

THE ROLE OF VENTURE CAPITAL ON THE GROWTH OF STARTUP ENTERPRISES
IN NAIROBI.

BY

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DECLARATION

I hereby declare that this dissertation is my original work and has not been submitted or published elsewhere for any award. I also declare that it contains no materials written or published by other people except where due reference is made and author duly acknowledged.

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ABSTRACT

Venture Capital is a source of non-bank financing which is quite prevalent in developed financial markets that privately fund startup firms, offer management experience and technical support to startups (Sahlman, 1991). Furthermore, private equity firms are increasingly showing interest to invest in East Africa and preferably to put their money in Kenya owing to a vibrant private sector and ease of doing business deals (Deloitte, 2016). Most of entrepreneurial funding in Kenya is finding its way onto startups markets, which are the main engines of growth for the region with a total of 254 private equity deals have been reported in the region since 2010, with a cumulative value of \$21.1billion. There's a buoyant growth in start-ups in Kenya and hence there is need to identify the contribution of business angels to the success of these start up enterprises. Despite their significance and the increased efforts by governments and other stakeholders to ensure the success of startups, past statistics indicate that 40% of the startups fail by the second year with at least 60% closing their doors by the fourth year.

The target population of this study consisted of 254 SMEs that have used venture capital. The research employed a descriptive study and sampled 72 SMEs for the study. Data was collected through semi structured questionnaire. The completed questionnaires were reviewed and edited for accuracy, consistency and completeness. The data was analyzed using descriptive statistics, such as mean scores, percentages and standard deviations. The results were presented in frequency tables, charts and graphs. Regression and correlation analysis was applied to show the relationship between variables.

The study established that venture capital financing, management support, technical expertise and monitoring played a great role in growth of startups. From the findings, it is recommended that venture capital investors can do more to encourage startup investments. Venture capitalists have a role to play in stimulating direct venture capital investment via co-investments with corporations. The government and Policy makers should provide credit and equity financing to eligible Venture Capital Finance Companies to support startups and provide money to support other activities and programs for the promotion of Venture Capital Financing. This would be an important method for initially stimulating interest in an activity that many corporate executives are possibly not currently considering.

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DEDICATION

This research project is dedicated to my loving wife Josephine Maru and my wonderful daughter Joy Kemboi for being the source of my encouragement and support throughout the period of writing it.

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ABBREVIATIONS AND ACRONYMS

CMA	Capital Markets Authority
GDP	Gross Domestic Product
SMEs	Small and medium enterprises
VC	Venture Capital
NVCA	National Venture Capital Association

OPERATION DEFINITION OF TERMS

Growth: The process of improving some measure of an enterprise's success. Business growth can be achieved either by boosting the top line or revenue of the business with greater product sales or service income, or by increasing the bottom line or profitability of the operation by minimizing costs (Reynolds, 2005).

SME: Small and medium enterprises or small and medium-sized enterprises (SMEs, small and medium-sized businesses, SMBs, and variations of these terms) are fledgling businesses that is starting their operations whose initial capital is raised by an individual or by the founders of that start up (Bronwyn, 1995).

Startup: This is an entrepreneurial venture which is typically a newly emerged, fast-growing business aimed at developing a viable business model around innovative product, service, process or a platform. They are start small enterprises whose initial capital is raised by an individual or by the founders of that start up (Hellmann & Puri, 1999).

Venture capital: Money provided by investors to startup firms and small businesses with perceived long-term growth potential. This is a very important source of funding for startups that do not have access to capital markets. It typically entails high risk for the investor, but it has the potential for above-average returns (Lerner, 2002).

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

The European Venture Capital Association defines venture capital a subset of private equity investments made for the launch, early development or expansion of a business (NVCA, 2007). It is capital typically provided by outside investors to finance new and young ventures seeking to grow rapidly. Bronwyn (1995) defines venture capital as a process by which investors fund early stage, more risk-oriented ventures and thus such investments are usually associated with high risk but have the potential for above average returns. Lerner (2002) defines venture capital as equity or equity-linked investments in young privately held companies, where the investor is a financial intermediary who is typically active as a director, advisor, or even a manager of the firm.

The term Venture Capital (VC) is the generic term for business angels or any similar investments made in early stages of business. A VC fund is generally managed by a VC company. The VC firm invests the funds in startup enterprises to support them in four basic stages of development; Seed or start up, early growth, business expansion and later stage activities (Heilman, 1998). The entrepreneurial financing has proved to be a reliable delivery vehicle for financial services to SMEs. Sahlman (1991) defines Venture Capital is a source of non-bank financing which is quite prevalent in developed financial markets that privately fund startup firms, offer management experience and technical support to startups. They provide medium or long-term equity investment that is not publicly traded on an exchange and includes venture capital, buyout transactions as well as investments in hedge funds, funds of funds, private investment in public equity, distressed debt funds and other securities. According to Kaplan & Schoar (2005), VC also includes fund managers who provide private equity of operating companies by raising pools of capital that fund the equity contributions

for these transactions and receive a periodic management fee as well as a share in the profits earned from each private equity fund managed.

Venture capital is a post-war phenomenon in the business world mainly developed as a sideline activity of the rich in USA. The concept, thus, originated in USA in 1950s when the capital magnets like Rockefeller Group financed the new technology companies (Bygrave & Timmons, 1992). The concept became popular during 1960's and 1970's when several private enterprises started financing highly risky and highly rewarding projects. To denote the risk and adventure and some element of investment, the generic term "Venture Capital" was developed. According to Megginson (2001), the American Research and Development was formed as the first venture organization which financed over 100 companies and made profit over times its investment. Since then venture capital has grown' vastly in USA, UK, Europe and Japan and has been an important contribution in the economic development of these countries. Of late, a new class of professional investors called venture capitalists has emerged whose specialty is to combine risk capital with entrepreneurs' management and to use advanced technology to launch new products and companies in the market place (Lerner, 2002).

Venture capital in the UK originated in the late 18th century, when entrepreneurs found wealthy individuals to back their projects on an ad hoc basis (Byers, 1997). This informal method of financing became an industry in the late 1970s and early 1980s when a number of venture capital firms were founded. There are now over 100 active venture capital firms in the UK, which provide several billion pounds each year to unquoted companies mostly located in the UK (OECD, 2003). For decades, venture capitalists have nurtured the growth of America's high technology and entrepreneurial communities resulting in significant job creation, economic growth and international competitiveness (AMCHAM, 2006). Companies such as Digital Equipment Corporation, Apple, Federal Express, Compaq, Sun

Microsystems, Intel, Microsoft and Genentech are famous examples of companies that received venture capital early in their development (National venture capital Association, 2007).

According to Heilman & Puri (1999), Venture capital firms provide privately held entrepreneurial firms with equity, debt, or hybrid forms of financing, often in conjunction with managerial expertise unlike commercial banking or insurance. This is the capital investment by professional investors of long-term, unquoted, risk equity finance in new firms where the primary reward is an eventual capital gain, supplemented by dividend yield (Heilman & Puri, 1999). The venture capital industry is a particularly prides itself on 'nursing' companies, rather than just financing them. Venture capitalists add value to their companies by providing a variety of services: they help shape strategies, provide technical and commercial advice and attract key personnel (Sapienza, 1992).

Venture Capital is money provided by investors to startup firms and small businesses with perceived long-term growth potential. This is a very important source of funding for startups that do not have access to capital markets (NVCA, 2007). It typically entails high risk for the investor, but it has the potential for above-average returns. Venture capital firms also provide managerial and technical expertise. Most venture capital comes from a group of wealthy investors, investment banks and other financial institutions that pool such investments or partnerships (UNIDO, 2001). This form of raising capital is popular among new companies or ventures with limited operating history, which cannot raise funds by issuing debt. The downside for entrepreneurs is that venture capitalists usually get a say in company decisions, in addition to a portion of the equity (Heilman, 1998).

According to Muriithi (2012), venture capitalists take different approaches in investing in local companies and specifically interested in initial stage companies and these are referred to as angel investors. An angel investor is an affluent individual who provides

capital for a business start-up in early development or expansion stage, usually in exchange for debt or ownership equity (Amissah, 2009). A small but increasing number of angel investors organize themselves into fund management groups or angel networks to share research and pool their investment capital, as well as to provide advice to their portfolio companies (Peneder, 2010).

There are various financing structures that angel investors use when investing in startups in Kenya. According to Gatauwa & Mwithiga (2012), startup business venture are formed mostly based on an innovative and disruptive idea to search for a repeatable and scalable business model making them attractive for VC investors. These include giving away equity stake in the business, revenue share agreement, taking in debt or having convertible debt. According to an angel investor's directory there is \$2.2 million dollars investment by angel investment firms and individuals currently in Nairobi. Most of these investments have been made in technology based companies and usually involve ownership equity given in exchange for funds which average \$20,000 per investment (GSMA, 2014).

Besides financial assistance, start-up enterprises need proper development of human capital due to major advances in technology and great human potential (Sapienza, 1992). Such business development endeavors among the population, should therefore incorporate training, mentoring and provision of fund for entrepreneurship development to be effective and sustainable. Leidholm & Mead (1987) suggested that there could be more entrepreneurial opportunities in developing countries than in developed countries which have not been tapped, hence the need for entrepreneurship education and training in many African countries. Human capital can provide a competitive advantage to a firm over its competitors and human resource development directly influences human capital of a firm (Megginson, 2001). This is the kind of training that causes a change in the attitude of the youth and imparts an enterprise culture to them. They also need skills that will enable them to use

locally available materials and at the same time to exploit markets that are outside their communities where there is a scarcity of local resources. Selection of participants in such projects has to be done carefully.

According to Bygrave and Timmons (1992), venture capitalists, foreign investors, and corporations became increasingly active in providing capital to startups in the 1980s. Furthermore, they pointed out that importance of venture capitalists in value-adding in over and above capital provision. Reynolds (2005) also stated the necessity of venture capitalists to exercise creativity in order for venture capitalists to stay on the edge of the financial world, and not just profit from entrepreneurs. Creativity occurs when the venture capitalists work hard together with the entrepreneurs and participate in improving the value of the portfolio firms. With the rise of the developing nations, and the escalation of global economic competition, the commercialization and industrialization of new technologies is promising for the revitalization of the startups in these emerging economies. (OECD-MEN, 2006). The emergence of startups based on these new technologies is one of the important options for commercialization and industrialization, and it is desirable that during this creation process, venture capitalists not simply profit from high tech entrepreneurs, but instead provide management support and value addition to accelerate growth. (GSMA, 2014)

Africa faces the challenge to provide better economic opportunities to its citizens, through sustained growth led by the private sector and to alleviate the poverty that has long plagued the region according to AVCA (2007). A strong private entrepreneurial sector plays a vital role in this respect, in particular the SMEs that provide many Africans employment, income and hope for a better future (FSD, 2009). SMEs contribute around two thirds of national income and provide the foundation for a stable middle class in many countries. They help form strong communities and are a powerful force for poverty reduction. Indeed, SMEs

play a significant role in building economic stability and sustainability for the future (OECD-MENA, 2006).

Over the last two decades, many governments and regional authorities in Kenya and other developing countries have implemented programs to mobilize venture capital in support of newly established, innovative firms, with the objectives to remedy funding gaps in private capital markets, leverage private sector financing and fostering the creation and growth of technology-based companies (OECD, 2003). Stimulated by the implementation of such initiatives, in recent years several works in the field of entrepreneurial finance have tried to assess the effectiveness of different public policy instruments for the creation of active venture capital markets (Gompers & Lerner, 1999). Venture capital has had a significant impact on SMEs in the developed countries. Small businesses have been and are the stepping stone of industrialization in these countries whereas venture capital has been present since independence yet industrialization is slow (Kaplan & Stomberg, 2009).

The benefits of venture capital go beyond the provision of long-term finance since they share risks, venture capitalists, unlike banks, get actively involved in the functioning of the firm, from management to shop-floor operations (UNIDO, 2002). Given their knowledge gained from investing in other companies with similar growth challenges, venture capitalists or business angels can help their investees in overcoming the specific bottlenecks that hamper their performance. Following profit-making principles, venture capitalists seek high-return opportunities while minimizing risks. In the developed world, business angels have played a significant role in the success of small export-oriented high-tech firms, particularly in the fields of electronics and ICT (Wanjohi & Mugure, 2008).

In Kenya private Venture Capital firms include: Kenya Equity and Term financing which supports existing companies that wish to expand rather than start-up operations. Acacia Fund Limited provides risk capital to newer expanding enterprises, including the

reorganization, rationalization and reconstruction. Aureos East Africa provides private equity and loan facilities. (Nairobi Angel Investors, 2015). Kenya Management Company Limited provides equity related investments in private sector to companies with high growth potential to expand well run businesses. These are just among many listed venture capital firms in Kenya as indicated in Appendix I.

1.1.1 Startup Enterprises

The principle of Startups is correlated to the concept of innovation and progression. These are fledgling businesses that are starting their operations (Bronwyn, 1995). Startup businesses are start small and the initial capital is raised by an individual or by the founders of that start up. The startups proposition goods and services that are already being offered in the market place or which they feel can be offered in a more superior manner. In the initial phases the overheads supersede revenue as startups develop, test and market the idea. Small businesses have created more employment than large businesses have and in the United States, almost half of their payroll is provided by the small businesses (Leidholm & Mead, 1987). The impact of the small businesses is seen in the number of people they employ, this goes to show how startup businesses are important to an economy. According to Wanjohi (2010), when a new venture is launched, it's mostly starts small. Therefore, it makes sense to adopt a small structure that is easy to administer. As ventures begin to grow, more resources and people are needed and basic structure of 'one person' organization is no longer possible.

SMEs play a significant role in the economic growth of most countries and in recent times has been observed to employ an increasing proportion of the workforce of these countries (OECD, 2003). Apart from increasing per capita income and output, SMEs enhance regional economic balance and generally promote effective resource utilization considered critical to engineering economic development and growth (Kaplan *et al*, 2002). These enterprises are the backbone Kenyan economy and are a key source of economic growth,

dynamism and flexibility in emerging and developing economies. SMEs form a large proportion of the firm tissue in Kenya and there's a fast growth in the number of privately owned small and medium-sized in Kenya. (Kenya Economic Survey, 2012)

The theory on the early growth of the firm is that all startups need to be persistent in its operations. There is proof that most firms does not thrive after the first years of being in business (Jensen, 1993). For this reason, a solution needs to be arrived at to ensure that firms get to their growth stage and begin to break even. The processes that are important to overcoming these hurdles are majorly in the early stages though they may extend beyond. All firms must utilize their resources properly in order to begin recording revenues and profits, and for these to happen the firms need to access, mobilize and deploy resources as needed. The startup genome project analyzed data from 3200 companies and came up with two conclusions; that a startup needs a good product and a market for that product (Jensen, 1993). That is what a startup needs to scale properly and pull these five elements which include the client, the goods or services, the team, the business model and financing (Wanjohi *et al*, 2008).

According to Ogojiuba & Ohuche (2004), startup businesses are plagued by several issues that deter this growth, a key challenge being the financing problems due to tight liquidity constraints. The long-term growth and competitiveness of startups are compromised by the constraints on their access to alternative forms of finance, among other systematic and institutional problems in developing countries. This is rightly confirmed by Sahlman (1991) that access of SMEs to credit and financial services and human capacity development from venture capitalists has been identified as one of the most important growth accelerators for startup firms in USA. Locally, startups share of financing resources is disproportionately less than their relative importance in domestic employment and to the value added. Generating an entrepreneurial idea is one thing but accessing the necessary finance to translate such ideas

into reality is another (Wanjohi, 2010). Graduation of many novel entrepreneurial ideas from startups to corporate levels have been thwarted simply because their originators could not fund them, and banks could not be convinced that they were worth investing in. Finance, whether owned or borrowed, is needed to expand so as to maximize profit and given the nature of SMES, there is a need for financing (Ngigi, 1997).

The availability of finance in developing economies has been highlighted as a major factor in the development, growth and successfulness of SMEs according to Rogers *et al* (2002). The importance of financing decisions in any enterprise cannot be over emphasized since many of the factors that contribute to business failure can be addressed using strategies and financial decisions that drive growth and the achievement of organizational objectives (Sapienza, 1992). Financing methods employed by startups vary from initial internal sources, such as owner–manager’s personal savings and retained profits to informal outside sources, including financial assistance from family and friends, trade credit, venture capital and angel financiers, and thence to formal external sources represented by financial intermediaries such as banks, financial institutions and securities markets (Momba *et al*, 2012). Financing decisions however must take into account the risks of choosing the source of finance since it has impact on financial performance of the firm (Jehnsen & Meckling, 1996).

There are a number of sources of finance that a small and medium enterprise can choose from for their financing needs. These include personal sources of finance, bank loans, micro-finance funds, venture capital funds, and leasing, among others according to Kenya Economic Survey (2012). However, most SMEs get funding from personal savings, informal lending schemes, savings collectors, and money lenders, rotating savings and credit associations and family members. This is further confirmed in a survey by OECD (2003) where 24% of the surveyed respondents agreed to use informal finance services.

According to Ngigi (1997), Commercial banks constitute the main providers of financial services across the globe offering a wide range of financial services including savings, deposits, credits, transfers, insurance arrangements, and even leasing. Commercial banks are in a better position to gather information on SMEs through established relationships which they and their staff have with SMEs and their owners. In addition, commercial banks have extensive branch networks that can be accessed by new SMEs even in remote locations (Krauz *et al*, 1973). Given their profit-maximizing principles, commercial banks however find it difficult to provide financial services to SMEs due to high risk and the high costs for banks in terms of monitoring and screening SMEs. Poor or incomplete business plans, high transaction costs relative to loan size and restrictive financial policies limit commercial banks appetite for lending to this sector (Wanjohi, 2010). This means that a bank can only provide a limited proportion of the required long term capital and the entrepreneur will therefore need to mobilize a significant portion. Unlike traditional financing methods, VC is more amenable to higher risk undertakings and higher returns.

Therefore, entrepreneurial financing acts as a substitute for domestic investment in countries where domestic investors are not well established or afraid to take risks (Megginson, 2001). Entrepreneurial sources of finance including private equity, venture capital and buy outs play a critical role in SME financing since they cannot meet the stringent bank requirement access funds (Soderblom, 2011). Some of the stringent requirements to access finance from bank or equity include collateral, guarantors, audited financial statements and stable income. This source of finance bridge the gap between those who cannot access funds through banks by providing a cheaper means of procuring finance and at the same time flexible repayment terms Philipou *et al* (2009)

1.1.2 Venture Capital and Growth of Startups in Kenya

According to Sahlman (2001), access to external funding helped to ease cash flow management, generate more institutional income, increase membership size and promote training and capacity building. Kenya Economic Survey (2012) revealed that firms borrowed outside funds in order to increase membership size since individuals would be drawn to an institution with accessible funds for loans. A survey conducted by GSMA (2014) indicated that majority of firms sought external credit in order to meet the demands of savings and withdrawals, loan disbursement and maintenance of operational expenses. Wanjohi & Mugure (2008) did a Study on factors affecting growth of Kenya's rural SMEs and concluded that Kenya had a weak enterprise finance sources that do not support in particular the financial needs of SMEs.

Financing decisions constitute the most significant role played by financial managers. It is therefore absolutely imperative to raise finance in the most efficient and effective means to enjoy tax allowances, low cost of funds, liquidity and reduce overall risk of the business (Kaplan & Stomberg, 2002). There is a strong relationship between access to finance and growth of SMEs all over the world. The inaccessibility of credit and capital has been a major impediment to the development of SMEs, particularly because it prevents them from acquiring the new technologies that would make them more productive and remain competitive. Access to finance will provide assistance to SMEs in the area of accounting, financial management and entrepreneurship that complies with national accounting requirements and best practices, this will improve the performance of SMEs (UNIDO, 2001).

As SMEs seek to grow, and given the role they play in economic growth of various countries, venture capital financing research has been growing as people look for alternative ways of financing businesses (Kaplan & Schoar, 2005). According to Megginson (2001), venture capital firms operate in a rapidly changing environment. Normally, venture capitalists

are looking for features such as competent management, competitive edge, growth potential, a viable exit strategy and other intangible factors (NVCA, 2007).

Theoretically, it has been established by Philipou & Gottschalg (2009) that venture capital financing has a positive influence on SMEs in terms of their performance either in growth or financial performance. They examined the impact of venture capital financing method on SME performance and found that venture capital financing has a positive effect on financial performance. The presence of venture capital in SME's equity has a marginal effect on the operating cycle efficiency. These results point to the fact that venture capital has an impact on performance of SMEs but the results have been mixed while some of the methodologies flawed (Gompers & Lerner, 1999).

In Kenya, the growth of startups has been hampered by the lack of adequate knowledge and a well-structured financial market for the mobilization of capital. The role of finance has been viewed as a critical element for the development of SMEs according to Kenya Economic Survey, (2012). However, venture capital has had a significant impact on SMEs in the developed countries; small businesses have been the stepping stone of industrialization in these countries. But among the developing countries and especially Kenya, graduation of SMEs to mid-tier and large enterprises is low despite significant presence of VC financing. Thus the study is geared towards establishing the effects of venture capital on SME's performance using the case of Nairobi.

1.2 Problem Statement

Venture Capital is a source of non-bank financing which is quite prevalent in developed financial markets for small that privately fund startup firms, offer management experience and technical support to startups (Sahlman, 1991). Startup enterprises in developing countries have been receiving new attention from investors as the respective economies continue to outperform the sub-Saharan Africa economic growth (OECD 2003). According to a survey

done by Deloitte (2016), venture capital firms are increasingly showing interest to invest in East Africa and preferably to put their money in Kenya owing to a vibrant private sector and ease of doing business deals. Private Equity Survey released by consulting firm KPMG and the East Africa Private Equity and Venture Capital Association (2017), Kenyan firms took 61 per cent of deals signed in the region last year alone. According to the report, a total of 254 private equity deals have been reported in the region since 2010, with a cumulative value of \$21.1billion (Sh2.1 trillion). In Kenya, local funds such as pension funds and insurance companies have also started to utilize their financial muscle by investing in enterprises with the potential for growth and good returns.

Despite of increased efforts to secure VC financing to ensure success of small scale enterprises, past statistics indicate that 40% of such startups fail by the second year with at least 60% closing their doors by the fourth year (KNBS, 2007; Fina Bank Report, 2007). SMEs, in Kenya have difficulties in growth and hardly grow beyond the start-up stage while others go out of business at a very early stage. There is a high failure rate of startups range between 50% and 95% within the five years of operations especially in emerging economies (Wanjohi, 2010). The study undertaken by Mead & Liedholm (1998) revealed that access to credit, credit conditions, and adequate financial and operational policies has been considered as main problems that startup SMEs have to deal with in order to survive and grow competitively. However, past studies have noted a significant problem of poor performance of these Small and medium scale startup enterprises in Kenya, and this is threatening a critical source of livelihoods and in the process resulting in increasing poverty.

Furthermore, Gakure and Karanja (2012) and Mbogo (2008) examined the impact of venture capital on growth of SMEs in Kenya and found that venture capital financing led to improved growth of firms. Mogiro *et al* (2012) carried out a Study on Kenyan manufacturing SMEs needs to information on entrepreneurial sources of finance and found alternative

sources of finance are little known to SMEs. VC Market Infrastructure in Kenya is still not fully developed lacking an organized exchange as well as over the counter markets and venture capital arrangements. There is also lack of market information since it only reaches a few people especially those in urban areas (Masinde and Kibua, 2005). Though venture capital firms have been present in Kenya as early as 1970s, their impact on startup SMEs has not been significant. It is for this reason that this study was undertaken to investigate the influence of venture capital financing on the growth of startup enterprises in Nairobi and assess the role of business angels in promoting the growth of startups in Nairobi.

1.3 Study Objective

To determine the role of venture capital financing on the growth of startup enterprises in Nairobi.

1.3.1 Specific Objectives

The specific objectives are:

- i. To establish the role of venture capital debt/equity financing on the growth of startup enterprises in Nairobi.
- ii. To establish the role of venture capitalists' management support on growth startup enterprises in Nairobi.
- iii. To establish the role of venture capitalists' technical support on growth of startup enterprises in Nairobi.
- iv. To establish the role of venture capitalists' monitoring on growth of startup enterprises in Nairobi.

1.4 RESEARCH QUESTIONS

- i. What is the role of venture capital debt/equity financing on the growth of startup enterprises in Nairobi?

- ii. What is the role of venture capitalists' management support on the growth of startup enterprises in Nairobi?
- iii. What is the role of venture capitalists' technical support on the growth of startup enterprises in Nairobi?
- iv. What is the role of venture capitalists' monitoring on growth of startup enterprises in Nairobi?

1.5 Significance/Justification of the Study

This study will enlighten sector players, policy and strategy makers, SME's and private equity firms on the impact of entrepreneurial financing in Kenya, the various forms of funding available for SMEs and how it could be embraced. It would help financiers and investors improve relations between each other and with the regulator.

The study will be very useful to venture capital firms in providing insights on strategic opportunities in Kenyan SME sector as well as ways of addressing challenges currently facing the sector and for potential private equity firm entrants into Kenya, aiding them in making a smooth entry into Kenya. This is particularly important as it brings in the perspective from an African emerging economy with SMEs as the major drivers of growth.

The understanding of the relationship between these variables is crucial for policy makers in formulating policies relating to sources of finance because it determines growth and stability of the firms. Therefore, policy makers would have a better understanding of the issues relating to the study and help in tackling emerging issues in this field.

The research work could also serve as a source of future reference to future researchers who may find it helpful in carrying out a research work of similar nature or related topic. It would also provide a platform for further Study of the concerned variables.

1.6 Scope of the study

This study concentrates on venture capital as a source of SMEs sources of financing both informal and formal. The study examines the impact of venture capital on SMEs growth before and after use of venture capital. This study will selectively examine SMEs financed by venture capitalists to ascertain whether there has been any significant improvement in performance before and after use of this kind of finance. The study will consider SMEs from Nairobi that have used venture capital.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter reviews literature that would help inform the study as well as illuminate issues related to venture capital financing. The literature review is divided into areas that deal with: the theoretical review in relation to venture capital financing; the empirical review showing the various past works of authors in venture capital financing and startup enterprises growth; the contributions of on growth of startups and conceptual framework.

2.2 Theoretical Review

2.2.1 Trade-Off Theory

The trade-off theory of capital structure refers to the idea that a firms chooses how much debt finance and how much equity finance to use by balancing the costs and benefits. This theory goes back to Kraus and Litzenberger (1973) who considered a balance between the deadweight costs of bankruptcy and the tax saving benefits of debt. The theory posits that there is an advantage to financing with debt, the tax benefits of debt and there is a cost of financing with debt, the costs of financial distress including bankruptcy costs of debt and non-bankruptcy costs e.g. staff leaving, suppliers demanding disadvantageous payment terms, bondholder or stockholder infighting, etc. (Frank and Goyal, 2007).

The marginal benefit in debt declines as debt increases, while the marginal cost increases, so that a firm that is optimizing its overall value will focus on this trade-off when choosing how much debt and equity to use for financing. According to Myers and Majluf (1984), a firm that follows the trade-off theory sets a target debt-to-value ratio and then gradually moves towards the target. The target is determined by balancing debt tax shields against costs of bankruptcy.

The theory states that firms borrow up to the point where the tax savings from an extra dollar in debt are exactly equal to the costs that come from the increased probability of financial distress. Under the trade-off theory framework, a firm is viewed as setting a target debt to equity ratio and gradually moving toward it which indicates that some form of optimal capital structure exist that can maximize the firm value. The trade-off theory has strong practical appeal. It rationalizes moderate debt ratios. It is also consistent with certain obvious facts, for instance, companies with relatively safe tangible assets tend to borrow more than companies with risky intangible assets.

The trade-off theory postulated that there is a limit to debt financing and the target debt may vary from one SME's to another depending on profitability, among other factors referring to microfinance. This allows profitable SME's, which have lot of tangible asset that can be offered as collateral for debt, may have a higher target debt ratio (Byers, 1997). The alternative theory of capital structure is known as 'pecking order' theory, the origin of which is asymmetric information where managers know more about a firm's prospect than the outside investors. According to Myers (1984), the theory is based on the premise that successful zero debt firms with high and consistent profitability rarely uses debt financing. The theory suggest that in avoiding controversy the management may wish to finance project by internal fund generation, such as by retained earnings. Hence, the financing order goes in this way, first-retained earnings, then-debt and finally, equity when debt capacity gets exhausted, and explains why profitable firms use less debt (Heilman, 1998)

2.2.2 The Economic Theory of the Entrepreneur

While seeking to understand the very nature of commerce, Cantillon (1955) wrote his seminal work on the entrepreneur as a person willing to take risks and able to manage uncertainty. He defined an entrepreneur as non-fixed income earners who take risks in committing themselves firmly, without guarantee as to the solvency of his client or his backers.

Entrepreneurship is often categorized as the entrepreneurial factor, the entrepreneurial function, entrepreneurial initiative, and entrepreneurial behavior and is even referred to as the entrepreneurial “spirit. The entrepreneurial function can be conceptualized as the discovery of opportunities and the subsequent creation of new economic activity, often via the creation of a new organization (Reynolds, 2005). The entrepreneurial factor is understood to be a new factor in production that is different to the classic ideas of earth, work and capital, which must be explained via remuneration through income for the entrepreneur along with the shortage of people with entrepreneurial capabilities. Its consideration as an entrepreneurial function refers to the discovery and exploitation of opportunities or to the creation of enterprise (Byers, 1997)

The entrepreneurial function implies the discovery, assessment and exploitation of opportunities, in other words, new products, services or production processes; new strategies and organizational forms and new markets for products and inputs that did not previously exist (Shane and Venkataraman, 2000). The entrepreneurial opportunity is an unexpected and as yet unvalued economic opportunity. Entrepreneurial opportunities exist because different agents have differing ideas on the relative value of resources or when resources are turned from inputs into outputs. The theory of the entrepreneur focuses on the heterogeneity of beliefs about the value of resources (Alvarez and Busenitz, 2001).

Entrepreneurial behavior is seen as behavior that manages to combine innovation, risk-taking and pro-activeness (Miller, 1983). In other words, it combines the classic theories of Schumpeter’s innovative entrepreneur (1934, 1942), the risk-taking entrepreneur that occupies a position of uncertainty as proposed by Knight (1921), and the entrepreneur with initiative and imagination who creates new opportunities. Reference to entrepreneurial initiative underlines the reasons for correctly anticipating market imperfections or the capacity to innovate in order to create a ‘new combination’. Entrepreneurial initiative covers

the concepts of creation, risk-taking, renewal or innovation inside or outside an existing organization. Lastly, the entrepreneurial spirit emphasizes exploration, search and innovation, as opposed to the exploitation of business opportunities pertaining to managers.

This theory shows the motivations for additional financing in an SME is expansion of operations of entrepreneurs by venture capitalists. Thus, venture capitalists assume some levels of risk when financing startups to expand the activities of an SME in return for higher returns. Startups are vital for economic growth and development in both industrialized and developing countries, by playing a key role in creating new jobs. According to Ngigi (1997), Financing is necessary to help them set up and expand their operations, develop new products, and invest in new staff or production facilities. Many small businesses start out as an idea from one or two innovators, who invest their own money and probably turn to family and friends for financial help in return for a share in the business (Reynolds, 2005). But if they are successful, there comes a time for all developing SMEs when they need new investment to expand or innovate further. That is where they often run into problems, because they find it much harder than larger businesses to obtain financing from banks, capital markets or other suppliers of credit. This “financing gap” is all the more important in a fast-changing knowledge-based economy because of the speed of innovation. If SMEs cannot find the financing they need, brilliant ideas may fall by the wayside and this represents a loss in potential growth for the economy (Memba *et al*, 2012)

2.2.3 Modern Portfolio Theory

Modern Portfolio Theory (MPT), a hypothesis put forth by Harry Markowitz in his paper "Portfolio Selection," (published in 1952 by the Journal of Finance) is an investment theory based on the idea that risk-averse investors can construct portfolios to optimize or maximize expected return based on a given level of market risk, emphasizing that risk is an inherent

part of higher reward. It is one of the most important and influential economic theories dealing with finance and investment (Kaplan and Schoar, 2005).

Also called "portfolio management theory," MPT suggests that it is possible to construct an "efficient frontier" of optimal portfolios, offering the maximum possible expected return for a given level of risk. It suggests that it is not enough to look at the expected risk and return of one particular stock. By investing in more than one stock, an investor can reap the benefits of diversification, particularly a reduction in the riskiness of the portfolio. Venture capitalists play a very important role as financial intermediary bridging the gap between demand and supply of capital by entrepreneurs and investors. MPT on the other hand quantifies the benefits of diversification (Kaplan and Schoar, 2005).

The theoretical rationale for investing in an alternative asset class such as private equity is to improve the risk and reward characteristics of an investment portfolio, with the expectation that the asset will offer a higher absolute return whilst improving portfolio diversification (Bodie *et al*, 2005). In comparison with investing in more traditional securities such as public stocks or bonds, however, investing in PE funds is considered a complex task due to their long-term and illiquid nature, as well as the noticeable lack of transparent and publically available information pertaining to PE funds (Bygrave & Timmons, 1992). Moreover, there are material variations in performance across PE funds, implying that while PE investing may generate excellent returns, investors could also face large losses (Phalippou and Gottschalg, 2009). Hence, a PE fund investor needs to have the ability to select funds with the potential to deliver attractive returns.

Deeper insights about which investment strategies have proven successful, and, more specifically, about how these strategies may differ across various investor types, seem to be missing from the literature. This is somewhat surprising given the large amounts of capital that private as well as public institutions devote to this particular asset class each year, as a

broader understanding about performance determinants could improve investor returns. However, Post modern portfolio theory provides an optimization methodology that uses the downside risk of returns instead of the mean variance of investment returns used by modern portfolio theory which is a key factor in portfolio construction and uses the standard deviation of negative returns as the measure of risk, while modern portfolio uses the standard deviation of all returns as a measure of risk.

2.3 Empirical Evidence

A number of factual evidence on the economic impact of venture capital has been published especially for the USA economy which supports the finding of this study. According to a study carried out by Astrid & Bruno (2004) on venture capital funded firms for the period 1970-2000, the sales doubled, paid almost twice the federal taxes, generated almost twice the exports and invested almost three times as much in research and development as the average non-venture capital backed firms. The National Venture Capital Association (2007) has also established that venture capital backed firms report a high growth in sales as compared to other firms. Venture capital backed firms employed more than 12 million people and generated nearly \$3 trillion in revenue. Respectively, these figures accounted for 11 % of private sector employment and represented the equivalent of 21 % of U.S.A GDP during that same year. The result reveals that venture capital leads to growth on sales of the firms that use these funds. Peneder (2010) tested the impact of venture capital financing on corporate performance and found out that venture capital is invested in firms with high performance potential and perform value adding function in terms of a genuine causal impact on firm growth.

Once the investor introduces its money in a business, he must devote much of his time in helping the business to succeed, structuring internal organization and appropriate human resources management (Hellmann and Puri, 2002). In other words, venture capitalists help in

adding value to professionalization in the firm and generally firm's professionalization is the major benefit from the venture capital financing. Hellmann and Puri (2002) offer good explanation of the process of professionalization. Besides above mentioned features, they point out the speed of developing and bringing ambitious product to the market by venture backed companies. This is crucial to achieve market leadership, especially among innovative firms. According to Jensen & Meckling (1979), venture backed companies are, in fact, found to pursue more radical and ambitious product or process innovations than other companies.

Studies in five African countries (Botswana, Kenya, Malawi, Swaziland, and Zimbabwe) found that SMEs generate nearly twice the level of employment as registered, large-scale enterprises and the public sector (Mead and Liedholm, 1998). Momba, Gakure, and Karanja (2012) examined the impact of venture capital on growth of SMEs in Kenya and found that venture capital financing led to improved growth of firms. The analysis concluded that SME that use venture capital experience improved growth and thus more SMEs should be encouraged to use this form of finance if the country has to achieve its vision 2030.

In a recent study on the effect of venture capital financing on SMEs in Kenya, Gikomo (2013) noted that there was a positive and significant relationship between growth of SMEs and venture capital financing. Murithi (2012) assessed risk-return trade off among private equity firms in Kenya. The study revealed that the risk is very low for private equity firms in Kenya as the betas were negative and the returns for the firms were quite impressive given the Treasury bill rate rose towards the end of the year 2011 and this contributed to negative beta for the firms.

According to Gatauwa and Mwithiga (2014) in their study on private equity and economic growth of a region found out that private equity tends to increase when there is economic growth in an economy as underpinned by the economic growth models; for economic growth to be sustainable there is need for continuous advancement in technical

knowledge mainly in the form of new products, processes and markets (Masinde & Kibua, 2005). Furthermore, a well-developed legal and regulatory framework would lead to increased financial activities in a country hence facilitating exits which would result to a more favorable legal environment that induces venture capitalists and private equity funds to invest more often in the home country. Investors face principal-agent problems, and geographical distance between a principal and an agent do not alleviate this asymmetry. Consequently, the distance and information asymmetry between a shareholder and the management of any SME'S might be too large for direct investment, instead seeing the investor prefer a managed investment through a microfinance investment vehicle dedicated to and specialized in analyzing and managing risk exposures (AVCA, 2008).

2.4 The Influence of Venture Capital on Growth of Startups

Venture capitalists have different approaches to investment, which may relate to the location of the business, the size of the investment, the stage of the company, the industry specialization, the structure of the investment, the financial state of the company and the amount of involvement of the venture capitalists in the company's activities (UNIDO, 2001). There are various growth acceleration structures that angel investors use when investing in startups in Kenya. These include giving away equity stake in the business, revenue share agreement, taking in debt or having convertible debt and human capital development.

2.4.1 Equity/Debt Financing Startups

Issuing stock in their startup is the route most entrepreneurs pursue, especially for early stage businesses where cash flow is difficult to predict, hence making it tough to forecast repaying debts. Equity is typically secured from angel investors. A typical institutional investor is looking for 25% to 35% of the company, in exchange for its investment. Most professional investors seek for equity in the form of preferred stock, not common stock, where they get a 10% interest and a liquidation preference of one times their money back before the common

shareholders begin to participate in any sale proceeds for the business (OECD, 2003). Financing decisions and the issue of raising finance constitute the most significant role played by financial managers. It is therefore absolutely imperative to raise finance in the most efficient and effective means to enjoy tax allowances, low cost of funds, liquidity and reduce overall risk of the business (Kaplan & Stomberg, 2002).

According to Soderblom (2011), security for the investment includes fixed assets and movable assets that are purchased using the seed fund, some form of anti-dilution protection for the investor, typically a weighted-average ratchet in the event of a subsequent financing at a lower valuation. The VC investor will also be looking for protective provisions, in terms of their rights as a shareholder to block certain major actions (e.g. change of control, modification of the board size, changing the charter so as to adversely affect their security, etc.). The rationale for investing in private equity is to improve the risk and reward characteristics of an investment portfolio, with the expectation that the asset will offer a higher absolute return whilst improving portfolio diversification (Bodie *et al*, 2005). Moreover, there are material variations in performance across PE funds, implying that while PE investing may generate excellent returns, investors could also face large losses (Phalippou and Gottschalg, 2009). Hence VC investor needs to have the ability to select funds with the potential to deliver attractive returns.

The advantage of equity approach is that the investment does not have to be repaid, like debt does. However, it gives certainty of valuation for the firm which disadvantages the firm if the value is too low (for diluting founders' stake) or too high (which can impact interest from next round investors who do not like to price down rounds from the round before, to avoid legal risks from diluted shareholders (UNIDO, 2001). Equity is also more complex to structure (highest legal bills, longest time to close) and involves giving some level of board control to investors (Soderblom, 2011). However, if the firm issues equity

shares to finance a project it has to issue shares at less than the prevailing market price. This signals that the shares are overvalued and the management is not confident to serve the debt if the project is financed by debt. This means that issuing shares is ‘bad’ news (Hubner *et al*, 2013).

Some entrepreneurs may not prefer to set an equity valuation and simply want the option of potentially paying back the cash, for a period of time prior to taking in permanent equity capital. A convertible note is a hybrid, part debt and part equity, where it functions as debt, until some point in the future, when it may convert to equity at some predefined terms (OECD, 2003). Sahlman (2001), noted that access to external debt funding helped to ease cash flow management, generate more institutional income, increase membership size and promote training and capacity building. A survey conducted by GSMA (2014) indicated that majority of firms sought external credit in order to meet the demands of savings and withdrawals, loan disbursement and maintenance of operational expenses. There’s a limit to debt financing and the target debt varying from one SME to another depending on profitability, among other factors. This allows profitable startups, which have lot of tangible asset that can be offered as collateral for debt, may have a higher target debt ratio.

Convertible debt is much quicker and cheaper than issuing equity since it doesn’t incur legal fees and there’s no ownership dilution. It leaves valuation flexible in order to meet the needs of subsequent investors and interest payments do not typically need to be paid in cash each month (Cumming & Macintosh; 2000, 2002). Venture Capital have been instrumental in organizing finances for winning but risky business proposals by Small and Medium enterprises that have promising but as yet unproven ideas. If the Venture capitalist is convinced that a business idea is promising, they will take up the ownership stake in the business and provide the needed fund while sharing the risk. The disadvantage is that the firm has a limited time frame before it needs to be repaid, or convert into equity (Megginson,

2001). Startups with an existing product and track record or existing or future assets to secure a loan access venture debt. However, technology startups which do not have a track record and may not be able to secure investment by venture beat (Baldwin & Rafiquzzaman, 1995).

2.4.2 Management Support of Startups

Venture capitalists are usually very keen with the way a venture is managed, according to Megginso, (2001), between 70% and 90% start-ups fail within five years but the intervention of venture capitalists reduced the failure rate down to 15% to 25%. The presence of venture capital in the capital structure of SMEs has greatly contributed to the reduced failure. It is not only the viability of business that determines whether the venture capitalist will fund a venture but management has to be improved and a step-by-step funding procedure followed (Kiungu, 2012).

Venture capitalists are actively involved in management of the venture they fund, typically becoming members of the board of directors and retaining important economic rights in addition to their ownership rights (Sahlman, 1990). Venture capitalists often hold extensive control rights over entrepreneurial companies, including the right to fire entrepreneurs. According to Hellmann (1998), this provides the correct incentives for the venture capitalists to search for a superior management team. Wealth-constrained entrepreneurs may give up control even if the change in management imposes a greater loss of private benefit to them than a monetary gain to the company. Hellmann and Puri (2002) in their study inferred that once the investor introduces its money in a business, he must devote much of his time in helping the business to succeed, structuring internal organization and appropriate management support. In other words, venture capitalists help in adding value to professionalization in the firm. Besides above mentioned features, they point out the speed of developing and bringing ambitious product to the market by venture backed companies. This is crucial to achieve market leadership, especially among innovative firms. Venture backed

companies are, in fact, found to pursue more radical and ambitious product or process innovations than other companies.

Venture capitalists offer a joint provision of both capital and management support especially in later stages of the company development when the product is developed and thus, the technical know-how of the founding management team becomes redundant, venture capitalists may prefer to replace some of the leading management team members with experienced professional managers (Sahlman, 1990). Whereas the founders typically may be academics spinning out from a university or technically oriented entrepreneurs with little management experience, professional managers have industry expertise, better knowledge of the relevant market, established contacts and more know-how in marketing, financial and human resource management (Lerner, 2002). Typically, the venture capitalists' right to replace the leading management is part of the contract between the venture capitalists and the firm and this ensures sound governance. Venture capitalists help in improving business practice among SMEs in keeping proper books of account by either hiring consultants or doing the work alone. Accounting records furnish substantial information about the volume of a business. Good accounting records will monitor inventory, control expenses, determine profit margin, measure performance and improve cash flow (Gombers & Lerner, 1999).

2.4.3 Technical Support to Startups

Venture capitalists add value to their companies by providing a variety of services such as helping shape strategies, provide technical and commercial advice and attract key personnel (Byers, 1997; Bygrave and Timmons, 1992; Sahlman, 1990; Sapienza, 1992). The true situation on the ground however, is that many people still do not understand the concept enough to undertake it (Atieno, 2007). Venture capitalists provide technical support in identifying and evaluating business opportunities, including management, entry, or growth strategies; negotiating and closing the investment; and tracking and coaching the company;

providing technical and management assistance; attracting additional capital, directors, management, suppliers, and other key stakeholders and resources (Bygrave and Timmons, 1992).

Venture capitalists specifically provide particular skills including fundraising, mergers and acquisitions, international marketing and networks. The venture capitalist will want to ensure that the company has the willingness to adopt modern corporate governance standards, such as nonexecutive directors, including a representative of the venture capitalist appropriate investment structure as well as the requirement of being an attractive business opportunity, the venture capitalist will also be seeking to structure a satisfactory deal to produce the anticipated financial returns to investors (Bygrave and Timmons, 1992).

A venture capitalist typically seeks superior businesses, they generally look for companies with superior products or services targeted at fast-growing or untapped markets with a defensible strategic position quality and depth of management. Venture capitalists must be confident that the business has the quality and depth in the management team to achieve its aspirations. Venture capitalists look for clear exit routes for their investment such as public listing or a third-party acquisition of the company. Entrepreneurial investors seek for qualities such as a solid business plan, a good management team, investment and passion from the founders, a good potential to exit the investment before the end of their funding cycle, and target minimum returns in excess of 40% per year (Sapienza, 1992).

Startup enterprises need proper development of human capital due to major advances in technology and great human potential (Sapienza, 1992). Such business development endeavors among the population, should therefore incorporate youth training, mentoring and provision of fund for entrepreneurship development to be effective and sustainable. Leidholm & Mead (1987) suggested that there could be more entrepreneurial opportunities in developing countries than in developed countries which have not been tapped, hence the need

for entrepreneurship education and training in many African countries. Human capital can provide a competitive advantage to a firm over its competitors and human resource development directly influences human capital of a firm (Megginson, 2001). This is the kind of training that causes a change in the attitude of the youth and imparts an enterprise culture to them. They also need skills that will enable them to use locally available materials and at the same time to exploit markets that are outside their communities where there is a scarcity of local resources. Selection of participants in such projects has to be done carefully.

Moreover, the venture capital industry play a crucial role in the expansion of a business. It is in the expansion stage of a business that most jobs are usually created. It is also the time when the management team will probably need to expand and become professional. The involvement of venture capital providers is essential to the success of this process. About a quarter of business angel activity takes place in the expansion stage, where the practical guidance angels can offer is again immensely valuable. Indeed, it has been argued that the UK's venture capital industry is much more effective at this stage than at the start-up stage (NVCA, 2007).

2.4.4 Monitoring of Startups

The monitoring and stewardship role of the venture capital investors is an important corporate governance issue that has gained heightened attention as the lead investor is generally more actively involved in the monitoring of the portfolio company, while others act more as passive providers of capital (Sahlman, 1990). The absence of collateral means they cannot simply leave the entrepreneurs to their own devices, but must ensure resources are not squandered to try and earn a return on their investment. They provide finance in stages to ensure that option value is maximized (Kaplan and Stromberg, 2002). Venture capitalists typically provide finance for a limited period of time and if a firm is successful, its needs for capital rapidly outstrip the capacity of limited partnerships that are the usual providers of

venture capital. An important exit mechanism for venture capitalists is an initial public offering (IPO) of the company and outright sale of the start-up to a large firm (Megginson, 2001).

Venture capital investors can create value for entrepreneurial firms through intensive monitoring (Lerner, 2002) which ensures that cash management, proper strategies of debt collection and inventory control policies are in place and enforced. Venture capital backed firms have advantage over others due to the presence of a venture capital member in their board of management who ensure certain recommended policies for sound finance management are in place (Lerner, 2002).

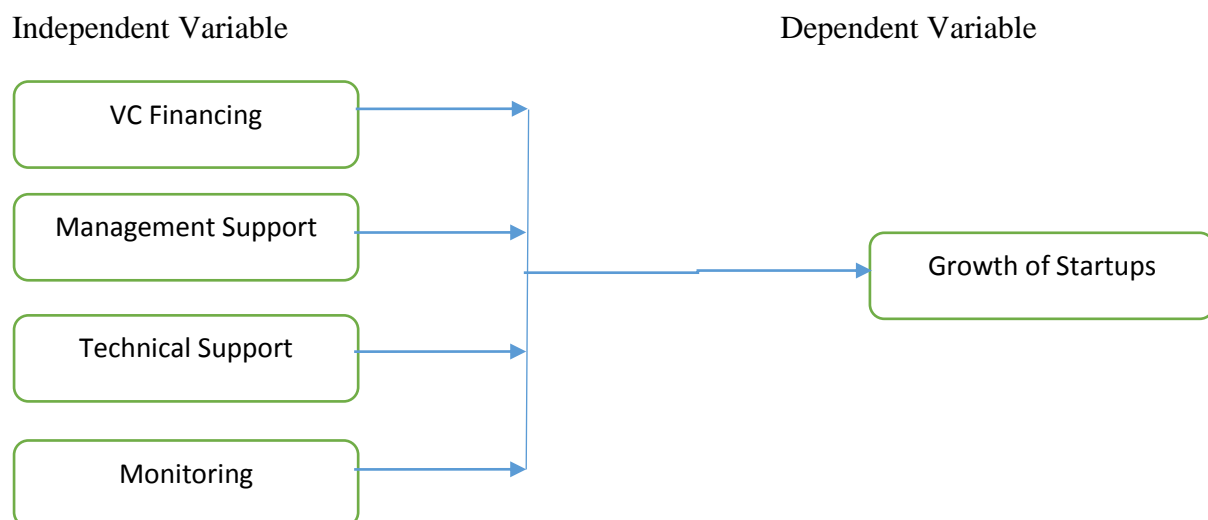
Venture capitalists are believed to be extensively involved in the firms they finance, closely monitoring their activities and providing valuable support and governance. According to Kaplan and Stromberg (2002), VC investors negotiate complex control rights at the time of their investment and put into place extensive monitoring and advisory systems while Hellmann and Puri (2002) indicate that venture capitalists play a role in CEO turnover. Venture capitalists have strong incentives to set strong governance structures in their portfolio firms since their investments in startup firms involve higher levels of uncertainty, asymmetric information, and typically higher intangible assets and growth opportunities (Gompers & Lerner, 1999) hence venture capitalists take an equity position in the company and play an active role in the governance of the firm (Sapienza 1992). This monitoring goes beyond what a traditional financing institution would do and includes spending time at the companies, frequent meetings with managers, and being involved in the definition of the companies' strategies, hiring decisions (Hellmann and Puri 2001), and top management compensation (Kaplan and Stromberg 2000).

In addition, venture capitalists bring their experience in evaluating the prospects of startups through their screening of potential investments (Rogers *et al*, 2002), their

collaboration with other startups, their understanding of the solutions to the problems that these firms may face, and when startups are best positioned to raise money (Gompers and Lerner 1999). They also assist with their reputation in the capital and product markets (Meggison 2001). Finally, they provide access to a strategic network including potential clients or suppliers, management talent (Bygrave and Timmons 1992), additional funding, strategic partners and infrastructure providers like accounting firms, law firms, and public relations firms (Shalman 1990). These returns which are the key measure used to determine VC fund performance, are determined by share prices at the time the VCs sell or distribute their stake in portfolio firms. As a result, venture capitalists have incentives to ensure that optimal governance systems are in place in their portfolio firms at the time the firm goes public to ensure the preservation of the value of their investment.

2.5 Conceptual Framework

Fig 2.5.1 Conceptual Framework



Source: Research findings (2017)

2.6 Operationalization of Variables

Table 2.1 presents the research variables, variable measures, scale and section in the questionnaire that covers them. There are two sets of variables; the dependent and the independent variables

Table 2.6.1 Operationalization of Variables

Variable	Indicator	Measure	Scale	Questions in questionnaire
Independent variables				
Financing Role	Access to VC Equity/Debt	Amount of credit, Debt/equity ratio & Net Assets, Expansion of operations, Increase in Sales	Nominal	Section B
Management Support	Improvement in Management styles.	Restructuring, Change in Decision making, Cash flow management, No. of managers posted	Nominal	Section C
Technical Support	Prudent Management of Startups	New products, New Markets, Access to other sources of finance, Decision making.	Nominal	Section D
Monitoring	Monitoring and Evaluation of progress	Auditing, Monitoring & Evaluation, Variance Analysis, Staggered funding, Monitoring costs, Auditing & Evaluation costs, Budget preparation.	Nominal	Section E
Dependent variable				
Growth of Startups	Capacity for capitalization for growth.	Growth in sales, revenue, Net assets, liquidity & profitability	Nominal	Section F

Source: Research findings (2017)

2.7 Summary

This chapter reviewed the relevant literature in relation to venture capital financing. Three theories have been specifically reviewed, Trade off theory, the economic theory of entrepreneurship and Modern Portfolio Theory. A review of empirical studies on venture capital financing and performance of SMEs was also done based on studies done in and outside Kenya. Finally a conceptual frameworks and operationalization of variables is developed from the existing literature to enable us ascertain the directions for research.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter focuses on the methodology used to complete the research study. It highlights on the areas of the research design, the method for collecting the data and finally the ways of analyzing the collected data.

3.2 Research design

A research design is a presentation of the plan, the structure and the strategy of investigation, which seek to obtain or answer various research questions. Borg and Gall (1983) define research design as a detailed plan for how research study will be conducted. It is a plan according to which data are collected to investigate the research hypothesis or question in an economical manner. This study incorporated a descriptive research approach using surveys. A descriptive research is a study designed to depict the participants in an accurate way. It is a process of collecting data in order to answer questions regarding the current status of the subjects in the study (Mugenda and Mugenda, 1999). It is an attempt to collect data from members of the population with respect to one or more variables.

According to Cooper and Schindler (2003), descriptive design discovers and measures the cause and effect of relationships between variables. The study used a descriptive design because it enabled the researcher to collect a large quantity of in-depth information about the population being studied. Owing to the limited geographical scope in this study, a descriptive design was ideal as it is logistically easier and simpler to conduct. It also enabled the researcher to test and measure the population needed for quantitative experimentation since it gives valuable pointers as to what variables are worth testing quantitatively. Therefore, descriptive survey was adopted for it is appropriate for this study.

3.3 Population of the study

Cooper and Schindler (2003) define a population element as the subject on which the measurement is being taken and is the unit of study. The population of this study was the owner managers of the 254 startups funded by venture capital between the years 2010 to 2016 according to KPMG & East Africa Private Equity and Venture Capital Association (2017). A manager of an enterprise is identified as the personnel responsible for the overall management and running of the startup, in this case the manager was the overall manager or owners of the startup. The figure was arrived at by using directories provided by venture capital firms drawn from Nairobi.

Mugenda and Mugenda (1999) define a target population as the population from which a sample can be obtained and conclusion applied on it. The target population of this study composed of all SMEs using venture capital. This was obtained from directories provided by venture capital firms and fund managers. Apparently, the target population may appear small but literature (Rodgers *et al*, 2003) shows that for every 100 applicants for venture capital only 5% may qualify for funding as the rest fall short of the stringent requirements of venture capitalists. This study used the 254 SMEs that had been financed by venture capitalists as the target population.

3.4 Sampling Frame and Sampling Techniques

Sampling is the procedure by which a researcher gathers people or things to study Cooper and Schindler (2003). The sampling frame of this study was drawn from directories of venture capitalists as shown in Appendix I. These institutions provide venture capital to various SMEs located in Nairobi. The Fisher formula was used to obtain a sample size for the study.

Mugenda and Mugenda (1999) define probabilistic sampling as a method of sampling where each unit of the population has a probability of being selected as a unit of a sample.

Stratified sampling method was used in the research study to sample respondents that received funding from various VC investors. Saunder (2003) asserts that stratified random sampling involves dividing population into subgroups and giving a number to every strata of the accessible population, and then randomly selects the final subjects proportionally from the different strata. Stratified sampling was well suited for this study because the population of interest is heterogeneous in terms of type of the business and VC investors. On ascertaining these startups, they were then stratified according to their VC investment firms and random sampling carried out. The Fisher (2003) formula was employed to calculate the sample size as follows:

$$n = \frac{z^2 p(1-p)}{d^2}$$

Where; n = sample size

z = the standard normal deviate value for the level of confidence, for instance 95% level of confidence, $z = 1.96$

d = margin of error or level of precision at 0.1 for total population at 90%

p = proportion to be estimated, Mugenda & Mugenda (2003) recommends that where p is unknown, the value is assumed to be 0.5

Therefore, sample size was arrived at as follows:

$$n = \frac{(1.96^2)(0.5)(1-0.5)}{0.1^2} = 96$$

A sample of 96 firms were selected at random from which data was collected.

3.5 Data Collection Instruments.

This study was based on primary data collected by way of structured questionnaires. Cooper and Schindler (2003) and Mugenda & Mugenda (2003) noted that questionnaires obtain in depth information as the researcher can model the questions as necessary for ease and clarify

and ensure that the responses are properly understood thus improving the quality of the information received. The questionnaires were closed ended and based on the Likert scale. The questionnaires were divided into six sections each section covering the study variables. The questionnaires were administered to the entrepreneurs who are the founders and managers of the enterprises that had received VC funding. This approach enabled the researcher to collect as much information as possible on the topic of study. The research instruments were first tested in the field before being used in the actual data collection (Mugenda & Mugenda, 2003). These research instruments were structured according to the research objectives. Questionnaires were then administered to the sampled 96 managers or owners in the sampled startups in Nairobi.

The researcher administered the questionnaire personally on the owners and managers of startup firms. Many respondents were comfortable with giving information about their firms, the researcher employed Saunder (2003)'s strategies on gaining access to collect data. Saunder advocates that time should be allowed for requests to be received and considered and an interview meeting to be arranged at a convenient time.

3.5.1 Pilot Study

A pilot study was conducted in Nairobi to improve the quality of the research instruments and data collection procedures. It was necessary to carry out a pilot study on a sample of the target population to identify the problems, minimize errors, and refines the instruments for data collection and to test the reliability and validity of the research instruments.

3.6 Data Processing and Analysis

Data analysis refers to examining what has been collected in a study and making deductions and inferences (Cooper and Schindler, 2003). Before the actual analysis is done, data organization was done. Data organization is the orderliness in research data and includes putting data in a systematic form. The organization involves correcting errors in data, coding

the data and sorting it in an appropriate form (Mugenda & Mugenda, 2003). Data was keyed in to excel spreadsheet and then copied in to Eviews for organization. Upon carrying out data organization, analysis was done by use of statistical techniques (correlation, ANOVA, and Chi-square). Microsoft Excel and Eviews was used to facilitate analysis as they have in-build formulas.

Results of pre-test were analyzed using Shapiro-Wilk method to determine whether data is normally distributed with the threshold for normality being $p^* > 0.05$. The study investigated for multicollinearity by computing variance inflation factor, VIF. A recommended cut off of 4 by Pan & Jackson (2008) was used. To detect heteroscedasticity, white General test will be employed.

The data analysis and statistical software Eviews was used in establishing the data associations, analyzing the data and help in coming up with the findings of the research, the conclusions and the recommendations for further research, in line with the objectives of the research study Cooper and Schindler (2003).

3.7 Model Specification

The data collected was analyzed by use of regression analysis model using Eviews. The model developed from the study findings took the form of:

$$Y_i = \beta_0 + \beta_1 X_{i1} + \beta_2 X_{i2} + \beta_3 X_{i3} + \beta_4 X_{i4} + \mu_i \dots\dots\dots \text{Eqn (i)}$$

Where; Y represents the growth of Startups

X_1 represents VC Financing in growth of Startups

X_2 represents VC Management Support in growth of Startups

X_3 represents VC Technical Support in growth of Startups

X_4 represents VC Monitoring in growth of Startups

β_0 represents the constant

$\beta_1, \beta_2, \beta_3$ and β_4, β_5 represent the co-efficient of regression for VC financing, Management support, Technical Support and Monitoring respectively. While μ is the random error term accounting for all other variables on financial stability of the IFGs but not captured in the model.

3.8 Data Validity and Reliability

According to Mugenda and Mugenda (2003), Validity is the accuracy and meaningfulness of inferences, which are based on the research results. To establish the validity of the research instruments the researcher will seek opinions of experts in the field of study especially the lecturers in the school of graduate studies and research. The research instrument was validated in terms of expert validity. This helped facilitate the necessary revision and modification of the research instrument thereby enhancing validity. Further, the time between the test run and actual study was short enough to avoid historical effects. To ensure representatives of the sample with regard to the target population and the degree to which the findings can be generated to represent the population, given the number of licensed fund management firms, all the firms as per CMA were considered to be a fair representative of the population.

According to Mugenda and Mugenda (2003), reliability refers to the consistency of measurement and is frequently assessed using the test–retest reliability method. To ensure reliability, the study adopted the test retest technique. This was achieved by testing the questionnaire to a sample of the population to test its consistency and adjust for any inconsistencies before the real field work begins. In order to reduce the levels of biases and increase the levels of reliability, Cronbach's alpha technique was used to calculate reliability coefficient. It is the most common measure of internal consistency used when one has multiple Likert questions in a questionnaire that form a scale and one wish to determine if the scale is a reliable research instruments. Inter-correlations among test items are maximized

when all items measure the same construct (Kombo & Tromp, 2016). Hence, Cronbach's alpha is widely believed to indirectly indicate the degree to which a set of items measures a single unidimensional latent construct. However, it can easily be shown that tests with the same test length and variance but different underlying factorial structures can result in the same values of Cronbach's alpha. Indeed, several investigators have shown that alpha can take on quite high values even when the set of items measures several unrelated latent constructs. The method is preferred owing to its ability to take care of the continuous variables in the Likert scale. A coefficient of 0.6 or more is considered acceptable (Saunders, 2003).

3.9 Ethical Issues

Prior to the commencement of data collection, the researcher obtained all the necessary documents, including an introduction letter from KCA University and sought audience with the regulatory authorities to clarify the purpose of the study. Upon getting clearance, the researcher in person distributed the questionnaires to the sampled individuals (Mugenda & Mugenda, 2003).

The researcher explained to the respondents about the research and that the study will be for academic purposes only. It was made clear that the participation is voluntary and that the respondents are free to decline or withdraw any time during the research period. Respondents were not coerced into participating in the study (Mugenda & Mugenda, 2003). They were guaranteed that their privacy would be protected by strict standard of anonymity. The study explored impact of venture capital on growth of startups in Nairobi. All data used were acknowledged appropriately.

CHAPTER FOUR

DATA ANALYSIS, FINDINGS AND DISCUSSION

4.1 Introduction

This chapter focused on the analysis of the data collected and discussions of the findings, are structured according to the questions in the questionnaire, and provides discussion of the findings together with their implications. Primary data was collected using a questionnaire that targeted 254 SMEs in Nairobi. Computations of frequencies, averages, statistical tests like correlation, ANOVA tests, Chi square, were used to analyze the data guided by the research questions in reference to study objectives.

4.2 Response Rate

Primary data was collected using a questionnaire administered to 96 SMEs in Nairobi and 72 questionnaires were returned by startups. This response rate is considered accurate and it reflects its population, the response rate in this case of 75% is very good. This high response rate can be attributed to the data collection procedures, where the researcher pre-notified the potential participants of the intended survey, the questionnaire was self-administered the respondents completed them and these were picked shortly after.

4.3 Demographic Information

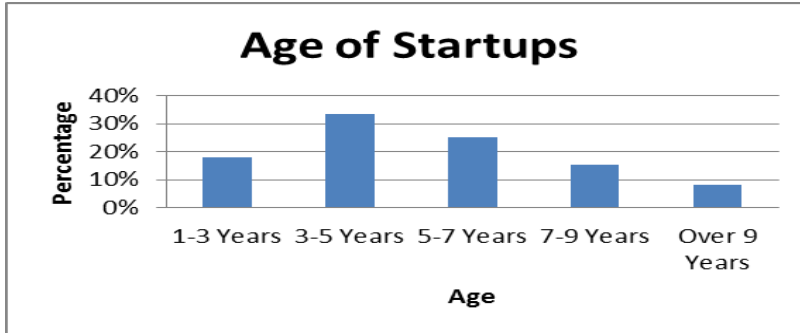
The aspects covered under this section included: age of the startup enterprises, type of ownership, nature of business, main sources of finance and growth trends of the startup enterprise prior to introduction of VC funding. This study considered this section important as it provided information on the nature of businesses under study and the respondents.

4.3.1 Age of the Startup Enterprises

The study sought to determine the age of startups. The analysis revealed in Fig. 4.3.1 below that many firms had been in operations for 3-5 years with the least having been in operation

for over 9 years by the time of study. These findings imply that venture capitalists prefer investing in young firms in their launch, early development or expansion stages of a business.

Fig. 4.3.1 Age of Startups

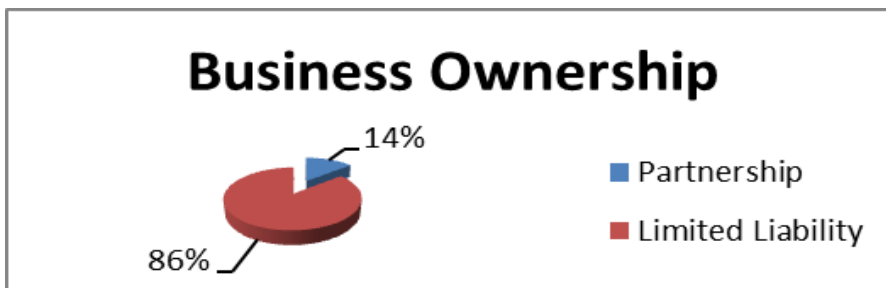


Source: Author (2017)

4.3.2 Business Ownership

The study sought to determine the type of business ownership. Fig. 4.3.2 shows that majorities (86%) of the firms were limited liability companies and only 14% were under partnerships. This means that an overwhelming majority had registered as limited liability companies.

Fig. 4.3.2 Business Ownership



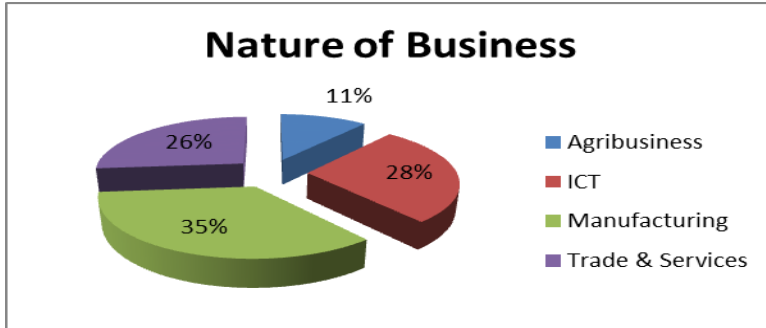
Source: Author (2017)

4.3.3 Nature of Startup

The study sought to determine the nature of the startup. Fig 4.3.3 below presents the findings that 35% of the financed ventures were in manufacturing, 28% were in ICT, Trade & Services had 26% while Agribusiness had 11% of venture capital finance. The findings

indicate that many firms in the manufacturing and the ICT sector have used venture capital hence an induction that venture capitalists have a preference of these sectors.

Fig. 4.3.3 Nature of Business

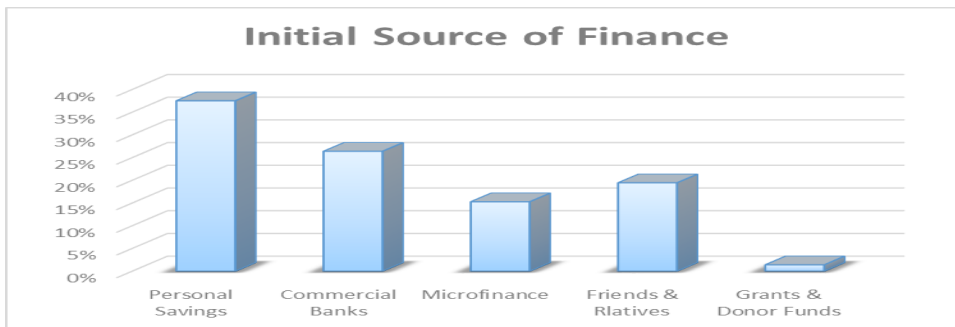


Source: Author (2017)

4.3.4 Initial Source of Finance

The study sought to determine the initial source of financing. The study shows in Fig. 4.3.4 that although all the businesses are using venture capital, these startups started their businesses by sourcing initial capital from other sources such as personal savings 38%, loans from banks 28% and borrowing from friends 19%. Only 1% of these startups were initially funded by grants and donor funds with 15% startups being funded initially by microfinance institutions. These findings show some of the main financing problems that startups have to deal with in order to survive and grow competitively such as access to credit, credit conditions, and adequate financial and operational policies which do not favor startups.

Fig. 4.3.4 Initial Source of Finance

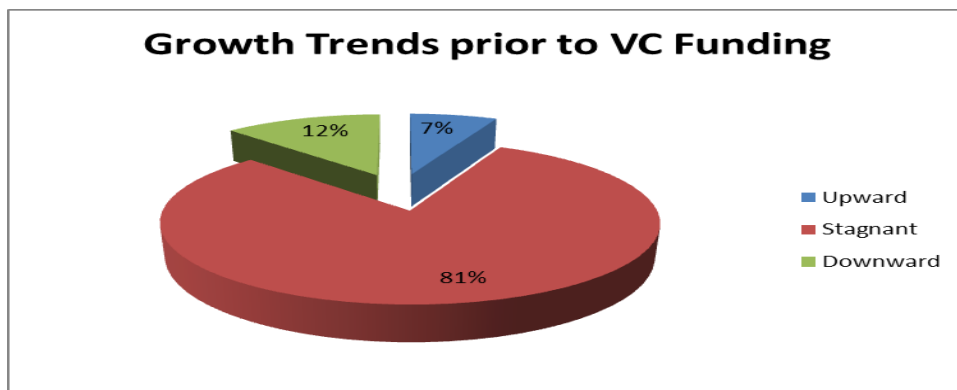


Source: Author (2017)

4.3.5 Growth Trends prior to Venture capital Financing

The study sought to determine the growth trends prior to venture capital investment. The findings as shown in Figure 4.3.5 below indicated that 81% of the respondents reported stagnant growth trends before use of venture capital while 12% reported that growth was downward. Only 7% of respondents indicated that growth prior to using venture capital was upward. This findings show that lack of adequate funding is a major impediment to growth of startups.

Fig. 4.3.5 Growth Trends prior to VC Financing



Source: Author (2017)

4.4 Venture Capital and Growth of Startups

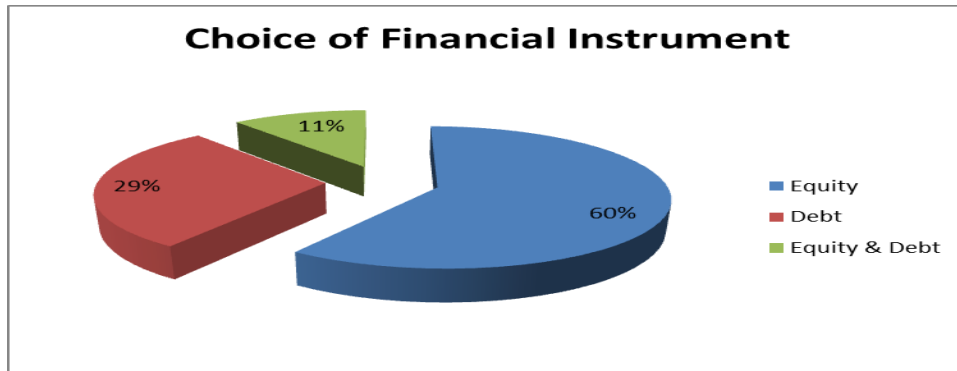
To address the above objective, a number of variables were considered to determine if use of venture capital by firms lead to growth. Growth is a one-dimensional construct operationalized by a variety of growth measures. In this study, the variables that were used to measure growth included; sales, net assets, profitability, and liquidity among others. These variables were analyzed on a before and after venture capital basis.

4.4.1 Venture Capital Financing and Growth of Startups

The study sought to find out the set of contracts which determines the instrument or combination of instrument which venture capital deals were negotiated and concluded. Fig. 4.4.1 below shows that 60% of the deals were concluded with preferred equity as an instrument of

choice, 29% used preferred debt while 11% used combination of both debt and equity. This shows that most professional investors seek for equity in the form of preferred stock where they get say 10% interest and a liquidation preference.

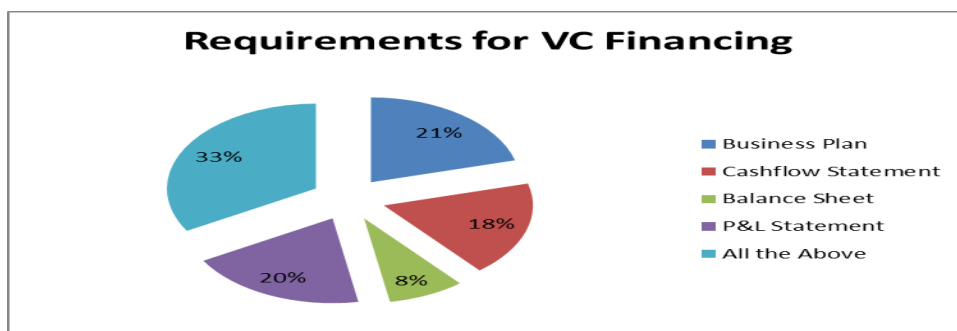
Fig. 4.4.1 Choice of Financial Instrument



Source: Author (2017)

The study further sought to establish the requirement for venture capital financing. Fig. 4.4.2 below indicates that 21% of the deals required a business plan while 19% required a profit and loss statement. 18% of respondents had been tasked to provide a cash flow statement while 8% required a balance sheet. 33% were however required to produce all these documents. From the findings, it is noted that VC financing has less stringent requirements compared to commercial banks and micro financé institutions.

Fig. 4.4.2 Requirements for VC Financing

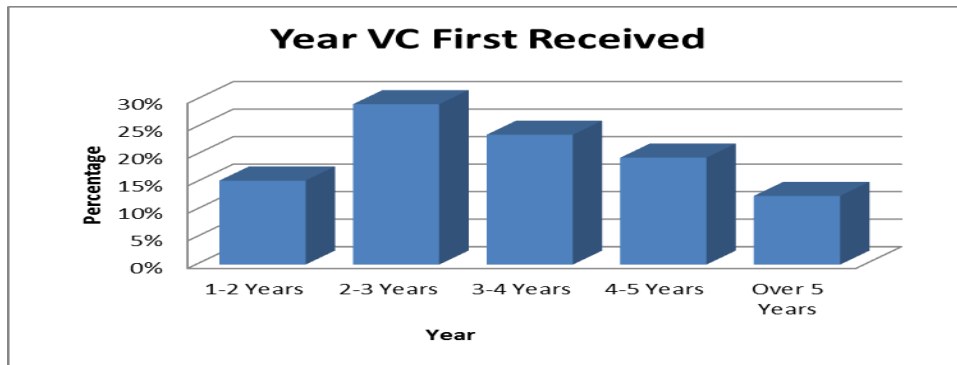


Source: Author (2017)

The study also sought to establish the duration which venture capital was first received. Figure 4.4.3 below reveals that a majority (29%) of the firms had received venture

capital 2-3 years ago while 24% received funding 3-4 years ago. 19% of these firms received their first funding 4-5 years ago while 15% were funded less than 2 years ago. Of these firms, only 13% were first funded over 5 years ago. From the findings, it's noted that VC investors fund firms in their startup and expansion stages.

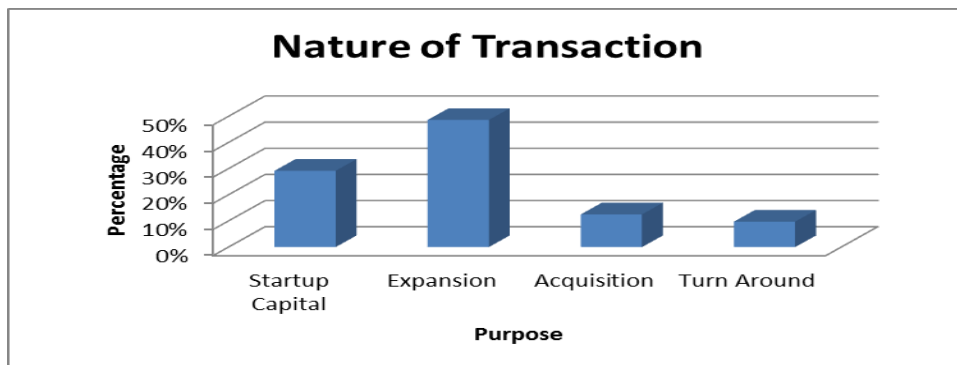
Fig. 4.4.3 Year VC First Received



Source: Author (2017)

The study further sought to find out the nature of various transaction agreements with which these startups were financed. Fig. 4.4.4 below shows that 49% of the firms received finances for expansion purposes, 29% received startup capital, and 13% for acquisition purposes whereas 10% were meant for turnaround of firms performance. Findings point out that startups seek funding to ease cash flow position and generate more institutional income in their early stages of growth and expansion.

Fig. 4.4.4 Nature of Transactions



Source: Author (2017)

The study sought to determine the extent to which aspects of VC financing influence growth of startup enterprises. The respondents were asked to rate the aspects of VC financing and the influence on the firm's growth in a five point Likert scale. The range was 'Strongly Agree (5) to 'Strongly Disagree' (1). The scores of Strongly Agree (SA) had an equivalent mean score of $4.5 \leq SA < 5.0$ while the scores of Agree (A) had an equivalent mean score of $3.5 \leq A < 4.4$. The scores of Neutral (N) had an equivalent mean score of $2.5 \leq N < 3.4$ while the scores of Disagree (D) had an equivalent mean score of $1.5 \leq D < 2.4$. The scores of Strongly Disagree (SD) had an equivalent mean score of $0 \leq SD < 1.4$

Table 4.1 Aspects of VC Financing on Growth of Startups

Measure of VC Financing on Growth of Startups	Mean	Std. Dev.
There are benefits associated with VC financing relative to bank loans	3.8	1.1
Lower Interest Rates and the flexible payback period	3.8	1.0
Terms and conditions of the financing are done through private placement	3.7	1.1
The repayment conditions are less stringent relative to commercial banks	3.6	1.1
Investor financing increased the sales revenue by greater magnitudes	3.7	1.1
Return on assets increases with increase in venture capital	3.6	1.1
Value added income increased with venture capital usage	3.5	1.0
VC capital financing enabled you to expand operations	3.3	1.1

Source: Author (2017)

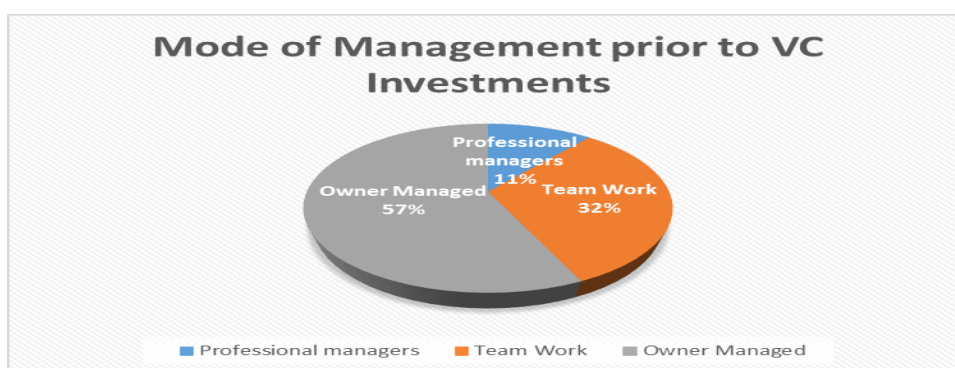
Table 4.1 above shows that respondents agreed that there are benefits associated with VC financing relative to bank loans and that venture capital has lower Interest Rates and the flexible payback period both with a means of 3.8 each. Respondents also agreed that; the terms and conditions of the financing are done through private placement, the repayment conditions are less stringent relative to commercial banks and that investor financing increased the sales revenue by greater magnitudes all with means of 3.7, 3.6 and 3.7

respectively. The respondents also agreed that return on assets and value added income increased with means of 3.6 and 3.5 respectively. However, they were neutral on the influence of venture capital financing had in enabling them expand operations rating this aspect with a mean of 3.3. From the findings, it's noted that FC financing significantly influenced growth of startups as firms find it absolutely imperative to raise finance in the most efficient and effective means to enjoy tax allowances, low cost of funds, improve liquidity and reduce overall risk of the business.

4.4.2 Venture Capital Management Support and Growth of Startups

The study sought to establish management structures prior to VC funding. Fig. 4.4.5 below shows that 57% of these startups were owner managed while only 11% had sought the services of professional managers. 32% of these startups however indicated teamwork in their management. This is an indication that startups fail in their initial years since they lack of experienced management techniques hence VC adds value in professionalizing management of startups. Venture capital firms were included the management boards of 40% of the startups while 82% reported a change in management style.

Fig. 4.4.5 Mode of Management prior to VC Investments

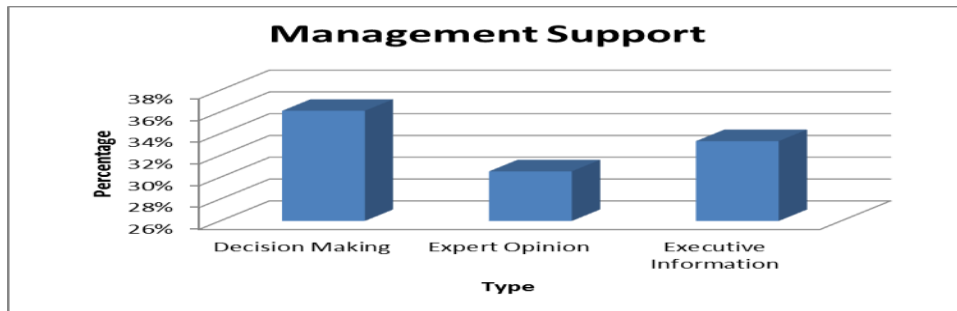


Source: Author (2017)

The study further sought to establish the kind of management support the startups had received from venture capital firms. Fig. 4.4.6 below indicates that 36% of startups had

received decision-making support with 31% having accessed expert opinions from VC investors. 33% had access executive information through VC firms. From the findings, it's noted that VC investors compliments the leading management team members with experienced professional managers.

Fig. 4.4.6 Type of Management Support received



Source: Author (2017)

The study sought to determine the extent to which aspects of VC management support influenced growth of startup enterprises. The respondents were asked to rate the aspects of VC management support and the influence on the firm's growth in a five point Likert scale. The range was 'Strongly Agree (5) to 'Strongly Disagree' (1).

According to the findings in table 4.2 below, respondents agreed to have experienced improvement of business efficiency, reduction in business costs and diversification of operations with means of 3.5, 3.5 and 3.6 respectively. Respondents were impartial on the influence of management support in the implementation of Total Quality Management, better management structures and the improvement financial statements on growth of their startups as they rated these aspects with means of 3.4 each. The study inferred that once the investor introduces its money in a business, he must devote much of his time in helping the business to succeed, structuring internal organization and appropriate management support.

Table 4.2 Aspects of VC Management Support on Growth of Startups

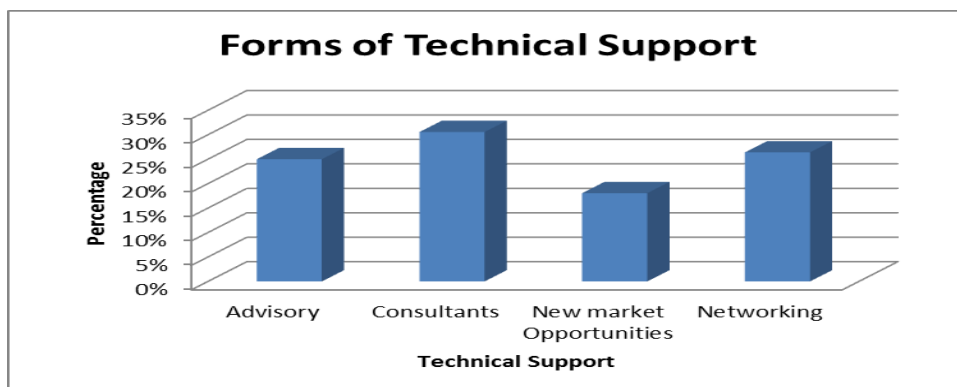
Measure of VC Managerial Support on Growth of Startups	Mean	Std. Dev.
There's improvement in business efficiency	3.5	1.2
Reduction in business costs was experienced	3.5	1.1
Enhanced understanding and implementation of Total Quality Management	3.4	1.0
Better management structures	3.4	1.1
Improvement in the financial statements	3.4	1.0
Diversification of business operations	3.6	1.0

Source: Author (2017)

4.4.3 Venture Capital Technical Support and Growth of Startups

The study sought to establish the mode of technical support the startup had received from VC investors. Findings indicated that 88% of startups had been trained and that 82% participated in the strategic planning of startups. Fig. 4.4.7 below shows that Consultancy (31%), Networking (26%) and Advisory (25%) services are mostly used by VC investors to support startup enterprises. 18% of startups also reported to have received support to identify new market opportunities. This shows that venture capitalists add value to their companies by providing a variety of services that help shape strategies, provide technical and commercial advice and attract key personnel.

Fig. 4.4.7 Forms of Technical Support received



Source: Author (2017)

The study sought to determine the extent to which aspects of VC technical support influenced growth of startup enterprises. The respondents were asked to rate the aspects of VC technical support and the influence on the firm’s growth in a five point Likert scale ranging from ‘Strongly Agree (5) to ‘Strongly Disagree’ (1).

The findings in table 4.3 below shows that respondents agreed to the role of technical support in increasing their chances of getting secondary financing, access to External Markets and use of improved technology with means of 4.0, 4.0 and 4.1 respectively. Respondents also agreed to have experienced rapid prototyping and marketing strategies, expansion of business networks and human capacity development as they rated these aspects with means of 4.1, 3.9 and 3.9 respectively. This shows the role of VC in providing particular skills including fundraising, mergers and acquisitions, international marketing and networks to ensure that the startups become attractive business opportunity.

Table 4.3 Aspects of VC Technical Support on Growth of Startups

Measure of VC Technical Support on Growth of Startups	Mean	Std. Dev.
Higher chances of getting secondary financing	4.0	0.8
Access to External Markets	4.0	0.7
Use of improved technology	4.1	0.7
Rapid Prototyping and Marketing Strategies	4.1	0.8
Expansion of Business Networks	3.9	0.9
Human Capacity Development	3.9	0.9

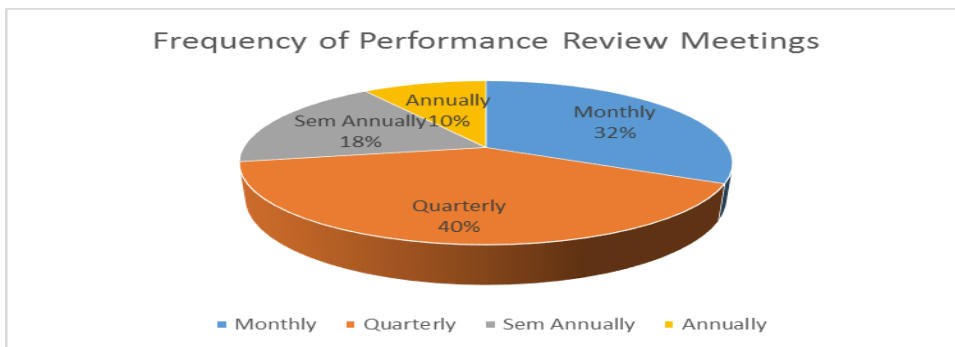
Source: Author (2017)

4.4.4 Venture Capital Monitoring and Growth of Startups

The study sought to establish the extent to which venture capital monitoring influenced growth of startups. According to the findings, 90% of VC investors had a monitoring and evaluation system with 85% holding progress review meetings regularly startup enterprises.

Fig. 4.4.8 below shows that 40% of respondents indicated that they had quarterly progress review meetings while 32% held monthly meetings with VC investors. 18% and 10% of respondents held such meetings semiannually and annually respectively. The absence of collateral means VC investors cannot simply leave the entrepreneurs to their own devices, but must ensure resources are not squandered to try and earn a return on their investment.

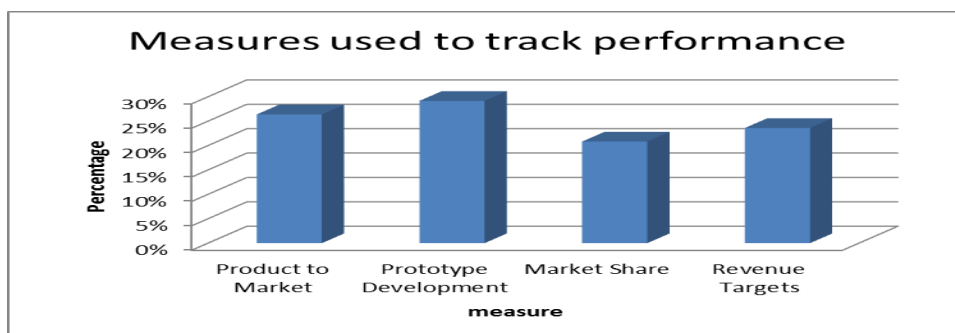
Fig. 4.4.8 Frequency of Performance Review Meetings



Source: Author (2017)

The study further sought to establish measures used by VC investors to track startups' performance. From fig. 4.4.9 below, 29% of VC investors used prototype development while 26% used product to market. 24% used revenue targets while 21% used market share. This shows that monitoring goes beyond financing and includes spending time at the companies, frequent meetings with managers, and being involved in the definition of the companies' strategies, hiring decisions.

Fig. 4.4.9 Measures used to track performance



Source: Author (2017)

The study sought to determine the extent to which aspects of VC monitoring influenced growth of startup enterprises. The respondents were asked to rate the aspects of VC monitoring and the influence on the firm’s growth in a five point Likert scale ranging from ‘Strongly Agree (5) to ‘Strongly Disagree’ (1).

The findings in table 4.4 below indicates that respondents agreed to have agreed to have had a clear monitoring and communication of the implementation of strategic plan, venture capital investors involvement in budgeting and auditing of startups with means of 3.5 each. Respondents were also impartial on the improvement in management strategies and increase in annual turnover of their businesses as they rated these aspects with means of 3.3 each. This proves that venture capitalists are extensively involved in the firms they finance, closely monitoring their activities and providing valuable support and governance. They negotiate complex control rights at the time of their investment and put into place extensive monitoring and advisory systems.

Table 4.4 Aspects of VC Monitoring on Growth of Startups

Measure of VC monitoring on Growth of Startups	Mean	Std. Dev.
Clear Monitoring and Communication of the implementation of Strategic Plan	3.5	1.0
VC Investors Involvement in Budgeting	3.5	1.0
Auditing of financial performance by VC investors	3.5	0.9
Improved Management Strategies	3.3	0.9
Improvement in Annual Turnover of your business	3.3	1.1

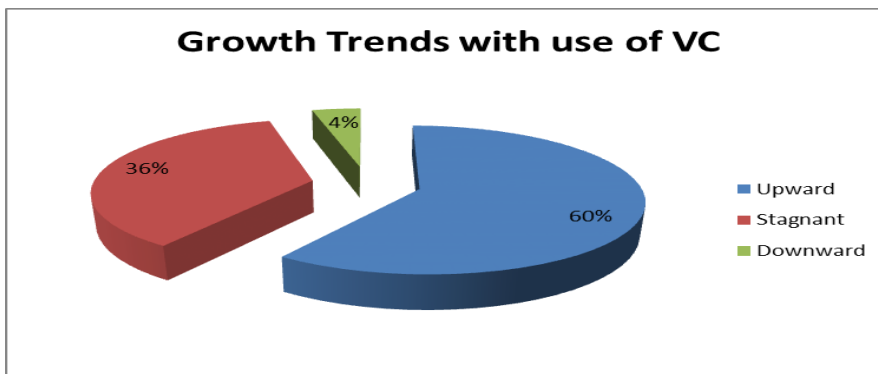
Source: Author (2017)

4.4.5 Growth of Startups

The study sought to determine the growth of startups and the indicators that contribute to its growth. The findings in fig. 4.4.10 below shows that 60% of the respondents reported upward

growth trends of their startups after use of venture capital while 36% reported that growth was stagnant. Only 4% of respondents indicated a decline in growth after using venture capital. Respondents also agreed that venture capital was effective with a mean of 4.2. In comparison with growth trends before VC investments, this points out the critical role these investors play in catalyzing performance of startups.

Fig. 4.4.10 Growth Trends with use of Venture Capital



Source: Author (2017)

The respondents were asked to rate the growth of startups and the indicators that contribute to its growth in a five point Likert scale ranging from ‘Strongly Agree (5) to ‘Strongly Disagree’ (1). From the findings in table 4.5 below, respondents agreed that venture capital led to growth in sales, increase in revenue, net assets, and liquidity with means of 4.0, 3.7, 3.7 and 3.8 respectively. Respondents also agreed that profitability of their startups had significantly improved with VC investments with a mean of 3.9. These findings shows that venture capital financing has a positive influence on growth or financial performance of startups they invest in.

Table 4.5 Measure of the Growth of Startups

Measure of the Growth of Startups	Mean	Std. Dev.
VC has contributed to growth of sales	4.0	1.1
Increase in revenue is attributed to VC	3.7	1.0

Net assets grew with VC funding	3.7	1.0
Liquidity has improved since VC financing	3.8	1.1
Profitability of your startup has significantly improved after acquiring VC financing	3.9	1.2

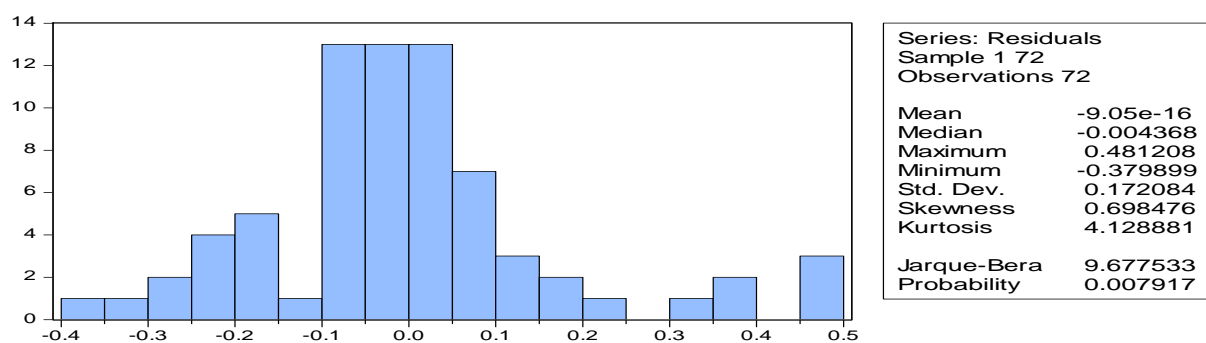
Source: Author (2017)

4.5 Diagnostic Tests

4.5.1 Normality Test

The study sought to establish normality tests. A plot of the residual values from the regression model was first obtained to give a graphical outlook of the assumption of normality. As shown in figure 4.5.1, the residuals are not normally distributed as we have a thicker tail to the left of the mean zero. This implies that a few observations lie outside the fitted normal curve on the histogram. These results are confirmed by the Jarque-Bera test for normality in which case a p-value = 0.0079 indicates that we should reject the null hypothesis that data is normally distributed.

Figure 4.5.1: Normality Test



Source: Author (2017)

4.5.2 Heteroskedasticity Test

The study sought to establish heteroskedasticity in the data. Whites General test was used to test for heteroskedasticity. These results as presented in table 4.6 below shows that calculated

R^2 is less than the critical values of R^2 (11.34<29.71) hence there is presence of heteroskedasticity in the observed data.

Table 4.6 Heteroskedasticity Test

Heteroskedasticity Test: White

F-statistic	0.761439	Prob. F(14,57)	0.7044
Obs*R-squared	11.34391	Prob. Chi-Square(14)	0.6588
Scaled explained SS	15.36761	Prob. Chi-Square(14)	0.3535

Source: Author (2017)

4.5.3 Multicollinearity Test

The study also sought to test for multicollinearity in the variables. This was achieved by computing variance inflation factor (VIF) values. The results are presented in Table 4.7 below shows that there is no evidence of multicollinearity as all VIF values of the variables are less than 4.

Table 4.7 Multicollinearity Test

Variance Inflation Factors

Date: 09/29/17 Time: 06:25

Sample: 1 72

Included observations: 72

Variable	Coefficient Variance	Uncentered VIF	Centered VIF
C	0.087651	201.1072	NA
FINANCING	0.021670	674.9263	19.31728
MANAGEMENT	0.006954	196.0055	6.625915
TECHNICAL	0.004575	167.6345	1.030000
MONITORING	0.014433	400.4788	12.96038

Source: Author (2017)

4.6 Model Fitting

4.6.1 Correlation Analysis

Correlation analysis was used to determine both the significance and degree of association of the variables. A Pearson product moment correlation coefficient was computed to assess the relationship between venture capital and growth of startups. The results of the correlation analysis as summarized in Table 4.8 shows a strong positive relationship between growth of startup enterprises and financing (0.96) and monitoring support (0.92). Findings also shows a

strong positive relationship between growth of startup enterprises and management support (0.91) and technical support (0.90)

Table 4.8 Pearson Correlation Matrix

	FINANCING	MANAGEMENT	TECHNICAL	MONITORING	GROWTH
FINANCING	1.00				
MANAGEMENT	0.92	1.00			
TECHNICAL	0.91	0.89	1.00		
MONITORING	0.97	0.87	0.88	1.00	
GROWTH	0.96	0.91	0.90	0.92	1.00

Source: Author (2017)

4.6.2 Analysis of Variance

The study also sought to establish whether there are any statistically significant differences between the means of growth of startups and the independent variables. Findings from the ANOVA statistics presented in Table 4.9 was used to present the regression model significance. Levene test results shows that $p < 0.000$ at 5% level of significance hence the model is significant for the regression analysis. This therefore implies that all the variables are good predictors and has a significant influence on the growth of growth startups.

Table 4.9 Variance Analysis

Test for Equality of Variances Between Series

Date: 09/29/17 Time: 06:55

Sample: 1 72

Included observations: 72

Method	df	Value	Probability
Bartlett	4	43.30511	0.0000
Levene	(4, 355)	3.520902	0.0078
Brown-Forsythe	(4, 355)	2.546854	0.0392

Category Statistics

Variable	Count	Std. Dev.	Mean Abs. Mean Diff.	Mean Abs. Median Diff.
FINANCING	72	0.627688	0.453819	0.439583
GROWTH	72	0.674693	0.477315	0.450000
MANAGEMENT	72	0.648933	0.495679	0.489583
MONITORING	72	0.629987	0.465046	0.443056
TECHNICAL	72	0.315435	0.280993	0.280093
All	360	0.629483	0.434570	0.420463

Bartlett weighted standard deviation: 0.594424

4.7 Regression Model

The study conducted regression analysis on the dependent variable (growth) against the independent variables (Financing, Management Support, Technical Support & Monitoring) to determine the role of venture capital in the growth of startup enterprises in Nairobi.

$$Y_i = \beta_0 + \beta_1 X_{i1} + \beta_2 X_{i2} + \beta_3 X_{i3} + \beta_4 X_{i4} + \mu_i \dots \dots \dots \text{Eqn (2)}$$

The table below shows the results for the goodness of fit statistics.

Table 4.10 Equation Estimation

Dependent Variable: GROWTH
 Method: Least Squares
 Date: 09/29/17 Time: 05:07
 Sample: 1 72
 Included observations: 72

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.063912	0.296060	0.215874	0.8297
FINANCING	0.613805	0.147208	4.169645	0.0001
MANAGEMENT	0.172080	0.083392	2.063508	0.0429
TECHNICAL	0.004552	0.067641	0.067299	0.9465
MONITORING	0.266865	0.120138	2.221321	0.0297
R-squared	0.934947	Mean dependent var		3.816667
Adjusted R-squared	0.931063	S.D. dependent var		0.674693
S.E. of regression	0.177146	Akaike info criterion		-0.556769
Sum squared resid	2.102509	Schwarz criterion		-0.398667
Log likelihood	25.04368	Hannan-Quinn criter.		-0.493828
F-statistic	240.7329	Durbin-Watson stat		0.865480
Prob(F-statistic)	0.000000			

Source: Author (2017)

The specified model becomes:

$$Y_i = 0.064 + 0.614X_{i1} + 0.172X_{i2} + 0.005X_{i3} + 0.267X_{i4} + \mu_i \dots \dots \dots \text{Eqn (3)}$$

All the explanatory variables are significant in at 5% level of significance with the exception of technical support which is insignificant in explaining the variation in SME’s Growth. Going by the rule of the thumb, at level of significance of 5 % the P-value of technical support than 0.05 hence not important in explaining the changes in SME’s growth.

Changes in the independent variables as shown in Table 4.10 above together describe about 93.5% of the variations in growth of startups in Nairobi. With an adjusted R² 93.1%

indicates that the independent variables in the model have a strong power of explanation on the changes growth of startups. Further, the results show F-statistic of 240.7 which is statistically significant at 5% level. This implies that the overall model is significant and well fitted to explain changes in growth of startups in Nairobi.

From the model, a unit increase in venture capital financing in SMEs would cause an increase in growth of the startup by a factor of 0.614, also a unit increase in venture capital management would cause an increase in growth of startups by a factor of 0.172 while a unit increase in technical expertise would cause an increase in growth of startups by a factor of 0.005. Moreover, a unit increase in monitoring would cause an increase in growth of startups by a factor of 0.267.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter is a synthesis of the entire report and contains summary of findings, conclusions arrived at, the recommendations and the suggestions for further study.

5.2 Summary

The study established that the independent variables describe about 93.5% of the total variations in growth of startups in Nairobi. With an adjusted R^2 of 0.931 indicates that the independent variables in the model have a strong power of explanation on the changes growth of startups. The study established that there is a positive relationship between growth of startups and financing, management and technical support and monitoring. Further, the results show F-statistic of 240.7 that is statistically significant at 5% level. This implies that the overall model is significant and well fitted to explain changes in growth of startups in Nairobi. The study further established that there is a significant relationship between growth of startups and financing, management and monitoring at 5% level. The indicators of growth of startups were growth in sales, revenue and net assets, and the improvement in liquidity and profitability.

5.2.1 Venture Capital Financing

The study found out that VC financing affects growth of startups. A unit increase in venture capital financing in SMEs would cause an increase in growth of the startup by a factor of 0.614. It was also established that majority of funding was meant for expansion and seed capital purposes. This correlates with Sahlman (2001) that access to external debt funding helped to ease cash flow management, generate more institutional income, increase membership size and promote training and capacity building. However, there is a limit to debt financing and the target debt varying from one startup to another depending on

profitability, among other factors. Hence, startups with an existing product and track record or existing or future assets can access venture debt (Baldwin & Rafiquzzaman, 1995).

5.2.1 Management Support

The study also established that management support influences the growth of startups. A unit increase in venture capital management would cause an increase in growth of startups by a factor of 0.172. It was also established that VC firms offer decision making support, expert opinion and access to executive information to startups they invest in. This correlates to Puri (2002) in their study inferred that once the investor introduces its money in a business, he must devote much of his time in helping the business to succeed, structuring internal organization and appropriate management support.

5.2.1 Technical Support

The study further established that technical expertise had insignificant influences the growth of startups. A unit increase in technical expertise would cause an increase in growth of startups by a factor of 0.005. VC investors offer a wide array of advisory, consultancy and networking to capitalize on new market opportunities. The findings are in line with Lerner (2002) that whereas the founders typically may be academics spinning out from a university or technically oriented entrepreneurs with little management experience, professional managers have industry expertise, better knowledge of the relevant market, established contacts and more expertise in marketing, financial and human resource management.

5.2.1 Monitoring

From the findings, it was established that monitoring also influences growth of startups. A unit increase in monitoring would cause an increase in growth of startups by a factor of 0.171. VC investors have an established monitoring and evaluation system and hold regular progress review meetings with startups. This agrees to Sahlman (1990) that the monitoring and stewardship role of the venture capital investors is an important corporate governance

issue that has gained heightened attention as the lead investor is generally more actively involved in the monitoring of the portfolio company, while others act more as passive providers of capital.

5.3 Conclusions

From the study, it can be concluded that the effect of venture capital on growth of startups is real and practical as established by this study. The study has shown a positive and significant relationship between growth in startups and venture capital financing. This is to say that increased venture capital financing improves performance of the startups.

Startups have been constrained by lack of skilled human capital, technological resources as well as capital resources. However, with good management expertise and technical expertise, the firms have the ability to strategically use information and resources available to them to present well-crafted business growth strategies that also reduces risk to the business; strong management team can also demonstrate past successes in similar businesses.

5.4 Recommendations

In view of the findings, it was recommendations that startups need to recognize the potential advantages of seeking external equity finance from corporate sources. Corporate investors can therefore become very important assets for startups both financially and strategically as they provide tangible and intangible value added resources which can play a valuable role in startups growth. Moreover, startups should be trained and assisted to set up basic planning and record keeping systems, and to write financing proposals.

Venture capital fund managers can do more to encourage venture capital investment. Non-financial companies can be a very significant alternative source of funds for independent venture capital groups specializing in investing in startups at a time when they are experiencing difficulties in raising funds from financial institutions. Venture capital fund

managers need to recognize the motivations of the corporate investor and to tailor their funds accordingly. Venture capitalists have a role to play in stimulating direct venture capital investment via co-investments with corporations.

The government and Policy makers should provide credit and equity financing to eligible Venture Capital Finance Companies to support startups and provide money to support other activities and programs for the promotion of Venture Capital Financing. The government should also serve as both facilitators and educators in encouraging the venture capital process and provide tax incentives to companies prepared to make venture capital investments. This would be an important method for initially stimulating interest in an activity that many corporate executives are possibly not currently considering.

5.5 Recommendations for Future Research

A review of the findings of this study poses the following research question is worth more exploration: Why are startups not still willing to use Venture Capital Finance as alternative source of funding when they do not get funding from financial institutions? There is also need to conduct further studies to establish why startups do not prefer Venture Capital Funds in spite of the ranging benefits that are accrued to startups in using Venture Capital Financing as a means of financing.

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APPENDICES

Appendix 1: Licensed Equity Fund Management Firms

Equity Fund Management Firms		Portfolio Investments in Startup Enterprises
1.	Actis	Auto Express, Garden City, Mentor Management, Nairobi Business Park
2.	Acumen	First Access, Burn, Biolite, Jawabu Microhealth, D.Light Design, Sanergy, Ecotact, Insta Products
3.	AfricInvest	Silafrika Plastics & Packaging, UAP, Brookhouse Schools, Family Bank
4.	AgriVie	African Spirit Group (Asilia), Kariki Group
5.	Burbidge Capital	Flame Tree Group, Wakulima Tea Company Ltd, MaCuisine Ltd
6.	Catalyst Principal Partners	Goodlife Pharmacy, Kensta Group, Britania Foods, Orbit Chemical Industries Ltd, Jamii Bora
7.	Centum Investments Company Plc	Zohari Leasing, Platinum Credit, Sidian Bank, Broll (K), Genesis (K), Nas Servair, KWAL, GM East Africa, Two Rivers, AMU Power
8.	DOB Equity	Africa Logistics Properties, Countryside Dairy, Twiga Foods, PowerGen Renewable Energy, Globology
	Dry Associates Limited	Multiple Hauliers, RMA Motors, Nakumatt, ARM cement, KK security, Davis & Shirlieff, ASL Credit
9.	Emerging Capital Partners	Maarifa Education Holdings, Wananchi Group Holdings, Java House, Africa Media Group, Celtel International, Bank of Africa Group, Blue Financial Services
10.	Energy Access Ventures	PayGo Energy, Sunculture, Inspirafarms, D.Light,
11.	Fanisi Capital	European Foods Africa, Live Ad, Haltons, Hillcrest International Schools, Ngare Narok Meat Industries.
12.	Fusion Capital Asset Management Limited	Thika Royal Palms, Flamingo Towers, 4 th Avenue Towers, Meru Greenwood City, Graceland Athi River, Galaxy Gardens, Remu Microfinance Bank
13.	Grassroots Business Fund	BrazAfric Enterprises, SOKO, WAMU
14.	HEVA	Katungulu Designs, Mwendwa Designs, Itikadi Designs, Mambo Pambo Designs, Ogake Designs, Peperuka, Aprelle Duany and Wazawazi, Victor Peace Photography, Thomson Photography.
15.	iBiz Africa	Valu Raha, Tatu Creatives, Eliteways Travel, Putpink, Jaynaz, Mapjam, Soo Tano
16.	Kibo Capital Partners	Ceil Healthcare, General Cargo Services
17.	Loita Capital Partners	AAR Credit Services, Kwik Fit East Africa Group
18.	Norfund	HFC Ltd., Kinangop Windfarm, Pure Power Ltd., BaseCamp Explorer, L. Turkana Windpower
19.	Novastar Ventures	PendA health, Poa Internet, Hivi Sasa, Soko, Komasa, Solar

		Now, Mfarm, Sanergy
20.	Pan African Investment Company	Bridge International, Mobius Motors, Trubooks,
21.	Pearl Capital	Western Seed, Dryland Seed Ltd, Midlands Ltd., Wilmar Flowers, Mimea International Ltd., Freshco (K) Ltd., Eldoville Dairies, Meru Horticulture Ltd
22.	Phatisa	General Plastics, Westpoint Heights, Westlands Place, 72 Magadi Road
23.	Progression Capital EA	Cellulant, Jamii Bora
24.	Savannah Fund	Copia, Sendy, Forex, Djuaji, Angani, Sevani Ltd, Safari Desk, Card Planet, Eneza Education.
25.	Swedfund	Timsales, AAR Healthcare, Deacons (K), Athi River Steel Plant, Radisson Blu,
26.	TBL Invest	Cellulant, Highlands Mineral Water, Kencall, Meridian Medical Services, Neo Amadiva, Research Solutions, Software Technologies, TKM Maestro
27.	Voxtra	Western Seed Company

APPENDIX II: QUESTIONNAIRE

Dear survey respondent,

Thank you for taking the time to complete this short survey. This study investigates the impact of Venture Capital financing on growth of Startup enterprises in Kenya. This is an academic research to be submitted in partial fulfillment for the award of Master of Science Commerce at KCA University.

Please fill this questionnaire by either ticking the correct answer in the boxes next to the question or indicating it in the spaces provided

SECTION A: GENERAL INFORMATION

1. How long has the business been in operation?

- 1-3 Years [] 3-5 Years [] 5-7 Years []
7-9 Years [] Over 9 Years []

2. What is the type of your business ownership?

- Partnership [] Limited Liability []

3. What is the nature of your startup?

- A. Agribusiness [] D. Manufacturing []
B. ICT [] Trade and Services []

4. What was your main source of finance? (Tick where applicable)

- Personal Savings [] Friends & Relatives []
Commercial Banks [] Grants & Donor Funds []
Microfinance []

5. How was growth of your firm prior to introduction of VC investments in your firm?

- Upward [] Stagnant [] Downward []

SECTION B: VENTURE CAPITAL FINANCING

1. What are the terms of the investment?

Debt [] Equity [] Both Equity & Debt []

2. What were the requirements of venture capitalist?

Business Plan [] Balance Sheet []

Cash flow Statement [] Profit & Loss Statement []

All of the above []

3. When did you receive VC funds?

1-2 Years [] 2-3 Years [] 3-4 Years []

4-5 Years [] Over 5 Years []

4. What was your purpose of acquiring these funds

Start Up [] Expansion []

Acquisition [] Turnaround []

6. Would you consider more rounds of financing from the same/other venture capital investors?

Yes [] No []

7. Please indicate the extent to which access to Venture Capital Financing has contributed to the growth of your business by ticking (√) the extent of agreement or disagreement with the descriptions for access to venture capital financing.

Variable	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
There are benefits associated with VC financing relative to bank loans					
The interest rate charged is lower and the payback period is spread over reasonable time					
Terms and conditions of the financing are done through private placement					
The repayment conditions are less stringent relative to commercial banks					
Investor financing increased the sales revenue by greater magnitudes					

Return on assets increases with increase in venture capital					
Value added income increased with venture capital usage					
VC capital financing enabled you to expand operations					

SECTION C: MANAGEMENT SUPPORT

1. How was the business managed prior to introduction of venture capital investor?

Owner Managed [] Team Work [] Professional Managers []

2. Does the board of management of your business include members of venture capital investor?

Yes [] No []

3. What kind of management support have you received from your investor?

Decision Making [] Expert Opinion [] Executive Information []

4. Has the management style changed with the presence of venture capital?

Yes [] No []

8. Please indicate the extent to which access to Venture Management Support has contributed to the growth of your business by ticking (√) the extent of agreement or disagreement with the descriptions for access to venture management support.

Variable	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
There's improvement in business efficiency					
Reduction in business costs was experienced					
Enhanced understanding and implementation of Total Quality Management					
Better management structures					
Improvement in the financial statements					
Diversification of business operations					

SECTION D: TECHNICAL SUPPORT

1. Do you receive any training from your VC investor?

Yes [] No []

2. What other ways of support apart from monetary input do the angel investors bring on board?

Advisory [] Consultant(s) []

New market opportunities [] Networking []

3. Does your investor participate in strategic planning of your business?

Yes [] No []

4. Does your venture capital investor take you to local or foreign business continuity forums, symposiums, conferences and training events?

Yes [] No []

5. In your opinion how effective is the input of the venture capital technical support in your business?

Very Effective [] Effective [] Neutral []

Not Effective [] Very Ineffective []

9. Please indicate the extent to which access to Venture Technical Support has contributed to the growth of your business by ticking (√) the extent of agreement or disagreement with the descriptions for access to venture technical support.

Variable	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Higher chances of getting secondary financing					
Access to External Markets					
Use of improved technology					
Rapid Prototyping and Marketing Strategies					

Expansion of Business Networks					
Human Capacity Development					

SECTION E: MONITORING

1. Do you have any performance review meetings with your investor?

Yes [] No []

2. How often do you hold progress review meetings of the startup?

Monthly [] Quarterly []

Semi Annually [] Annually []

3. Do you have monitoring and evaluation system?

Yes [] No []

4. What are the performance measuring approaches that fund managers use to monitor the progress of the startup?

Product to market [] Prototype development []

Market Share [] Revenue target []

5. Please indicate the extent to which access to Venture Capital Monitoring has contributed to the growth of your business by ticking (√) the extent of agreement or disagreement with the descriptions for access to venture capital monitoring.

Variable	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Clear Monitoring and Evaluation of the implementation of Strategic Plan					
Management Involvement in Budgeting					
Auditing of financial performance by VC investors					
Improved Management Strategies					
Improvement in Annual Turnover of your business					

SECTION F: GROWTH OF STARTUPS

1. What is the growth trend of your firm over the years you have used venture capital?

Upward [] Stagnant [] Downward []

2. How effective has VC investment been in growth of your firm relative to your earlier sources of financing?

Very Effective [] Effective [] Neutral []

Not Effective [] Very Ineffective []

3. Please indicate the extent to which access to Venture Capital investments has contributed to the growth of your business by ticking (✓) the extent of agreement or disagreement with the descriptions for access to venture capital.

Variable	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
VC has contributed to growth of sales					
Increase in revenue is attributed to VC					
Net assets grew with VC funding					
Liquidity has improved since VC financing					
Profitability of your startup has significantly improved after acquiring VC financing					

Thank you so much for your cooperation in filling this questionnaire.