
EXAMINING FIRM SPECIFIC DETERMINANTS OF PROFITABILITY OF MICRO FINANCE INSTITUTIONS IN ETHIOPIA

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Abstract

The main objective of this study is to examine firm specific determinants of profitability of micro finance institutions in Ethiopia. Profitability is proxied by return on assets. Ten years secondary data obtained from micro finance institutions head office consolidated annual report by analyzing quantitatively in terms of descriptive statistics by using simple econometric model to measure the effect of internal determinants of profitability. The data is analyzed by using basic statistical techniques such as descriptive analysis and multiple regression analysis by using STATA version 11.0. The findings revealed that growth rate of capital size, personnel productivity, company growth rate, portfolio quality, number of clients and average disbursed loan size were significant in determining the profitability of microfinance Institution. The results also revealed that company growth rate is the most influential factor followed by capital size and the average disbursed loan size in affecting the profitability. It is recommended that high consideration of increasing the company capital, having highly qualified employees, increase the number of clients by designing customer attracting strategies and have portfolio quality measures.

Key words: Profitability, micro finance, firm specific determinants, Ethiopia

Introduction

Micro finance organizations are the most prevalent in developing countries. The development of microfinance institutions is a recent phenomenon. The proclamation which provides the establishment microfinance institution was issued in July 1996 since then various microfinance institutions have legally been registered and started delivering microfinance service (Wolday 2000).

Profitability is a suitable mechanism for achieving long term viability and sustainability of the microfinance industry. At the micro level, profitability is a precondition to a competitive microfinance industry and the cheapest source of capital, without which no firm would draw external capital. Moreover, market sources of funding are accessible only to MFIs that have established for to turn a profit. By minimizing the probability of financial crisis, remarkable profits are vital in reassuring ACSI stakeholders, including investors, borrowers, suppliers and regulators. A profitable microfinance industry is better placed to overcome negative shocks and contribute

meaningfully to the stability of the overall financial system (Muriu, 2011).

Profitability reflects how ACSI are run given the environment in which they operate, which should optimize efficiency, risk management capabilities, their competitive strategies, quality of their management and levels of capitalization. The focus on financial Profitability is attributed to its conformity to the perspective that only independent, financially sustainable microfinance institutions will be able to attain the wide outreach necessary to achieve the highest level of impact on their target population (Yonas, 2012).

Although there are significant number of microfinance institutions in Ethiopia since the late 1990s, this sector's concern in achieving widespread outreach and sustainability, hence compromising on client impact remained to be investigative. Furthermore, poverty levels have deepened as a consequence of the increasing level of unemployment. One of the justifications of the advancement of microfinance is that, a microfinance sector that is both profitable and sustainable can ultimately impact positively on the lives of the poor (*The Microfinance Gateway*: 2005). In light of this, the existences of MFIs in Ethiopia have implications for sustainability in achieving poverty reduction.

While many research on financial institutions' profitability has been undertaken in the conventional banking industry in Ethiopia, example Belayneh (2011) Habtamu (2012) Birhanu (2012) but the study of firm specific determinantsof profitability of micro finance institutions is rare. The studies conducted in the area of microfinance institutions are few in number and did not give emphasize on factors that determine profitability. This study tried to examine the major firm specific determinants of microfinance institutions.

Objectives of the study

The general objective of this study is to examine firm specific determinants of profitability of micro finance institutions in Ethiopia. The study was focus on the following specific objective:

To examine the effect of growth rate of capital size, personnel productivity, company growth rate, portfolio quality, number of clients and average disbursed loan size on the profitability of micro finance institutions.

Theoretical Review

The concept of micro credit became prominent in the 1980s, even though it has been in existence long before then in Bangladesh, Brazil and a few other countries (*The Microfinance Gateway*, 2005). The recent decade has however seen an increasing interest in microfinance and it is regarded as one of the promising tools to address poverty in the developing world (Carlton et al. 2001).

Microfinance, according to Otero (1999) is “the provision of financial services to low-income poor and very poor self-employed people”. Schreiner and Colombet (2001) define microfinance as “the attempt to improve access to small deposits and small loans for poor households neglected by banks.”

Carlton et al., (2001) state that Micro-Finance Institutions (MFIs) clients tend to cluster around the poverty line and most beneficiaries of the MFI services are neither poor nor affluent and tend to come from households that usually meet their daily needs.

However, in order to serve the poor clients, it is necessary to classify them based on their level of poverty instead of treating them as an undifferentiated, homogeneous group. The segregation of the poor will ease the burden of the poor in terms of repayment especially because most MFIs require sustained, regular repayments which can prove to be challenging to households with seasonal or variable income, which is normally the case with the poor (Davis 2005).

Profitability indicators measure profitability 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. The higher the ratio, the more profitable each currency lent (Ledgerwood, 1999 and Barres, 2006). Investors, financiers, and clients would determine their future ties with the institution by examining its profitability.

Empirical Review

Related to the nature of the problem and objectives of the study, the researcher believed that factor wise review is appropriate. Most of the empirical studies have identified firm-level determinants that affect the profitability of micro finance institutions (Malik, 2011 in Pakistan, Kozak, 2011 in Poland, Swiss, 2008 in Egypt, Ahmed et al., 2011, in Pakistan, Adams et al., 2008 in Canada, Desheng, Sandra, & Lianga, 2008 and Wright, 1992). Most of these variables, investigated by most researchers, are discussed below:

Growth rate of capital size

Majumdar (1997), the capital size of the firm, as measured by the percentage change in total size of the capital, affects its profitability in many ways. Large firms can exploit economies of scale and scope and thus being more efficient compared to small firms Swiss Re (2008). In addition, small firms may have less power than large firms; hence they may find it difficult to compete with the large firms particularly in highly competitive markets. On the other hand, as firms become larger, they might suffer from inefficiencies, leading to inferior profitability. The relationship between size and performance and the influence of company capital size on its profitability was also analyzed by other previous studies (Liargovas & Skandalis, 2008, Amal et al., 2012, Renbao & Kie, 2004, and Malik, 2011).

Personnel productivity

MFI may wish to measure the overall productivity of MFI personnel in terms of managing clients, including borrowers, savers, and other clients. This ratio is the most useful ratio for comparing MFIs (CGAP, 2003). More specifically, as cited by Amal et al. (2012), the term personnel productivity can be defined as an underlying characteristic of a person like motive, trait, and skill, aspect of one's self-image or social role or a body of knowledge which he or she uses. Woodruffe (1993) points out, that this definition leaves the term open to a multitude of interpretations and argues that the term personnel productivity can be used to refer to a set of behaviors, skills, knowledge and

understanding which are crucial to the effective performance of a position in proper management of clients. Rees (2003) argues that there has been an enormous diversity of interpretation of the personnel productivity and no agreed definition however, it is the ability of the staffs and board of directors client managing quality to achieve the objectives of the companies and measured with profitability and growth. Personnel productivity has a significant statistical impact on Profitability of companies (Liargavas & Skandalis, 2008 and Merikas, G., Merikas, A., & Skandalis, 2006). The higher the qualified employees, the better the profitability of micro finance institutions (Amal et al., 2012).

Company Growth Rate

According to Renbao & Kie (2004), one of the factors significantly affects firms' financial health. Growth is the change in size of the company as measured by the percentage change in total assets. There is a positive and statistically significant relationship between growth rate and profitability (Darzi, 2009). Micro financial institutions having more and more assets over the years have also better chance of being profitable for the reason that they do have internal capacity though it depends on their ability to exploit external opportunities. Empirical evidence by Ahmad et al (2011) in Pakistan, Yuqi (2007) in UK, and Hamadin (2008) in UAE of their investigation found a positive and statistically significant relationship between growth rate and profitability.

Portfolio Quality

Since the largest source of risk for any financial institution exists in its loan portfolio, the quality of portfolio is crucial for MFIs. In case of microfinance institutions, whose loans are typically not backed by property collateral, the quality of portfolio is absolutely crucial. A study of Imai (2011) investigated that the effect of both institutional factors and the macro economy on the profitability of MFIs. Similarly Ahlin et al.'s (2010), found that among institutional factors affect MFIs' profitability one is portfolio quality. It is also found that portfolio quality have positive impacts on MFIs' profitability. Portfolio quality is a measure of how well or how best the institution is able to protect the portfolio against all forms of risks (Nelson, 2011) Portfolio quality is a critical area of performance analysis, since the largest source of risk for any financial institution resides in its loan portfolio (American Development Bank, 2003 cited in AEMFI, 2013).

Number of Clients

Assessing the number of clients being served by a MFIs has been noted in literatures as core performance indicator for a given MFIs. To this end, the study's finding to Ethiopian case is hopeful. Number of active clients of the individual MFIs and at the industry level is surging. The number of client is a mere indicator for how MFI is reaching the poor (Kereta, 2007). A study of Yeshe (2015), aimed at establishing the relationship between loan outreach as measured by number of clients and microfinance institutions' profitability in Ethiopia and found that significant positive relationship between breadth of outreach measured as number of active clients and profitability was evident among microfinance institutions in Ethiopia. The other study which is undertaken by Lafourcade et al, (2006) Overview of the number of clients (in terms of outreach) and Profitability of Microfinance Institutions in Africa by taking 163 MFIs from 25 countries show that number of clients is positively correlated with MFIs profitability.

Average disbursed loan size

By using the average loan size that is disbursed to clients, MFIs should be careful to distinguish

between disbursed loan size and outstanding loan size (CGAP, 2003). Though it is not precise, loan size is one of the simpler indicators that small loans represent poor clientele (Robert Cull et al., 2007). The logic is that better off clients are not interested in smaller loans. Larger loans as well as higher interest rates would of course result in more income for MFIs and make them more profitable due to cost and some scale effects (Guntz, 2011). Results from a study by Ongaki (2012) indicated that there is a positive relationship between size of loan and profitability. An increase in asset quality ratio leads to an increase in profit margin (Imali, 2013). Average loan size has statistically significant association with financial sustainability (Yesi, 2015). Offering loans to economically active people will likely result in high repayment rates and consequently lead to increased levels of MFI efficiency Ayayi&Yusupov (2008).

Research methods

The study adopted quantitative research design. This approach involves the generation of data in quantitative form which can be subjected to rigorous quantitative analysis in a formal and rigid fashion (Kothari, 2004). Quantitative research involves studies that make use of statistical analyses to obtain their findings (Geoffrey, David & David, 2005). The method consisted of the analysis of financial statements of micro finance institutions.

The study purposively and conveniently conducted on Amhara credit and saving institution and Harbu micro finance institution within the study period of 2006-2015. In the study secondary data were used. The collected data for the research can be analyzed through various analysis techniques. Hence, in this study, these analyses were performed using STATA version 11.0.

Measurement

The following factors are used as explanatory variables of financial performance assumed most appropriate ones for Ethiopian context and can be easily measured by using the data afforded by Ethiopian insurance companies. Measures of these variables are shown below:

Table 3.1: measurement methods for variables of the current study

Variables	Measured by:
Portfolio quality	Portfolio-at-risk (PAR) ratio which is the ratio of Portfolio at risk (X days) to Gross loan portfolio
Number of clients	The total number of active clients plus the number of Individuals who are neither active borrowers nor depositors, but members.
Company growth rate	The percentage change in total assets
Average disbursed loan size	The Value of loans disbursed divided by Total number of loans disbursed during period
Growth rate of capital size	The percentage change in total capital size
Personnel productivity	Number of active clients divided by Number of personnel
Profitability	ROA (net income to total assets)

Regression model

By structuring the model in an appropriate way, we can remove the impact of certain forms of omitted variables bias in regression results. Thus, parameters for the following regression are estimated upon the equation indicated below:

$$FP = f(CS, PP, NoC, PFQ, ADLS, GWR)$$

Hence, the equation for this study can be stated as:

$$ROA_{ti} = a + \beta_1 SC_{ti} + \beta_2 PP_{ti} + \beta_3 NoC_{ti} + \beta_4 PFQ_{ti} + \beta_5 ALDS_{ti} + \beta_6 GWR_{ti} + u_{ti}$$

Descriptive statistics

Descriptive statistics produced the mean and standard deviation for each variable for the study. Mean and standard deviation are used mostly in research studies and regarded as very satisfactory measures of variation.

Table 4.1 Descriptive Statistics

Variable	Obs.	Mean	Std. deviation
Return on Assets	10	0.0387506	0.0187004
Portfolio quality	10	14.69867	3.647301
Number of clients	10	13.229903	1.488904
Company growth rate	10	0.0275592	0.0241881
Average disbursed loan size	10	8.164003	1.06935
Growth rate of capital size	10	0.1250965	0.10395906
Personnel productivity	10	3.770095	0.5753719

As the above table shows, the presence of high variations among the values of profitability across period included for this study. The mean value of portfolio quality indicates that there were moderate differences between the values of portfolio quality across period. Similarly the mean value of number of clients shows the existence of low difference among the values of number of clients. The mean value of company growth rate shows high difference between the values of growth rate with the standard deviation. With regard to size of disbursed loan as shown in the table above, there exists a moderate variation across the period. In contrast to this, the value of growth of capital size indicates the presence of significant differences between the values of growth of capital size. The mean value of personnel productivity and the value of standard deviation show that there were highly moderate variations among the values of personnel productivity across the period of the study.

4.3. Correlation Analysis

Correlation analysis measures the strength or degree of linear association between two variables. It is a measure of linear association or linear dependence only; it has no meaning for describing nonlinear relations. It does not necessarily imply any cause-and-effect relationship (Guajarati 2004).

Table 4.2 Correlation table

Variables	ROA	LnPFQ	LnNoC	GWR	LnDLS	GRCS	LnPP
ROA	1.0000						
LnPFQ	0.3818	1.0000					
LnNoC	0.6970	-0.1273	1.0000				
GWR	0.4182	0.0667	0.3818	1.0000			
LnDLS	0.6485	-0.0909	0.5030	0.3455	1.0000		
GRCS	0.5879	0.2848	0.3939	0.2364	-0.0303	1.0000	
LnPP	0.6606	0.0545	0.6727	0.3212	0.4545	0.5636	1.0000

As it shown in the correlation matrix, each variable is perfectly positively correlated with itself. All

the coefficient estimates of correlation for all variables show that these variables are positively correlated with ROA. The correlation matrix also shows that there is a positive and relatively strong linear association between the number of clients, personnel productivity and average disbursed loan with ROA. The analysis also indicates that several independent variables are correlated with each other.

4.1. Regression Analysis

To determine the influence of explanatory variables on the dependent variable, time series regression analysis is used for the study.

Table 4.3 OLS Regression outputs and Coefficients using STATA

Source	SS	Df	MS		
Model	0.002138918	6	0.000523153	Number of obs. =	10
Residual	0.000008429	3	0.000039442	F(6, 3) =	186.205
Total	0.002147347	9	0.000562595	Prob. > F =	0.0001
				R-squared =	0.8030
				Adj. R-squared =	0.51536
				Root MSE =	0.00168
				Durbin-Watson stat=	1.93666

ROA	Coefficients	Standard error	t	P > t
(Constant)	-0.1021061	0.0063201	-16.16	0.001
LnPFQ	0.0017096	0.0001646	10.39	0.002
LnNoC	0.0033274	0.0005619	5.92	0.010
GWR	0.1152602	0.0308521	3.74	0.033
LnDLS	0.0113223	0.000667	16.97	0.000
GRCS	0.0658845	0.0052877	12.46	0.001
LnPP	0.0082213	0.0015272	5.38	0.013

R-square shows that 80.3% of variations in dependent variable (ROA) are explained by the variations in the independent variables (portfolio quality, number of clients, Company Growth Rate, average size of disbursed loans, the growth of capital size and personnel productivity). The adjusted R square in the model shows that 51.5 % of the change in profitability as measured by ROA can be explained by the variables in the model. The model is statistically significant as the p-value for the model is 0.0001. That is less than the limit for statistical significance which is 0.01 or 0.05 for significance. This is good; meaning the fitness of the model in explaining the performance is high.

Findings discussion

Capital Size has a significant statistical impact on Profitability of companies. Large firms have more resources, more accounting staff and sophisticated information systems that result in high performance (Liargavas and Skandalis, 2008; 2005; Renbao&Kie, 2004). The regression results by different researchers indicated that there exists a positive relationship between growth rate of capital size and profitability of firms (Swiss Re, 2008, Ali Al-Shami, 2008, and Malik, 2011). Similar to most of the researchers mentioned above, in this study, the regression estimation result revealed that there exist a significant and positive relationship between growth rate of capital size and profitability of ACSI. This has an implication that larger micro finance institutions can maintain high

ROA.

The results of the regression analysis show that there is a positive and statistically significant relationship between personnel productivity and profitability. It has a significant statistical impact on profitability of microfinance institutions. This finding is consistent with what (Liargavas and Skandalis, 2008) and (Merikas et al, 2006) have found. Empirical evidence by Amal et.al (2011) in his investigation also found a positive and statistically significant relationship between personnel productivity as proxied by management competence and profitability of companies. Hence, companies having higher ability to manage clients, the better quality of their competence and thus the company's ability to be healthy in their profitability. This predicts that micro finance institutions with higher productive Management body and qualified professionals placed at a better position in performing higher ROA than that of with lower Management aptitude.

Similar with what Renbao&Kie (2004) found, company growth rate as measured by the percentage change in total assets is positively related with profitability of companies. The result of the regression analysis for this study shows that there is a positive and statistically significant relationship between company growth rate and profitability. This is also consistent with the empirical evidence by Ahmad et al (2011) in their investigation that found a positive and statistically significant relationship between growth and profitability of microfinance companies. With the researcher's understanding, there are no contradicting findings for this factor. Hence, micro finance institutions having more and more assets over the years have also better chance of being profitable for the reason that they do have internal capacity though it depends on their ability to exploit external opportunities.

Portfolio quality is a measure of how well or how best the institution is able to protect the portfolio against all forms of risks. Portfolio quality is a critical area of performance analysis, since the largest source of risk for any financial institution resides in its loan portfolio (American Development Bank, 2003 cited in AEMFI, 2013). The result of the regression analysis for this study shows that there is a positive and statistically significant relationship between portfolio quality and profitability. This is also consistent with the empirical evidence by Imai (2011) and Ahlin et al.'s (2010) however, it is against what Yenesew (2014) found that was a negatively and not significant relationship between portfolio quality and profitability of microfinance companies.

The number of client is a mere indicator for how MFI is reaching the poor (Kereta, 2007). A study of Yeshi (2015), aimed at establishing the relationship between loan outreach as measured by number of clients and microfinance institutions' profitability in Ethiopia and found that significant positive relationship number of clients and profitability. The other study which is undertaken by Lafourcade et al,(2006) show that number of clients is positively correlated with MFIs profitability. The result of the regression analysis for this study shows that there is a positive and statistically significant relationship between number of clients and profitability. This is also consistent with the empirical evidence by Lafourcade et al,(2006), (Kereta, 2007), Yeshi (2015) and Ahlin et al.'s (2010) all found positive and statistically significant relationship between number of clients and profitabilityprofitability.

The result of the regression analysis for this study shows that there is a positive and statistically significant relationship between size of disbursed loan and profitability. This is also consistent with the empirical evidence by Guntz (2011), Imali (2013)), Yeshi (2015), Ayayi&Yusupov (2008),

Robert Cull et al., (2007) and Ongaki (2012) all found positive and statistically significant relationship between number of clients and profitability. With the researcher's understanding, there are no contradicting findings for this factor. Hence, micro finance institutions having larger loans as well as higher interest rates would of course result in more income and make them more profitable due to cost and some scale effects. This leads to focus on offering loans to economically active people that will likely result in high repayment rates and consequently lead to increased levels of MFI efficiency.

Recommendations

It is worthwhile to have high consideration of increasing the company capital. Because the capital size of the company is an important factor as it influences its competitive power. Small micro finance institutions have less power than large ones; hence they may find it difficult to compete with the large firms particularly in highly competitive markets.

It is advisable to micro finance institutions to have highly qualified employees in managing and treating clients.

Micro finance institutions should increase the number of clients by designing customer attracting strategies. This in turn, is an important tool to increase the amount of loan disbursed and total assets. The increment in loan size and total assets has a positive contribution to the growth of the institution in general.

Micro finance institutions should have portfolio quality measures and strategies that will indicate it how well or how best the institutions are able to protect the portfolio against all forms of risks. It should design and perform better portfolio protection mechanisms and keeping the quality of all assets portfolio to increase its levels of profitability.

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