Venture capital (VC): The all important MSMEs financing Strategy under neglect in Kenya

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Abstract

Micro, Small and Medium Enterprises (MSMEs) in Africa, have been variously reported to suffer lack of financial resources for growth and sustainability, especially because debt financing for financial institutions is generally expensive. That Equity financing through Venture capital (VC) is a non-bank source of funds considered to be an important alternative financing for small scale enterprising yearning to grow. Studies show that VC has the capacity to reduce problems of information asymmetry, adverse selection and moral hazard. VC though touted as the best alternative financial resource for MSMEs worldwide is still less appreciated by entrepreneurs in Africa in general and Kenya in particular. Empirical studies have shown that VCs portend more risk in financing MSMEs in earlier development stages, however, with proportionate breath; reasonable return is expected from early stage financing, into their mezzanine, growth and early maturity stages. Study reports therefore provide that there should be no cause for alarm on the side of the entrepreneur and the Venture Capitalist. This paper sought to investigate the level of awareness, appreciation and acknowleggement among the Kenyan investment community about the role Venture Capital financing play in boosting industrial development through MSMEs. The study employed a case study methodology that utilized a sample of 106 MSMES out of a target population of 229 MSMES registered in Nairobi Central Business District in Kenya. Data were collected by use of semi-structured questionnaire and personal interviews. Descriptive statistics including correlation analysis, ANOVA and measures of central tendencies using SPSS version 19 were employed to determine the variable associations, relationships and dispersion. The main findings were that all entrepreneurship development stakeholders were largely ignorant of the potentials for VCs to bridge the MSME financing gap. That venture capitalists were not willing to finance MSMEs in Kenya due to their volatility, inability to meet the requirements of venture capitalists and their inexperience in business financial management. That MSMEs in Kenya were found to be scarcely in partnerships, which denied them reasonable capital base requisite to attract VCs. Despite the fact that VC is one of the most relevant and important sources of finance for innovative entrepreneurship growth, this study found lack of enterprising culture to drive the promotion, competition, innovation, sector development and industrialization in Kenya.

Key words: Micro, Small and Medium Enterprises (MSMEs); Venture capital (VC); Equity financing; debt financing

Introduction

Government throughout the world is nowadays turning their attention to small scale enterprises. This is because attempts to promote economic progress by establishing large industries have usually failed to improve the lives of the majority of the populations concerned (White paper on international Development, 2000) Therefore, small and Medium Enterprises (SMEs) are now viewed as important in even and equitable economic development.
Kenya's policy on SMEs as outlined in the Sessional paper number 2 (2005) clearly show that the sector is not only a provider of goods and services but also a driver in promoting competition, innovation and enhancing the enterprise culture which is necessary for private sector development and industrialization. The sector should effectively respond to challenges of creating productive and sustainable employment opportunities, promoting economic growth and poverty eradication in the country.

The sessional paper further provides a framework that will support research and development to boost SMEs's access to appropriate technologies; encourage innovation and promote product design, development and quality control. SMEs will play a significant roll in contributing to the national goal of wealth creation and making Kenya an industrialized country.

Lack of access to credit is a major constraint inhibiting the growth of SMEs sector. The issues and problems limiting SMEs acquisition of financial services include lack of tangible security coupled with appropriate legal regulatory framework that does not recognize innovative strategies for lending to SMEs. Limited access to formal finance due to poor and insufficient capacity to deliver financial services to SMEs continues to be a constraint in the growth and expansion of the sector. Formal financial institutions perceive SMEs as high risk and commercially unviable as a result only a few SMEs access credit from formal financial institutions in the country. Various types of assistance have been provided to SMEs to boost their growth and development by making them more profitable (EA/SID, 2001). Several Organizations including business associations, voluntary organizations and other nongovernmental organizations have set up programs to enhance the factors that influence development of SME especially as it relates to enterprise growth and development. The types of the assistance offered by these organizations. Vary with some giving financial assistance, others training and extension services, pre-constructed commercial shades or assisting in marketing of products (Admati 1994)

Despite the large number of assistance programs, the growth and development of SME has not been satisfactory. Ventures have collapsed as soon as assisting organizations pull out of the project, and remaining ones have remained small (CBS/K – REP/ICEG, 1999). What then contributes to this kind of scenario? According to the study undertaken by Hallberg (1998), Mead and Liedholm (1998) and Ronge (2002), access to finance is an import ingredient to development. Financial constraints are likely to affect business creation and improvement. SME in Kenya have difficulties of accessing both credit finance and equity.

Venture capital is one source of non-bank financing, which is quite prevalent in developed financial markets for small or start up firms (Keuschnigg 1998). Venture Capitalists are organized providers of financing for winning but risky business proposals by small and medium firms that have a promising but yet unproven idea. If the venture capitalists are convinced that a business and provide the needed fund while sharing the risk. It is expected that many of the country's small businesses whose growth has been constrained by shortage of capital differs substantially from 'traditional' financing in the following ways:

(i) Funding provided to new or existing firms with potential for above average growth.
(ii) Often provided to start-up and other emerging enterprises because they lack the collateral, track record, or earnings required to get a loan.
(iii) The investment, typically requiring a high potential of return, is structured so that it can be liquidated within a three to seven year period.
(iv) Then an initial public offering may take place, or the business merges or is sold, or other sources of capital are found.
(v) The entrepreneur typically relinquishes some level of ownership and control of the business.
(vi) Venture capitalist typically expects a 20-50% annual return on their investment at the time they are bought out.
(vii) Typical investments range from $500,000 to $ 5 million.
(viii) Management experience is a major consideration in evaluating financing prospects (William 2004).

Unlike investment in secured debt which tend to risk averse. Venture capital seeks significant returns to compensate the high risk of loss of entire equity investment. It involves building and financing self sustaining companies from scratch and also assist revive their enterprises by merger and reconstruction.

According to Kibiriti et al (2000 three general criteria before a venture capitalist commits funds to an entrepreneur include: The company must have strong management team with solid experience and strong commitment to a company, the product /market opportunity must be unique having a differential advantage in a growing market, able to secure a unique market niche and the business opportunity must have significant capital appreciation ranging between 40 to 60% Return On Investment (ROI) in most investment situations. Therefore the chance for success of a new upstart company is a manifestation not only of entrepreneurial effort but also of a venture Capitalist's contributions.

Firms that utilize VC enjoy a number of benefits as compared to those that are not as many researchers have observed. Venture Capitalists play a critical role in reducing information asymmetries through the collection of critical, private information In perfect financial markets, funds are always available for value creating investment projects and financing decisions can be separated from investment decisions (Modigliani and Miller, 1958). Financial markets, however, are not perfect. Generally, they are characterized by important information asymmetries between entrepreneurs and investors and by resulting agency problems such as goal incongruence, adverse selection and moral hazard (Eisenhardt, 1989) In the presence of market imperfections, investors may ration capital and positive net present value projects may be denied financing, or only be able to obtain certain types of funding (fluck, 1998).

Venture capitalists play a critical role in reducing information asymmetries through the collection of critical, private information (Berger and Udell, 1995; Manigart et al., 2000). Amit (1998) argue that one of the primary reasons for the existence of VC companies is their information processing capacities which may reduce information asymmetries, and hence potential agency problems. Adverse selection problems are addressed through intensive screening before the funds are provided (M anigart and Sapienza, 1999; Lerner, 1995). VCs screen potential investments by collection of information about the business, the market in which it operates, and the entrepreneur or start-up team (Berger and Udell,1998). A good financing contract can reduce goal incongruence between entrepreneurs and investors (Sahlman. 1990) for exqmple by using convertible instruments (Gompers, 1998). Moral hazard problems are dealt with by monitoring the firm as soon as funds are provided (Cable and Shane, 1997; Lerner 1995; Gompers 1995). Finally the investment is typically staged to hedge against moral hazard problems (Sahlman,1990; gompers,1995). Ventures capitalists further provide value creating services to their portfolio companies (Amit et al, 1998).

Attracting VC financing may not only offer a financing solution for those companies that are unable to attract sufficient fund. The presence of VC in a company may influence the further financing of the company. Besides financial resources, VC provides credibility and legitimacy to its portfolio companies (Manigart and Sapienza, 1999). Moreover because they reduce information asymmetrics through screening and monitoring, their portfolio companies will be more attractive to other investors. Other parties may therefore free ride on the efforts that the VC has exerted. Once they have received VC funding.

A screening is an important role of VC companies (Lerner, 1995; Manigart and Sapienza, 1999) and as VCs are extremely selective, the mere fact that a VC company has invested in an unquoted company conveys positive information about that company. Hence, convincing a VC to invest should increase the potential of portfolio companies to attract subsequent financing from other parties. Moreover, through their roles of screening, contracting and monitoring, venture capitalists minimize the costs of delegating decisions to entrepreneurs or induce them to reveal critical information on their activities (Berger and Udell, 1998; Manigart and sapienza, 1999) If they perform their roles well, informed investors, such as venture capitalists, may develop an information monopoly on the firm (Rajan, 1992), Which enables them to generate substantial profits by proving funds at a higher price. The information monopoly, however, is limited in time; goes by other financing parties will observe the performances and creditworthiness of the firm. A strong, positive signal about the financial health and the future prospects of the firm is then sent to other potential investors, which increases the legitimacy of the firm (Megginson and weiss, 1991). This should allow companies with a good reputation to attract financing at better conditions (Diamond, 1991). Moreover, by providing equity, venture capitalists reduce the financial risk of other potential investors and hence should improve the access to subsequent financing. Finally, funding provided by venture capitalists can be used to buy tangible assets, such as buildings, which can in turn be used to collateral to acquire additional funds. This and many other reasons make a dynamic financing strategy for SMEs.

There is empirical evidence of the participation of VC in the industrialization of developed countries. In the United States of America, the role of venture Capital has been instrumental throughout its industrialization; however it became institutionalized after 2nd Word war. Before World War II, venture investment was a monopoly led by wealthy individuals, investment banking syndicates and few family organizations with a professional manger (Hisrich and Peters, 2002). For example, over the years, The Rockefeller family has made the initial capital contribution to a number of successful businesses. The first step towards institutionalizing Venture Capital industry took place in 1946 with formation of American Research and Development Corporation (ARD).

The next major development was the small business investment company act of 1958 which married private capital with government funds. It was led by professionally managed small Business Investment Companies (SBIC) to provide capital to start - up and growing businesses with tax advantage and incentives. SBIC were to start of the now formal Venture Capital Industry. During the late 1960s, small private Venture Capital firms emerged which were formed to provide investment funds. The organizers behind the partnership could raise capital from institutional investors such as insurance companies, pension funds and Bank Trust departments. There are over 2000 Venture Capital of these types in the USA (Hisrich and Peters 2002) both formal and informal. The Venture Capital Market in the USA has grown so rapidly that there exists another group referred to as **Business angels**. According to Freer et al. (2002) informal investors, include persons affectively referred to as **"angels**". Along with Family and Friends, they are the largest providers of early stage financing, both from a dollar standpoint as well as their sheer numbers. They are a homogeneous group that is very difficult to identify and capture and surprisingly may be your next door neighbor or a relative of your friends. They may be affiliated in that they have some contact with you or your business, or they could be non-affiliated in that they currently have no idea you even exist. However they are significant providers of equity risk capital at early stages of an entrepreneurial venture's life. Unlike the venture capital funds which are more visible, angels are less visible and difficult to find.

Due to perceived market opportunities and demonstrated of the USA, Venture Capital industry had a capital base of USA. $3.8 billion in 1995. Other developed countries like United Kingdom, Australia, Israel and Japan have joined a" bandwagon" mentality by establishing unlisted securities markets and developing tax shelters to encourage investors to create Venture Capital pools (Keushnigg, 1998). 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 new or expanding enterprises, including the reorganization, rationalization and reconstruction. Aureos East Africa which provides private equity and loan facilities has replaced the activities of Acacia(Finance Mail vol 9 no. 6 2003). Kenya Management Company Limited, which provides equity, related investments in private sector to companies with high growth potential to expand well-run businesses.

Donor backed public Debt Corporation that offer Venture Capital includes:

(i) Industrial credit and development Corporation (ICDC) provide capital directed at profitable existing small and medium sized industrial or commercial projects seeking expansion, modernization, recon structuring or diversification of existing activities. They also support business start-ups with firm prospects for financial and technical development. However its performance has been poor in the resent past and the World Bank which is the major source of its funds has called for liquidation.
(ii) Industrial Development Bank (IDB), which is a subsidiary of ICDC, currently restructuring its operations to serve SMEs better.
(iii) Commonwealth Development Corporation.

The presence of both private and government venture capital in Kenya is evidence that firms have a wide range of different sources of finance. But are the funds used? Are they known that they exist? This paper is concerned with enlightening the Kenyan investment community of the role Venture Capital firms has played in other countries to boost industrial development through SMEs and that the same finance is available in Kenya although little known. With the presence of Venture Capital firms in Kenya, entrepreneurs have an assured alternative source of finance available.

Statement of the problem

SMEs in Kenya lack knowledge about the existence of venture capital and hence do not utilize it as an alternative source of finance. The study carried out by Bronwy (1995), identifies unawareness as one of the factors that hinder entrepreneurs from using venture capital. Is this the same case for Kenya? Price water House (1989) also reveals a number of problems that face SME from utilizing venture capital. This paper is to examine whether unawareness and other factors are the cause of entrepreneurs not to use venture capital finance even when such funds are available locally. SMEs hardly grow beyond the start-up stage. Others go out of business at very early stage due to lack of funds. If the business community can be sensitized of other alternative of funding that may not discriminate against them despite their size, they will reach high of growth.

Objectives of study

The overall objective of study was to determine whether SME in Kenya were aware of venture capital and whether such capital was being utilized as an alternative finance strategy.

Methodology

A sample of 60 SMEs from Thika Municipal council was interviewed to get their perception and attitude towards utilizing venture capital as an alternative source of financing. A probability sampling random methods was used to select a sample size. Under this technique both stratified and simple random methods were used. Since the population was not homogeneous it was divided in to stratus of medium businesses and small businesses. Simple random sampling was then carried out by assigning numbers to subjects of each stratum size was determined as shown in the table below

Stratus	Sample
Medium Business	25
Small businesses	32
Total	60

Semi- structured questionnaire was the main instrument for data collection. Brien (1996) defines a systematic semi-structured questionnaire as a set of questions that logically follow each other and questions are both open ended and closed ended. The questionnaire was to interrogate respondents on various issues namely;

(i) Sources of finance they use in their businesses
(ii) If they have ever heard of venture capital
(iii) If they have used venture capital
(iv) Whether they use bank loan, among others.

Data was analyzed by using descriptive statistics, and statistical inference.

Results and Discussion

The findings Table 1 indicated that 87% of the respondents used personal savings as a source of finance in their capital structure. SMEs that used funds from friends constituted 48%. 57% used funds from micro finance institutions. Venture capital was least used (2%) and factoring of accounts receivables was not used at all (0%). Bank loan (7%) was also not popular in the capital structure of SME. Rouge (2002) confirms as the findings have revealed that, financial institutions perceive SMEs as high risk and commercially unviable and as a result only a few SMEs attempt the use of bank loans. The unreliable interest rates charged by the banks are also a concern to SMEs. SMEs use personal savings more as it does not haunt them even when the business is not performing.

The reasons given by respondents as to why they do not use bank loan include lack of collateral 58%, high interest rates 20% and 16.75% said that both lack of collateral and high interest rates were factors that scared them from approaching banks for funds. The Sessional paper no 2 of 1992 on small scale and Juakali development in Kenya (RoK, 1992) confirms that lack of reasonable collateral, lack of credit history. poor documentation, cash flow analysis and financial statement are hindrances to growth of SMEs).

The study indicated that 90% of the respondents lacked information about existence and operations of venture capitalists table 2. This finding is in agreement with Brownyn (1995) ,s study which indicated that many entrepreneurs were not aware of the existence of venture capitalists and how they operate. Unawareness is a factor that has made SMES not to use venture capital. Education program os mandatory in educating entrepreneurs on the roll and advantages of venture capital. 8.3% though had heard of venture capital , they lacked or had no knowledge of preparing investment proposal a firm must present to venture capitalists for consideration. When a correlation test was carried out table 3 to see if there is a relationship between use of venture capital and lack of knowledge of venture capital, the test showered that there a significant relationship as correlation co-efficient $r = -0.664$, meaning that lack of use of venture capital can be explained by an awareness of venture capital. It is then important that necessary action is taken to educate the Kenyan community of the benefits of venture capital fund relative to other sources of finance

Conclusion

The ignorance of the SME about VC as a finance alternative should be eliminated through educative programs countrywide. VC should be viewed as a dynamic financing strategy to SMEs for participation in leveraging indigenous products through innovations to enhance development. Though venture capitalists are not willing to finance SME due to their inability to meet requirements of venture capitalists, SME need to be educated on this aspect. They should also increase their capital base by forming partnerships so as to attract such funds. The study shows that there are significant benefits derived by a firm utilizing VC. This form of financing which has been in use in developed countries has led to industrial growth. VC is one of the most relevant sources of finance for innovative entrepreneurs to fund their growth. A venture capitalist may invest before there is real product or organized business (seed capita), or may provide capital to start up a business to grow beyond a critical point to become more successful. If the VC are convinced that a business idea is promising they will take an ownership stake in the business and provide the need fund while sharing the risk.

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Table1 Types of Finance used by SMEs

Types of Finance	Frequencies	
	Yes	No
Personal savings	52 (87%)	8 (13%)
Friends /relatives	29 (48%)	31 (52%)
Venture Capital	1 (2%)	59 (98%)
Commercial Bank loan	4 (7%)	56 (93%)
Microfinance institutions	26 (57%)	34(43%)
Factoring of receivable	0(0%	60(100%)

Table 2 Reasons for not Using Bank Loan

	Frequency	Percent
Lack of Collateral	35	58.3
High interest rates	12	20.0
Both	10	16.7
N/A	3	5.0
Total	60	100.0

Table 3 Reasons for not Using Venture Capital

	Frequency	Percent
Not heard of it	54	90.0
Lack of investment	5	8.3
Proposal		
N/A	1	1.7
Total	60	100.0

Table 4 Correlations Test

		Reasons for not using VC	VC as source of finance
Reasons for not using VC	Pearson Correlation	1	-664 (**)
	sig. (2-tailed)		.000
	N	60	60
VC as source of finance	Pearson Correlation	-664 (**)	1
	Sig. (2- tailed)	.000	
	N	60	60