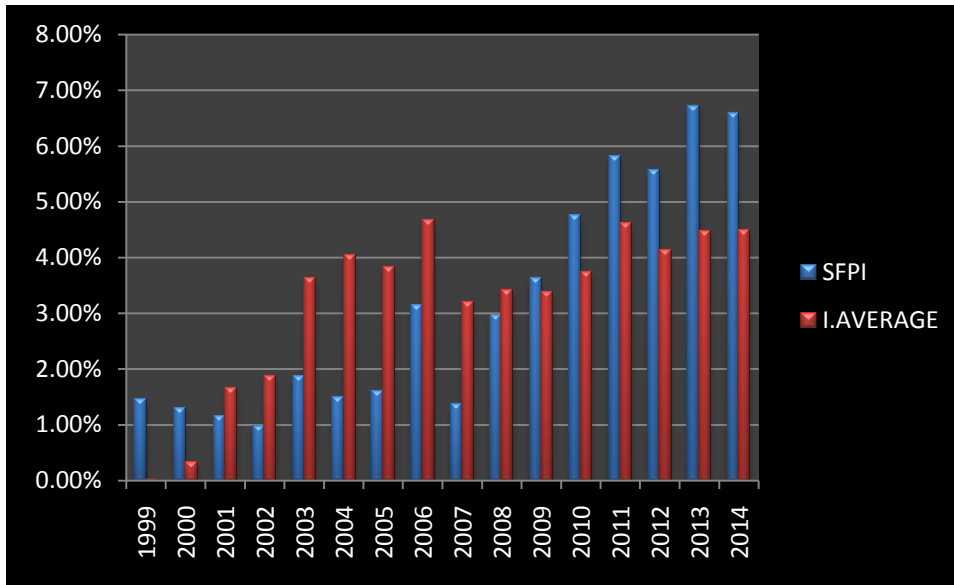
Yield on gross portfolio of SFPI was swing from year to year as we can observe from the above table and Figure 4.6 below. The highest yield on portfolio of SFPI was around 25 cents per Birr in portfolio in 2009 and 2014 but declined to 12 cents in 2010. The highest extreme of SFPI (i.e. 25 cents) is higher than the highest extremes of the

Industry Average (i.e. 17 cents) and the lowest extreme of SFPI (i.e. 12 cents) is higher than the lowest extremes of the Industry Average (i.e.11 cents). From this it can be concluded that SFPI has better asset management (better utilization of assets in generating revenue) and better management of portfolio as compared to the industry average during the years under the study.

Generally; as shown on Table 4.3 above and Figure 4.3, 4.4, 4.5 and 4.6 below SFPI is going down the ladder of Sustainability and Profitability measures during the periods of the study. On average SFPI is operationally self-sufficient at around 111.44% over the sixteen years period but it is less than the Industry Average i.e. around 148.98%. At the end of 2014, SFPI achieved 6.58%, 18.10% and 24.73% of ROA, ROE and yield on gross portfolio respectively higher than the industry Average.

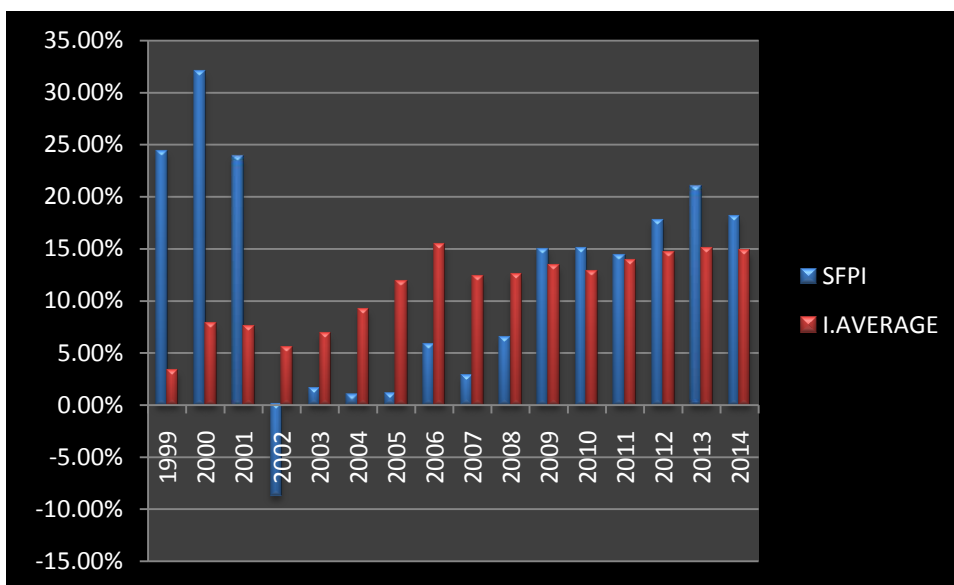
SFPI had high ROE and (YGP) Yield on gross portfolio as compared to the Industry Average over the sixteen years likewise SFPI's OSS was lower than the Industry Average all over the period covered by the study. The above table showed that average operational Self-Sufficiency (OSS) for SFPI is 111.44% where as average operational self sufficiency still below the threshold level (148.93%). From this it can be concluded that SFPI is in a position to generate sufficient revenue to cover operating costs and at the same time their ability to operate and expand without subsidies is possible for these institutions. Better efficiency, high productivity, more leverage, and more MFIs age (experience) all leads to good OSS.

Figure 4.3 Returns on Asset (ROA)



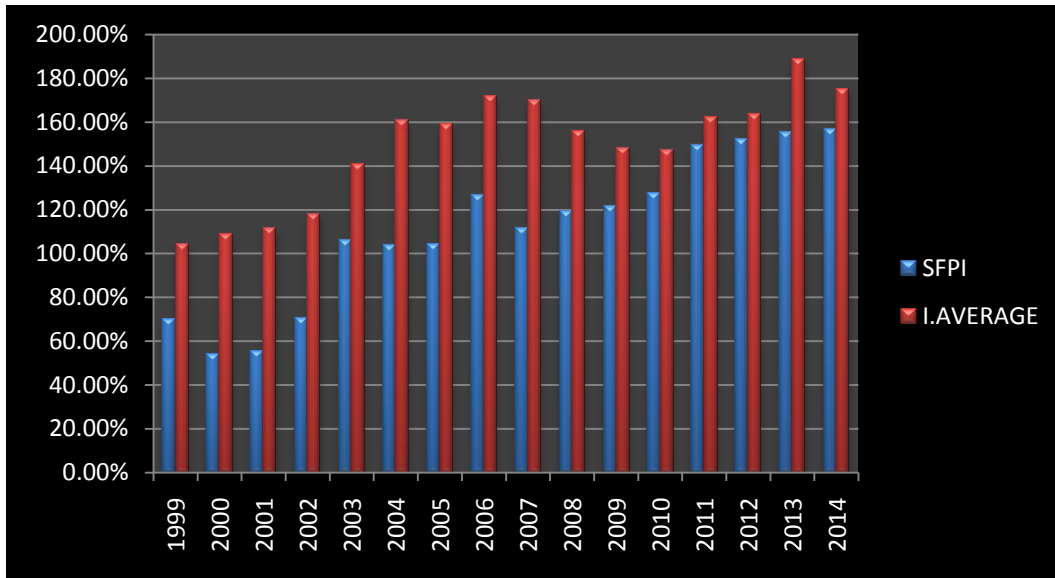
Source: - Researcher's own computation from MIX Market Inc. website (www.themixmarket.com)

Figure 4.4:- Returns on Equity (ROE)



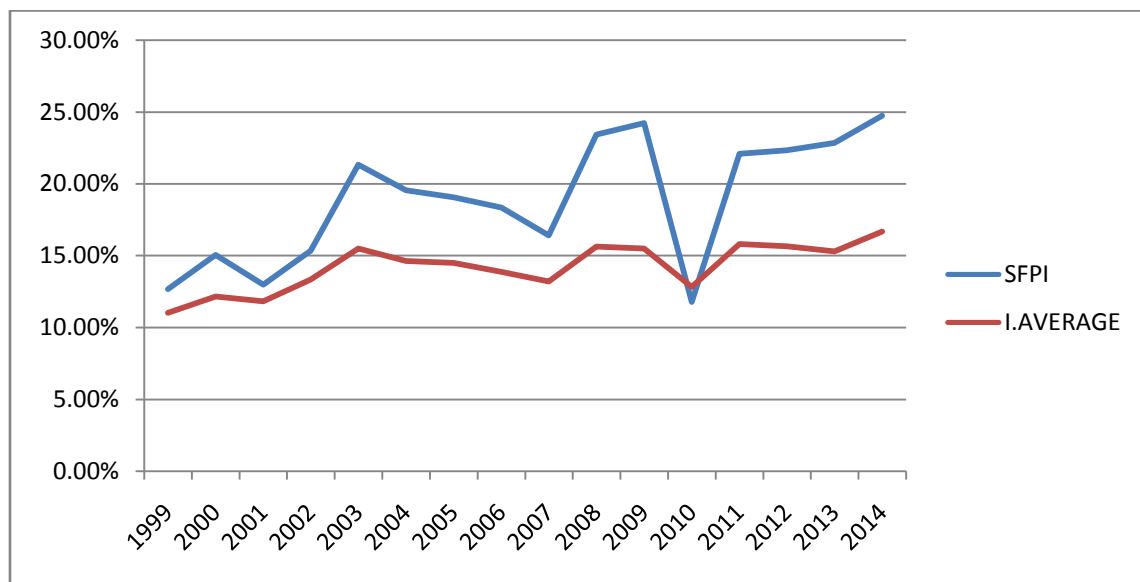
Source: - Researcher's own computation from MIX Market Inc. website (www.themixmarket.com)

Figure 4.5:- Operating Self- Sufficiency (OSS)



Source: - Researcher's own computation from MIX Market Inc. website (www.themixmarket.com)

Figure 4.6:- Yield on Gross portfolio



Source: - Researcher's own computation from MIX Market Inc. website (www.themixmarket.com)

4.3 Efficiency and Productivity

Efficiency and productivity indicators are performance measures that show how well the institution is streamlining its operations. Productivity indicators reflect the amount of output per unit of input. These indicators reflect how efficiently the MFI is using its resources, particularly its assets and its Personnel. So, to analyze efficiency and productivity of SFPI & Industry Average during sixteen years of the study period using the variables operating expense/loan portfolio, personnel expense / loan portfolio, no of active borrowers per staff member, no of active borrowers per loan officer and depositors per staff member are presented as follows;

Table 4.4:- Productivity and Efficiency Measures

| Indicator /Year | Operating Expense/ Loan Portfolio | | Personnel Expense/ Loan portfolio | | No of Active Borrowers per staff member | | No of Active Borrowers per Loan officer | | Depositors per staff Member | |
|-----------------|-----------------------------------|------------------|-----------------------------------|------------------|---|------------------|---|------------------|-----------------------------|------------------|
| | SFPI | Industry Average | SFPI | Industry Average | SFPI | Industry Average | SFPI | Industry Average | SFPI | Industry Average |
| 1999 | 36.21% | 16.39% | 11.30% | 9.51% | 114.00 | 203.60 | 276.00 | 393.00 | 118.00 | 212.60 |
| 2000 | 26.17% | 14.59% | 10.01% | 8.81% | 119.00 | 199.40 | 270.00 | 350.00 | 120.00 | 217.00 |
| 2001 | 21.16% | 12.69% | 9.24% | 7.98% | 121.00 | 206.00 | 283.00 | 347.00 | 122.00 | 215.60 |
| 2002 | 19.33% | 12.00% | 9.21% | 7.28% | 138.00 | 213.60 | 336.00 | 403.40 | 139.00 | 219.00 |
| 2003 | 18.25% | 10.83% | 8.90% | 6.11% | 180.00 | 221.00 | 415.00 | 597.60 | 180.00 | 232.00 |
| 2004 | 15.54% | 9.20% | 7.80% | 5.06% | 176.00 | 235.80 | 408.00 | 741.00 | 176.00 | 164.40 |
| 2005 | 12.89% | 7.40% | 5.90% | 4.15% | 191.00 | 229.80 | 531.00 | 566.40 | 191.00 | 197.60 |
| 2006 | 12.40% | 6.50% | 5.03% | 3.57% | 208.00 | 228.20 | 581.00 | 522.80 | 208.00 | 168.40 |
| 2007 | 12.02% | 6.53% | 5.40% | 3.59% | 220.00 | 232.20 | 468.00 | 578.20 | 220.00 | 241.60 |
| 2008 | 13.00% | 6.89% | 8.21% | 4.16% | 186.00 | 235.60 | 427.00 | 616.80 | 198.00 | 235.20 |
| 2009 | 15.48% | 7.03% | 7.65% | 4.16% | 164.00 | 236.20 | 433.00 | 563.00 | 167.00 | 252.60 |
| 2010 | 6.54% | 5.08% | 4.09% | 3.38% | 171.00 | 229.00 | 480.00 | 532.80 | 172.00 | 231.40 |
| 2011 | 12.70% | 6.52% | 7.99% | 4.53% | 189.00 | 226.80 | 518.00 | 511.20 | 201.00 | 268.20 |
| 2012 | 11.59% | 6.27% | 7.51% | 4.37% | 174.00 | 182.60 | 574.00 | 472.00 | 175.00 | 271.20 |
| 2013 | 10.30% | 5.60% | 6.72% | 4.00% | 174.00 | 177.40 | 719.00 | 474.20 | 176.00 | 277.40 |
| 2014 | 11.30% | 6.09% | 7.57% | 4.23% | 176.00 | 169.40 | 668.00 | 460.60 | 181.00 | 284.60 |
| Average | 15.93% | 8.72% | 7.66% | 5.31% | 168.81 | 214.16 | 461.69 | 508.13 | 171.50 | 230.55 |

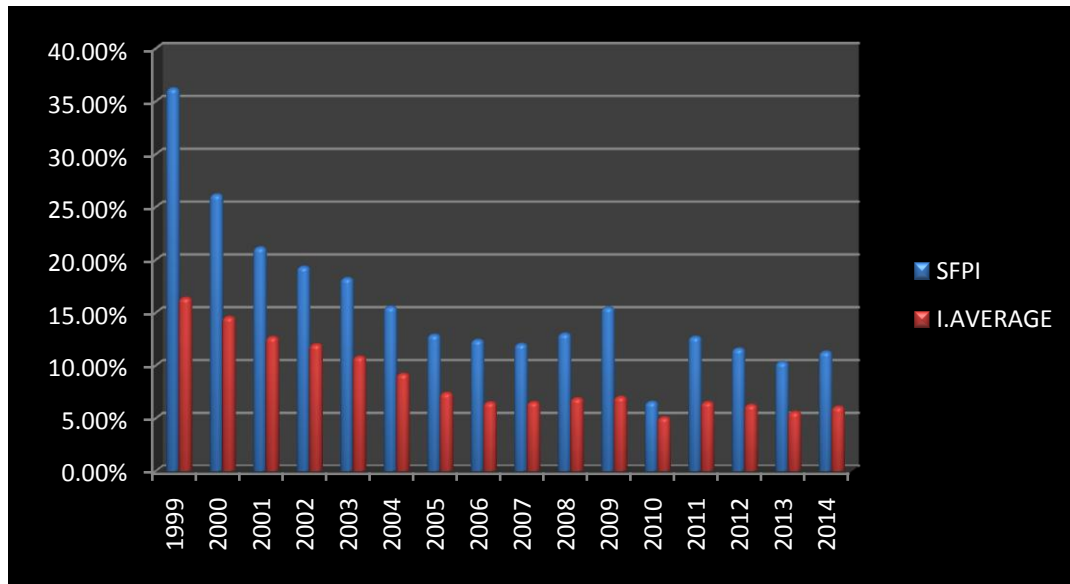
Source: Researcher’s own computation from MIX Market Inc. website (www.themixmarket.com).

As shown on Table 4.4, the operating cost has decreased from 36.21% in 1999 to 6.54% in 2010 but at the end of 2014 SFPI registered 11.30% per Birr in outstanding portfolio. Table 5.4 also indicates that SFPI's productivity in terms of number of active borrowers per staff is lower than the industry average all over the periods covered by the study. At the industry level productivity in terms of number of active borrowers per staff share is 214.16 on average while at SFPI number of active borrowers per staff is only 168.81 on average. However, the borrowers to credit officer ratio / borrowers per loan officer has increased 270 in 2000 to 719 in 2013.

On average SFPI has been able to serve only 461.69 active borrowers per loan officer which is lower than the average number of active borrowers per loan officer of the Industry Average (508.13). Hence it is possible to say that on average SFPI is less efficient and less productive than the industry average by using the productivity and efficiency measures.

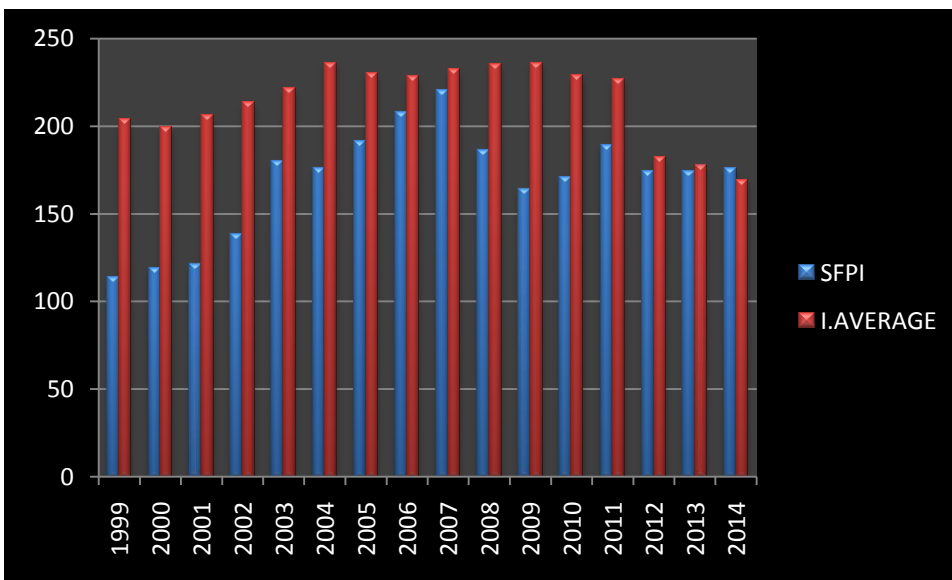
As shown on Table 4.4 above, the operating expense ratio of SFPI is higher than the Industry average all over the periods covered by the study. On average SFPI had operating expense ratio of 15.93% which is higher than the average of operating expense ratio of the Industry, i.e. 8.72%. This rate is very high compared to the industry average. So SFPI is less efficient in comparison to the operating expense ratio of the industry average. Therefore, SFPI is required to adjust its policy that affect the poor achievements may be factored into, ineffectual Human Resource Management (HRM) and high operating costs resulting from cost-inefficiency. The higher cost per borrower is a measure of inefficiency achieved by SFPI compared to other microfinance institutions in the same industry.

Figure 4.7 Operating Expense/Loan portfolios



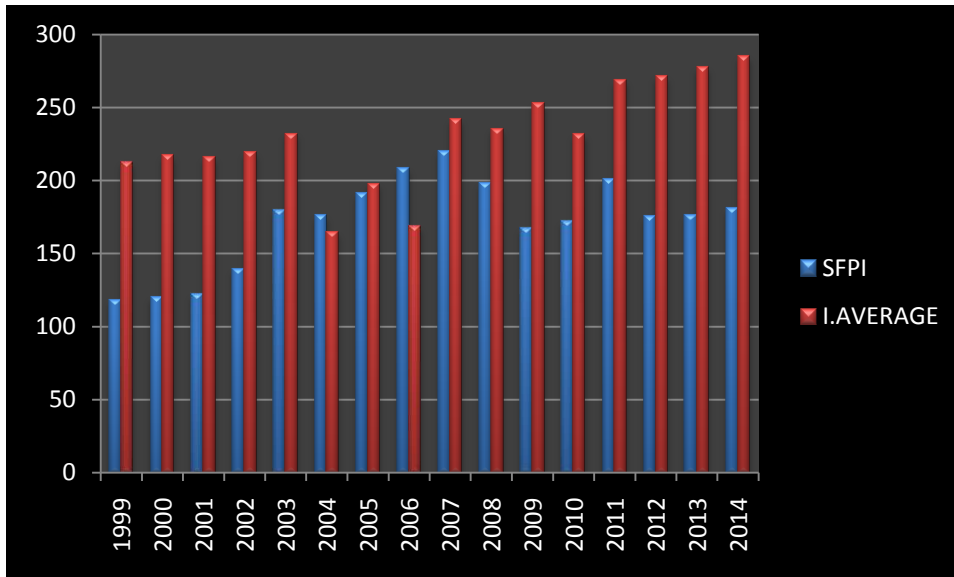
Source: - Researcher's own computation from MIX Market Inc. website (www.themixmarket.com)

Figure 4.8 No of Active Borrowers per staff member



Source: - Researcher's own computation from MIX Market Inc. website (www.themixmarket.com)

Figure 4.9 Depositor per Staff member



Source: - Researcher’s own computation from MIX Market Inc. website (www.themixmarket.com)

4.4 Financing or Capital Structure

MFI's finance their activities with funds from various sources, both debt (deposits from clients and borrowings from banks and other financial institutions) and net worth. Measures of financial structure describe these various fund sources and compare them with assets purchased with those funds. Financing structure ratios, also termed as stability ratios, include leverage and capital adequacy measures. So, to analyze financing structure of SFPI & Industry Average during sixteen years of the study period using the variables equity capital to asset ratio, debt to equity ratio, deposit to loan ratio & gross loan portfolio to total asset ratio are presented as follows;

As indicated on table 4.5 and Figure 4.10 below, all over the period of the study SFPI’s equity financing was higher than the industry average. On average SFPI Equity

financing/ equity ratio is 49.40% over the sixteen year period which is higher than the Equity financing/ equity ratio of the Industry Average (i.e. 34.55%).

Debt-to-Equity ratio of SFPI increased from 0.49 times in 1999 to 1.76 times in 2013 over the sixteen years period. So we can say that Debt to Equity ratio of SFPI is on an increasing trend but below the industry average over the study period. This increasing trend indicates that deposits base of SFPI is increasing but not more than its equity base i.e. SFPI's more reliance on Equity financing as compared and high deposits base. The table and Figure below shows Debt-to-Equity ratio of SFPI is less than the Debt-to-Equity ratio of the Industry Average all over the periods of the study (1999 to 2014).

On an average the Debt-to- Equity ratio of SFPI (1.08 times) is less than the Debt-to-Equity ratio of the industry average (2.61 times). However; the researcher finds that SFPI is less profitable than the Industry Average for the period of the study as indicted by ROA and ROE on Table 4.3 above. This indicates that SFPI is less leveraged than the industry average and it is less profitable. This indicates that SFPI as a Microfinance is not having optimum capital structure and is not using the advantage of debt financing for increasing profitability of the given firm because debt financing is having less cost than other sources of financing and it is also having tax advantage.

Less deposit to loan ratio of SFPI compared with the Industry Average all over the study period indicates that SFPI has been comparatively high liquid. As depicted on table 4.5 and Figure 4.12 below on an average the highest Deposit to loan ratio of SFPI was registered 58.40% in 1999 and the lowest was 34.27% all over the study period. On an average SFPI had Deposit to loan of 43.74% which is lower than the average Deposit to loan of the industry Average, i.e. 48.74%. Loan to asset ratio measures the gross loan outstanding as a percentage of total assts. higher ratio indicates that the microfinance increased the loan it has granted and its liquidity is low. The higher the ratio, the more risky the microfinance may be due to higher defaults. The table below shows that, loan

to asset ratio of SFPI was swing from year to year as we can observe from the Table 4.5 and Figure 4.13 below. However, on an average loan to asset ratio of SFPI was showing an increasing at decreasing trend as compared to Industry Average over the years under the study. Whereas the loan to asset ratio of the Industry Average is rolling between 51.57% to 77.75%.

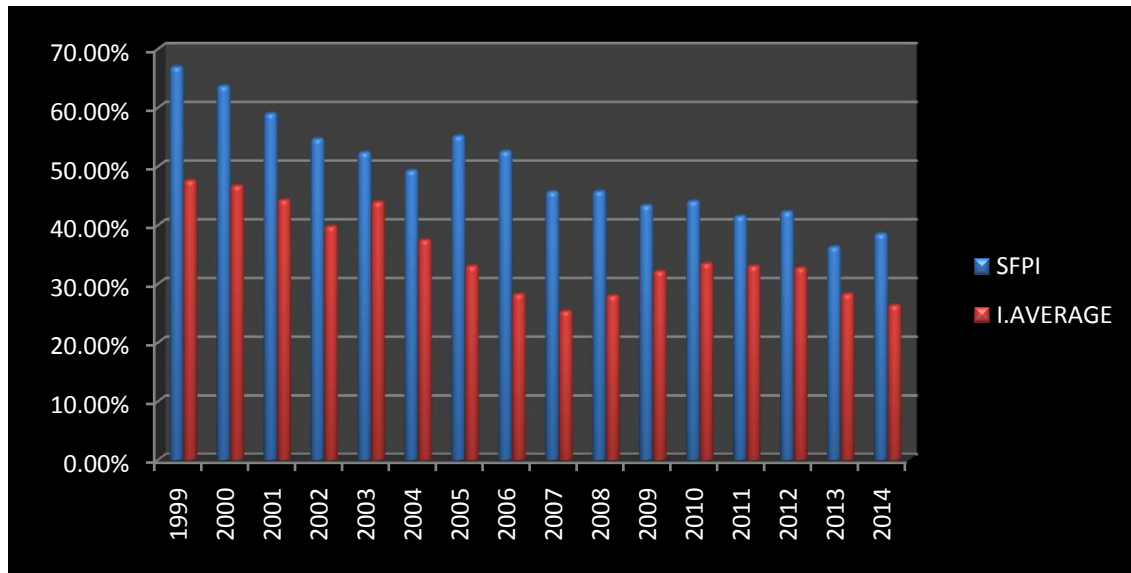
The average loan to asset ratio of SFPI (67.19%) is lower than the average loan to asset ratio of the industry (69.63%) during the sixteen years (1999-2014) of the study. Therefore, overall result of loan to asset ratio indicates that SFPI is high liquid than the industry average during the study period. This implies that SFPI as microfinance is having low short term debt financing that is why in the above page it has been said SFPI is less leveraged and having also low profit as compared to the industry average.

Table 4.5: Financial structure indicators

| Indicator /Year | Equity Capital/Asset Ratio | | Debt to Equity Ratio | | Deposit to Loans | | Gross Loan portfolio to Total Assets | |
|-----------------|----------------------------|------------------|----------------------|------------------|------------------|------------------|--------------------------------------|------------------|
| | SFPI | Industry Average | SFPI | Industry Average | SFPI | Industry Average | SFPI | Industry Average |
| 1999 | 66.88% | 47.53% | 0.49 | 2.71 | 58.40% | 46.00% | 33.00% | 51.57% |
| 2000 | 63.62% | 46.66% | 0.57 | 3.21 | 49.97% | 46.68% | 36.00% | 53.29% |
| 2001 | 58.94% | 44.24% | 0.70 | 3.16 | 49.60% | 48.55% | 58.55% | 62.11% |
| 2002 | 54.64% | 39.73% | 0.83 | 2.78 | 52.61% | 51.79% | 65.82% | 64.02% |
| 2003 | 52.33% | 43.89% | 0.91 | 1.52 | 51.72% | 52.33% | 66.47% | 69.53% |
| 2004 | 49.24% | 37.42% | 1.03 | 2.10 | 41.84% | 43.99% | 72.26% | 71.30% |
| 2005 | 55.14% | 32.98% | 0.81 | 3.21 | 38.40% | 40.16% | 74.64% | 74.90% |
| 2006 | 52.52% | 28.18% | 0.90 | 3.48 | 35.42% | 38.80% | 81.34% | 77.51% |
| 2007 | 45.62% | 25.29% | 1.19 | 3.09 | 37.67% | 38.08% | 80.58% | 71.26% |
| 2008 | 45.70% | 27.94% | 1.19 | 3.40 | 43.55% | 38.80% | 74.67% | 77.75% |
| 2009 | 43.31% | 32.09% | 1.31 | 2.29 | 47.84% | 46.40% | 63.52% | 71.72% |
| 2010 | 44.02% | 33.42% | 1.23 | 1.89 | 43.71% | 51.72% | 71.00% | 72.55% |
| 2011 | 41.46% | 32.98% | 1.41 | 2.23 | 43.13% | 56.82% | 72.70% | 71.32% |
| 2012 | 42.22% | 32.67% | 1.37 | 2.13 | 37.17% | 55.93% | 76.87% | 74.66% |
| 2013 | 36.23% | 28.23% | 1.76 | 2.20 | 34.27% | 58.24% | 73.13% | 75.52% |
| 2014 | 38.46% | 26.28% | 1.60 | 2.27 | 34.49% | 65.63% | 74.53% | 75.02% |
| Average | 49.40% | 34.55% | 1.08 | 2.61 | 43.74% | 48.74% | 67.19% | 69.63% |

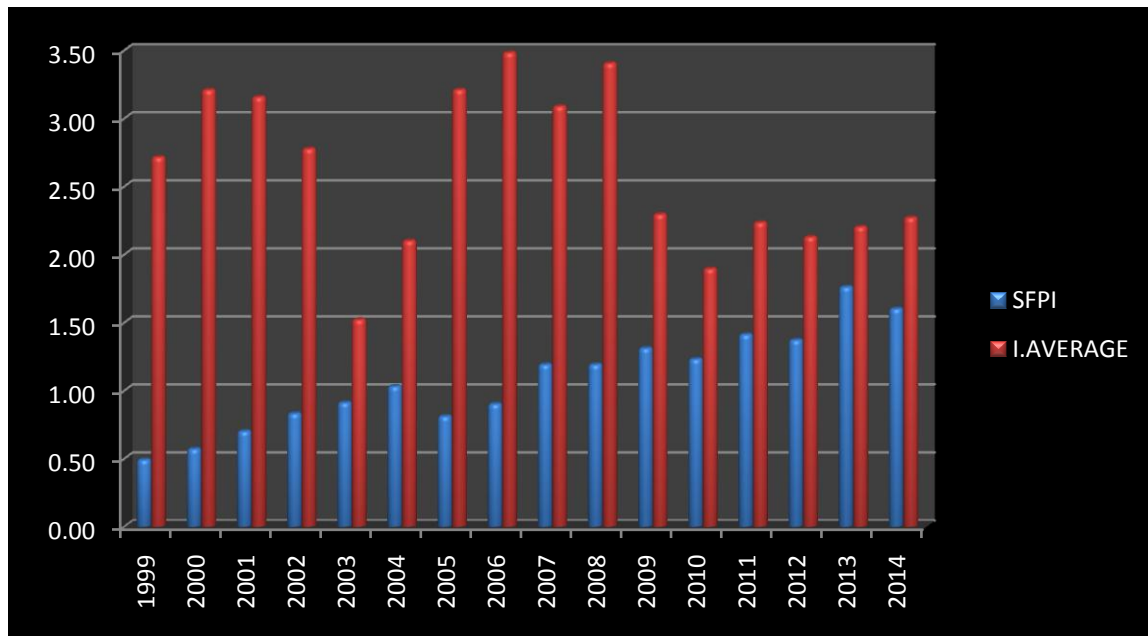
Source: - Researcher's own computation from MIX Market Inc. website (www.themixmarket.com)

Figure 4.10:- Equity Capital to Asset ratio



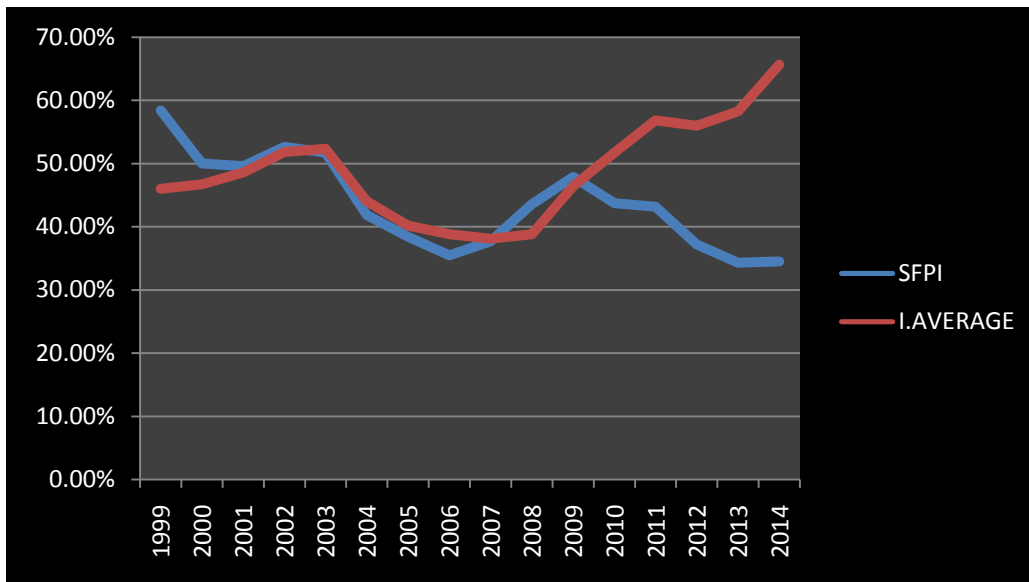
Source: - Researcher's own computation from MIX Market Inc. website (www.themixmarket.com)

Figure 4.11:- Debt to Equity ratio



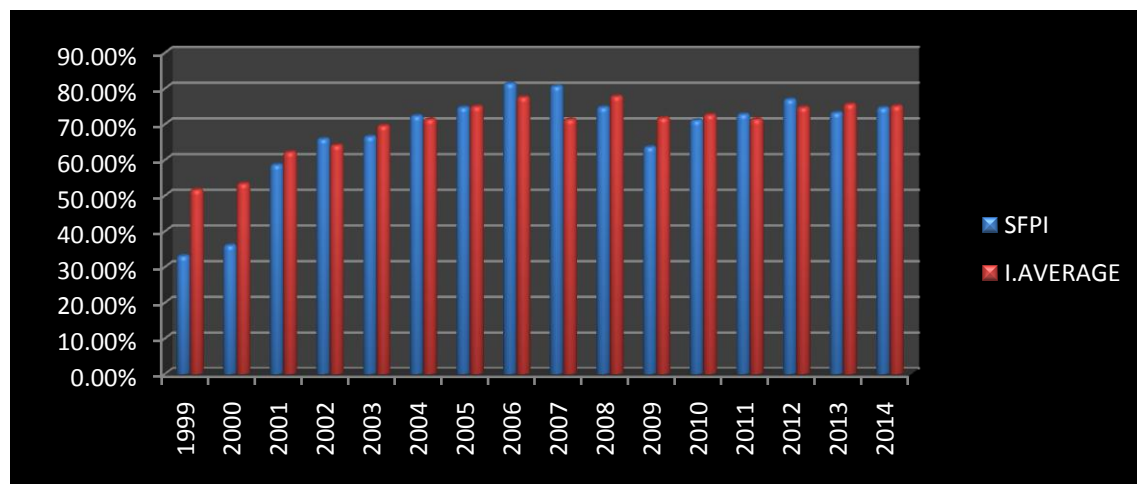
Source: - Researcher's own computation from MIX Market Inc. website (www.themixmarket.com)

Figure 4.12 Deposit to Loans



Source: - Researcher's own computation from MIX Market Inc. website (www.themixmarket.com)

Figure 4.13 Gross Loan portfolio to Total Asset



Source: - Researcher's own computation from MIX Market Inc. website (www.themixmarket.com)

4.5 Portfolio Quality

The loan portfolio is by far the MFI's largest asset and, in addition, the quality of that asset and therefore, the risk it poses for the institution can be quite difficult to measure. For microfinance institutions, whose loans are typically not backed by bankable collateral, the quality of the portfolio is absolutely crucial. Thus, to analyze portfolio quality of SFPI & Industry Average during sixteen years of the study period using the variable PaR > 30 days, PaR > 90 days, write-off ratio, loan loss rate, & risk coverage ratio are presented as follows;

Table 4.6:-Portfolio quality indicators

| Indicator /Year | Portfolio at Risk > 30 days | | Portfolio at Risk > 90 days | | Write-off Ratio | | Loan Loss Rate | | Risk Coverage | |
|-----------------|-----------------------------|------------------|-----------------------------|------------------|-----------------|------------------|----------------|------------------|---------------|------------------|
| | SFPI | Industry Average | SFPI | Industry Average | SFPI | Industry Average | SFPI | Industry Average | SFPI | Industry Average |
| 1999 | 2.71% | 3.15% | 3.13% | 4.31% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 5.20% |
| 2000 | 2.59% | 10.39% | 2.33% | 6.12% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 36.78% |
| 2001 | 2.13% | 10.70% | 2.11% | 7.45% | 0.00% | 0.17% | 0.00% | 0.17% | 0.00% | 39.01% |
| 2002 | 2.41% | 10.40% | 1.25% | 7.18% | 0.00% | 0.17% | 0.00% | 0.17% | 0.00% | 57.80% |
| 2003 | 2.18% | 11.31% | 1.97% | 7.59% | 0.00% | 0.07% | 0.00% | 0.07% | 109.32% | 72.39% |
| 2004 | 4.74% | 8.47% | 4.16% | 6.21% | 0.00% | 0.04% | 0.00% | 0.04% | 58.52% | 63.72% |
| 2005 | 8.60% | 4.79% | 7.19% | 5.28% | 0.00% | 0.06% | 0.00% | 0.06% | 58.79% | 61.05% |
| 2006 | 4.05% | 4.26% | 3.51% | 4.58% | 0.00% | 0.12% | 0.00% | 0.12% | 82.57% | 60.64% |
| 2007 | 6.86% | 3.72% | 6.46% | 4.06% | 0.00% | 0.10% | 0.00% | 0.09% | 36.97% | 54.45% |
| 2008 | 3.77% | 3.19% | 3.31% | 2.98% | 2.11% | 0.46% | 1.20% | 0.28% | 68.18% | 55.19% |
| 2009 | 3.41% | 3.68% | 3.17% | 3.29% | 0.00% | 0.07% | 0.00% | 0.07% | 32.79% | 46.42% |
| 2010 | 3.05% | 2.85% | 3.08% | 2.96% | 0.00% | 0.07% | 0.00% | 0.07% | 56.23% | 55.78% |
| 2011 | 3.33% | 3.00% | 3.12% | 2.70% | 0.00% | 0.11% | 0.00% | 0.11% | 65.05% | 66.48% |
| 2012 | 2.35% | 2.79% | 3.05% | 2.51% | 0.00% | 0.08% | 0.00% | 0.08% | 118.43% | 66.99% |
| 2013 | 2.31% | 2.69% | 2.07% | 2.19% | 0.00% | 0.02% | 0.00% | 0.02% | 66.64% | 51.57% |
| 2014 | 2.37% | 2.40% | 2.01% | 1.74% | 0.00% | 0.03% | 0.00% | 0.03% | 90.95% | 60.70% |
| Average | 3.55% | 5.49% | 3.25% | 4.45% | 0.13% | 0.10% | 0.08% | 0.09% | 52.78% | 53.38% |

Source: - Researcher's own computation from MIX Market Inc. website (www.themixmarket.com)

PAR is a better indicator or measure of risk associated with the portfolio. The loan portfolio are said to be portfolio at risk, means that the loans are infected to be arrears. The PAR helps to see the real picture of the risk of delinquency particularly in credit terms with small loan payments over a long credit period.

SFPI displays portfolio quality with PAR of an average of 3.55% with 30 days past due. The minimum portfolio at risk of > 30 days was registered during the year of 2001 which is 2.13% and the maximum portfolio at risk of > 30 days in the year of 2005 which was 8.60%. These minimum and maximum ratios are less than the minimum (2.40% in 2014) and maximum (11.31% in 2003) portfolio at risk of > 30 days of the industry average.

As indicated on Table 4.6 above and figure 4.14 below, even if, SFPI was perform an average of 3.55% with 30 days past due which is less than the Industry average of 5.49% we can say that SFPI was not maintain high portfolio quality by having portfolio at risk (PAR) of > 30 days because it was unable to display below 2% all over the years of the study.

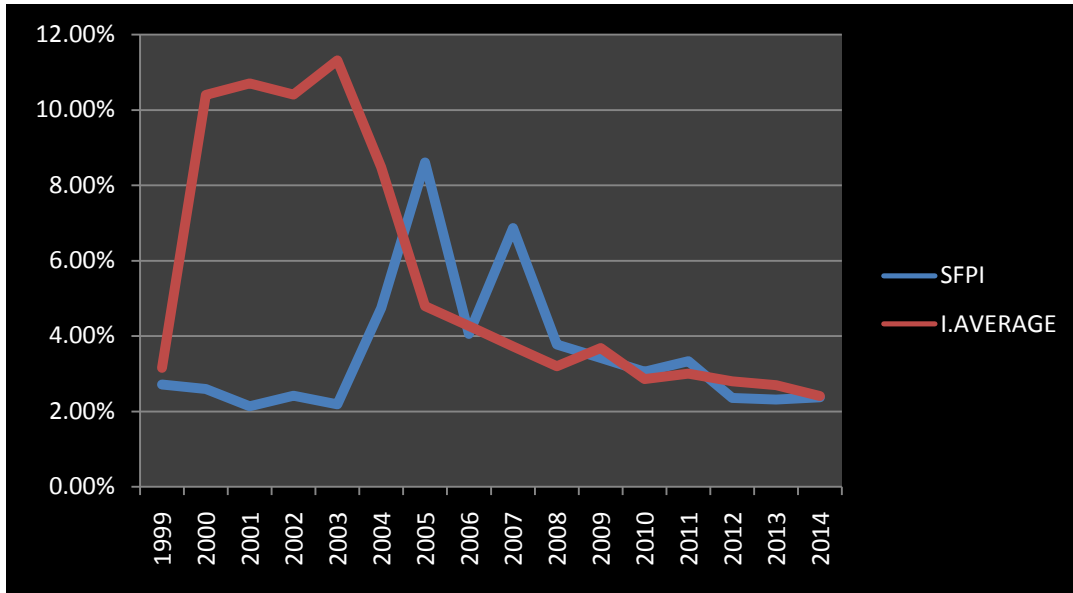
The portfolio at risk (PAR) with more than 90 days is 3.25% on an average. The minimum portfolio at risk of > 90 days was registered during the year of 2002 which is 1.25% and the maximum portfolio at risk > 90 days in the year of 2005 which is 7.19%, in which the minimum extreme point of SFPI is below the minimum portfolio at risk (PAR) of > 90 days of the industry average which is 1.74% in 2014 and maximum extreme point of SFPI is also below the maximum portfolio at risk (PAR) of > 90 days of the industry average which is 7.59% in 2003.

Generally; portfolio quality of SFPI based on its PAR ratio of both greater than 30 days and greater than 90 days were above 2% but below the industry average so, we can say that SFPI was at its best compared to the industry average.

The loan loss rate has increased which shows the increment in non-performing loans only during the years 2008 i.e. 1.2% from the entire study period (1999 - 2014) and the decline in loan loss rate shows the reduction in non-performing loans which is 0.00% for the whole period except 2008. The loan loss rate of SFPI was lower than the loan loss rate of the industry average except for the year 2008. The average loan loss rate of SFPI (0.08%) is lower than the average loan loss rate of industry average (0.09%) during the sixteen years (1999 - 2014) of the study. From this on average SFPI has a low non performing loan as compared to the industry average.

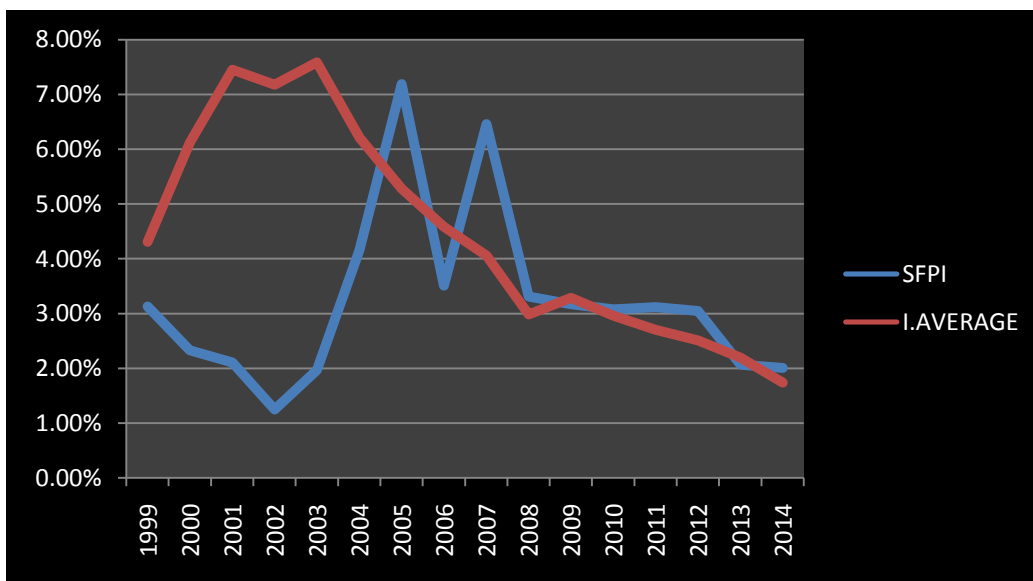
SFPI's Write-off ratio was nil all over the study period except the year 2008 (2.11%). The average write-off ratio of SFPI (0.13%) is a bit higher than the Industry average (0.10%). From 1999 to 2014, SFPI has been able to maintain enough amount of risk coverage rate at an average of 52.78%. Therefore, the overall result of the portfolio quality indicates that SFPI is able to maintain reasonable portfolio quality as compared to the industry average during the sixteen years (1999-2014) of the study. Such a remarkable performance is hard to achieve even in conventional banks backed by huge collaterals having a few credit clients but a bulk of credit balances. This performance might be attached to proper client selection, follow-up and monitoring both by the staff and credit and saving committee, credit discipline and profitability of clients.

Figure 4.14 Portfolio at risk of > 30 days



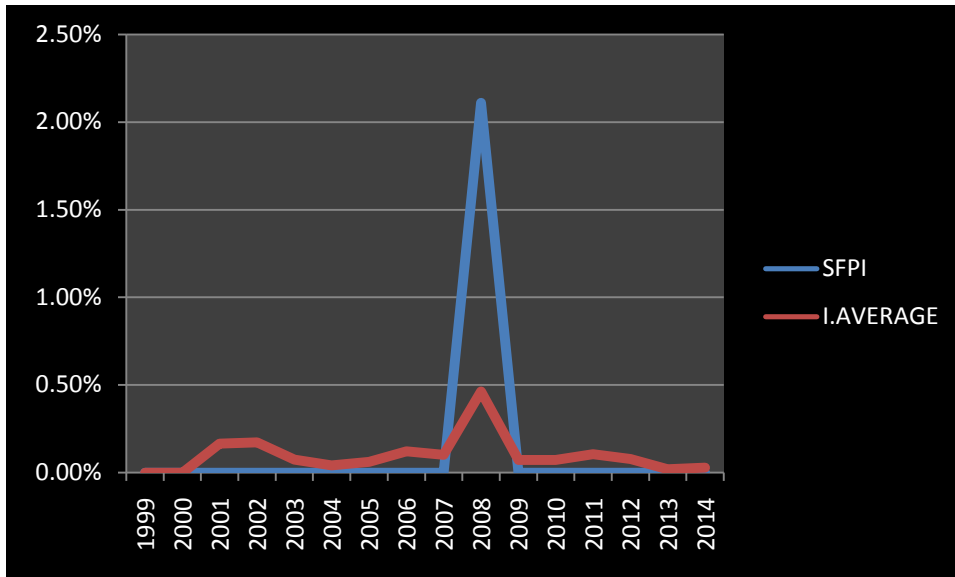
Source: - Researcher's own computation from MIX Market Inc. website (www.themixmarket.com)

Figure 4.15 Portfolio at risk of > 90 days



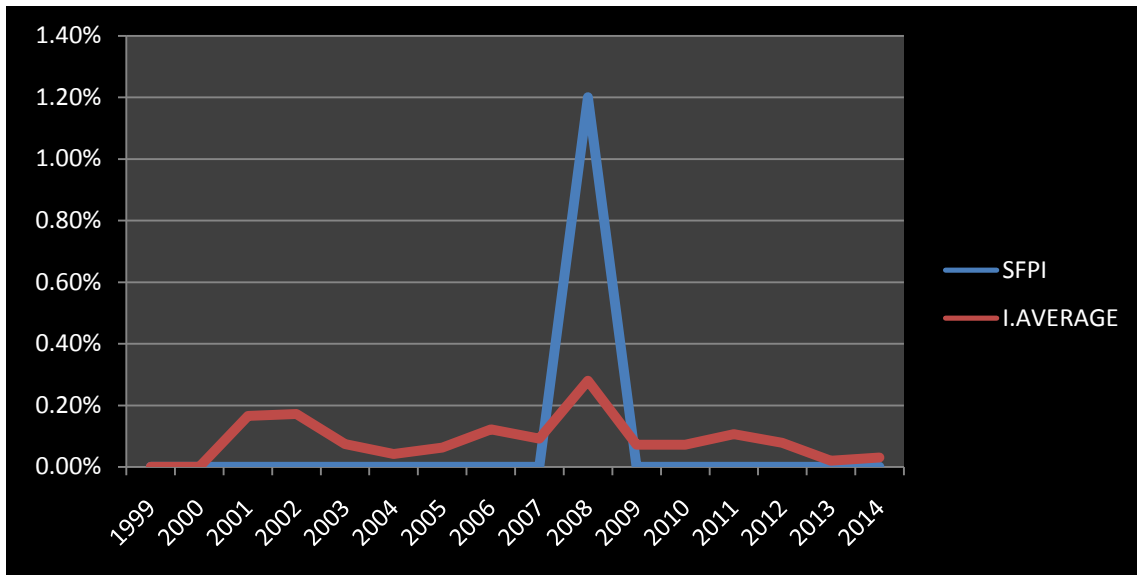
Source: - Researcher's own computation from MIX Market Inc. website (www.themixmarket.com)

Figure 4.16 Write-off ratio



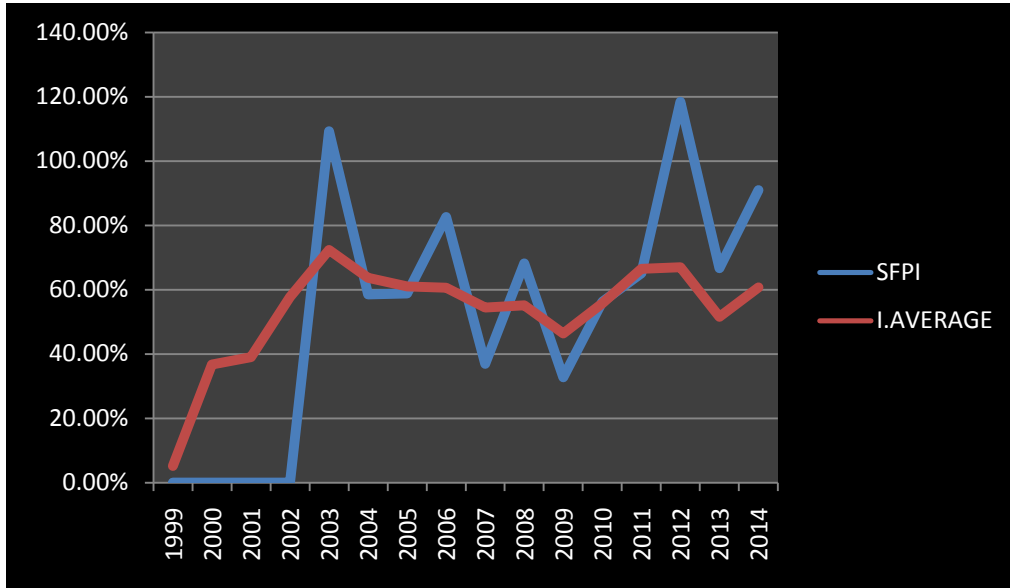
Source: - Researcher's own computation from MIX Market Inc. website (www.themixmarket.com)

Figure 4.17 Loan Loss rate



Source: - Researcher's own computation from MIX Market Inc. website (www.themixmarket.com)

Figure 4.18 Risk coverage



Source: - Researcher's own computation from MIX Market Inc. website (www.themixmarket.com)

CHAPTER- V

5. SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATION

In chapter five, the actual performance of SFPI in comparison with the Industry Average has been made. Hence; this chapter presents the conclusions and recommendations that were drawn from the previous chapter of this study.

5.1 Summary of Findings

This study aims to evaluate the financial and operating performance of SFPI and compare with the industry average. The comparison of SFPI with the Industry Averages financial performance was made from Sustainability and Profitability; Portfolio Quality; Efficiency and Productivity and Outreach level perspectives. Data for the study was from secondary sources and various ratios and indicators were used to measure the performance of SFPI. The financial performance indicators are usually ratios extracted from the financial reports (Balance Sheet, Income Statement and Portfolio Report). In addition, various theoretical aspects and related studies made on the performance analysis of Microfinance Institution in various countries were also reviewed. Thus, based on such analysis on the secondary data, the following conclusions are drawn:

The outreach of SFPI's has shown increment over the period of the study with different rates of growth. However, all over the period of the study the absolute number of active borrowers of SFPI is less than the number of active borrowers of the Industry Average. But comparing the size might not be meaningful in this context so, to get the real effect of outreach we better to compare in terms of the growth of active borrowers of SFPI with growth of Industry average and we found that SFPI is better than industry average especially starting from the year 2009 up to 2014(i.e. the recent data). The

average growth of SFPI over the sixteen years period is 2.07% which is better than the industry average of 1.99%. Therefore; SFPI is performing well as compared to the industry average. Besides to this; the percent of women borrowers of SFPI is higher than the percent of women borrowers of the Industry Average all over the periods of the study. From this it can be concluded that SFPI has shown a remarkable progress in terms of emphasizing more number of women borrowers in order to balance the gender aspect of its clients and to support the disadvantaged group of the economy. So the industry is required to adjust its policy that increases the percent/the number of women borrowers like SFPI. Since empowering women and serving the active poor are the primary objectives of any microfinance institutions.

The Financial Sustainability and Profitability of SFPI is going down the ladder of Sustainability and Profitability measures during the periods of the study. On average SFPI is operationally self-sufficient at around 111.44% over the sixteen years period. SFPI had high ROE but less ROA as compared to the Industry Average during the years under the study. Likewise SFPI's OSS was less than the Industry Average during the years under the study. From this it can be inferred that even though SFPI's Sustainability and Profitability was on a waning trend but on average SFPI was performing better as compared to the industry average from ROE and Yield on gross portfolio (YGP) measures. But SFPI was performing less in comparison of the industry average from ROA and OSS measures of Sustainability and Profitability. From this it can be concluded that SFPI has better asset management (asset utilization) and better management of portfolio as compared to the industry average during the years under the study.

With respect to productivity and efficiency; Operating expense ratio, personnel expense per loan portfolio, cost per borrower, number of active borrowers per staff member and borrowers per loan officer are some of the main focus of the study. SFPI's productivity of the staff and credit officers has decreased from year to year. Number of

active borrowers per staff has gone down from year to year. Similarly, the borrowers to credit officer ratio / borrowers per loan officer has decreased from year to year until 2010. However; SFPI's Number of Active Borrowers per Loan Officer has shown a continuous incremental during the year 2011 to 2014 as compared to industry average.

During the period of 1999 up to 2010 SFPI were scoring lower number of active borrowers per loan officers. On average SFPI has been able to serve only 461.69 active borrowers per loan officer during the study period which is lower than the average number of active borrowers per loan officer of the Industry Average (508.13). So, it is possible to say that on average SFPI is less efficient and less productive than the industry average by using the productivity and efficiency measures. Similarly, the average cost per borrower for the Industry Average is 15.93% for SFPI which is higher than the average cost per borrower of the Industry Average (8.72%). This rate is very high compared to the industry average thus SFPI operates at highest cost per borrower compared to the industry average.

So SFPI is less efficient in comparison to the operating expense ratio of the industry average. Therefore, SFPI is required to adjust its policy that affect the poor achievements may be factored into, ineffectual Human Resource Management (HRM) and high operating costs resulting from cost-inefficiency. The higher cost per borrower is a measure of inefficiency achieved by SFPI compared to other microfinance institutions in the same industry during the study period.

With regard to portfolio quality performance, SFPI was able to maintain high portfolio quality. PAR as an excellent measure of portfolio quality indicated that portfolio quality of SFPI based on its PAR ratio of both greater than 30 days and greater than 90 days were above 2% but below the industry average so, we can say that SFPI was at its best compared to the industry average. The average loan loss rate of SFPI (0.08%) is lower than the average loan loss rate of the industry average (0.09%) during the sixteen

years (1999-2014) of the study. SFPI has average Write-off ratio of 0.13% which is a bit higher than the average Write-Off ratio of the industry average (0.10%). Besides; SFPI has average Risk Coverage ratio of 52.78% which is almost equivalent to the average Risk Coverage ratio of the industry average (53.38%). From this it can be concluded that, the study found that PAR of > 30 days, PAR of > 90 days, Write-Off ratio, Loan Loss ratio, and Risk Coverage ratio reveals that SFPI has better portfolio quality performance in comparison with the Industry Average. This performance might be attributed to proper client selection, follow-up and monitoring both by the staff and credit and saving committee.

5.2 Conclusion

Generally, in terms of outreach SFPI is performing well compared to the industry average especially SFPI has shown a remarkable progress in terms of emphasizing more number of women borrowers in order to balance the gender aspect of its clients and to support the disadvantaged group of the economy, in terms of portfolio quality SFPI has also better than the industry average. In terms of financial Sustainability and Profitability SFPI is in a position to generate sufficient revenue to cover operating costs and at the same time their ability to operate and expand without subsidies is possible for these institutions. Better efficiency, high productivity, more leverage, and more MFIs age (experience) all leads to good OSS. However in terms of productivity and efficiency SFPI is seen to be inefficient as compared to the industry average because SFPI operates on average at highest cost per borrower as compared to the industry average. Therefore, SFPI is required to adjust its policy that affects the poor achievements.

Overall we can conclude that SFPI's financial and operating performance is well and sound as compared to the Industry average.

5.3 Recommendation

This study attempted to evaluate the financial and operating performance of SFPI and tried to compare with the industry average by using financial ratios. Based on the findings and conclusions reached above, the following recommendations are made by the researcher:

- ❖ Even if Specialized Financial and Promotional Institution share company (SFPI) as a Microfinance Institution (MFIs) its depth of outreach shows better than the industry average over the periods of the study that measured by number of active borrowers by growth, it needs further effort to increase the existing performance taking into consideration the total population in the region, the status of our country as well as age of the institution. So SFPI should have to work hard to get more motivated borrowers and savers. Because outreach refers to the central purpose of successful MFI.

- ❖ Since SFPI's sustainability and profitability was declining continuously during the study period of years (1999-2014) as compared to Industry Average, SFPI should have to work on it in order to increase the ROA, ROE and OSS and YGP parameters of measuring profitability and sustainability because these are the means to guarantee its survival in the market and makes to stand on its own leg. i.e. without the massive support of the government and donors. For this to happen, higher saving mobilization, product expansion (efficient loan administration) and better resource management should be sighted in depth by SFPI to achieve sustainability and profitability and rural infrastructure predominantly, the road net-work, and telephone net-work needs special attention by government and others for healthy microfinance operations and clients profitability since the success of the microfinance institutions depends on the success (profitability) of their clients.

- ❖ SFPI should have to give due attention to productivity and efficiency; Operating expense ratio, personnel expense per loan portfolio, cost per borrower, number of active borrowers per staff member and borrowers per loan officer are some of the main focus of the study. But the result shows on average SFPI is less efficient and less productive than the industry average by using the productivity and efficiency measures. Similarly, the average cost per borrower of SFPI is higher than the average cost per borrower of the Industry Average. Thus SFPI operates at highest cost per borrower compared to the industry average. Therefore, SFPI is required to adjust its policy that affect the poor achievements may be factored into, ineffectual Human Resource Management (HRM) and high operating costs resulting from cost-inefficiency. The higher cost per borrower is a measure of inefficiency achieved by SFPI compared to other microfinance institutions in the same industry during the study period.

5.4 AREAS FOR FURTHER RESEARCH

- ❖ Finally, the financial and operating performance indicators, i.e. financial ratios, independently are not enough to measure the performance of microfinance institutions and also the researcher has not made adjustments for inflation, in-kind subsidies, cost of funds, and varying accounting practices across institutions. Thus, alternative financial measures such as Data Envelopment Analysis (DEA), Stochastic Frontier Approach (SFA) and adjustment of the financial statement of the microfinance shall be considered by further researchers.

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