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Enterprise Viability & Sustainability Diagnostic Toolkit

Assess Sustainability | Financial Independence Assessment

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Enterprise Viability & Sustainability Diagnostic Toolkit Modules

1. **Preliminary research**
2. **Understand current performance**
3. **Identify factors to improve viability**
4. **Assess sustainability**

Analytical activities

Enterprise Mapping

Select diverse enterprises based on their market context and sales performance for in-depth research

Exploratory Research

Understand enterprises' contexts and operations to customize tools and research questionnaires

Profit & Loss Statement Preparation

Prepare profit & loss (P&L) statements with revenues, costs, and resulting profits to support analyses

Profit & Loss Statement Analysis

Analyze P&L statements using financial ratios to enable inter-enterprise comparisons

Enterprise Classification

Categorize enterprise based on revenue and profit

Gross Margin Variance analysis

Identify the profit drivers that differentiate performance among enterprise categories

Strategy Identification

Identify the strategies that improve profit of enterprises in different contexts

Financial Independence Assessment

Assess enterprises' ability to meet recurring future financial investments independently

Operational Independence Assessment

Assess enterprises' ability to operate independently in future market conditions

Return on Capital Employed Analysis

Compute returns from sanitation relative to other opportunities available to the entrepreneur

Focus of this document

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- Introduction
- Ability to pay for recurring non-market support
- Ability to pay for recurring future capital expenditure
- Ability to pay for future working capital needs

Objective of this document

Intended outcomes

This document is intended to help MBS programs:

- Understand the different aspects of financial independence
- Compute suggested indicators for financial independence
- Interpret results, and assess enterprises ability to finance recurring business needs independently

Value for MBS programs

Provides an assessment of the **likelihood of enterprises continuing to finance recurring business needs** independently, by providing a set of tools that can be used to **predict future financial health.**

Indicators of financial independence

Financial independence of enterprises is based on their ability to meet three types of financial needs, which can be assessed using appropriate indicators.

The indicators have been chosen due to their relevance for the sanitation sector, and the ease with which MBS programs can gather data for them and compute their values.

Aspect of financial independence	Indicators
1 Ability to **pay for recurring non-market support** (if any)	• Cash net profit after computing a fully-costed Profit & Loss statement (i.e., after accounting for costs of all subsidized support provided by MBS programs or other non-market actors)
2 Ability to meet **recurring future capital expenditure needs**	• Share of profit required to be set aside for recurring capital expenditures
3 Ability to meet **future working capital needs**	• "Inventory days" (i.e., the average days taken to sell inventory) compared to sales volumes

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Ability to **pay for recurring non-market support** (1/3)

Sanitation enterprises often receive support from MBS programs or other non-market actors for recurring expenses (e.g., partial or full payment to sales agents, subsidized raw materials). Enterprise sustainability depends on their ability to generate sufficient profits after fully accounting for these expenses in their Profit & Loss (P&L) statements.

Assessing ability to pay for recurring non-market or subsidized support

Identify non-market support

Identify all recurring non-market support provided to enterprises

Data can be obtained through entrepreneur interviews or through internal knowledge of MBS programs

Account for non-market support

Account for the costs of all non-market support in the P&L statement of enterprises

The P&L statement can be built using the methodology explained in Module 2

Compare profits

Compare enterprise profits before and after accounting for non-market support

Tip

Sanitation enterprises also receive one-time support from non-market actors (such as trainings on building toilets, demand generation campaigns in their target markets). These items are not considered for assessing financial independence, as enterprises do not need to pay for them in the future to continue operations.

Ability to **pay for recurring non-market support** (2/3)

Example – Subsidized P&L statement (left) vs fully-costed P&L statement (right)

P&L statement summary	
Revenue	
Revenue from toilet sales	4,400.0
Revenue from related services	0.0
Cost of goods sold	
Raw materials	2,181.7
Direct labor	650.0
Transport of raw materials	90.0
Damaged components	102.3
Gross profit	1,478.3
Gross margin	*34%*
Operating expenses	
Transport for delivery	310.0
Land rent	192.0
Utilities	40.0
Marketing (commissions)	0.0
Marketing (non-commission)	0.0
Repairs	36.0
Bad debts	16.0
Depreciation	12.8
Operating profit	871.5
Operating margin	*20%*
Other expenses	
Interest	85.4
Net profit	786.1
Net margin	*18%*
Cash net profit	798.9
Cash net margin	*18%*

P&L statement summary	
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Raw materials	2,181.7
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Transport of raw materials	90.0
Damaged components	102.3
Gross profit	1,478.3
Gross margin	*34%*
Operating expenses	
Transport for delivery	310.0
Land rent	192.0
Utilities	40.0
Marketing (commissions)	80.0
Marketing (non-commission)	0.0
Repairs	36.0
Bad debts	16.0
Depreciation	12.8
Operating profit	791.5
Operating margin	*18%*
Other expenses	
Interest	85.4
Net profit	706.1
Net margin	*16%*
Cash net profit	718.9
Cash net margin	*16%*

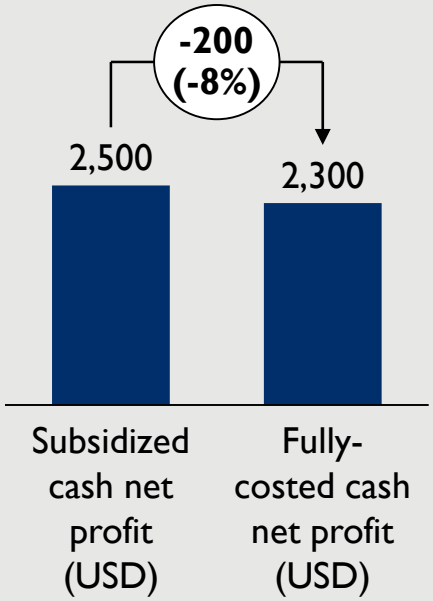
Marketing commissions (paid by MBS program) accounted for in the fully-costed P&L statement

The cash net profit in the fully-costed P&L statement reduces

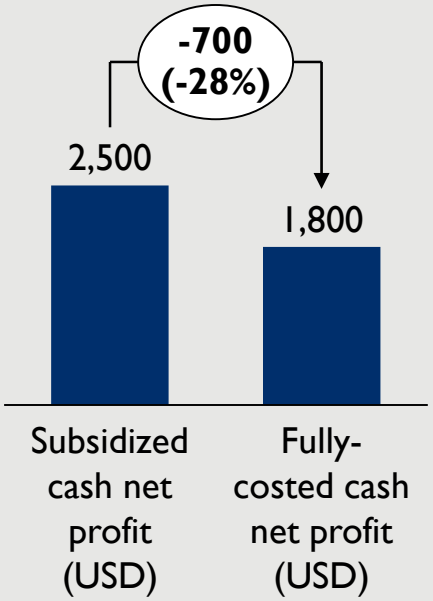
Ability to **pay for recurring non-market support** (3/3)

Enterprises that will experience a significant drop in their cash net profit (either in absolute or percentage terms) after accounting for recurring non-market support are less likely to remain sustainable.

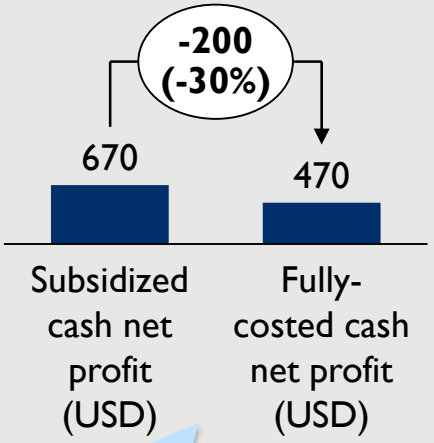
Sample enterprise 1



Sample enterprise 2



Sample enterprise 3



*Enterprise 2 is less likely to be sustainable, compared to Enterprise 1, as it experiences **a significant absolute drop** in cash net profit., despite both enterprises having similar current cash net profits.*

*Enterprise 3 is less likely to be sustainable, compared to Enterprise 1, as it experiences **a significant percentage drop** in its cash net profit., even though the absolute drop in profits is similar.*

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- Ability to meet future working capital needs

2

Ability to **meet recurring future capital expenditure needs** (1/2)

Sanitation enterprises need to pay for recurring capital expenditures (such as molds or other equipment use to manufacture toilets) at regular intervals. Their sustainability depends on the amount of profit that enterprises will need to set aside for these capital expenditures.

Assessing ability to pay for future capital expenditure

Tip

- One-time capital expenditures (such as buying land) are not considered for assessing financial independence as enterprises do not need incur them on a regular basis in the future
- Refer to the *Data Requirements* document of this module for potential sources for the above mentioned data

2

Ability to **meet recurring future capital expenditure needs** (2/2)

Enterprises that need to set aside a significant share of their annual profits are less likely to be sustainable, as this will reduce the share of profit that can be set aside for other investments or for the entrepreneur's income.

	Sample enterprise 1	Sample enterprise 2
Recurring capital expenditure	Molds, Shovels	Molds, Shovels
Cost of recurring capital expenditure	USD 200, USD 50	USD 200, USD 50
Cash net profit (annual)	USD 500	USD 200
Shelf life of capital expenditure	3 years	3 years
Share of profit to be set aside for capital expenditure	$\frac{\text{Cost of capital expenditure}}{\text{(Annual cash net profit x shelf life)}} = 17\%$	$\frac{\text{Cost of capital expenditure}}{\text{(Annual cash net profit x shelf life)}} = 42\%$

Enterprise 2 is less likely to be sustainable as it will need to set aside a significantly greater share of its annual cash net profits for investing in recurring capital expenditures.

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3

Ability to **meet future working capital needs** (1/2)

Sanitation enterprises typically invest in working capital to maintain an inventory of raw materials and products to ensure they can fulfil customer orders quickly. Inventory is defined as the value of the finished products or raw materials held by a business before they are converted to sales.

Their sustainability depends on their ability to meet these working capital needs in the future. This can be assessed by analyzing the average duration it takes enterprises to convert their inventory to sales (known as "inventory days") .

Assessing ability to meet future working capital needs

Gather data on inventory → **Calculate inventory days** → **Compare inventory days to sales volumes**

Can be obtained through entrepreneur interviews

Calculated as

$$\frac{\text{Average inventory}}{\text{Cost of Goods Sold}} \times 365$$

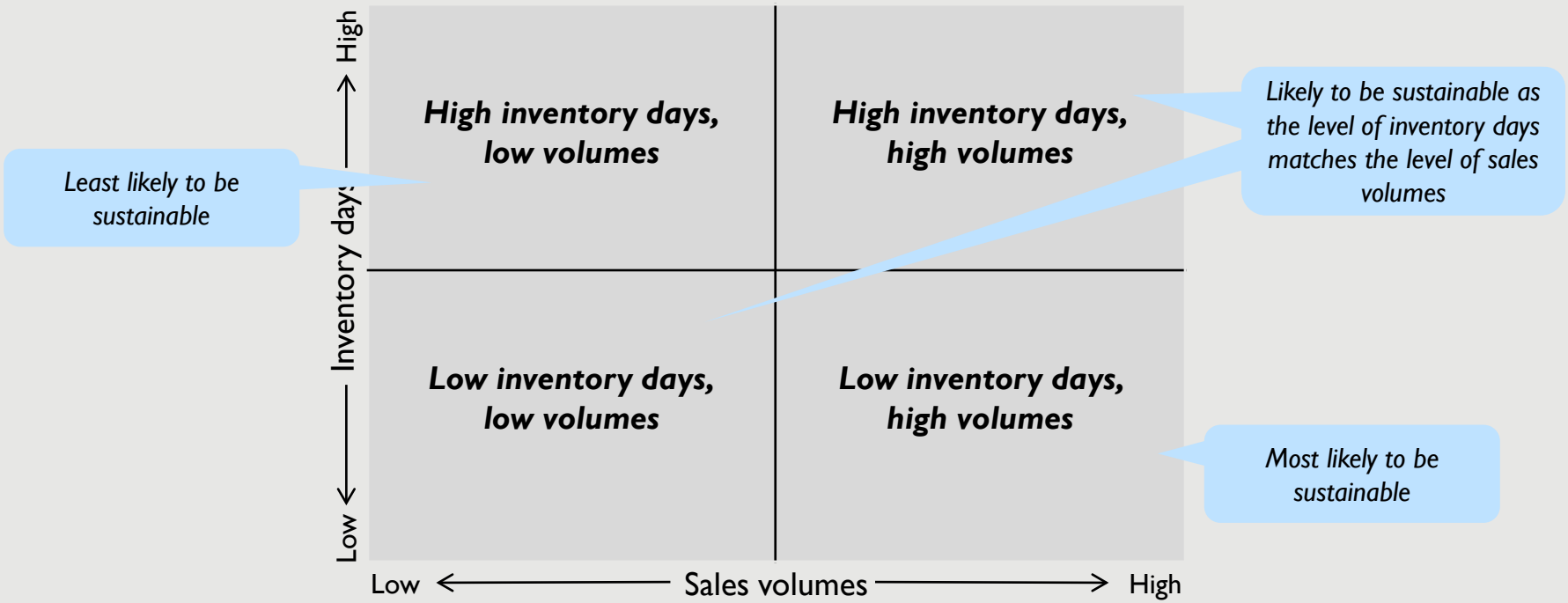
Tip

- Average inventory is the average of the value of inventory held at the beginning and end of a financial period. It can also be estimated by gathering data on the typical inventory held by an enterprise.
- The value of inventory is the sum of
  - Product of the Cost of Goods Sold (COGS) and the quantity of finished products held, and
  - Product of the procurement price and quantity of raw materials held (i.e., unfinished goods)
- Refer to the *Profit & Loss Statement Preparation* document of Module 2 for details on COGS.

3

Ability to **meet future working capital needs** (2/2)

Enterprises that have high inventory days, while having low sales volumes, are least likely to be sustainable. Their ability to pay for working capital will diminish over time due to their funds getting held up in maintaining inventory, which is inadequately compensated by their sales volumes.



Tip The two dimensions (inventory days and sales volumes) can be ranked as "high" or "'low" using their median values as the segmentation point (similar to the methodology explained in the *Enterprise Classification* document which is part of Module 2.