

**ST. MARY’S UNIVERSITY**

**SCHOOL OF GRADUATE STUDIES**

**ASSESSMENT OF FINACIAL PERFORMANCE ANALYSIS OF MICROFINANCE INSTITUTION IN ETHIOPIA**

**A Research Paper submitted to St. Mary’s University in partial fulfillment of the requirements for the Degree of Masters of Business Administration in Accounting and Finance.**

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**DECLARATION**

**I, the undersigned, declare that this thesis is my original work and prepared under the guidance of Asmamaw Getie (Ass. Professor) which is 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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**ENDORSEMENT**

**This thesis has been submitted to St. Mary’s University, School of Graduate**

**Studies for examination with my approval as a University advisor.**

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**LIST OF ABBREVIATION**

MFIs- Micro Finance Institution

OSS- Operational Self-Sufficiency

FSS- Financial self sufficiency

PAR- Portfolio at Risk

ROA- Return on Asset

ROE- Return on Equity

NGOs- non-government organizations

GDP- Gross domestic product

PBDIT- Profits before Depreciation Interest & Tax

P/R ratio- Price to Net Operating Revenue Ratio

P/BV ratio- Price to Book Value Ratio

PBIT- Profit before Interest and Taxes

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*Abstract*

*Micro finance service intervention in Ethiopia have also be considered as one of the policy instrument of the government and non-government organizations (NGOs) to enable rural and urban poor increase output and productivity, induce technology adoption, improve input and productivity, induce technology adoption, improve input supply, increase income, reduce poverty and attain food security. The main objective of this study is to assess the financial performance of Ethiopian MFIs by using different variables. Although the actual number of Ethiopian MFIs is around 35 as per NBE data base, it was accessed the data for 27 MFIs.*

*The result of the study shows that Ethiopian MFIs are good performers in turn equity investments into profits, covering their costs from their work and microfinance institutions have a good relation with their customer and have a proper loan follow up. On the other hand the microfinances in Ethiopia are not utilizing their resource or asset properly in generating income, regarding the capacity to cover its costs from financial revenue and the MFI in Ethiopia have reduced their performance by covering their costs from their operations. It suggested that to efficient utilization of resource or asset in generating income and should improve their asset management, to improve capital management in generation of income, improve and balances their financial revenue in connection with covering their costs and should manage it effectively and balance their operations and costs effectively and should improve their management.*

**CHAPTER ONE**

1. **INTRODUCTION**
   1. **Introduction**

Microfinance is defined as, financial services such as savings accounts, insurance funds and credit provided to poor and low-income clients so as to help them increase their income, thereby improving their standard of living. Microfinance institutions (MFIs) provide a range of financial services to poor households. Their worldwide growth in numbers had a positive impact by providing the poor with loans, savings products, fund transfers and insurance facilities. This helped to create an encouraging socio-economic environment for many of developing countries households. 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-free group loans. Most MFIs depend on donor funds and are not-for profit-oriented organizations that share a common bond among the members. They also differ in their two main operational objectives. First, as mentioned they act as financial intermediaries to poor households. Microfinance institutions (MFIs) are a special case in the financial world. They have a double financial and social role and need to be efficient at (Kaur, Sunanda, Garima Tungal and Pandey 2019).

Microfinance allows people to better provide their families, gives access to small amounts of credit, offers better overall repayment rate than traditional banking products. It also gives families an opportunity to provide an education to their children, creates the possibilities of future investments. Microfinance is also able to let entrepreneurs in developing countries be able to create new employment opportunities for the others. Grammen bank in Bangladesh employs over 21,000 people and their primary financing products are related to microfinance. Tens of thousands of jobs that are created by the industry with the sole purpose of being able to drag people to save, reduces stress. In many developing nations the primary recipients of micro loans tends to be women. Up to 95 % of some loan products are extended by microfinance institutions are given to women. Those with disabilities, those who are unemployed, and those who even simply beg to meet their basic needs are also recipients of micro finance products that can help them take control of their own lives. Continuous efforts towards automation of operations are steady inefficiency. The automated systems have also helped to accelerate the growth rate of the microfinance sector (Ayres, 2019).

In Ethiopia, the poverty reduction strategy is becoming the operational framework to translate the global MDGs targets in to national action (UNDP 2005). Micro finance service intervention in Ethiopia have also be considered as one of the policy instrument of the government and non-government organizations (NGOs) to enable rural and urban poor increase output and productivity, induce technology adoption, improve input and productivity, induce technology adoption, improve input supply, increase income, reduce poverty and attain food security. The sustainability of micro finance institutions 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)

These are the core indicators recommended in Good Practice Guidelines for Funders of Microfinance (CGAP 2006), based on decades of experience working with retail MFIs. There is widespread consensus on the three indicators of financial performance, portfolio quality, financial sustainability, and efficiency

Microfinance is relatively new to Ethiopia and come to appear in 1994s with the government’s licensing and supervision of microfinance institutions and proclamation designed to encourage MFIs to extend credit to both the rural and urban poor of the country. Following this, several microfinance institutions were established and have been preparing in providing access to financial services to poor, rural family and people engaged in other similar activities as well as micro and small-scale enterprises and entrepreneurs. Almost all the MFIs operating in the country have the dual mission of reaching poor clients and being financially sustainable (Welday, 2005). Before the emergence of MFIs in Ethiopia, financial services have been delivered for several years by projects designed by government ministries, departments and nongovernmental organizations (Tadesse, 2010).

In Ethiopia microfinance services were introduced after the fall of the Dergue regime following the policy of economic liberation. Microfinance is taken as a shift from government and NGO subsidized credit programs to financial services run by specialized financial institutions. With this shift some NGO and government microcredit programs were transferred to microfinance institutions (Degefe, 2009).

Currently, in Ethiopia there are more than 38 MFIs which deliver credit, savings local transfer and drawing and accepting drafts payable within Ethiopia, micro-insurance business purchasing income generating financial instruments such as treasury bills and other short term instrument, supporting income generating project of urban and micro and small scale operators managing funds for small scale businesses, providing financial leasing services to peasant farmers, micro and small-scale urban and rural entrepreneurs etc. These MFIs are registered and regulated by National Bank of Ethiopia. (Pro.626/2009).

* 1. **Statement of the problem**

In Ethiopia, the formal base of MFIs has been laid by the issuance of proclamation No.40/1996, which is reaped by proclamation No 626/2009. The proclamation has established the licensing and supervision of MFIs as share companies with objective of providing financial services for low income society which are not included in the formal banking sectors. This is because due to collateral requirements the poor could not have access to loan services from commercial banks. Hence, by providing loan to marginalized groups, MFIs are expected to provide loan services and to make profit for their existence (Welday, 2005).

The objective of almost all of the micro fiancé institutions in Ethiopia is poverty alleviation. To achieve these objectives micro finance institutions should be financially viable and sustainable. The Ethiopian microfinance sector is one of the fastest growing in the world today. As per the end of year 2005 the then 26 operational MFIs serviced 1277939 borrowing clients with an aggregated portfolio of 1622 billion birr. In terms of outreach these figures represent a nearly 300% increase from end of year 2001 (Ethiopian micro finance institutions performance report, June 2007).

For instance, (Abdi & Batra, 2018) conducted a research on Performance Analysis of Microfinance Institutions in Ethiopia in terms of outreach and financial sustainability; other studies conducted on Financial Sustainability of Microfinance Institutions (MFIs) in Ethiopia; (Degefe, 2009) studied on assessing performance of MFIs in terms of sustainability focus on cost and performance of finance services in relation to volume (scale) of operation. There are also many similar studies conducted by different scholars. However, some of the studies tried to assess the performance of MFIs using few performance metrics (indicators) and some of them used 3 to 7 years data, which may lack sufficient information to assess the overall performance of MFIs in Ethiopia. Because those institution are not well organized and there is unwillingness to give the data. Other studies are not recent (Yirsaw, 2008).Moreover, others tried to assess the performance of one MFI only, which is to generalize the findings of the MFIs in Ethiopia (Chala & Dessie, 2016). But it doesn’t consider all of the MFIs.

Thus, the purpose of this project is to analyze the performance MFIs. So far, most research tried to assess the impact of microfinance on poverty, women empowerment, income generation, agricultural productivity, etc. But the paper tried to assess whether the MFIs are financially and operationally sound or not. The paper tried to answer questions like:

* Do MFIs have good financial and operational performance?
* What are the indicators of the financial and operational performances?
* What is the outreach status of the performance of microfinance institutions in Ethiopia?
* What do the performances of the Microfinance Institution look like both financial and operational over the study period 2013-2020?
  1. **Objectives of the study**
     1. **General objectives of the study**

The general objective of the study is on assessment of financial performance of microfinance institutions in Ethiopia.

* + 1. **Specific objectives of the study**
* To assess the financial and operational performance of micro finance institutions
* To see the sustainability of MFIs in Ethiopia
* To assess the outreach status of the performance of microfinance institutions in Ethiopia
* To assess the performances of the microfinance Institution over the study period 2013-2020
  1. **Significance of the study**

The research would be useful for other researchers who conduct their research on the same topic. In addition to that the findings of the study give relevant information for to microfinance institution related to financial performance. Moreover it provides recent information about the performance of microfinance institutions for other companies, individuals, investors and other users.

* 1. **Scope of the study**

The scope of the study is limited to financial performance of Microfinance Institution in Ethiopia. The study was taken in to account of the performance of the Micro Finance Institution for the period ranging from 2013 to 2020. Because I get all sufficient data for the research and it is the recent one that support this study. I couldn’t get sufficient data on the preceding years.

* 1. **Limitation of the study**

The limitation of the study is discussed below. There is limitation of sufficient data regarding the information of those microfinance institutions. In addition to that there was limitation of finance and time.

* 1. **Organization of the study**

The study is organized into five chapters. The first chapter deals with the introduction of the study, statement of the problem, objectives of the study, scope of the study and limitation of the study. The second chapter deals with the literature review which gives detail explanation about the topic. The third chapter deals with methodology of the study. The fourth chapter deals with the analysis and interpretation of the collected data. The last chapter deals with conclusion and recommendation of the study.

**CHAPTER TWO**

1. **LITERATURE REVIEW**

**2.1. Introduction**

This chapter deals with definitions, history, thoughts, benefits of MFIs in developing countries, key principles, challenges faced by microfinance institutions, performance measurements of MFIs, the trends of MFI in Ethiopia, empirical literature reviews and findings from previous microfinance literatures. The general objective of the literature is to give explanation about the financial performance of microfinance institutions. The specific objectives are to explain about the aspects of financial performance and the measurements of financial performance of microfinance institutions.

* 1. **Theoretical review**
     1. **Definition of microfinance**

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 (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 has been defined as: - the means by which poor people convert small sums of money into large lump sums (M.kabir, 2009) Microfinance services may be seen in terms of four main mechanisms. They are loans, savings, insurance and pensions.

In other words, micro finance is the arrangement of financial services including loans, savings, insurance, money transfer and remittances offered to the lower income groups or poor entrepreneurs, who otherwise cannot avail the standard banking services. The motive behind microfinance is to give people in poverty a privilege to become self-sufficient by offering them crucial banking services at considerable smaller monetary amounts. Therefore microfinance institutions (MFIs) are organizations that provide both social and financial services to the poor.

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

* + 1. **History of microfinance institutions**

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.

When Mohammed Yunus started making small loans to local villagers in 1970’s it was unclear where the idea would go. Around the world scores of state –run banks had already tried to provide loans to poor households, and they left a legacy of inefficiency, corruption, and millions of dollars of squandered subsidies. Economic theory also provided ample cautions against lending to low-income households that lack collateral to secure their loans. But Yunus vowed to one day make profits and he argued that, his poor clients would pay back the loan reliably. Today, Mohammed Yunus is recognized as a visionary in a movement that has globally, claiming over 65 million customers at the end of 2002. They are served by microfinance institutions that are providing small loans without collateral, collecting deposits, and increasingly selling insurance, all to customers who had been written off by commercial banks as being unprofitable. The today use expression of microfinance has its roots in the 1970’s when organizations, such as Grameen Bank of Bangladesh with the microfinance pioneer Mohammed Yunus, were starting and shaping the modern industry of micro financing. Another pioneer in this sector is Akhtar Hammed Khan .At that time a new wave of microfinance initiative introduced many new innovations into the sector. Many pioneering enterprises began experimenting with loaning to the underserved people .The main reason why microfinance is dated to the 1970’s is that the program could show that people can relied on to repay their loan and that it is possible to provide financial services to poor people through market based enterprises without subsidiary (Scheyvens, 2015).

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). 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).

The history of micro financing can be traced back to the middle of the 1800s when the theorist Lysander Spooner was writing over the benefits from small credits to entrepreneurs and farmers as a way getting the people out of poverty. But it was at the end of World war II with marshal plan the concept had big impact (Stanley, 2018). Friedrich Whiliam Raiffeisen and his supporters developed the concept of credit union. They wanted to help the rural population become less dependent on money lenders and to improve their welfare. From 1870, the unions expanded rapidly across the Rhine province and other regions of German states. Then the movements quickly spread to other European countries and to North American, eventually reaching developing countries as well. The Indonesian people’s credit banks or the Bank Perkreditan Rakyat opened in 1895 and became the biggest microfinance in Indonesia. Various adaptations of these models started to appear across rural Latin America at the beginning of the twentieth century. Unlike the banks in Europe, which were owned by the poor themselves, these new banks were owned by government agencies or private banks. Over the years, these institutions became inefficient and sometimes abusive.

In the 1800s, Europe saw the emergence of larger and more formal savings and credit institutions that focused primarily on the rural and urban poor. The movement emerged in France in 1865 and Quebec in 1900. Many of today’s financial cooperatives in Africa, Latin America and Asia find their roots in this European movement. Another early example is the Indonesian people’s credit Banks (BPRs) that in 1895 and became the largest microfinance system in Indonesia, with close to 9,000 branches (Amaha & Kifile, 2016).

According to “microfinance Barometer” (2017), in the year 2016 there were 123 million customers at microfinance institution worldwide for a loan of $ 102 billion. India was the leader in terms of microfinance in 2016, with 47 million borrowers and roughly $ 15 billion in outstanding loans. Vietnam was second, followed by Bangladesh, Peru and Mexico. The ranking shows strong momentum in South Asia. The region accounts for roughly 60 % of all borrowers and has the highest growth in terms of loans, up to 23.5% in 2016. Latin America and the Caribbean are also highly active in microfinance, with $ 42.5 billion in outstanding loans, compared with $9.3 % billon in Europe and $8.7 billion in Sub-Saharan Africa. Most borrowers were women in living in rural areas. They made up 84 % of borrowers in 2016, with people in rural areas representing roughly 60 % of the market.

* + 1. **Evolution of Microfinance in Ethiopia**

Initially, micro credit started as a government and non-government organizations motivated scheme. Following the 1984/85 severe drought and famine, many NGOs star started to provide micro credit along with heir relief activities although this was on a limited scale and not in a sustained manner (IFAD 2001). Funds were simple been given from the DBE to clients identified and screened by The Trade and Industry Breaux of regional Gove rally led to a low loan recovery rate (DBE 1999). In line with this, the early formal microfinance activity is the DBE (Development Bank of Ethiopia) Place, Pilot Credit Scheme, initiated in 1990 under the Market Towns Development Project was implemented in 1994. While many NGOs Programmers that emphasizes both credit and savings began in early 1990s. For example, the REST Credit Scheme of Tigray (RCST) (own Dedebit Credit and Savings Institution, DECSI) was launched in 1993; Sidama Saving and Credit scheme (now Sidama Microfinance Institution) was established in 1994; Oromia Credit and Saving Scheme (Now Oromia Credit and Saving S.C.) Started in 1996 ( Gerehiwot Ageba). The formulization of the Micro finance institutions, micro credit used to be provided in a fragmented and unplanned manner even during the early 1990s. The micro credit scheme was donor driven rather than an outcome stemming from a clear policy direction and development strategy. Their outreach and impact also remained Limited (IFAD 2001).

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).

Another feature of these credit schemes is that all was trying to address the credit delivery service alone. The provision of savings facilities, which is essential for a sustained credit service delivery, was completely ignored. The failure of the formal banks to provide banking facilities, on the one hand, led the unsustainability of the NGO’s credit scheme on the other hand, led the government to issue out a legal framework for the establishment and operation of micro finance institutions. 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).

* + 1. **Two schools of thought in microfinance**
       1. **Pro-poor school of thought**

The primary goal of the pro-poor school is to serve the poorest of the poor. These organizations look to microfinance as means to break the cycle of poverty and work with people to build stronger livelihoods. It can be riskier and more expensive to serve this group. The poverty camp is housed within the development sector. Non-profits and NGOs servicing this segment of the population often rely on grants and donor funding to sustain their programs. Those in the propoor camp feel that unless they focus on the poorest of the poor, this group will not realize the benefit of microfinance.

* + - 1. **Sustainable school of thought**

The primary goal of sustainability school is to grow in scale and be financially self-sustaining, providing loan without grants or donor funding. The sustainability camp views the private sector with socially conscious for profit organization as the future home of microfinance. These organizations look to sustainability and efficiency to provide loans on a larger scale. However, self-sustainability is difficult, and many organizations seeking this as their primary goal will have to make difficult decisions. More stringent collateral requirements and practical favoritism to larger loans may lead sustainability-bound organizations away from serving the poor clients that they originally served. Both development and sustainability are two sides of the same coin and are most important two pillars of microfinance.

* + 1. **Benefits of microfinance in developing countries**

According to (Ayres, 2019) the benefits of microfinance in the developing countries were discussed as follows;

**1. It allows people to better provide for their families**

Microfinance allows for an added level of resiliency in the developing world. Even when households are able to work their way out of poverty, it often takes just one adverse event to send them right back into it. It’s often a health care issue that causes a return to poverty. By allowing entrepreneurs to become more resilient through their own effort at their own business, it gives them the opportunity to make it through times of economic difficulty.

Most of the households that take advantage of the microfinance offer that are available in developing countries live in what would be considered “abject poverty”. This is defined as on $ 1.25 per day or less- though some definitions extend this amount to $ 2 per day or more. About 80% of that amount goes to the purchase or creation of food resources. By offering microfinance products that can be repaid with that remaining 20 %, more households have the opportunity to expand their current opportunities so that more income accumulation may occur.

**2. It gives people access to credit**

Muhammad Yunus, who is often credited as the modern father of microfinance, once gave $27 to women out of his own pocket because he saw how the cycle of debt affect their work crafting bamboo chairs. Most banks will not extend loans to someone without credit or collateral because of the risks involved in doing so, yet those in poverty do not have any credit or collateral. By extending microfinance opportunities, people have access to small amount of credit, which can then stop poverty at a rapid pace. Yunus has always believed that credit is a fundamental human right. There are certainly some financial institutions which may disagree with his assessment. Yet without credit, it can be difficult, if not impossible for someone in poverty, to pursue an idea that could bring about a giant payday one day. Microfinance makes that pursuit possible.

**3. It serves those who are often overlooked in society**

In many developing nations, the primary recipient of microloans tends to be women. Up to 95 % of some loan products are extended by microfinance institutions are given to women. Those with disabilities, those who are unemployed, and even those who simply beg to meet their basic needs are also recipients of microfinance products that can help them take control of their own lives.

Women are key figures leadership roles in business, even in the developed world. Catalyst has reported that companies with female board directors are able to obtain returns that are up to 66 % better in returns in invested capital and 42% better in terms of sales returns than companies with male board members only. Women also develop others more frequently when it comes to entrepreneurial roles. This comes from coaching, feedback, or investments. Even in the developed world, women helping women is an economic force that poverty can’t stop.

**4. It offers a better overall loan repayment rate than traditional banking products**

As a side effect of this approach, many developing countries are taking a new look at what roles women should play in society. Instead of treating a women as a second-class citizen, or the ”barefoot in the kitchen and pregnant” attitude that has been prevalent in the past, the success of women in bring their households out of poverty is evidence that proves women not only have an initiative to get things done, but they produce consistent results. For these reasons, microfinance institutions see total repayment rates of higher than 98% though there can be several accounts that are overdue at any given time.

When people are empowered, they are more likely to avoid defaulting on a loan. Women are also statistically more likely to repay a loan than men, which is another reason, why women are targeted in the microfinance world. There’s also the fact that for many who receive a microloan, it is their only real chance to get themselves out of poverty, so they’re not going to mess things up. Zenger Folkman published a survey regarding ratings of high integrity and honesty in leadership roles that was separated by gender. The mean percentile of women displaying these traits was 55%, while for men, it was just 48 %. In business, the bottom line is this: integrity matters. Microfinance institutions have recognized this and approached women because of this.

**5. It provides families with an opportunity to provide an education to their children**

Children who are living in poverty are more likely to have missed school days or not even enrolled in school at all. This is because the majority of families who live in poverty are working in the agricultural sector. The families need the children to be working and productive so their financial needs can be met. By receiving micro financing products, there is less of a threat of going without funding, and that means more opportunities for children to stay in school.

This is especially important for families with girls. When girls receive just 8 years of a formal education, they are four times less likely to become married young. They are less likely to have a teen pregnancy. In return, this makes girls more likely to finish schooling and then either obtain a fair-paying job or go onto a further educational opportunity.

**6. It creates the possibility of future investments**

The problem with poverty is that it is a cycle that perpetuates itself. When there is lack of money, there is a lack of food. When there is a lack of clean water there is a lack of sanitary living condition. When people are suffering from malnutrition, they are less likely to work. A lack of sanitary creates the potential of illness that prevents working days.

Microfinance changes this by making more money available. When basic needs are met, families can then invest into better wells, better sanitation, and afford the time it may take to access the health care they need. As these basic needs are met, it also means that there are fewer Interruptions to the routine. People can stay more productive. Kids can stay in school more consistently. Better health care can be obtained. This creates a lower average family size because there are more guarantees of survival in place. And when that happens, the possibilities of future investments will occur because there is more confidence in being able to meet basic needs.

**7. It is a sustainable process**

How much risk is there with a $100 loan? Some investors might pay that for a decent dinner somewhere. Yet $100 could be enough for an entrepreneur in a developing country to pull themselves out of poverty. This small level of working capital is sustainable because it’s essentially a forgettable amount. If there is a default on that money, the interest and high repayment rates of other microloans will make up for it. Then repayments are reinvested into communities so that the benefits of microfinance can be continually enhanced. Each repayment becomes the foundation of another potential loan.

This is why many microfinance products have relatively high interest rates. Some institutions may charge the equivalent of a 20% APR, but others have interest rates which exceed 80%. Although interest is high, recipients are invested into making these products work because virtually all institutions put repayments back into new loans that target the most vulnerable households in the developing world.

**8. It can create real jobs**

Microfinance is also able to let entrepreneurs in developing countries be able to create new employment opportunities for others. With more people able to work and earn an income, rest of the local economy also benefits because there are revenues available to more through local businesses and service providers. It’s not just the entrepreneurial level that benefits from job creation through microfinance. Grameen Bank in Bangladesh employs over 21,000 people and their primary financial products are related to microfinance. That’s tens of thousands of jobs that are created by the industry with the sole purpose of being able to drag people up and out of poverty.

**9. It encourages people to save**

When people have their basic needs met, the natural inclination is for them to save the leftover earnings for a future emergency. These create the potential for more investments and ultimately even more income for those who are in the developing world. Some microfinance institutions have seen extraordinary number of savings occur when products are extended. The unit Desai of Bank Rakyat Indonesia counts 28 million savers to just 3 million microloan borrowers.

Now saving isn’t always seen, especially from borrowers, but this is part of the expected microfinance process. Small loans make small financial improvements for households living in poverty. The difference between making $ 1.90 per day and $ 2.30 per day is not much in reality, but by definition, that amount takes someone out of extreme poverty. Instead of big improvements, microfinance allows for small improvements. When enough of those improvements occur, then there is a safe place for people to store their income thanks to this industry.

* + 1. **Performance measurement in microfinance**
       1. **Sustainability and profitability**

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).

* + - 1. **Portfolio quality**

The most widely used measure of portfolio quality in the microfinance industry includes: Portfolio at Risk, Write-off ratio, & Risk cove-rage ratio. 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.

* + - 1. **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 an MFI is using its resources, particularly its assets and its Personnel. The Most common efficiency and productivity indicators includes: Personnel productivity, Average Outstanding Loan Size, Operating expense ratio &Cost per borrower.

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 (Tor Jansson, 2003). This sector 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.

* + 1. **Challenges faced by micro finance institutions**

According to (Vilkar, 2016), the following challenges face by microfinance institutions:

* **Cost of outreach**- reaching the unbanked populations of the world means servicing small loan amounts and servicing remote and sparsely populated areas of the planet, which can be dangerously unprofitable without high rates of process automation and mobile delivery.
* **Lack of scalability**- smaller microfinance systems often struggle to preserve the profitability and performance in these markets, as financial institutions experience high growth rates that result from getting the service delivery right. This results in thwarting the growth of these organizations.
* **Quality of self-help groups**- Due to the fast growth of self-help bank linkage program, the quality of MFIs has come under stress. This is due to various reasons such as:

- The intrusive involvement of government departments in promoting groups,

- Diminishing skill sets on part of the MFIs members in managing their groups,

- Changing group dynamics.

* **Geographic factors-** most MFIs agree that the geographic factors make it difficult to communicate with clients of far areas which create a problem in growth and expansion of the organization.
* **Diverse business models**- supporting the very wide range of features and lending activities is difficult and requires a considerable amount of cost and efforts.
* **High transaction cost-** High transaction cost is a big challenge for microfinance institutions. The volume of transactions is very small, whereas the fixed cost of those transactions is very high.
* **Limited budgets-** Making provisions for large upfront investments is not possible. Most of the MFIs which link their capability to purchase world class banking solutions that can help them fulfill their requirements and support their growth targets.
  + 1. **Determinants of performance of MFIs**

MFIs performance can be affected by various determining factors. Empirical literatures in relation to determinants of MFIs performance are very limited. Most of previous studies done in this area are depended upon the theory of banking financial performance by assuming that MFIs also provide banking service to the poor (Yenesew, 2014). These empirical studies divide performance determinants into two main categories, namely internal determinants and external determinants.

* + - 1. **Internal determinants**

**Internal determinants of MFIs are those which are controllable by management.**

**a) Portfolio quality**

According to (CGAP, 2009), portfolio quality (loan repayment) is the most revealing of performance areas.

A retail lender’s ability to collect loans is critical for its success if delinquency is not kept to very low levels, it can quickly spin out of control. Furthermore, loan collection has provided to a strong proxy for general management competence. The standard international measure of portfolio in banking is portfolio at risk (PAR) beyond a specified number of days:

PAR (x days) = outstanding principal of all loans past due more than x days

Outstanding principal balance of all loans

The number of days (x) used for this measurement varies. In microfinance, 30 days is a common break point.

**b) Capital to asset ratio**

Capital to asset ratio is a simple measure of solvency of MFIs. This ratio helps and MFIs assess its ability to meet its obligations and absorb unexpected loss. The determination of an acceptable capital to asset ratio level is generally based on MFIs accounting policies through provisioning by the MFI’s accounting policies, which removes expected losses from both assets and equity. Thus, the ratio measures the amount of capital required to cover additional unexpected losses to ensure that the MFI is well capitalized for potential shocks (Yenesew, 2014).

**c) Operational Efficiency**

It is a performance measure that shows how well MFI is doing its operations and takes into account the cost of the input and/or the price of output. They are recommended to measure whether a retail microfinance provider is cost effective. The most commonly used indicator of efficiency expresses nonfinancial expenses as a percentage of the gross loan portfolio It allows a quick comparison between a MFI’s portfolio yields with its personnel and administrative expenses how much it earns on loans versus how much it spends to make them and monitor them (CGAP, 2009).

**d) Gearing Ratio/ Debt to Equity Ratio**

The debt to equity ratio is calculated by dividing total liability by total equity. Total debt includes everything the MFI owes to others, including deposit, borrowings, account payable and other liability accounts. The debt/equity ratio is the simplest and best known measure of capital adequacy because it measures the overall leverage of the MFIs.

**e) Size of microfinance (Total Asset)**

The Size of a MFI is measured by value of its assets (Hermes & Hundon, 2018). Large firms have the advantage due to the size of operations, large firms have the advantage of getting the access to credit finance for investment, possess a larger pool of qualified human capital and have a greater choice for strategic diversification compared to small firms.

**f) Age of MFIs**

There is a thought that as MFIs mature, and acquire experience, they increase their livelihood of allowing financial sustainability. This can be explained by the fact MFIs gradually control over their all operations related to issuance of microcredit. In other cases, MFIs that have considerable experience in microfinance sector have diligently applied credit risk management and general efficient management techniques to attain financial sustainability (Ayayi, 2010).

**2.2.8.2. External Factors**

Some research papers undertaken on performance of MFIs, mentioned real GDP, market concentration and others as external determinants of performance of MFIs.

**a) Real GDP**

According to (Yenesew, 2014), Real GDP is a variable which is expected to exhibit positive relationship with MFIs profitability. It is the most informative single indicator of progress in economic development. Poor economic conditions can worsen the quality of loan portfolio, thereby reducing profitability. In contrast, an improvement in economic conditions, have positive effect on the profitability of MFIs.

**b) Market concentration**

(Molyneux P. &., 1992), in their study tried to conclude market concentration shows a positive statistically significant correlation with pre-tax return on assets which is a consistence with the traditional structure conduct –performance paradigm.

* + 1. **The Measurement of Financial Performance**

Understanding Financial Performance Measures is helpful to calculate the measures that are relevant to the business. Interpreting Financial Performance Measures is helpful to assess financial strengths and weaknesses of the business and also in the process of Building Equity in the Business.

There are areas where the performance can be improved by effective assessment of various activities performed by a business enterprise in different areas of operations. The areas of operations may be termed as the areas of performance. The important areas are as follows:

**2.1.9.1. Operational Efficiency Performance:**

**2.1.9.1.1. Assets Turnover Ratio:**

Turnover ratios are used to indicate the efficiency with which assets and resources of the firm are being utilized. These ratios are known as turnover ratios because they indicate the speed with which assets are being converted or turned over into sales. These ratio, thus, express the relationship between sales and various assets. A higher turnover ratio generally indicates better use of capital resources which in turn has a favorable effect on the profitability of the firm.

Funds of creditors and owners are invested in various assets to generate sales and profits. If better the management of assets, the larger the amount of sales. Activity ratios are employed to evaluate the efficiency with which the firm manages and utilizes its assets. These ratios also called turnover ratio because they indicate the speed with which assets are being converted or turned over into sales. Activity ratio, thus, involve a relationships between sales or cost of production and assets. A proper balance between cost of production and assets generally reflects that assets are managed well. Several assets are used to generate sales. Therefore firm should manage its assets efficiently to maximize sales. The relationship between cost of production and assets is called assets turnover.

**2.1.9.1.2. Debtors Turnover Ratio**

Debtors Turnover Ratio indicates the number of times average debtors are turned over during a year. This ratio is also known as accounts receivable turnover ratio. An accounting measure used to quantify a firm’s effectiveness in extending credit and in collecting debts on that credit. The receivables turnover ratio is an activity ratio measuring how efficiency a firm uses its assets.

Receivables turnover ratio can be calculated by dividing the net value of credit sales during a given period by the average accounts receivable during the same period. Average accounts receivable can be calculated by adding the value of account receivable at the beginning of the desired period of their value at the end of the period and dividing the sum by two.

**2.1.9.1.3. EV to Net Operating Revenue Ratio:**

The enter price value to Revenue multiple (EV/Net operating Revenue) is a measure of a stock that compares a company’s enterprise value to its revenue. EV/R is one of several fundamental indicators that investors use to determine whether a stock is priced well. The EV/R multiple is also often used to determine a company’s valuation in the case of a potential acquisition.

Investors should compare EV/R for the company being analyzed to that of other public companies in the industry to get an idea of the company’s relative financial health.

**2.1.9.1.4. Enterprise to EBITDA Ratio**

EV /EBITDA equals a company’s enterprise value divided by earnings before interest, tax, depreciation, and amortization. Enterprise value to EBITDA, or EV/EBITDA, is measure of the cost of stock which is more frequently valid for comparisons across companies than the price to earnings ratio. It is the most widely used valuation multiple based on enterprise value and is often used in conjunction with, or as an alternative to, the P/E ratio (Price/Earnings ratio) to determine the fair market value of a company.

An advantage of this multiple is that it is capital structure neutral, and, therefore, this multiple can be used to directly compare companies with different level of debt. This ratio requires prudent use for companies with low profit margins (i.e. for an EBITDA estimate to be reasonably accurate, the company under evaluation must have legitimate profitability). The reciprocate ratio used as a measure of cash return on investment.

**2.1.9.1.5. Market Cap to Net Operating Revenue Ratio:**

It is valuation metric for stock. It is calculated by dividing the company’s market Cap by the Revenue in the most recent year; or, equivalently, divide the per share stock price by the per share revenue. The smaller this ratio (i.e. less than 1.0) is usually thought to be a better investment since the investor is paying less for each unit of sales. However, sales do not reveal the whole picture, as the company may be unprofitable with a low ratio. The metric can be used to determine the value of stock relative to its past performance. It may also be used to determine relative valuation of a sector or the market as a whole.

**2.1.9.1.6. Retention Ratio**

Retention ratio indicates the percentage of a company’s earnings that are not paid out in dividends but credited to retained earnings. It is the opposite of the dividend payout ratio, so that also called the retention rate. The payout ratio is the amount of dividends the company pays out dividend by the net income. This ratio can be rearranged to show that the retention ratio plus payout ratio equals 1, or essentially 100%. That is to say that the amount paid out in dividends plus the amount kept by the company comprises all of net income. It is also known as ‘Plowback Ratio’.

**2.1.9.1.7. Price to Book Value Ratio**

The price to book value ratio is a ratio used to compare a stock’s market value to its book value. It is calculated by dividing the current closing price of the stock by the latest quarter’s book value per share. It is also known as the “Price Equity Ratio”. A lower P/BV ratio could mean that the stock is undervalued. However, it could also mean that something is fundamentally wrong with the company. As with ratios, be aware that this varies by industry. This ratio also gives some idea of whether you’re paying too much for what would be left if the company went bankrupt immediately.

This ratio reflects the value that market participants attach to a company’s equity relative to its book value of equity. A stock’s market value is a forward looking metric that reflects a company’s future cash flows. The book value of equity is an accounting measure that is based on the historic cost principle, and reflects past issuances of equity, augmented by any profits or losses, and reduced by dividends and share buybacks.

**2.1.9.1.8. Price to Net Operating Revenue Ratio”**

A valuation ratio that compares a company’s stock price to it’s revenues. The price to revenue ratio an indicator of the value placed on each dollar of a company’s sales or revenues. It can be calculated either by dividing the company’s market cap by its total sales over a 12 month period. Like all ratios, the price to revenue ratio is most relevant when used to compare companies in the same sector. A low ratio may indicate possible undervaluation, while ratio that is significantly above the average may suggest overvaluation. Abbreviated as the P/R ratio or PSR, this ratio also known as a “sales multiple” and “revenue multiple”. 4.4 Profitability Performance:

Profitability is the ability of an enterprise to earn profits. The bank management is vitally interested in profit as it is often used as performance measure. Measurement of profitability is the overall measurement of performance. Profit is also important to financial institutions, bankers and creditors. Moreover, even a layman also assesses the performance of a business enterprise by its ability to earn profit. Profitability performance can be made by computing and interpreting various profitability ratios.

**2.1.9.2. Ratio under Profitability**

**2.1.9.2.1. Profits before Depreciation Interest & Tax to Gross Sales:**

The ratio shows the relationship between gross profit and sales. The first profitability ratio in relation to sales is the gross profit margin. It is calculated by dividing the gross profit by sales: A high gross profit margin relative to the industry average implies that the firm is able to produce at relatively lower cost. A high gross profit margin ratio is a sign of goods management.

PBDIT to gross sales reflect the efficiency with which management produces each unit of product. This ratio indicates the average spread between the cost of goods sold and the sales revenue. This ratio show profits relative to sales after the deduction of production costs, and indicate the relation between production costs and selling price. A low gross profit margin may reflect higher cost of goods sold due to the company’s inability to purchase raw materials at favorable terms, inefficient utilization of plant and machinery resulting in higher cost of production. The ratio will also be low due to a fall in prices in the market. Marketed reduction in selling product by the firm in an attempt to obtain large sales volume, the cost of goods sold remaining uncharged. The financial manager must be able to detect the causes of a falling gross margin and initiate action to improve the situation.

**2.1.9.2.2. PBIT Margin Ratio:**

Profit before Interest and Taxes (PBIT) or operating income is a investment formula to measure of a corporation’s profitability by subtracting operating expenses from revenue excluding tax and interest. Sometimes, profit before interest and taxes (PBIT) is also referred as operating income, operating profit even operating earnings. Normally, investors will see profit before interest and taxes in income statement.

Some investors might confuse earnings before interest and taxes with gross profits. There is significant difference between profits before taxes with gross profit. For gross profit, revenue was deducted with cost of goods sold only to obtain the gross profit, while for profit before interest and taxes (PBIT), revenue was deducted with operating expenses excluding interest and taxes. For companies with minimal depreciation and amortization activities, profit before interest and taxes (PBIT) is monitored closely by the creditors since it represents the amount of cash that the companies can earn to pay off creditors. For companies with high depreciation and amortization activities, earnings before interest, taxes, depreciation and amortization is used rather than profit before interest and taxes (PBIT). 4.4.3 Profit before Tax Margin Ratio:

Profit before tax (PBT) is a profitability measure that looks at a company’s profits before the company has to pay corporate income tax. This measure deducts all expenses from revenue including interest expenses and operating expenses, but it leaves out the payment of tax. This measure combines the company’s entire profit before tax, including operating, non-operating, continuing operations and non-continuing operations. PBT exists because tax expense is constantly changing and taking it out helps to give an investor a good idea of changes in a company’s profits or earnings from year to year.

PBT margin is a company’s earnings before tax as a percentage of total sales or revenues. The higher the PBT margin is the more profitable company. The trend of the PBT margin is an important as the figure itself, since it provides an indication of which way the company’s profitability is headed.

**2.1.9.2.3. Net Profit Margin Ratio:**

Net profit margin is the ratio of net profit to revenue for a company or business segment typically expressed as a percentage – that shows how much of each dollar earned by the company is translated into profits. Net margins will vary from company to company, and certain ranges can be expected from industry to industry, as similar business constraints exist in each distinct industry. Net profit margin is the percentage of revenue remaining after all operating expenses, interest, taxes and preferred stock dividends (but not common stock dividends) have been deducted from a company’s total revenue.

Net profit margin is one of the most closely followed numbers in finance. Shareholders look net profit margin closely because it shows how good a company is at converting revenue into profits available for shareholders. In general, when a company’s net profit margin is declining over time, a myriad of problems could be to blame, ranging from decreasing sales or poor customer experience to inadequate expense management.

**2.1.9.2.4. Return on Net Worth to Equity Ratio**

Return on Net worth is a measure of profitability that calculates how many dollars of profit a company generates with each dollar of shareholder’s equity.

This measure is more than a measure of a profit; it’s a measure of efficiency. A rising return on net worth suggest that a company is increased its ability to generate profit without needing as much capital. It also indicates how well a company’s management is deploying the shareholder’s capital. However, it is important to note that if the value of the shareholder’s equity goes down, ROE goes up. Thus write downs and share buybacks can artificially boost return on net worth. Likewise, a high level of debt can artificially boost ROE; after all, the more debt a company has the less shareholders equity. It has (as a percentage of total assets), and the higher its return on net worth is.

Some industries tend to have higher returns on equity than others. As a result, comparisons of return on equity are generally most meaningful among companies within the same industry, and the definition of a “high” and “low” ratio should be made within the context.

**2.1.9.2.5. Return on Capital Employed Ratio**

This is the most important test of profitability of business. It measures the overall profitability. It is ascertained by comparing profit earned and capital (or funds) employed to earn it. It is also called as ‘Return on Investment’ on capital employed. It indicates percentage of return on the total capital employed in the business.

The term capital employed has been given different meaning by different accountants. Some of the popular meanings are as follows:

¾ Sum – Total of all Assets whether fixed or current. ¾ Sum – Total of fixed Assets. ¾ Sum – Total of long term funds employed in the business i.e. Share capital + long term loan – (Non business Assets + Fictitious Assets).

The term capital employed can also be computed as follows:

Equity share capital + Preference share capital + Reserves and other Undistributed Profits + Long term loans and Debentures – Fictitious Assets (e.g. Preliminary Expenses) – Non operating Assets (e.g. Investments).

The term ‘Operating Profit’ means Profit before interest and Tax. The term interest means ‘Interest on Long term borrowing’. Interest on short term borrowing will be deducted for computing operating profit. Non trading losses or expenses such as loss on account of fire etc. will also be excluded.

Thus, the return on capital employed is dependent upon two factors, viz.

(1) Net Profit ratio and

(2) Capital Turnover ratio.

ROI is the only ratio which measures satisfactorily the overall performance of a business from the point of profitability. This ratio indicates how well the management has utilized the fund supplied by the owners and creditors. In other words this ratio is intended to measure the earning power of the net assets of the business. The higher the ROI, the more efficient the management is considered to be in using the funds available. In fact, this ratio can also be advantageously used in judging the performance efficiency of different firms in different industries. Management also uses this ratio for decision making purposes.

**2.1.9.2.6. Return on Assets Ratio:**

This ratio is compared to know the productivity of the total assets. The profitability of the firm is measured by establishing relation of net profit which is also called profit after tax with the total assets of the company. This ratio is indicates the efficiency of utilization of assets in generating revenues. This ratio measures firm’s ability to turn assets into profit. This is a very useful measure of comparison within an industry. A low ratio compared to industry may mean that your competitors have found a way to operate more efficiently. After tax interest expense can be added back to numerator since ROA measures profitability on all assets whether or not they are financed by equity or debt.

**2.1.9.3. Ratios under Liquidity**

**2.1.9.3.1. Current Ratio**

It is most commonly used to perform the short term financial analysis. It is also known as the working capital ratios. This ratio matches the current assets to of the firm to the current liabilities. This ratio is an indication of the company’s commitment to meet its short term liabilities. It is calculated by dividing current assets by current liabilities.

Current assets mean assets that will either be used up or converted into cash within a year’s time or during normal operating cycle by business whichever is higher. Current assets include cash and those assets which can be converted into cash within a year such as marketable securities, debtors, inventories, bill receivables, prepaid expenses. Current liabilities include all obligations maturing within a year such as sundry creditors, bills payable, and accrued expenses, short term bank loans, income tax liabilities, and accrued taxes, long term debt maturing in current year. Current liabilities mean liabilities payable within a year or during the operating cycle whatever is longer out of the existing current assets or by creation of current liabilities.

The current ratio is the measure of the company’s short term solvency. It indicates the availability of current assets in rupees for every one rupee of current liabilities. A ratio of greater than one means that the firm has more current assets than current claims against them.

Normally a current ratio of 2:1 is considered satisfactory. In other words current assets should be twice the amount of current liabilities. If the current ratio 1:1, it means that funds fielded by current assets are just sufficient to pay the amounts due to various creditors and there will be nothing left to meet the expenses which are being currently incurred. Thus the ratio should always be more than 1:1. A very high current ratio is also not desirable because it indicates idleness of funds which is not a sign of efficient financial management. This is because a high current ratio means excessive depended on long term sources of rising funds long term liabilities are customer than current liabilities and therefore, this will result in considerably lowering down the profitability of the concern.

Thus, the current ratio is an index of the concern’s financial stability since it shows the extent of the working capital which is the amount by which the current assets exceed the current liabilities. As stated earlier a higher current ratio would indicate inadequate employment of funds while a poor current ratio is danger signal to the management. It shows that business is trading beyond its resources.

**2.1.9.3.2. Quick Ratio**

The quick ratio is an indicator of a company’s short term liquidity. The quick ratio measures a company’s ability to meet its short term obligations with its most liquid assets. For this reason, the ratio excludes from current assets. The quick ratio measures the dollar amount of liquid assets available for each dollar of current liabilities. The higher quick ratio is the better the company’s liquidity position. Also known as “acid-test ratio” or “Quick Assets Ratio”.

**2.1.9.3.3. Dividend Payout Ratio (NP):**

Dividend payout ratio is the fraction of net income a firm pays to its stockholders in dividends.

The part of the earnings not paid to investors is left for investment to provide for future earning growths. Investors seeking high current income and limited capital growth prefer companies with high dividend payout ratio. However investors seeking capital growth may prefer lower payout ratio because capital gains are taxed at a lower rate. High growth firms in early life generally have low or zero payout ratios. As they mature, they tend to return more of the earnings back to investors.

Some companies choose stock buybacks as an alternative to dividends; in such cases this ratio becomes less meaningful. One way to adapt is using an augmented payout ratio.

**2.1.9.3.4. Dividend Payout Ratio (CP):**

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Payout Ratio = (Dividends – Preferred stock dividends)/Cash Income

Some companies choose stock buybacks as an alternative to dividends; in such cases this ratio becomes less meaningful. One way to adapt it is using an augmented payout ratio.

**2.1.9.3.5. Earnings Retention Ratio:**

Earnings Retention Ratio is also called as plowback ratio. As per definition, Earnings Retention Ratio is that measures the amount of earnings retained after dividend have been paid out to the shareholders. The prime idea behind earnings retention ratio is that more the company retains the faster it has chances of growing as a business. This is also known as retention rate or retention ratio. There is always a conflict when it calculation of Earnings retention ratio, the managers of the company want a higher earnings retention ratio, while shareholders of the company would think otherwise, as the higher ratio the uncertain their control over their shares and finances are.

Retained Earnings refer to the percentage of net earnings not paid out as dividends, but retained by the company to be reinvested in its core business, or to pay debt. It is recorded under shareholder’s equity on the balance sheet.

**2.1.9.3.6. Cash Earning Retention Ratio:**

Retention ratio is the percentage of a company’s earnings retained and reinvested by the company. Cash retention ratio is the opposite of payout ratio. Equity shareholders invest in a company expecting payback in the form of dividends and capital gains. A company’s board of directors takes its dividend policy decisions i.e. decisions about the extent and timings of dividend payments. If the company has surplus cash, the board may decide to pay higher dividend resulting in lower retention rate. But if they believe more profitable investment opportunities are available and that the company may elect to pay less dividends or do not pay dividends at all, and instead invest the money in future projects, in which case the company will have higher retention ratio. Cash earnings retention ratio is calculated by dividing earnings retained during the period by total earnings for the period. Earnings retained during a period equals total earnings for the period less total dividend payments during the period.

Higher Cash Retention ratio of a company suggests that it may generate higher growth in future periods resulting in higher share price and potential gain. A lower cash retention ratio means that the company’s management is not so confident about future profitability and has elected to pay back cash to the investors. Cash retention ratio and future growth potential are so much linked that future sustainable growth rate is calculated as a product of cash retention ratio and return on equity of the company.

**2.1.9.4. Financial management**

**2.1.9.4.1. Funding expense ratio**

This ratio measures the total interest expense incurred by the institution to fund its loan portfolio. The difference between the portfolio yield (the income generated by the portfolio) and the funding expense ratio (the financial cost incurred by the institution to fund itself) is the net interest margin. The funding expense ratio is not the institution’s credit spread, nor the average interest rate at which it borrows (for that, see Cost of Funds below). Rather, this measure is used to help determine the minimum lending rate an MFI must charge in order to cover its costs. The minimum lending rate is determined by adding the provision expense ratio and the operating expense ratio to the funding expense ratio.

**2.1.9.4.2. Cost of funds ratio**

As its name indicates, this ratio measures the average cost of the company’s borrowed funds. In comparing MFIs, the cost of funds ratio shows whether they have gained access to low cost funding sources such as savings. MFIs that can mobilize savings tend to have relatively low cost of funds. However this advantage is offset to some extent by the higher administrative cost of mobilizing savings. In many cases, the funding liabilities of MFIs include subsidized funds. Such subsidies will drive the cost of funds down, when in fact the real cost of commercial borrowing for the institution is far higher. As subsidized MFIs grow, and as they increasingly resort to commercial borrowing to sustain their growth, rapidly rising cost of funds can lead to severe pressure on margins, which management must counteract by cutting other costs or raising lending rates.

**2.1.9.4.3. Debt/equity ratio**

The debt/equity ratio is the simplest and best-known measure of capital adequacy because it measures the overall leverage of the institution. The debt/equity ratio is of particular interest to lenders because it indicates how much of a safety cushion (in the form of equity) there is in the institution to absorb losses. Traditionally, microfinance institutions have had low debt/equity ratios, because as NGOs their ability to borrow from commercial lenders has been limited. As MFIs transform into regulated intermediaries, however, debt/equity ratios typically rise rapidly. Risk and volatility of the MFI (exposure to shifts in the business environment, for instance) determine how much debt can be carried for a given amount of equity. Even the most highly leveraged MFIs still carry less debt than conventional banks because microloan portfolios are backed by less collateral and their risk profiles are still not as well understood as those of conventional banks. The Debt/Equity Ratio is calculated by dividing total liabilities by total equity. Total liabilities include everything the MFI owes to others, including deposits, borrowings, accounts payable and other liability accounts. Total equity is total assets less total liabilities.

**Empirical framework of the study**

(Abdi & Batra, 2018), made a research on performance analysis of MFIs in Ethiopia. Their study methodologies were secondary data of 31 MIF’s for the period of 2010-2016 collected from the NBE, journals AEMFI and the primary data were collected using questioners. The data have been descriptive statistics and financial ratios to measure the performance of MFI’s in the country. In general, the study result shows that the Ethiopian MFIs are serving clients which are not poor and this leads to that their performance can be said poor.

(Chala & Semeneh, 2016), in their research entitled “Factors affecting performance of microfinance institutions in Bale Zone, Oromia region”, used primary data of 389 household heads through structured and unstructured interviews and collected secondary data from three years (2005 to 2007) annual reports of selected MFI. The study used both quantitative and qualitative methods of data analysis. Their research study result revealed that lack of experience of employees, inadequate trained manpower and lack of efficient system to enforce contract as the main factors influencing the performance of MFIs in the study area.

(Yirsaw, 2008), in his case study on the performance of six microfinance institutions in Ethiopia, tried to assess the financial and operational performance of microfinance institutions. He used mainly secondary data of selected microfinances such as income statement and balance sheet. The data were analyzed by using different statistical tools like mean and ratio analysis to address the scientific evidence in financial and operational performance of MFI’s. Five years data from 2002 to 2006 were used to the trend in performance. He found that an increase in portfolio to assets ratio over years for medium and large MFIs, and cost of fund was high in 2005 in the institutions. But liquidity was not major problem for small MFI compared to medium and large ones.

(Hermes & Hundon, 2018), in their research on “determinants of microfinance institutions”, made a systematic review on determinants of financial and social performance of MFIs, by using secondary data. The majority of their study was based on quantitative methods to analyze the performance of microfinance institutions. Their result was maturity; size and type of organization, funding sources available, governance structure, conditions external to MFIs etc. have positive and negative influence on performance of MFIs.

**CHAPTER THREE**

**3. RESEARCH DESIGN AND METHODOLOGY**

The study employed quantitative research as the literature on the research methodology shows quantitative research approach tends to assume that there is a cause and effect relationship between known variables of interest. Thus, quantitative research methodology is applied in this research paper. Descriptive statistics particularly percentage and mean have been used to assess the significant performance of microfinance institutions on sustainability and profitability as well as the overall performance status of MFIs in Ethiopia. To measure the financial sustainability of microfinance institutions in Ethiopia, Operational Self-Sufficiency and Financial Self-Sufficiency ratios were applied. In addition those to measure profitability, return on equity and return on asset were applied as the dependent variables in the study.

**3.1. Research Design**

This research was a quantitative in its nature in which the research design used is the longitudinal design. The type of longitudinal design that has been used, in this research, is the panel one. The advantages of using longitudinal research design are threefold; first it reveals individual level changes, second, establishes time order of variables, and third it can show how relationship emerges between variables. Therefore to ensure the evidence obtained enable the researcher to answer the initial questions, the type of data needed has been used for nine consecutive years (2013- 2020).

**3.2. Population and Sampling Technique**

The target populations for this particular study were all audited financial statements of microfinance institutions currently operating in the country. According to the statistics from the NBE in 2020, there are 41 microfinance institutions which are providing a microfinance service to the poor society in Ethiopia on the current period; however, there are 27 audited MFIs. The researcher has selected the microfinance institutions based on whether the MFIs are audited or not in the year 2013-2020 E.C due to sufficiency of data and it is recent period. Thus, from the total population of all the microfinance institutions in Ethiopia, sample size of this study was 27 microfinances, which is 71% (27/38) of the total MFIs based on the availability of the audited financial data.

**3.3. Data type and sources**

The data used for this study is purely secondary data that taken from the national bank of Ethiopia. Although, there are 38 MFIs in Ethiopia, only 27 audited MFIs were considered in this research study in order to get the reliable and valid data. Accordingly, financial data for twenty seven MFIs for the period of 2013-2020 were collected from the NBE.

**3.4. Methods of Data Collection**

As data gathering tools for this research study, the financial document review of 27 audited MFIs regarding return on asset, return on equity, operational sufficiency, portfolio quality and financial sustainability and measuring efficiency from financial and operation of MFIs was assessed. The documents are authoritative and acceptable for the research purpose, because, in one hand, it is audited and in other hand, it was collected from NBE and legitimate organization.

**3.5. Data Analysis Methods**

The financial data of selected MFIs for the period of eight years (2013-2020) had been collected from NBE, and analyzed by using ratios, and percentage. The panel data of the study have been analyzed using descriptive statistics and financial ratios to measure the performance of MFIs in Ethiopia using performance indicators suggested by Richard Rosenberg (2009) and other widely used MFIs performance measure such as outreach, loan repayment, financial sustainability, efficiency and financial management. However due to lack of sufficient data, the study measures the financial sustainability and profitability of microfinance institutions in Ethiopia. The independent variables are return on asset, return on equity, Operational Self-Sufficiency and Financial Self-Sufficiency. The dependent variables are the financial sustainability and profitability.

**CHAPTER FOUR**

**4. DATA ANALYSIS AND INTERPRETATION**

* 1. **Sustainability and profitability of microfinance institution**
     + 1. **Return on asset**

Return on assets (ROA) is an indicator of how profitable a company is relative to its total assets. ROA gives a manager, [investor](https://www.investopedia.com/terms/i/investor.asp), or analyst an idea as to how efficient a company's management is at [using its assets](https://www.investopedia.com/terms/r/return-on-assets-managed-roam.asp) to generate earning.

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | |  | | Year | | | | | | | |
| Variable | | 2013 | | 2014 | | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | Average |
| Return on asset | | 5.3 | | 4.1 | | 4.5 | 4.4 | 4.2 | 4.1 | 3.2 | 2.7 | 4.06 |

Source: researcher’s survey from NBE, 2020

Figure 1: return on assset

As shown in the above table the value of the return of asset of MFIs in Ethiopia is 4.06% in average. The data shows that the return on asset from 2013 up to 2016 shows variation from year to year and from 2017 up to 2020 shows a decreasing value from year to year. In other words the institutions are not the institutions are not utilizing their resource properly in generating income after 2017. The best practice for ROA is >6% (Getachew, 2017). However the microfinance institution in Ethiopia has not a best practice by tits value. It affects the profitability of the institution. The more ROA is the better profit we get from our asset.

* + - 1. **Return on equity**

The Return on Equity ratio essentially measures the rate of return that the owners of common stock of a company receive on their shareholdings. Return on equity signifies how good the company is in generating returns on the investment it received from its shareholders.

Return on equity = net income

Shareholder’s equity

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | | Year | | | | | | | | |
| Variable | 2013 | | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | Average |
| Return on equity | 3.5 | | 14.7 | 19 | 22.8 | 20 | 21.5 | 20.7 | 13.15 | 16.91 |

Source: researcher’s survey from NBE, 2020

Figure 2: return on equity

As shown in the above table, there is a fluctuation among the years. The ROE starts to increase continuously from 2013 up to 2018. Then after those years, it began to decrease the amount. In the last 9 years the data shows that 27 microfinance institutions in Ethiopia gives 1 ETB to generates 0.16 ETB of shareholder’s equity on average. It means that the Microfinance institutions have increased their performance in relation with having a better profit without needing of more capital. The more ROE is the more profit from common stock.

* + - 1. **Operational self sufficiency**

. Operational Self Sufficiency (OSS) is expressed in percentage terms, provides an indication of whether a MFI has earned sufficient operating revenue in order to cover its total expenses, comprising operational expenses, financial expenses and loan loss provisions.

Operational self-sufficiency = loans +investments

Operating Costs + Loan Loss Provisions + Financing Costs

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | | Year | | | | | | | | |
| Variable | 2013 | | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | Average |
| Operational self-sufficiency in percent | 168.3 | | 230.81 | 219.36 | 24.5 | 109.5 | 89.7 | 80.1 | 63.5 | 123.22 |

Source: researcher’s survey from NBE, 2020

Figure 3: operational self sufficiency

Source: researcher’s survey from NBE, 2020

As shown in the above table, there is a big difference among the years. For instance if we see the data from 2013-2015, it increases constantly from year to year. Then after it begin to fall and rise in the following years. We can see that there is inconsistency of data on the above years. The data shows that the MFIs in Ethiopia have 123.22 average of OSS in the last 8 years. So that the MFI in Ethiopia are covering their costs by their work and it is advisable and good for them.

* + - 1. **Financial self sufficiency**

Financial sustainability is one of the important areas to examine the MFI performance. The financial self-sufficiency measures how well MFI is earning from loans after covering its expense.

Financial self-sufficiency = financial revenue

Adjusted financial expense+ adjusted net impairment loss on loans+ adjusted operating expense

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | | Year | | | | | | | | |
| Variable | 2013 | | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | Average |
| Financial self-sufficiency in percent | 75.3 | | 85 | 91 | 98.3 | 74 | 124.2 | 101 | 141.5 | 98.78 |

Source: researcher’s survey from NBE, 2020

Figure 4: financial self sufficiency

As show in the above table, the financial self-sufficiency starts to increase from 2013 to 2016 and declines in 2017. Then after there is increment and decrement of the value on succeeding years. The eight years data shows an average of 98.78 of financial self-sufficiency of Microfinance institutions in Ethiopia. It shows that there is a problem of the microfinance institution regarding the capacity to cover its costs from financial revenue.

* + 1. **portfolio quality**

Portfolio quality indicates the risk of loan delinquency and influences the future earnings and the microfinance institution’s ability to extend outreach and serve current clients. A money lender’s ability to collect loans is essential for its success. If delinquency not maintained to very low levels it can rapidly spin out of control. Portfolio quality is measured by portfolio at risk ≥ 30 days and Loan loss rate. The lower value for the two parameters is an indication that MFIs are maintaining good portfolio quality. The international measure of portfolio quality in banking is portfolio at risk (PAR) beyond specific number of days.

PAR (X days) = outstanding principal of all loans past due more than X days

Outstanding principal balance of all loans

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  | | Year | | | | | | | | |
| Variable | 2013 | | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | Average |
| PAR | 4.3 | | 2.9 | 3.3 | 4.9 | 5 | 4 | 4.2 | 4.4 | 4.12 |

Source: researcher’s survey from NBE, 2020

Figure 5: PAR or portfolio quality

As we see in the above table, the data collected shows that the PAR (>30 days) shows that an average of 4.12 value which indicates that a good loan portfolio. This shows that the microfinance institutions have a good relation with their customer and have a proper loan follow up. There is a variation among the years and after 2018 it begins to increase time to time.

**\**

**CHAPTER FIVE**

1. **CONCLUSION AND RECOMMENDATION**
   1. **Conclusion**

From the collected data, the following conclusions were made.

* The microfinances in Ethiopia are not utilizing their resource or asset properly in generating income. This shows that they are not using their resource efficiently and effectively. In other words they need more and more resources to generate income.
* The number represents the total return on equity capital and shows the firm’s ability to turn equity investments into profits. It means that the Microfinance institutions have increased their performance in relation with having a better profit without needing of more capital. They just get the desired profit with the existing capital.
* With regard to financial sufficiency, the data shows that there is a problem of the microfinance institution in Ethiopia regarding the capacity to cover its costs from financial revenue. This means that they have problem in covering cost from financial revenue.
* The data from operational sufficiency shows that the microfinances are covering their costs from their work. However the data started to decline from 2017. So that the MFI in Ethiopia have reduced their performance by covering their costs from their operations.
* The portfolio quality of microfinance institution has a better value as shown in the above data. This shows that the microfinance institutions have a good relation with their customer and have a proper loan follow up.
  1. **Recommendation**

The following recommendations have been made from the conclusions.

* It is better that the institution to improve their utilization of resource or assets in generating income. The value of ROA of those microfinance institutions have a low value in related to generating income. There must be efficient utilization of resource or asset in generating income and should improve their asset management.
* In relation with ROE, the average value is good and shows a better performance. However the institutions’ value of ROE starts to decrease from 2018. So that the microfinance institutions is ought to improve capital management in generation of income.
* It is better that the microfinance institution should improve and balances their financial revenue in connection with covering their costs and should manage it effectively.
* It is better that those institutions should balance their operations and costs effectively and should improve their management.
* The performance of portfolio quality of the microfinance institutions is good. It is better that to make the data sustainable and make it continuous.

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