ASSESSMENT OF THE CAPITAL STRUCTURE IN ETHIOPIA MICROFINANCE INSTITUIONs.

A Research project submitted to Wolkite University, college of Business and Economics, Department of Accounting and Finance in partial full filament of the requirements for BA degree in Accounting.

Wolkite University
We Strive for Wisdom!

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ABSTRACT

This study conducted on the assessment of capital structure on microfinance institutions in Ethiopia is an attempt to indicate the importance of capital structure in financial institutions such as micro finances and others. The main objective of the study is to evaluate the capital structure of microfinance institutions as requirements in compare. The target population for these particular studies all the microfinance institutions currently operating in the country. Among the MFIs four (4) micro finance institutions was selected using purposive sampling technique. Purposive sampling was used to select MFIs which better performance in order to analysis capital structure institution. Descriptive statistical tools are used in analyzing the data collected. Hence, the nature of the Study is descriptive. Finally, based on the findings possible recommendations are given. These include the issues impeding capital structure on the micro finance regarding the valuing of properties offered for collateral, lengthy of loan processing, amount of loan processed and approved, loan period, and discretionary limits affecting the performance of capital structure managements.

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ACRONYMS

MFI	MICRO FINANCE INSTITUSTION
NBE	NATIONAL BANK OF ETHIOPIA
AMFI	ASSOCATION OF MICRO FINANCE INSTITUSTION
NGO	NON-GOVERNEMENT ORGANIZATION

CHAPTER ONE

1. INTRODUCTION

1.1 Background of the study

Capital structure was one of the finance topic among the studies of the researchers and scholars. Its importance drives from the fact that capital structure was strongly related to the ability of the firms to full fill the need of various stock holder. Capital structure refers to the way that a corporation finances its assets through the combination of equity and debt. That means firm's capital structure is then the combination or structure of its liabilities. Since Modigliani and miller, several theories have been developed to go to optimal decision and explain the capital structure assess of the firm.

Microfinance refers to the provision of non-exploitative small-scale financial services to low-income clients (Lidgerwood, 1999GC). Microfinance Institutions have risen to the forefront as invaluable institutions in the development process. These institutions have expanded the frontiers of institutional finance and have brought the poor, especially poor women, into the formal financial system by enabling them to access credit in order to fight poverty (Began, 2008). According to the World Bank (2009) report approximately 80% of the world's 4.5 billion people are living in low- and middle-income economies lacking access to formal sector of financial services.

MFIs have become distinguished by their impressive low level of default rates on the average and return on equity ranging from 20 to 40 percent. According to Began (2008) despite the successes of many MFIs, millions of low-income individuals in developing countries still do not have access to financial services. High operating costs and capital constraints within the MFI industry have prevented MFIs from meeting the enormous demand. Thus, institutional structure and capital flows to MFIs have become much more salient issues. Currently, microfinance industry is in a state of flux. The non-governmental organizations (NGOs) that once dominated that industry are transforming into licensed banks and non-bank financial intermediaries (Hogue M. et al, 2011). The donor agencies and soft loan providers want the

MFIs to become independent of their help as they mature. So, it is not surprising that finding a new way to access capital by MFIs has become the trend in the industry as the lack of access to capital causes slower than optimal growth and large operational deficits. Research indicates that debt financing may be underutilized by MFIs as a new source of funding. Some advocates of innovation say transformation from non-profit to commercial enterprises was the only way to go.

The assessment of capital structure is one of the most important debatable issues in the fields of corporate finance. A number of capital structure theories have been developed after the work of Modigliani and Miller (1958) to explain many matters as the relationship between capital structure and firm value. Given the contribution of microfinance in the development process, factors that affect their capital structure have been overlooked by empirical studies. The study tries to borrow the assessment capital structure that were studied under banking industry and examines to what extent these factors affect leverage of MFI in Ethiopia. Various studies examined factors that assess the capital structure of financial firms in general such as banks (Berger 2002, Benston et al 2003, Gropp and Heider 2009, Octavia and Brown 2008, Iwarere and Akinleye (2010).

This study was addressed to fill this gap. Therefore, more or less MFI industry is much related to the financial sector. As a starting point the assessment of capital structure of microfinance institution a result would be taken to study the assess of capital structure decisions of MFI. Additionally, a few literatures have provided evidence that are converged on a number of standard variables of financial firms that are reliably related to the capital structure of non-financial firms as reported by Gropp and Heider (2009). Especially, MFI would need to share some characteristics of nonfinancial firms. So, this indicates there are common determinants of capital structure of MFI other than regulation that affect their financing decision. Studying assessment of capital structure is important because it has an effect on the sustainability and outreach of these organizations (Kyereboah-Coleman, A. 2007).

This study was important for various stakeholders like management of MFIs, practitioners, researchers and policy makers in many ways. Management of MFIs can identify factors that hinder their MFIs from proper utilization of debt financing so that they can take some

corrective actions that help them to their optimal debt-equity mix. This study was also important for researchers by showing the assessment of capital structure of MFIs in a poor country context using advanced econometric methods, panel data so that various extensions of this study be made.

The study may also generate valuable information to inform policy makers like National Bank of Ethiopia (NBE) in creating conducive environment for MFIs to utilize debt as a viable source of finance in the period of increased commercialization of microfinance and expanded outreach goals. The purpose of this study is to empirically examine assessment of capital structure some Ethiopian MFI that meet the criteria of data availability and to analyze using Panel regression model with a secondary data covering.

Capital structure of a firm describes the way in which a firm raises capital needed to establish and expand its business activities. The capital structure decision is one of the most important decisions made by financial managers in this modern period. The capital structure decision is at the center of many other decisions in the area of micro finance. One of the many objectives of a micro financial manager is to ensure low cost of capital and thus maximize the wealth of shareholders. Hence, capital structure is one of the effective tools of management to manage the cost of capital. An optimal capital structure is reached at a point where the cost of the capital is minimal.

1.2 Statement of the problem

Micro finance institutions play a great role in supporting the economic activities of the rural and urban poor in developing countries. Studies show that African MFIs are important actors in the financial sector, and they are well positioned to grow and reach the millions of potential clients who currently do not have access to mainstream financial services (Lafourcad etal., 2005). Ebisa et al. (2013) found that microfinance institutions are decisive way outs from the vicious circle of poverty particularly for the rural and urban poor, particularly in a country like Ethiopia where many people live barely below the absolute poverty line. The micro financing industry of Ethiopia is escalating in the face of the growing deep concerns for inflation and low interest rate in the microfinance industry affecting the

financial health and viability of MFIs. The situation can vary from one MFI to another. So, it is difficult to use her conclusions for all microfinance institutions. Though the strengths of the Micro Financing Industry outweigh its weaknesses, there are still big challenges facing the microfinance institutions (Ebisa et al., 2013). This study also concludes that the importance of MFIs is unquestionable. They contribute a lot to support the Ethiopian poor who are out of the formal banking system.

The study therefore to try answer the following basic questions.

1. How the MFIs are operating to control their capital structure?
2. What's status of efficiency of the micro finances institutions?
3. Is there a technique that must be used to evaluate the capital structure in Ethiopian MFIs?

1.4 The objective study

1.4.1 The general objective

The general objective of this study was to assess the capital structure in Ethiopia micro finance institutions.

1.4.2 The specific objective

- ✓ To assess how the MFIs are operating to control their capital structure.
- ✓ To measure the status of efficiency of the micro finances institutions.
- ✓ To apply the techniques that must be used to evaluate the capital structure in Ethiopian MFIs.

1.5 Significance of the study

This study was a significant for institutions as well as for future researchers. Since this researcher will be a good research because it has a replicable so that the validate results that gains form this study can used as an input for the future researcher that study related to these problems. For the institutions This study, as an attempt to assess the capital structure of MFIs

in Ethiopia, provides evidence on what effect the firm-specific factors, industry-specific factors and the general macroeconomic factors have on the MFIs financial in Ethiopia.

The findings of the study is also benefits to donors, managers and others interested in the MFIs study for it will show the level of financial performance of the MFIs operating in the country have reached. This in turn helps them knowing factors affecting financial performance and thereby takes appropriate actions to increase financial evidence of MFIs and the study will also initiate other MFIs service providers to give due attention on the management of identified variables. It is hoped that the outcome of this study will also provide an insight of the MFIs industry to other researchers.

1.6 Scope of study

This study was providing to assess the key capital structure of micro financial in Ethiopian by analyzing the financial statements start from 2009 to 2012 E.C. Those MFIs included in the recent annual performance report was limited in number so this paper is limited to analyze only 8 MFIs. Based on functionality this study is limited to find the major solution of the problems that occurs in different micro financial instructions found in Ethiopia. Since this study is used to find the problems that affect the micro finance, as well as used to find the methods that solves the problems that face the micro finance institutions in Ethiopian.

1.7 Limitation of the study

Limitation of this study was conducted based on secondary data, lack of primary data source is ists limitation.

1.7 Organization of the study

The study was containing five chapters .In the first chapter contains an introduction including the background of the study, statement of the problem, the objective of the study, the significance of the study, and scope of the study, the second chapter contains a literature review. The third chapter contains, research methodology. The fourth chapter contains data analysis and discussions and, the last chapter contains conclusion and recommendations

CHAPTER TWO.

2. REVIEW OF LITERATURE

2.1 What is capital structure?

Capital structure rrefers to several alternatives that could be adopted by a firm to get the necessary tends for its investing activities in a way that is consistent with its priorities. Two major sources of financing that are available to firms are debt and equity. The mixture of debt and equity is called capital structure. Most of the effort of the financial decision making process is centered on the assessment of the optima capital structure; where the firms' value is maximized and cost of capital is minimized. This chapter presents the theoretical and empirical literature review over the capital structure. Section 2.1 covers theoretical literature review, section 2.2 covers reviews of prior empirical studies including those conducted in Ethiopia.2.1 Theoretical review the literature shows the existence of different theories related to capital structure. These theories include Modigliani and miller (MM), static trade-off theory, pecking order theory, and agency cost theory. The purpose of this section is, hence, to review these theories of capital structure in an orderly.

2.1.1 History of Microfinance

Bornstein (1996) cited in (Zeller and Meyer, 2002) stated that Professor Mohammad Yunus, a Bangladesh, addressed the banking problem faced by poor villagers in southern Bangladesh through a program of action research. With his graduate students at Chittagong University, he designed an experimental credit program to serve the villagers. The program spread rapidly to hundreds of villages. Through a special experimental relationship with local commercial banks, he disbursed and recovered thousands of loans, but the bankers refused to take over the project at the end of the pilot phase. They feared it was too expensive and risky in spite of its success (Zeller and Meyer, 2002). When we see the condition of most microfinance clients, giving loans for them seems risky. Because getting the money back7from the borrower needs special follow up and also the absence of collateral for lending aggravate the fear.

2.1.3 Microfinance Institutions in Ethiopia

The development of microfinance institutions in Ethiopia is a recent phenomenon. The proclamation, which provides for the establishment of microfinance institutions, was issued in July 1996. Since then, various microfinance institutions have legally been registered and started delivering microfinance services (Wolday, 2000). The number of micro finance institutions as well as the number of clients is increasing from time to time. The existing political and economic condition of the country contributes a lot for the development of the microfinance industry.

According to Getaneh (2005) the Licensing and Supervision of Microfinance Institution Proclamation of the government encouraged the spread of Microfinance Institutions (MFIs) in both rural and urban areas as it authorized them, among other things, to legally accept deposits from the general public (hence diversify sources of funds), to draw and accept drafts, and to manage funds for the micro financing business.

In this case some MFIs have strong capacity to serve a large number of clients by using their financial and geographical advantage. These three institutions take more than 50% of the market share. This means they are reaching and serving many poor in their areas.

2.1.4 The Nature of Capital Structure of MFI

Bogan (2009) stated that the capital structure of lending institutions has become an increasingly prominent issue in the world of finance. According to the writer since capital constraints have hindered the expansion of microfinance especially the question of how best to finance these organizations is a key issue. As the paper examined the source of funding for MFIs globally using a panel data to link between the capital structure and MFI success, the study found that capital structure have significant effect on the sustainability of MFIs and the increased use of grants by large MFIs decreased operational self-sufficiency.

Today MFIs have an increasingly broad range of financing sources at their disposal. This allows for greater funding diversification, but it also makes decisions about capital structure more complex (CGPA, 2007). Similarly, with other firms the capital structure of MFIs, the mix between debt and equity financing, are the two components. In this era of commercialization many MFIs are launching large scale deposit mobilization and long term

debt campaign as a core funding strategy (CGPA, 2007). Assessment optimal capital structure of MFIs has been overlooked by empirical studies, which requires analysis of a number of factors. In general, this study tries to address the firm level assessment of capital structure using a panel data.

2.1.5 The benefits of Commercial debt for MFIs

One of the major studies that were conducted by Kyereboah-Coleman (2007) looks at microfinance institutions in Ethiopia. The results imply a positive effect of debt on MFI outreach and thus its capacity to exploit economies of 9scale, which leads to higher income margins. In addition, highly-leveraged MFIs were found to experience less defaults by microcredit customers. The age of an MFI is positively correlated with defaults. Kyereboah-Coleman interprets this result with the tendency of a micro-bank to grow (following the market penetration strategy) by granting credit to new customers, who may not be as creditworthy as its present customer base. The capital structure of a microfinance institution, hence, both directly and indirectly determines its financial sustainability. Long-term debt is observed to be the most beneficial type of capital to MFIs as Kyereboah-Coleman indicated.

Most MFIs employ high leverage, and finance their operations with long-term (as opposed to short-term) debt. Highly leveraged microfinance institutions perform better by reaching out to a wider clientele, enjoying economies of scale, and thus being better able to deal with moral hazard and adverse selection, enhancing their ability to deal with risk (Kyereboah-Coleman, 2007).Various factors, other than stage in the life cycle, seem to be associated with the performance of MFIs.

Bogan (2008) for example indicates that the size of assets and capital structure of MFIs are associated with performance. In terms of sustainability and outreach, asset size is important: a measure of grants received by MFIs (from donors such as charities, governments and international organizations) as a percentage of assets is significantly and negatively related to sustainability and is positively related to MFI cost per borrower. Bogan (2008) also finds evidence to support the assertion that the use of grants drives down MFI's operational self-sufficiency. She suggests that long term use of grants may be related to inefficient operations

due to lack of the competitive pressures that would be associated with attracting market funding. Notably, the results do not indicate that grants are related to greater or more costly outreach. Thus, grants could hinder the development of MFIs into competitive, efficient, sustainable operations (Bogan, 2008).

2.1.6 Theoretical Perspective

One of corporate finance areas highly debated is the capital structure theory arguments that describe the relevance of capital structure for value creation and identification of determinants of capital structure of firms.

In the capital structure theory, the optimal debt-equity ratio that a firm should maintain have been debated by a number of scholars after the work of MM in 1958 where they won a noble prize award for their proposition that the capital structure of a firm is irrelevant or financing decision doesn't matter for the creation of value of the firm

With the presence of tax, the theory states that a firm can benefit from the higher financing of debt because of tax shields. Hence this theory concludes optimal capital structure is 100% debt financing which is a not logical conclusion.

Another is the traditional theory that describes the optimality of debt-equity is obtained at the trade-off balance between the benefits from debt (tax shield) and the cost of debt which leads to bankruptcy (financial distress costs) as a result of higher debt financing and the risk of defaulting the interest and principal.

Finally, the theoretical sections of related literature sections the pecking order and agency theories have contributed on the debate of optimality of capital structure. All these theories focus on non-financial firms who are corporate organizations and the empirical finding of these studies indicated are also tested though there is no consensus on the optimality of debt-equity ratio that a firm should maintain.

From these empirical studies it was recognized that the assessment of the capital structure vary from industry to industry. Therefore, an industry classification is important in studying and understanding the unique firm level characteristics that affect leverage of a given industry. Unlike the non-financial firms that prefer debt for the tax advantage to create the

value of firm the benefits commercial debt, MFI prefer debt not for tax advantage rather debt is less expensive than equity because of unattractive investment opportunity the investors require to be compensated. The other benefits of debt financing are deposits cannot be collected in volumes sufficient to cover loan demand. The debt financing need of these institutions is to achieve the large scale outreach and increasing demand of loanable funds requirement.

Therefore, this study tries to link the optimal capital structure that the industry analysts in the sectors recommended as target. In order to understand these determinants of capital structure need to be identified and hypothesize it existing theories to empirically test and to understand how MFI in Ethiopia leverage is affected.

2.1.7 The Need for Microfinance

Microfinance institutions play many roles in the development process. The need for microfinance is also increasing in many countries. According to (Parker, 2000), in the right environments, microfinance can11accomplish many roles such as financer people's economic choices, diversifying household income, making household less vulnerable to downturn in the economy or personal, smoothening income flows of the household, improve quality of life throughout the year and strengthen the economic position of women so that they can take greater control of decisions and events in their lives. In addition to this MF contributes in the process of household asset building.

Microfinance services lead to women empowerment by positively influencing women's decision making power at household level and their overall socioeconomic status. By the end of 2000, microfinance services had reached over 79 million of the poorest of the world

2.1.8 Challenges of Microfinance Institutions

Most microfinance programs are small and vulnerable to resource constraints. Most operate in a few locations and serve specific clusters of clients, so they are exposed to the systematic risks of undiversified loan portfolios. Most mobilize few savings and not financially self-sufficient, so they are dependent on the whims of donors and government for their future existence (MEYER, 2002). Microfinance institutions may face financial problems which affect their performance. When the customer of the institutions increases the required money

for loan disbursement also increase. On the other hand, when the operational areas of the institutions is limited (less outreach), it is difficult to be profitable.

2.1.9 Factors affecting the capital structure of MFIs

Huang (2005) cited in (Vamoose, 2008) distinguishes three groups of factors: policy, geographical and institutional factors.

Policy Factors: There are different macro-economic factors related to MFIs. The first factor is the income level. Westley (2005) cited in (Vamoose, 2008) states that regions with higher levels of income have less developed microfinance sectors. He provides two reasons. Firstly, micro-entrepreneurs with higher incomes have more opportunities to self-finance through savings.

Secondly, they may benefit more easily from informal finance through family and friends, as well as from formal finance.12Similarly, Schreiner and Colombes (2001) argue that one of the reasons why microfinance in Argentina has not developed is due to the higher wages people earn. Traditionally, microfinance also focuses on the poor excluded clients, so microfinance should be reaching more clients in regions that are poor. The other factor is economic instability of the country. Microfinance is more developed in countries that have relatively in stable economies. The international donor community has historically played an important role in subsidizing the emergence and further development of microfinance programs.

Embolden (2005) cited in (Vamoose, 2008) stated that, as most institutions started as non-governmental organizations, external financial intervention was needed.

Geographic Variables: Stieglitz and Weiss (1981) cited in (Vamoose, 2008) stated that transaction and information costs influence financial development. In some cases, they lead to market failures. Good interconnectivity between regions, the availability of electricity, communications and sanitation networks lower these costs. A high population density also

helps. According to Sriram and Kumar (2005) cited in (Vamoose, 2008) two contradictory arguments could be made. The first is that formal financial institutions may be more developed in regions with higher population density and good regional interconnectivity. Thus the need for specific MFIs may not be present. The second is that, if the development of the two sectors is complementary, these factors could eventually also stimulate the development of the microfinance sector. Hume and Moore (2006) cited in (Vamoose, 2008) also support the hypothesis that microfinance tends to develop much faster in densely populated areas.13

Institutional Variables: Institutions play an important role in the development process of a country. One institution that is often mentioned in the microfinance literature is the educational system. The role of human capital in financial sector development is widely recognized (Vamoose, 2008). Paulson (2002) cited in (Vamoose, 2008) finds that regions with higher levels of education have more developed financial systems. Guise et al (2004) cited in (Vamoose, 2008) also find positive effects of social capital in financial sectors.

2.9.1 Measures of capital structure

Companies that use more debt than equity to finance their assets and fund operating activities have a high leverage ratio and an aggressive capital structure. A company that pays for assets with more equity than debt has a low leverage ratio and conservative capital structure. That said, a high leverage ratio and an aggressive capital structure also lead to higher growth rates, where as a conservative capital structure can lead to lower growth rates.

2.2 Empirical Literature Review

Since the pioneering work of Modigliani and Miller (1958), the question of what is assess of capital structure has been a major field in the corporate finance literature. Since then, several studies have been conducted in developing and developed countries to identify those factors that have an effect on firms choice of capital structure. Given the time constraint and the amount of empirical literature available on the topic of this research it would have been quite difficult to present the results of all the studies.

Thus, the review of the empirical studies in this section on the determinants of capital structure decision has as particular focus on those that have been conducted since the

1988s.Titman and Wessels (1988) studied the determinant of capital structure choice by examining them empirically.

They extended empirical work on capital structure theory in three ways. First, they examined a much broader set of capital structure theories many of which have not previously been analyzed empirically. Second, since the theories have different empirical implications in regard to different types of debt instruments, the authors analyzed measures of short-term, long-term, and convertible debt rather than an aggregate measure of total debt. Third, they used a factor-analytic technique that mitigates the measurement problems encountered when working with proxy variables.

The total number of active borrowing clients of the microfinance institutions in Ethiopia reached over 2.4 million customers in 2011 whereas the total credit extended by all microfinance institutions amounted to Birr 6.9 billion. Of the total credit granted, the share of the three largest Microfinance institutions is Birr 5.1 billion. The market shares based on the number of borrowing clients are 28.1, 16.1 and 20.4% for Amhara Credit and Saving Inst (ACSI), Deceit Credit and14Savings Inset (DECSI) and Oromia Credit and Savings (OCSSCO), respectively.

Lack of skilled personnel is the common problem in Ethiopian Microfinance Institutions. The Ethiopian context, MFIs are institutions that are licensed under the microfinance law (proclamation 40/96) to provide financial services to the unbanked community. Unlike other countries in Africa, they can mobilize saving from day one of their registration by the National Bank of Ethiopia. The NBE is legally empowered to supervise the activities of MFIs. Currently, there are 38 microfinance institutions operating in the country

In contrast the traditional banks have merely 568 branches, which are primarily located in urban areas. The branch availability data therefore denotes the significant stance microfinance institutions have in providing financial services to the undeserved and their potential as an intermediary for related financial and social services, particularly in rural areas Evolution of MFI source of finances, classification of Ethiopian MFI on the basis of their size, saving mobilization (voluntary and compulsory) trend of the industry, asset, capital and financial leverage trends of Ethiopia’s MFIs for the year 2009-2012 are reviewed to give

us an overview about the performance and dynamics of capital structure of the industry. The overall data on Ethiopian MFI is obtained from AEMFI and computed by the researcher.

Microfinance in Ethiopia began largely as a philanthropic effort or a quasi-philanthropic effort characterized by government mandated programs and non-governmental organizations (NGOs) whose supply of capital was principally derived from donors. These organizations have since transformed in to microfinance institutions that are seen today which are largely characterized by a donor funded equity base-exceptions include Aggar, PEACE and Wisdom who rely on a combination of quasi-commercial debt, paid-in capital, retained earnings and other equity accounts to fuel their growth.

Ethiopian microfinance institutions are classified into 3 peer groups relative to their size to allow for comparison. The bases of classification of the size of MFI as defined in the report analysis MFIs with less than or equal to 15,000 active borrowers are small MFIs (Metemamen, AVFS, Meklit and Gasha). MFIs with 15,001 to 50,000 active borrowers are medium MFIs (Buusaa, Eshet, PEACE, Wasasa, SFPI and Wisdom). MFIs with more than 50,000 active borrowers are categorized as large MFIs (ACSI, DECSI, OCSSCO, ADCSI and OMO) are of the sampled MFIs which are included in the category classifications. The report has shown that Ethiopian microfinance institutions industry has performed well despite the tumultuous events in the global financial markets, not to mention the global food crisis and the high inflationary pressures the country has experienced over the last two years.

Ethiopia's microfinance industry has shown steady growth trends over the last ten years that are marked by an industrial asset holding of Birr 8.6 billion as of fiscal year ending 2010 (refer total asset trend of Ethiopian MFIs attached at appendix section). However, the largest microfinance institutions (ACSI, DESCI, OCSSCO, OMO, ADSCI and Wisdom) completely dominate the sector's market share. Such market dominion is not unusual, existing studies indicate that the size distribution of microfinance institutions in developing countries is highly skewed, while outreach remains very limited-below 1% of the population in most countries. For example,

According to one study conducted in Ethiopian microfinance sectors the two largest institutions namely ACSI and DESCI dominate 62% of the entire market share and if the remaining four institutions were included the market shrink by 93%. It worthy to note that

the occurrence of such a highly skewed market is happening in a setting in which regional positioning prevails.

Savings can play a significant role in increasing levels of institutional sustainability and enhancing levels of outreach. The institutions were able to mobilize Birr 2.70 billion in total savings in the year 2010GC.

According to AEMFI the WWB report denotes leverage as one of the key indicators for measuring financial integration, since it reflects how successful a microfinance institution has been in accessing debt relative to its equity base. Leverage is also an indicator of how well an institution is maximizing its earnings, since for traditional company's debt is a cheaper source of capital than equity. Ethiopian microfinance institutions have not made the shift away from donor subsidies (donated equity and subsidized loans) to fully leverage commercial capital (commercial debt, deposits and equity investments).

Consequently, commercial debt is a marginal portion of institutional funding structure; and although institutions have increased their deposits intermediation they have not fully maximized its potential. Moreover, the current regulatory environment constraints institutions from exploring the full range of available equity investment options. However, investors have recognized the potential of the microfinance sector, which is evident from Apgar's ability to fund its capital base solely through public shareholder investment.

According to a financing strategies report issued by the USAID, some microfinance institutions have successfully used development funding to leverage commercial finance. The report indicates that some institutions use grant from development agencies to guarantee commercial bank loans. Therefore. This study, the researcher wants to assess capital structure in Ethiopia micro finance institution

2.3 Knowledge gap

This chapter reviewed the literature on assessment of capital structure decision starting with the famous irrelevance theory of Modigliani and miller's (1958) assumptions of perfect capital markets. Several theoretical frameworks have been developed to explain the firm's capital structure such as static trade -ott theory, pecking order theory, and agency theory. Static trade-off theory assumes that a firm's optimal debt ratio is determined by trade -off between the bankruptcy cost and tax advantage of borrowing. Holding the firm s assets and

investment plans constant. Whereas, pecking order theory is another dimension to the capital structure theories. According to this theory capital structure is driven by firm's desire to finance new investments, first internally, then with low-risk debt, and finally if all falls with equity.

Therefore, the firms prefer internal financing to external financing. Similarly, the findings of prior empirical studies have provided varying evidence related to the assessment of capital structure For instance, Caglayan and Sak (2010) have studied the assessment of capital structure of MFIs in Turkish and provided evidence that pecking order theory is pertinent theory to Turkish MFI. Beside, Buferna et al. (2005) provided evidence that trade of theory and agency are pertinent theories of the capital structure to a developing country. On the other hand, Amidu (2007) on Ghanaian MFIS supports the static trade-off and pecking order argument. However, in the context of Ethiopia as to the knowledge of the researcher there are a few studies conducted on the capital structure of the MFI industry. In addition, most empirical work on capital structure has predominantly relied on quantitative analysis of secondary data to examine the assessment of capital structure. Therefore this study will fill the gap by examining the assessment of capital structure in the context of Ethiopian MFI industry.

CHAPTER THREE

3. Research Methodology

Introduction

Under this chapter is to provide brief outline of the broad objectives of the study and the underlying principle of research methodology and the choice of the appropriate research method for the study. The chapter is arranged as follow: methodology of the study, research approach, research design, data type and sources, population, data collection, variables specifications and methods of data presentation are list as follows.

3.1. Research Approach

As noted in Creswell (2003), in an investigative study there are three familiar types of research approaches to business and social research namely, quantitative, qualitative and mixed methods approach. Creswell (2009) defined quantitative research as a formal, objective and systematic process in which numerical data are utilized to obtain information. Mmuya (2007) stated that qualitative research is an investigative methodology that is grounded in a philosophical position that focuses on making sense of the social world through a process involving how it is experienced, understood and interpreted. The qualitative method takes a theoretical and methodological focus on complex relations between personal and social meanings, individual and cultural practices and the material environment or context. Whereas, mixed research is characterized as the combination of both qualitative and quantitative research approaches. Considering the research problem and objective along with the philosophy of the different research approaches, the quantitative nature of the data collected, quantitative research approach was found to be appropriate for this study Besides, this study would be uses quantitative research approach to examine a stated objective because quantitative research is a systematic and scientific investigation of quantitative properties and phenomena.

3.2 Research design

This study employed descriptive type of research design to show the opinion of the managers in Microfinance Institutions, the employees and their clients to assess the capital structure performance of Microfinance Institutions. The researchers used quantitative approaches. Research in such a situation is a function of researchers' impressions. This study quantitative research approach is used to assess the opinion of the respondents towards the factors, their assumptions and the problems they faced. Quantitative approach is used to indicate the percentage of the present different secondary data.

3.3 Population and Sample Size

The target population for these particular studies all the microfinance institutions currently operates in the country. Among the 38(muluken2019) MFIs eighth (4) micro finance institutions is selected using purposive sampling technique. Purposive sampling is used to select MFIs which better performance in order to analysis capital structure institution.

By using purposive sampling technique, a sample of a subject is taken from the total population to make Inrefine about the population because it is time consuming and expensive to collect data about every individual institution in the population. The selected sample can reliably represent the population; the sample can still be used to make inferences about the population. This study would use a sample of 8 MFIs from the total population of 38 MFIs in the country. The criteria for choosing among the MFls were based on the availability and quality of data for the time..

3.4 Methods of Data Collection

In order to carry out any research activity; information is gathered from proper sources to achieve the objective of the study the researcher employ only secondary data. The secondary data for this study is to be secured from various sources include from microfinance books, journals MFl website. The sources of data for this research it would secondary sources. The secondary data which is collected from AEMFI annual report and also it collect from NBE financial report. As the study empirically investigates and assessment of capital structure, the researcher employed 4 MFIs from the data base depending on the data availability of financial statement for the period.

3.4 Methods for data analysis

The researcher used the descriptive technique are the study begins with the quantitative approach initially to collect and analyze secondary data of the sampled MFI in order to generalize results to population in this study the quantitative strategy with much higher weight is given to quantitative approach The chief advantage of this approach is that numbers are easy to work with, data are readily collected coded summarized and analyzed (Dunn 1999). Quantitative research approach has the advantage of being able to make generalizations, for a broader population, based on findings from the sample.

CHAPTE FOUR

RESULTS AND DISCUSSION

4.0 Introduction

In this chapter, the researcher used eight financial institutions in Ethiopia. The data extracted by the researcher were obtained from annual reports from each institution. As for macroeconomic factors, the data is extracted from NBE and MOFED. Further, the researcher carried out relevant assesses to identify for any presence of econometric problems using secondary data analysis. In the preceding chapters important literatures relating to the topic were reviewed that gives enough understanding about the topic and used to identify knowledge gap on the area. To meet the broad research objective the research design used for this study also discussed in the preceding chapter. This chapter discuss the results of analysis.

4.1 Documentary analysis

The main objective of this study was to identify the internal and external factors of capital structure in Ethiopia. The key data sources to this purpose are the documents held by the financial institutions report, NBE and MoFED. The subsequent discussion presents the results of the documentary analysis as follows.

Table 4.1: Summary of loans in Ethiopian microfinance by status

Loan category	Loan balance	Provision	Percentage
Pass	**211,560,070.37**	**2,115,600.70**	**86.41**
Special Mention	**12,836,133.26**	**385,083.99**	**5.24**
Substandard	**4,988,592.70**	**997,718.54**	**2.0**
Doubtful	**1,584,880.57**	**792,440.29**	**0.65**
Loss	**13,858,459.28**	**13,858,459.28**	**5.70**
Grand Total	**244,828,136.18**	**18,149,302.80**	**100.00**

Source: The microfinance Progress Reports.

Pass and Special mention are categorized as performing while the others are categorized as non-performing. Accordingly, Table 4.3.5 shows 91.65 percent of the loan size is performing while 8.35 percent is non-performing implying that the Nonperforming loan percent is below the requirement of the National Bank of Ethiopia (10 percent).Non performing loan have a great impact on capital structure of Ethiopian Microfinance institutions.

4.2.1Capital adequacy

Capital adequacy =total capital/total asset ratio

able 4.2 MFIs capitals

No	Name	Total Asset	Total Liabilities	Total Capital	ratio
	Digaf	1,765,814	806,696	959,118	0.543
	Benshangul	180,996,794	117,388,921	63,607,872	0.351
	Harar	116,844,214	91,884,345	24,959,869	0.2136
	agar	3,607,161	1,703,440	1,903,721	0.5278
	Nisir	121,526,952	106,261,389	15,265,563	0.1256

The significant impact of capital adequacy on capital structure as of finding analysis (Vodova 2011) . This is based on the argument of risk absorption. According to this argument the higher capital to total assets ratio of financial institutions the higher the capacity of the micro finance to absorb risks and create higher level of capital structure to the external public through deposits and loans. In other words, higher capital ratio of micro finance institutions create positive signal to the external public and attract more deposits. In turn these enable

microfinances to hold more liquid assets that create better potential to capital structure creation to the external public.

4.2.2 Loan growth

The results of analysis of loan growth show negative impact of loan growth on capital structure position. The negative impact of loan growth on microfinance capital structure was based on the argument of taking loans. According to this argument when the amount of loans provided by microfinance institutions increase, the amount of capital in the total assets portfolio of microfinance increase and lead to the reduction in the level of capital held by financial institutions Therefore, this finding reveal that larger amount of loans was provided from periodic deposits with affecting the amount of capital held by the microfinance institutions in Ethiopia according to the table below Number of active borrowers are the number of individuals who currently have an outstanding loan balance with the microfinance or individuals who are responsible for repaying any portion of the gross loan portfolio.

Table 4.3. **Loan growth**

No	**Name**	**No of Active Borrowers**
1	Aggar	14,248
2	Benshangul	37,583
3	Digaf	223
4	Harar	9,355
5	Nisir	720

Source; AEMFIs, 2018.

4.3.4 Capital structure

The results of the analysis showed the adjustment of microfinance capital structure position with the rise/decline in NPL/credit risk. For a 1% increase (decrease) in NPL in the total loan

portfolio of microfinance, the microfinance institutions increase (decrease) their capital structure holding in the total portfolio.

This is one of the most important criteria to assess the quality of capital structure of micro finance institutions. capital structure to Total Loan Ratio (NPTL) measures the percentage of gross loans which are doubtful in micro finances' portfolio. The lower the ratio of Non-performing loans to total loan ratio (NPTL), the better is the performance of capital structure.

Table 4.4 bellow shows the capital structure to total loan ratio of each microfinance in Ethiopia is below the requirement set by the National Bank of Ethiopia which denotes the ability of all microfinance in creating quality capital structure and arresting the level of capital structure is above the standard of the credit policy of the microfinance which is set in compliance to the regulation of the National Bank of Ethiopia.

On the other hand, the high ratio of capital structure loan to total loan ratio in some micro finance was caused by the fraud of checks occurred among the business community around and market price fluctuation.

Table 4.4.**Summary of total loan balance and capital structure by microfinance s**

Microfinance institutions	**Loan balance**	**Capital structure**	**%**
Digaf	**12,003,455.24**	**868,074.26**	**7.23**
Harar	**17,235,869.55**	**1,603,067.20**	**9.30**
Agar	**13,250,293.25**	**437,786.96**	
Gambella	**42,667,379.19**	**16,301,453.37**	**3.30**
Nisir	**21,118,743.10**	**17,586.17**	**38.2**
	18,567,158.30		
		345,5423 .45	**0.08**
			0.12

Source: Progress Report of each of microfinance institutions

4.3.5 Provisions

Loans and advances are financial instruments originated by the microfinance by providing money to the debtors. It is stated at costless impairment losses. Impairment losses comprise specific provisions against debts identified as bad and doubtful and general provisions against losses which are likely to be present in any loans and advances portfolio. The microfinance follows the national Bank of Ethiopia Supervision of Business Directives SBB/43/2008 in determining the extent of provisions for impairment losses.

The Directive classifies loans and advances into: Pass, Special Mention, Substandard, Doubtful, and Loss. The microfinance also classifies the loan categories in consistence to the National Banks criteria and manages as follow:

4.3.6 Profitability

Like loan growth real POF rate had significant impact on capital structure of microfinance measured by return on investment (ROE) in Ethiopia. The bank's profit ratios show increment time to time, microfinance institutions in Ethiopia prefer to hold more and more capital. This result indicates the micro finance institutions capital structure holding behavior in different stages of economic cycle hence, micro finance necessarily must balance both for better resilience to avoid capital shocks.

4.3.7 Real GDP growth rate

Like loan growth real GDP growth rate had impact on capital structure of micro finance measured by economic level. Even if the country has been recording double digit growth microfinance in Ethiopia prefer to hold more and more liquid assets. The insignificance impact of real GDP growth rate could be due to the high level of inflation rate and credit crunch problem.

4.3.10 Policy Factors

The results states that regions with higher levels of income have less developed microfinance sectors. Micro-entrepreneurs with higher capital have more opportunities to

self-finance through savings. They may benefit more easily from informal finance through family and friends, as well as from formal finance argue that one of the reasons why microfinance in Ethiopia has not developed is due to the higher wages people earn. Traditionally, microfinance also focuses on the poor excluded clients, so microfinance should be reaching more clients in regions that are poor. The other factor is economic instability of the country. Microfinance is more developed in countries that have relatively in stable economies. The international donor community has historically played an important role in subsidizing the emergence and further development of microfinance programs. The results of analysis stated that, as most institutions started as non-governmental organizations, external financial intervention was needed.

4.3. 11 Geographic Variables

Analysis results stated that transaction and information costs influence capital development. In some cases, they lead to market failures. Good interconnectivity between regions, the availability of electricity, communications and sanitation networks lower these costs. A high population density also helps. According to analysis results two contradictory arguments could be made. The first is that formal financial institutions may be more developed in regions with higher population density and good regional interconnectivity. Thus the need for specific MFIs may not be present. The second is that, if the development of the two sectors is complementary, these factors could eventually also stimulate the development of the microfinance sector and also support the hypothesis that microfinance tends to develop much faster in densely populated areas.

4.3.12 Institutional Variables

Institutions play an important role in the development process of a country. One institution that is often mentioned in the microfinance literature is the educational system. The role of human capital in financial sector development is widely finds that regions with higher levels of education have more developed financial systems. The results also find positive effects of social capital in financial sectors.

Chapter Five

Summary Conclusion and Recommendations

5.1 summary

Most microfinance programs are small and vulnerable to resource constraints. One of corporate finance areas highly debated is the capital structure Most operate in a few locations and serve specific clusters of clients, so they are exposed to the systematic risks of undiversified loan portfolios and mobilize few savings and not financially self-sufficient. According to the finding MFIs have an increasingly broad range of financing sources at their disposal. This allows for greater funding diversification, but it also makes decisions about capital structure more complex. These organizations have since transformed in to microfinance institutions that are seen today which are largely characterized by a donor funded equity base-exceptions

5.2 Conclusion

Micro finance institutions should remain to raise capital at all times to prevent falling into capital structure crisis and cause distress in the overall economy. Capital structure need is actually a constraint for micro finance institutions from investing all its cash as profit comes from either financial institutions lending activities or by investing it. National bank bill had impact on Ethiopian micro finance institutions capital structure it may indicate the presence of forced investment on bonds (NBE Bills) which of each total loans disbursed. Thus, this study attempts to identify capital structure of micro finance institutions in Ethiopia. This research also provides summary of previous studies on similar topics. The positive influence of the share of capital on total assets is consistent with the assumption that micro finance with sufficient capital adequacy should be efficient, too. based on which a microfinance needs to sacrifice growth of capital to achieve a higher profitability which in turn increases the structure risk and capital structure ratio.. Besides, factors such as total deposits, policy, institutional factors, geographic factors, branch network, efficient management of the liquid assets, availability of the adequate foreign currency on hand and bank's appetite to investments by themselves are also considered as possible internal factors that can affect Ethiopian microfinance capital structure. Furthermore, external variables such as change of interest rate by NBE, competition in the market, government regulation, absence of active

secondary stock market, limited number of micro finance issue holding branches and lack of public awareness in relation to savings also contributes their own impacts for the presence of high or low level of capital structure in the Ethiopian micro finance institutions.

5.2 Recommendations

External factors have influence on capital structure of Ethiopian microfinance institutions so all financial institutions in Ethiopia that they cannot ignore the macroeconomic indicators when strategizing to improve on their position of capital structure. Thus, micro finances in Ethiopia should not only be concerned about internal structures and policies/procedures, but they must consider both the internal environment and the macroeconomic environment together in developing their strategies to efficiently manage their capital structure position.

- Since the maturity date of the short term loans at maximum is one year, there would have high probability of purchasing of bonds for a number of times as same amount of facilities provided to different customers which in turn adversely affects capital structure position of the Ethiopian micro finance.
- As a result, the interdependence of most of the factors leads the institutions into success or failure. If they are positively interrelated, the factors may lead the institutions into success and if they are negatively interrelated they will affect the institution's success adversely.
- Due to limited studies done in Ethiopia, more researchers are encouraged to conduct research on capital structure issues faced by micro finance in Ethiopia. This would actually benefit the policy makers to setup a better new policy.
- Therefore, further investigation which includes the above factors might have a better role in identifying other factors contributing to capital structure of Ethiopian micro finance institutions.

- In order to solve problems related to clients like diverting the loan to nonbusiness activities, amount of money invested in income generating activities, factors related to loan repayment, absence of voluntary saving experience, business condition of the clients, it is better to have continuous monitoring system for clients to support the

borrowers by working with different concerned bodies. For instance, micro and small enterprise office facilitate different trainings for micro businesses and arrange market for them. So through working with different concerning bodies, the institutions can solve many problems with minimum cost.

- The researchers suggest application of cost effective and modern technologies which support the institutions to reduce different costs. Different software and databases to handle financial data and to cosmmunicate with branches and to register all transactions in a well- organized way, MFIs should use technologies.

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