

*Kashf Foundation Focus Notes Series*

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## Determining Net Profitability Ratios of Micro-Businesses: Findings from Kashf's Clients

*This focus note showcases research undertaken to assess the net incomes of 5 most frequently occurring micro-businesses being run by Kashf clients, i.e. beauty parlors, stitching units, grocery stores, cloth trade and rickshaw, to understand the resilience of these businesses to inflationary pressures.*

### MICRO-BUSINESSES & LOW- INCOME HOUSEHOLDS

A low income household's involvement in entrepreneurship is usually driven by necessity. Research suggests that there are two main reasons for low income households to engage in micro entrepreneurship; to increase income and consumption and to boost savings to cope with economic vulnerability (Swain, 2014). For many poor households, diversified income is the key to survival (Sharafat Ali, 2014) and imperative for meeting their needs (Maseya, 2015).

In order to gain a better understanding of the financial health of micro enterprises run by Kashf clients and their capacity to cover basic expenses, Kashf undertook a research study to assess the net profitability of five most frequently occurring businesses in the Kashf Karobar Karza database. These businesses included beauty salons, grocery stores, stitching units, cloth trade and rickshaw driving. Five entrepreneurs from each business were interviewed. These businesses were selected from the urban areas of Lahore.

### NET INCOME OF MICRO ENTERPRISES

In terms of the methodology for the study, a questionnaire focusing on cash-flows and qualitative questions was developed for each business. An important methodological note which needs to be made at the outset is that none of micro-entrepreneurs kept formal records of incomes and expenses which meant that a lot of the numbers that clients shared on both the revenues and expenses provide best estimates. Moreover, since most of the businesses were home based, a number of expenses were shared between personal use and business use – this included not having a separate electric supply/ meter for the business. The researchers thus ascribed a portion of

the electricity bill to the business while a portion of it was associated with home use.

Kashf's analysis of the selected businesses demonstrated that service providers had higher net income than traders. The following table shows the average net income across the 5 business types under review. The highest net income recorded in the cohort was for beauty salons followed by stitching units, and rickshaw drivers.

Business	Net Monthly Income
Beauty Salon	PKR 25,680
Stitching Unit	PKR 24,488
Rickshaw	PKR 24,074
Grocery Store	PKR 17,879
Cloth Trader	PKR 6,311

### Net Profitability of Beauty Salons

A typical Beauty Salon being run by Kashf's women micro-entrepreneurs has the following characteristics:

- Operated from a separate room in the client's house
- Basic Furnishing
- Family members are trained to help provide services
- Operates daily and do not have any days off
- No separation of electricity usage from household usage
- Wedding season (October to March) has high demand for salon services

The average net monthly income for the beauty salons was PKR 25,680 in the salons studied. On average the net annual profit margin of beauty salons was 56% with an Average Net Annual Income of PKR 308,160. Within the different beauty salons studied, the net monthly income ranged from PKR 11,638 to PKR 46,709. And annual net profitability varied

considerably with the highest being 76% and the lowest being 45%. On deeper scrutiny, Kashf was able to shortlist some key factors which were present in the better performing beauty salons, these included:

- Scale of Operations – Salons which were cleaner, had more space, and were maintained properly had more customers and higher profitabilities.
- Number of Services Offered – Salons with multiple service lines were able to generate more revenue. Moreover, makeup services generally, and bridal makeup specifically, had the highest profitability in terms of service lines. The most profitable beauty salons were the ones that were offering make-up services.
- Skill-level and Proficiency – Salons with higher skilled apprentices (that had been working with them for longer number of years) had more return customers. Moreover, the highest grossing salon's owner had undertaken a beautician training at a vocational skill center.
- Self-reported Factors – when salon owners were enquired about their ability to attract more customers they cited having good customer dealing and knowing more people in the community as key factors.

There was also a considerable difference in earnings between good months and regular months. When salon owners were enquired about the definition of good months, they cited the wedding season as months of high business turnover. All respondents also cited that wedding season lasted 6 months in the year. In a regular month the estimated net income of the parlors was PKR 13,630 however, in a good month, these parlors were able to increase their income to PKR 37,730. This demonstrates the ability of the beauty salon business to drive up revenues through provision of diversified services during peak seasons. The beauty salons were able to almost triple revenues from the same fixed set-up in highly productive months. While the consumables used in the parlor were increasing in times of high demand, these were purchased on a bi-annual or quarterly basis so these were annualized and divided to get to a monthly expense on consumables. When enquired about whether their costs went up in the busy months, the entrepreneurs reported that the costs had remained constant.

Our research thus shows that beauty salons had considerable resilience to endogenous household shocks and exogenous shocks. Beauty salons also had

the ability to offer service lines with higher cost (such as makeup services) and enhancing their operating hours to enhance incomes.

### *Net Profitability of Stitching Units*

A typical stitching unit being run by a Kashf women micro-entrepreneur has the following characteristics:

- Home-based
- 1-2 sewing machines
- If there are more than 2 stitching machines, the entrepreneur has other women working for her
- Customers are usually from nearby vicinity
- There is seasonality in demand for services – there are around 4 months of high demand

The average net monthly income for the stitching centers studied, was PKR 24,488. On average the net annual profit margin of stitching units is 51% with an Average Net Annual Income of PKR 293,863.

Within the different stitching centers studied, the net monthly income ranged from PKR 4,713 to PKR 46,340. And annual net profitability varied considerably from 44% to 66%. Some key factors which can be attributed to for these variances include the following:

- Scale – the size of the business and the number of machines determined the number of units that could be stitched hence setups with more than 2 machines and apprentices earned more revenue. Apprentices were being paid very meager amounts since this was considered on the job training for them so the marginal cost of adding an apprentice was very low.
- Number of Services – stitching units that produced clothes for women and children had higher profitability compared to set-ups only catering to women.
- Self-Reported Factors – Entrepreneurs relied on word of mouth of for business and the entrepreneurs that knew more people in the community were able to get more referrals.

Overall stitching units had a low cost of doing business – besides the asset (sewing machine) there were low costs of input materials (such as thread and needles), utility bills (shared with the household), financial charges for servicing the loan and some businesses had transportation costs. Transport costs were only applicable for businesses that were providing delivery to the market and/or buying whole

sale consumables from the market but even these were low as markets were not far. The relatively low cost of business creates opportunities for high returns vis-à-vis cost of business inputs in cases where the entrepreneur has the requisite skill and consistency in her work. Due to high profit margin the entrepreneur is also somewhat protected from inflationary pressures. Moreover, entrepreneurs with higher skill levels also have the opportunity to increase price of services.

### *Net Profitability of a Rickshaw Driver*

Typically, the rickshaw businesses studied, displayed the following characteristics:

- The primary user of the loans was male
- Most businesses had some set arrangement for pick and drop with certain individuals – school students or office going women which some of them supplemented with other rides
- The loans were used in conjunction with personal savings to buy the rickshaw being used for the business.

The average net monthly income for the rickshaw business was PKR 24,074 in the businesses studied. On average the net annual profit margin of rickshaws was 61% with an Average Net Annual Income of PKR 288,293.

Within the different rickshaws studied, the net monthly income ranged from PKR 18,005 to PKR 32,005. And annual net profitability had a smaller spread compared to other micro-businesses studied with the highest being 67% and the lowest being 54%. Some key factors which can be attributed to these variances include the following:

- Diversified Business – Rickshaw drivers who supplemented their stream of income from a fixed pick and drop arrangement with money earned from additional rides, earned more money.
- Upkeep and Maintenance of Rickshaw – the outlook of the rickshaw and its maintenance was important in attracting rides. Those that spent more on upkeep were making more revenue.
- Number of Working Hours – rickshaw drivers who had greater number of working hours earned more money. The cost of providing each additional ride was off-set by the income earned for each additional ride.

With respect to the cost and sales for the interviewed rickshaw drivers, the lowest cost of doing business was PKR 11,195 per month while the highest was PKR 16,285 per month. The cost included the price of fuel, per month depreciation charges, financial charges, and cost incurred on repair and maintenance in a month.

With respect to resilience to inflationary pressures, the rickshaw drivers seemed to be coping well as a result of diversified services (fixed monthly rides and additional rides on daily basis) and longer working hours. Maintenance and outlook of rickshaw was also a strategy to attract more customers. It was also seen that rickshaw drivers were in a unique position to be able to pass some inflationary pressure to the customers. Since there is no fixed amount for per kilometer charged, the income earned per ride mostly depended on the bargaining power of the rickshaw driver and the customer.

### *Net Profitability of a Cloth Trader*

Based on Kashf's research of the cloth-traders studied, a typical business in this sector has the following characteristics:

- Operating from home
- No employees or apprentices
- Customers are primarily women
- Business is usually seasonal and is undertaken when the weather changes and/or during the wedding season

Cloth-trade is a high turnover business with a short payback period, with average net monthly income of the businesses studied being PKR6,311. The average annual net profit ratio was 15% while the average Annual Net Income is PKR 75,738. The net monthly income of businesses studied varied from PKR 6,037 to PKR 11,441. In the businesses studied, one cloth trader was operating at a loss. All these traders were buying ladies suits from the market and were selling them in their locality at a profit margin ranging from PKR 150-350. The average annual net profit for the businesses studied varied from -9% to 8%.

The profit margin depended upon factors such as:

- Customer Segmentation – cloth traders who were able to sell to more affluent customers were able to sell more premium cloth which had higher margins and they were also able to sell greater number of suits which increased their revenues.

- Purchase Price – Cloth vendors that could source cloth from further off places were able to sell at higher rates due to novelty of the clothes being sold compared to those who purchased them from close by whole-sale markets.
- Time and Attention – Entrepreneurs that were spending more time on the business and giving it more attention were naturally doing better than others.

For most entrepreneurs cloth trade was a means of generating some extra income. All of the cloth traders had other income sources along with the cloth trade business. As a standalone business, cloth trade has very low-returns and most of the clients that had taken loans for cloth trade as a supplementary/side business to provide extra-cash flows for the household to fight inflationary pressures and/or generate money for a planned expense such as an upcoming wedding or purchase of a household asset. On its own the business has very little resilience to any kind of endogenous or exogenous shocks.

### ***Net Profitability of Grocery Stores***

A typical grocery store being run by Kashf women micro-entrepreneurs has the following characteristics:

- Usually an extension of the entrepreneur's living quarters
- Family run
- Open seven days a week
- Sells a variety of items which are sold at a mark-up from the market
- Shared electricity connection with the house

The average monthly net income for grocery stores was PKR 17, 879. The average annual net profit margin was 11% and the Average Annual Net Income was Rs. 214,548. This is significantly lower than the other micro-businesses studied in this research.

In the stores studied, the average monthly income varied from PKR 25,550 to PKR 59,145, and the overall cost of doing business varied from PKR 97,420 per month to PKR 190,550. The major difference in sales was dependent on two main factors:

- Variety and Quality of Items – generally local grocery stores have a large degree of replaceability i.e. proximity of the shop to the customer is the most important factor while purchasing items. However, if a certain grocery store carries

a specific variety or has higher quality products then customers will frequent that shop even if it is not the closest to their home.

- Ability to cater to children – this was self-reported by the entrepreneurs who stated that the highest traffic at their shops was brought by children. At first thought, it seems counter-intuitive as children have minimal purchasing power but makes sense when considered from a) the perspective that low value goods such as candies, chips, biscuits, have a high volume and can contribute to revenues and b) the fact that children are mostly accompanied by adults who may buy other products while their children buy low value high turnover products.

Given frequent purchase of inventory, the limitation of no formal book-keeping was most problematic while analyzing the cash-flows of grocery stores. Entrepreneurs were however, very clear about how much they were earning in revenues per day which was around PKR 5,500.

In terms of resilience to inflationary pressures, the grocery stores have very low resilience because of the low profit margins in the products being sold. Since the stores did not buy directly from the manufacturers they had to keep low prices. Even slight increase in the price of products would lead to buyers shifting to other shops or to wholesalers. Moreover, staple food and dairy items made a major portion of the grocery store business. Therefore, lower disposable incomes of consumers resulting from inflationary pressure combined with an increase in product prices would lead to lower consumption of these items (as evidenced through coping mechanisms used by low-income household to deal with rising food inflation) and reduce business for the grocery store owners.

### **CONCLUSION**

With respect to business level resilience to inflationary pressures, the micro-business profitability analysis has shown that some businesses have high non-elasticity in their demand such as rickshaw businesses and inflationary pressures have little or no impact on their revenues and/or profitability. Moreover, profitability of other businesses can be enhanced through adding diversity of services being offered such as beauty salons where high paying product lines such as bridal make-up can be introduced to drive up profitability in beauty salons.

Some businesses with low input costs such as stitching units are relatively insulated from rising inflation due to high profit margins. However, these businesses have elasticity in their demand, which means that they are bound to be impacted with respect to demand for the services they offer if inflation continues to rise at the present levels.

There are other businesses that are more vulnerable to inflationary pressures and will either not be able to stand alone businesses such as cloth trade or will require additional income streams such as grocery stores where additional service lines such as Public Call Offices or Retail Bank/Telco Agencies will need to be added.

The profitability research showed significant variations in net profitability among businesses similar in size and nature, and it was seen that entrepreneurs who were more organized were able to generate more income from their business. Moreover, factors such as customer dealing, reputation of the entrepreneur, scale of operation, and diversity of

services also affected the profit margin. This suggests the need for training of entrepreneurs in efficient business practices, so that they are able to minimize losses and generate maximum income out of the available resources. There is also a need to train the entrepreneurs in keeping separate business record in order to assess the health of the business since it was observed that in some cases household income from other sources was supporting the business activity that the entrepreneur perceived was operating in profit.

Another important factor that will have to be considered and watched out for is parallel loans, i.e. loans from other microfinance providers, will impact household level profitability. In another research undertaken by Kashf when clients were asked if they had loans from other microfinance providers 29% reported having loans from other MFPs. When asked if the additional loans had made them feel over-indebted 78% responded in the negative however, this could increase if inflation continues to rise, and is something that needs to be closely watched in coming months.

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