

**The Impact of Venture Capital Finance on Performance of Small
and Medium Enterprises in Kenya**

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**A thesis Submitted in Fulfillment for the Degree of Doctor of Philosophy in
Entrepreneurship in the Jomo Kenyatta University of
Agriculture and Technology**

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DECLARATION

This thesis is my original work and has not been presented for a degree in any other University.

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DEDICATION

This work has been dedicated to my family; my husband John, children Moraa, Kerubo, Winona, Nyaboke and Newton

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TABLE OF CONTENTS

DECLARATION	ii
DEDICATION.....	iii
ACKNOWLEDGMENT	iv
TABLE OF CONTENTS	v
LIST OF TABLES.....	ix
LIST OF FIGURES.....	xi
LIST OF APPENDICES	xii
LIST OF ABBREVIATIONS.....	xiii
ABSTRACT	xiv
CHAPTER ONE.....	1
1.0. INTRODUCTION.....	1
1.1 Background.....	1
1.2 Statement of the Problem	7
1.3 Objective of the Study.....	10
1.3.1 Specific Objectives.....	10
1.3.2 Research Questions	10
1.4 Importance of Study/ Justification.....	10
1.6 Limitations of the Study.....	12
1.7 Definition of key Words.....	12
CHAPTER TWO.....	15
2.0. LITERATURE REVIEW.....	15
2.1. Introduction	15
2.2. Theoretical Literature.....	15
2.2.1. Conceptual Framework	16

2.2.2. Finance Impact Assessment Theories	19
2.4 Performance of Small and Medium Enterprises.....	22
2.4.2 Performance Measurement	27
2.4.3. Models of Performance Measurement	28
2.5. Theory and Practice of Venture Capital.....	29
2.5.1. Venture Capital Defined.....	29
2.5.2. Business Angels	31
2.5.2. The History of Venture Capital.....	34
2.5.4. Venture Capital Investment Process	37
2.6. Empirical Literature	40
2.6.1. The Influence of Venture Capital on Growth of SMEs.....	40
2.6.2 Influence of Venture Capital on Financial Management of SMEs.....	42
2.6.3 Influence of Venture Capital on Management Styles of SMEs.....	44
2.6.7 Presence of Venture Capital May Attract Other Sources of Finance.....	47
2.7. Conclusion.....	51
CHAPTER THREE.....	52
3.0. RESEARCH METHODOLOGY	52
3.1 Introduction	52
3.2 Research Design	52
3.3. Population.....	54
3.3.1 Target Population	55
3.4 Sampling Frame.....	55
3.5 Sampling Techniques.....	56
3.6 Data Collection Instruments	57
3.7 Data Collection Procedure.....	58

3.8 Pilot Testing.....	59
3.9 Data Processing and Analysis.....	60
CHAPTER FOUR	63
4.0. RESEARCH FINDINGS AND DISCUSSION	63
4.1. Introduction	63
4.2 The Profile of the Respondents.....	63
4.2.1 The Designation of the Respondents.....	64
4.2.2 Location of Businesses	65
4.2.3 Type of Businesses.....	66
4.2.4 Age of the Firms Under Study.....	67
4.2.5 Business Ownership	68
4.2.6 Year Venture Capital was first used.....	69
4.2.7 Nature of Transactions	71
4.3 Accessing Whether or not Venture Capital Leads to Growth	72
4.3.1 Sales Before and After use of Venture Capital.....	72
4.3.2 Profit Before and After use of Venture Capital	74
4.3.3 Net Assets Before and After use of Venture Capital.	79
4.3.4 Employees Before and After use of Venture Capital.....	81
4.4 Influence of Venture Capital on Financial Management	83
4.4.2 Cash Planning Before and After use of Venture Capital.....	86
4.4.3 Debt Collection Before and After Venture Capital use.....	88
4.4.4 Inventory Control Before and After use of Venture Capital	90
4.5.1 Sources of Finance Before and After use of Venture Capital	93
4.5.2 Reasons why Bank Loan was Difficult to Accesses	96
4.5.3. Reasons for Financing by Other Sources upon use of Venture Capital	98

4.6.1	Employees in Decision Making Before and After Use of Venture Capital..	100
4.6.2	Gender Sensitivity	102
CHAPTER FIVE	106
5.0. SUMMARY, CONCLUSION AND RECOMMENDATIONS	106
5.1	Introduction	106
5.2	Summary	106
5.2.1	Does Access of Venture Capital Lead to Growth of SMEs?.....	106
5.2.2	Does the Presence of Venture Capital Improve Financial Management?107	
5.2.3	How do Venture Capitalists Influence the SMEs Management Style? ...	108
5.2.4	Does the Presence of Venture Capital Attract Other Sources of Finance?	108
5.3	Conclusion.....	109
5.4	Recommendations.....	110
5.5	Suggestions for Further Study	111
REFERENCES	113
APPENDICES	132

LIST OF TABLES

Table 3.1: Sample Size	57
Table 4.2: Location of Business and Type of Business Cross Tabulation.....	65
Table 4.3: The Age of the Firms	67
Table 4.4: Nature of Transactions	71
Table 4.5: Sales Before and After use of Venture Capital.....	73
Table 4.6: Correlations of Sales Before and After use of Venture Capital.....	73
Table 4.7: Chi-Square Test	74
Table 4.8: Profit Before and After use of Venture Capital	76
Table 4.9: Growth in Profit Margin by Business Type.....	78
Table 4.10: ANOVA Test Annual Profit After / Before use of Venture Capital	79
Table 4.11: Net Assets Before and After use of Venture Capital	80
Table 4.12: Return on Assets Before and After use of Venture Capital.....	80
Table 4.13: Assets Turnover Before and After use of Venture Capital.....	81
Table 4.14: Number of Employees Before use of Venture Capital.....	82
Table 4.15: Preparation of Budgets Before.....	84
Table 4.16: Preparation of Budgets After use of Venture Capital	85
Table 4.17: Presence of Venture Capital Members in the Board of Management...	86
Table 4.19: Debt Collection After use of Venture Capital	90
Table 4.20: Correlations Analysis	90
Table 4.21: Inventory Control Before use of Venture Capital.....	91
Table 4.22: Sources of Finance Before use of Venture Capital	94
Table 4.23: Bank Interest Rate	95
Table 4.24: Accesses to Bank Loan Before	96
Table 4.25: Reasons why Bank Loan was Difficult	97

Table 4.26: Sources of Finance After use of Venture Capital	98
Table 4.27: Chi-Square Test.....	98
Table 4.28: Employees in Decision Making Before.....	101
Table 4.29: Employees in Decision Making After use of Venture Capital	102
Table 4.30: Percentage of Male and Female to Total Workforce	104
Table 4.31: Chi-Squire Test	104

LIST OF FIGURES

Figure 2.1: Conceptual Framework.....	18
Figure 2.2: Investment Processes.	39
Figure 4.3: Respondents Designation.....	64
Figure 4.4: Type of Businesses	66
Figure 4.5: Growth in Profits in Terms of age of Businesses	68
Figure 4.6: The Businesses Ownership	69
Figure 4.7: Year Venture Capital was First Used.....	70
Figure 4.8: Respondents on Profitability Before Venture Capital	75
Figure 4.9: Response on Profitability Trend After Venture Capital	75
Figure 4.10: Growth in Profit in Relation to Period of Venture Capital	77
Figure 4.11: Number of Workers After use of Venture Capital	83
Figure 4.12: Cash Planning Before use of Venture Capital.....	87
Figure 4.13: Cash Planning After use of Venture Capital	88
Figure 4.14: Inventory Control After use of Venture Capital.....	92
Figure 4.15: Reasons for Finance Upon use of Venture Capital.....	100
Figure 4.16: Gender Sensitive.....	103

LIST OF APPENDICES

Appendix 1: Questionnaire	132
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LIST OF ABBREVIATIONS

BSC	Balanced Scorecard
CDC	Commonwealth Development Corporation
GDP	Gross Domestic Product
ICDC	Industrial Commercial Development Corporation
KIPPRA	Kenya Institute of Public Policy Research and Analysis
ROCE	Return on Capital Employed
ROI	Return on Investment
ROK	Republic of Kenya
SBIC	Small Business Investment Corporation
SMEs	Small and Medium Enterprises
SPSS	Statistical Package for Social Sciences
UNDP	United Nations Development Programs
USA	United States of America
VC	Venture Capital

ABSTRACT

Venture capital has impacted significantly on performance of Small and Medium Enterprises (SMEs) in developed countries. In Developed countries small businesses are the stepping stone of industrialization. However in the developing countries and especially Kenya venture capital has been present since 1970s yet industrialization is slow. Lack of finance has been cited as a major contributor to SMEs failure in Kenya. No studies have been done investigating the impact of venture capital in Kenya. The overall objective of this study was thus to establish the impact of venture capital on performance of SMEs in Kenya.

The research design adopted was exploratory due to the fact that venture capital is relatively an unknown area. The design also enabled the researcher to gain a deep understanding of the area. The impact methodology used in this study is where data was collected on firms before using venture capital and after using venture capital.

The target population of this study consisted of 200 SMEs that have used venture capital. The research employed a case study method of utilizing a sample of 100 SMEs that have been financed by venture capitalist in the major towns of Kenya (Nairobi, Kisumu, Nakuru & Mombasa). Data was collected through semi structured questionnaire. The e-mail system was used to send questionnaires to some firms.

Data analysis was carried out using statistical techniques with the help of computer software (SPSS and Excel). Frequency tables were prepared, averages determined, tests of hypothesis like ANOVA, chi-square, correlation analysis were carried out.

The findings in this study revealed that venture capital has an impact on performance of SMEs they finance. Upon use of venture capital average profits

doubled (Ksh 12,202,775), value of assets improved drastically (Ksh 102,547,692) as funds were available for expansion or for diversification. Sales on average also doubled (Ksh 139, 043,076) as was employment in the firms where a total of 24,802 workers were absorbed.

On assessing whether firms that use venture capital attract other sources of finance, the findings indicated that 100% confirmed that other sources of finance were willing to provide funding including banks which were initially difficult to consider SMEs for funding. There was improvement in financial management as cash planning was carried out by 98% of the firms, debt collection was satisfactory (75%) and inventory control was good (62%). Management style improved when firms used venture capital. Upon use of venture capital the findings revealed that 99% participated in decision making. The study has demonstrated that use of venture capital can be profitable in Kenya even in an inauspicious political and economic climate. The study concluded that SMEs that use venture capital experience improved performance.

Based on the above findings, the following recommendations are proposed: businesses should be encouraged to use this type of finance for economic development, more local institutions and individuals should be encouraged to join the venture capital fund to build the fund capacity for more investments. Currently, the contributors to the fund are foreign citizens. Venture capital has potentials of assisting Kenya to achieve vision 2030 which advocates for strengthening SMEs to become key industries of tomorrow.

CHAPTER ONE

1.0. INTRODUCTION

1.1 Background

In sub-Saharan Africa, poverty has persisted over the years despite efforts of the governments to fight it through implementation of special programs aimed at enhancing the countries' economic growth (United Nations Development Programs [UNDP], 2000). One of the most important strategies that the governments use to fight poverty is to enhance Small and Medium Enterprises (SMEs). However, the rise of the small-business class in Africa has been hindered by political instability or strong dependence on a few raw materials. In the Democratic Republic of Congo, for example, most SMEs went bankrupt in the 1990s as a result of looting in 1993 and 1996 or during the civil war. In Congo, Equatorial Guinea, Gabon and Chad, the dominance of oil has slowed the emergence of non-oil businesses. Between these two extremes, Senegal and Kenya have created conditions for private-sector growth but are still held back by an inadequate financial system. In Nigeria, SMEs are key to the economy but insecurity, corruption and poor infrastructure prevent them being motors of growth (Kauffmann, 2005).

The Kenyan Development Plan of 2002 – 2008 (RoK, 2002) has clearly outlined the importance of the SMEs in its contribution to economic growth as follows: promoting full productive and freely chosen employment, improving access to income earning opportunities, wealth creation leading to productive and sustainable employment quality, enhancing SMEs sustainable economic growth and ability to create change with flexibility, increase domestic savings and investment thus balancing regions and local development. Importantly, SMEs provide jobs and services that are better adapted to local markets and stimulate innovation, enterprise

technology development and research and improve access to international and domestic market.

The government's main objectives, policies and strategies for SMEs as articulated in the policy analysis and planning for SMEs (Kenya Institute of Public Policy Research and Analysis [KIPPRA], 2005) are aimed at reviving the private sector via the SMEs. The Economic Recovery Strategy for Wealth and Employment Creation of 2003-2007 (RoK, 2003) outlines a recovery centered on a reanimated private sector. Reviving the private sector activity and investment and specifically SMEs development feature prominently in the government's strategy for raising income and employment.

The government's mandate into prioritized program of action emphasizes the importance of the micro and small enterprises sector in job creation. Furthermore, the Sessional Paper No.2 (RoK, 2005) on development of micro and small enterprises for wealth and employment creation for poverty eradication provides a framework that will develop a vibrant SMEs sector capable of promoting the creation of durable, decent and productive employment opportunities. The sector will then stimulate economic growth, reduce economic disparities and strengthen linkages between firms. This will also bring about diversification of domestic production structure and industrial base; leveling the playing field between SMEs and the larger enterprise.

The Kenya Economic Survey (RoK, 2005) indicates that the sector's total employment recorded in 2004 was 5.97 million up from 5.1 million employees reported in 2002. The sector's job creation in the same period increased to 437,900 from 413,100 jobs recorded in the year 2003 compared to the formal sector which recorded an extra 36400 jobs (RoK, 2005). The informal sector also accounted for 18% of the national Gross Domestic Product (GDP). The Economic Survey (RoK,

2006) again confirms that the sector contributed over 50 percent of new jobs created in the year 2005.

It is intriguing to note that the informal sector, where SMEs are a major participant, contributes positively to eradication of poverty through employment creation. This was the focus of Sessional Paper no.2 of 1992 on Small Scale and Jua Kali Development in Kenya (RoK, 1992). The paper focuses on the role of SMEs and stresses the potential of SMEs sector to act as an engine of growth for the country's industrial development. The Chairman of Kenya Private Sector Alliance (KPSA) also expressed similar sentiments as reflected in the Finance Magazine August Issue of 2005. The report says that the private sector should be viewed as an engine of growth and to succeed in this endeavor, the sector must be more organized and dedicated in their mission of growing and that the SMEs should aim at graduating from informal to formal status.

Research carried out on eliminating world poverty as reported in the White Paper on International Development of 2000 acknowledged SMEs as the main source of new jobs and income for the poor. The work suggested that measures be taken to create a positive legal and regulatory environment by decentralizing registration of business names to the district level, eliminate trade licensing at the central government level, broadening access to finance and enacting an Act for SMEs. These measures will enable SMEs to facilitate economic growth.

Various types of assistance have been provided to SMEs to boost their growth and development by making them especially more profitable (Institute of Economic Affairs and Society for International Development [IEA/SID], 2001). Several organizations including business associations, voluntary organizations and other non-governmental organizations have set up programs to enhance the factors that

influence the development of SMEs especially as it relates to enterprise growth and development. The assistance offered by these organizations varies from financial assistance to training and extension services and pre-constructed commercial shades or assisting in marketing of products (Donde, 1995). Despite their significance, past statistics indicate that three out of five businesses fail within the first few months of operation as reported in the Kenya National Bureau of Statistics of 2007. According to Amyx (2005), one of the most significant challenges is the negative perception towards SMEs. Potential clients perceive small businesses as lacking the ability to provide quality services and are unable to satisfy more than one critical project simultaneously

Despite the large number of facilitation programs, the growth and development of SMEs has not been satisfactory. Many ventures have collapsed as soon as assisting organizations pull out of the project, and remaining ones have remained small (Kauffmann, 2005). What then contributes to this kind of scenario of failing SMEs? According to the study undertaken by Hallberg (1998), Mead and Liedholm (1998), access to finance is an important ingredient to development. The study indicated that financial constraints affected business creation and improvement. Many findings indicate that SMEs in Kenya experience difficulties in accessing both credit finance and equity.

According to the policy of financing SMEs in African countries (Kauffmann, 2005), African financial systems are fragmented and lack of funding for SMEs has partly been made up for by micro-credit institutions, whose growth is due to the flexible loans they offer small businesses. Loans are provided free of bank charges, without a minimum deposit and with informal guarantees (property assets and a guarantor), as well as permanent contact with loan managers. Though adapted to local

needs, however, micro-credit institutions remain fragile and modest-sized. Micro-credit institutions lack trained staff and also face limited expansion because of their limited funds. Their mainly short-term finance means they cannot easily turn the savings they collect into medium or long-term loans. The economic survey (RoK, 2005) attributes increased trend of SMEs in Kenya to the micro-finance sector. This source of finance has been of help to SMEs however, it does not provide equity capital and funds may not be sufficient for an expanding business. Evidence (KIPPRA, 2000) shows that in Kenya, Tanzania, Zimbabwe, South Africa and Zambia, formal credit is presently quantitatively the most important source of external finance; however the financial markets are inefficient.

The absence of an efficient financial intermediation mechanism, which can effectively channel resources towards private productive investment, has hampered the potential of SMEs. Lack of appropriate credit and equity capital also continue to constrain the growth and expansion of the sector. SMEs in developing countries, Kenya in particular, face the dilemma of expanding their enterprises because of the negative attitude towards them by banks and other conventional sources of finance. SMEs have few alternatives of accessing financing other than relying on their retained earnings to finance investments. In Kenya, commercial papers and other capital market instruments has remained the domain of large financially strong blue chip corporations (Mukherjee, 1999). The needs of SMEs remain largely ignored.

Other drawbacks SMEs experience includes lack of reasonable collateral, lack of credit history, poor documentation, lack of cash flow analysis and financial statements (RoK, 1992). Gakure, (2005) also noted that some of the factors hindering credit accessibility include lack of managerial skills, lack of finance, poor financial management, lack of technological know-how and lack of training. Many SMEs have

little access to many sources of finance due to legal and regulatory framework that does not recognize innovative strategies for lending to SMEs and limited access to formal finance due to poor and insufficient capacity to deliver financial services to SMEs

Venture capital (VC) is one source of non-bank financing, which is prevalent in developed financial markets for small scale and start up firms (Freear & Sohi, 1994). Gompers, Lerner (1998) also defined venture capital as a professionally managed pool of money raised for the sole purpose of making actively managed direct equity investments in rapidly growing private businesses. This form of finance is regarded as a modern entrepreneurial financial innovation. The availability of venture capital is critical for starting up a new business for a country that intends to join the community of highly developed industrialized economies. Venture capitalists are organized providers of financing for winning risky business proposals by SMEs that have promising but as yet unproven ideas. If the venture capitalists are convinced that a business idea is promising, they will take an ownership stake in the business and provide the needed funds while sharing the risk.

In developed economies where venture capital has played a big role in financing SMEs, the sector has grown so wide that it has both the formal venture capitalists and the informal venture capitalist (invisible venture capitalists) referred to as business angels (Freear, 2003). Venture capitalists have played a significant role in financing SMEs. It is the researcher's view that if small firms are to continue graduating from one level to another, it is critical for them to have variety sources of equity and even debt finance. The present study therefore was conducted to show the impact of venture capital on SMEs performance.

Performance is defined as “the manner in which or efficiency with which something fulfils its intended course measured against present standards” (Pearsall, 2001). Neeley et al., (1995) defines performance measurement as the process of quantifying the efficiency and effectiveness of an action. However, Sari et al., (2004) observed that measures of organizational performance or effectiveness is not easy for businesses with multiple objectives of profitability, employee satisfaction, production, growth, ability to adopt to ever changing environment among others. Studies that have measured performance have considered growth (turnover, number of employees, market share), profitability (for example amount of profit, return on investment) and survival (Storey, 1994; Hudson et al & Matambuya, 2001). Measures of performance may include both financial and non financial. In this study performance was measured by using, growth, financial management, other financiers, and management style.

1.2 Statement of the Problem

Many SMEs in Kenya remain small due to lack of working capital and funds for expansion. Such businesses do not provide the much hyped role of job creation, contribution to Gross Domestic Product (GDP) and above all contribution to social economic development as reported by the White Paper on International Development of 2000, although they have the potential. Many scholars (Mukherjee, 1999; KIPPRA, 2000; Bronwyn, 1995) point out that SMEs lack finance due to discrimination from the financial institutions especially banks. The study undertaken by Hallberg (1998) & Mead & Liedholm (1998) reveals that access to finance is an important ingredient to development of SMEs. SMEs have few alternatives of accessing finance other than relying on their retained earnings to finance their investments. Notwithstanding the

financial difficulties faced by SMEs presently in Kenya, alternative sources of funds have to be sought to sustain this important sector.

Venture capital, which is quite prevalent in developed countries, has played a big role in enhancing growth of SMEs by providing equity capital. Freear, Sohl & Wetzel (1994) have noted that there are two primary sources of external equity capital for entrepreneurs: visible and invisible (business angels). The visible (formal) venture capital market is composed of professional funds. The invisible (informal) venture capital market is composed of a diverse and dispersed population of high net worth individuals. In countries where both forms of venture capital participate in financing SMEs, they are value-adding investors who bring significant benefits of their business know-how, industry experience, and contact to a business venture (Sohl, 2003). Venture capital (formal) has been present in Kenya since 1970s (Abuodho, 1996). This coincided with the change of Kenya government policies to establishment of SMEs after the ILO report of 1972 which highlighted the important role played by SMEs to socio-economic development.

Empirical evidence as reported in the European Venture Capital Association (EVCA) Review of 2001 show that SMEs that have received venture capital funding created an average of 46 additional jobs and 60% of the respondents said that without venture capital the company would not have existed today. A report by Global insight (2009) on economic impact of venture capital backed firms as reported by USA's National Venture Capital Association revealed the following: In 2008, venture capital-backed companies employed more than 12 million people and generated nearly \$3 trillion in revenue. These figures accounted for 11 % of private sector employment and represented the equivalent of 21 % of U.S.A GDP during that same year. Empirical evidence (Brav & Gompers 1997) confirms that superior performance

by venture capital-backed firms is often attributed to better management teams and corporate governance structures that help these companies to perform better in the long run. A study on the impact of venture capital on the Canadian economy (CVCA, 2009) also revealed that firms that used venture capital employed 1.3% of all private sector employees and contributed 1% of GDP. The impact on growth was notable as venture capital backed firms grew more than 5 times faster than the overall. This therefore, demonstrates that venture capital influences performance of SMEs.

Earlier work on venture capital market in Kenya (Okongo, 2001) only focused on formal venture capital firms and their requirement in financing SMEs especially institutionalized venture capital firms. The study by Ngigi (1996) on the role of venture capital in financing technology based SMEs only focused on formal venture capital firms that are government owned. The findings indicated that many technology based firms do not qualify for venture capital finance due to lack of basic requirements. Another study by Sigara (2004) focused on factors hindering SMEs from using venture capital finance and unawareness was found to be the major contributing factor among others.

The present work although has a bearing to work of earlier researchers analysis, the impact of venture capital on performance of SMEs in Kenya has not been carried out. However, there are SMEs that have received venture capital funds in Kenya. What is the impact of this finance on performance of SMEs that have used these funds? The researcher feels that though venture capital firms have been present in Kenya as early as 1970s their impact on SMEs has not been significant. If there has been, then as is reported by other countries, Kenya would be experiencing massive industrial development via SMEs. The purpose of this study was therefore to establish the impact of venture capital on performance of SMEs in Kenya.

1.3 Objective of the Study

The overall objective of the study was to establish the impact of venture capital on performance of SMEs in Kenya.

1.3.1 Specific Objectives

- i. To investigate if venture capital finance leads to growth of SMEs.
- ii. To establish if SMEs that use venture capital attract other sources of finance.
- iii. To determine the influence of venture capital on management style used by SMEs.
- iv. To investigate the influence of venture capital on finance management of SMEs.

1.3.2 Research Questions

- i. Does access of venture capital finance lead to growth of SMEs?
- ii. Does the presence of venture capital in an SMEs attract other sources of finance?
- iii. How do venture capitalists influence the management style of SMEs?
- iv. Does the presence of venture capital influence finance management of SMEs?

1.4 Importance of Study/ Justification

These are aspects on how the study contributes or benefit people or researchers (Penneerselvam, 2006). This study brings in to record the impact of venture capital on SMEs performance in Kenya which will be useful to various stake holders as outlined below.

The study contributes to the pool of knowledge (as the impact of venture capital on SMEs performance has been empirically established) from which other

researchers will use the findings to understand issues raised and use them as reference material and/or base for further study.

The government will gain an understanding of the role played by both informal and formal venture capital market so as to provide a suitable environment for their operations especially to formulate policies that will support the entrepreneurs. This study will be of value to achievement of the Kenyan vision 2030 (which advocates for strengthening SMEs to become the key industries of tomorrow). This study having brought to light the impact of venture capital on performance of SMEs, the venture capitalists will review the need to provide seed financing which will lead to establishment of many such businesses. These financiers can also review their stringent requirements to accommodate more users of their fund.

Entrepreneurs unfamiliar with such equity providers will get access to funds to expand their establishments. The financially able individuals may join the network of invisible capitalists to finance SMEs in order to create employment, hence development. The formal venture capital market may know that the informal sector is its competitor in equity provision and as such relax their requirements.

1.5 Scope of the study

This study concentrated on SMEs sources of equity financing particularly venture capital finance both informal or invisible and formal. The study examined the impact of venture capital on SMEs performance before and after use of venture capital. This study selectively examined 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 considered SMEs from major urban centers of the country which included Nairobi, Mombasa, Nakuru and Kisumu that have used venture capital.

1.6 Limitations of the Study

The study experienced a number of limitations which made the work difficult. Finances available were insufficient to meet the field work expenditure. Some firms were uncooperative and it was difficult to secure an appointment. Many a time the respondents were held in their activities for example, being in meetings when they were to meet with the researcher and this was very inconveniencing and time wasting. The confidentiality required with private firms was high and so respondents were either not willing or shy to provide some information until permission was sort from the high office. To overcome such problems the researcher consistently made several visits and eventually there was a breakthrough in to data collection

Some respondents felt that they needed to be paid to fill the questionnaire as they felt that the exercise was time wasting and this delayed the data collection. Some respondents did not even submit a filled questionnaire and on enquiry they were not willing to give any reason. Some venture capital firms (for example the PTA bank which provides equity finance to SMEs in the region) were not willing to disclose the firms they have financed and this reduced the sample that actually responded. However despite the challenges, sufficient data was collected for analysis.

1.7 Definition of key Words

Business angels: They are formal venture capitalists that are significant suppliers of equity risk capital at early stages of business operations.

Equity financing: Money invested in a venture with no legal obligation for the enterprise to repay the principal interest on it.

Small and Medium Enterprises: SMEs area those that employ 6 to 50 people and with a turnover of not more than Kshs 50 million. This definition

has been used by studies ((Grey et al., 1996)) on SMEs in Kenya and this study adopted it as a working definition.

Venture capital: Is investment in long term risk equity finance where the primary rewards for it s providence is an eventual capital gain rather than income on dividend yield.

Due diligence: Carrying out duties or tasks carefully. Diligence is a zealous and careful nature in one's actions and work. Decisive work ethic. Budgeting one's time; monitoring one's own activities to guard against laziness. Putting forth full concentration in one's work.

Growth: The concept of expanding sales operations or assets and usually a major strategic objective of a business.

Screening: Check on or investigate (someone), typically to ascertain whether they are suitable for or can be trusted in a particular situation or job. Evaluate or analyze (something) for its suitability for a particular purpose or application.

Management buyout: A form of acquisition where a company's existing management acquires a large part or all of the company. The purpose of such a buyout from the managers' point of view may be to save their jobs, either if the business has been scheduled for closure or if an outside purchaser would bring in its own management team. They may also want to maximize the financial benefits they receive from the success they bring to the company by taking the profits for themselves.

Financial risk: is the risk that a firm will be unable to meet its financial obligations when they fall due. This risk is primarily a function of the relative amount of debt that the firm uses to finance its assets. A higher proportion of

debt increases the likelihood that at some point the firm will be unable to pay the required interest and principal payments.

Cash flow: Cash flow refers to the movement of cash into or out of a business, a project, or a financial product. It is usually measured during a specified, finite period of time.

Net present value: Is the difference between the present value of cash inflows and present value of cash out flows.

Financial markets: Mechanism that allows people to easily buy and sell (trade) financial securities (such as stocks and bonds), commodities (such as precious metals or agricultural goods),

Entrepreneurship: The act of being an entrepreneur is a French word meaning one who undertakes an endeavor. Entrepreneurs assemble resources including innovations, finance and business acumen in an effort to transform innovations into economic goods.

Performance: Performance is defined as the manner in which or efficiency with which something fulfils its intended course measured against present standards. Studies (Storey, 1994; Robinson et al., 1984) that have measured performance have considered growth (turnover, number of employees, market share), profitability (for example amount of profit, return on investment) and survivals among others. Measures of performance may be financial or non financial.

CHAPTER TWO

2.0. LITERATURE REVIEW

2.1. Introduction

The purpose of this chapter was to explore theoretical and empirical underpinning with the objective of finding what other scholars have researched on or written regarding venture capital. The chapter develops a conceptual framework, which forms the basis of comparison of data analysis and models. The chapter is structured as follows: Conceptual framework, theoretical background, performance of small and medium enterprises, small and medium enterprises defined, performance measurements, performance models, theory and practice of venture capital, venture capital defined, the history of venture capital, venture capital investment process, the influence of venture capital on growth of SMEs influence of venture capital on financial management of SMEs, influence of venture capital on management styles of SMEs and other sources of finances attracted buy SMEs using venture capital.

2.2. Theoretical Literature

A theory is a “set of interrelated concepts, definitions, and propositions that present a systematic view of events or situations by specifying relations among variables, in order to explain and predict the events or situations” (Van Ryn & Heaney, 1992).

Theoretical literature is concerned primarily with theories or hypotheses rather than practical application. Theoretical literature begins with a formal model that seeks to explain participation patterns in terms of underlying theory (Heilbrun & Gray, 1993). In this study theories of measuring impact and performance of SMEs have been addressed conceptual framework developed and the practice and theory of venture capital explored.

2.2.1. Conceptual Framework

Miles and Huberman (1984) define a conceptual framework as the current version of the researcher's map of the territory being investigated. Implicit in their view is that conceptual frameworks may evolve as research evolves. Their notion accommodates purpose (boundaries) with flexibility (evolution) and coherence of the research (plan/analysis/conclusion) which all stem from conceptual frameworks. Mugenda and Mugenda (1999) also view a conceptual framework as a hypothesized model identifying the model under study and the relationships between the dependent variable and independent variables. A researcher conceptualizes the relationship between variables in the study and shows the relationship graphically or diagrammatically. Newsman (1994) urge that in a conceptual framework, descriptive categories are systematically placed in broad structure of explicit prepositions, statement of relationships between two or more empirical properties (variables) to be accepted or rejected. A variable according to Kothari (2003) is a concept, which can take on qualities of quantitative values. Lumley (1994) sees a variable as an attribute or qualities of the cases that are recorded or measured. A dependant variable is the outcome variable, the one that is being predicted. Variation in the dependent variable is what the researcher tries to explain. The independent variable also known as the predictor or explanatory variables are factors that explain variation in the dependent variable (Allison, 1996).

The purpose of a conceptual framework is to assist the reader to quickly see the proposed relationship and hence its use in this study. A study by Shorsh and Vernon (2007) on overlooking the conceptual framework concluded that a conceptual framework has a critical role to play in doctoral research and examination process. In this study the independent variable is venture capital and the dependent variable is the

performance of SMEs which changes as independent variable changes. Growth, financial management, other financiers and management style were used as indicators or measures of performance (Figure 2.1). Growth was measured using sales, number of employees, profitability and value of net assets. Debt collection, cash planning, budget preparations and inventory control also measured financial management. Decision making and gender sensitivity were used to measure management style while sources of finance were used to measure other financiers that financed SMEs upon use of venture capital (figure 2.1). However finance is not the only factor that impacts on a firm's performance. Other non financial factors such as marketing, training, research and development, political climate among others influence the performance of a business. In this study these factors are held constant.

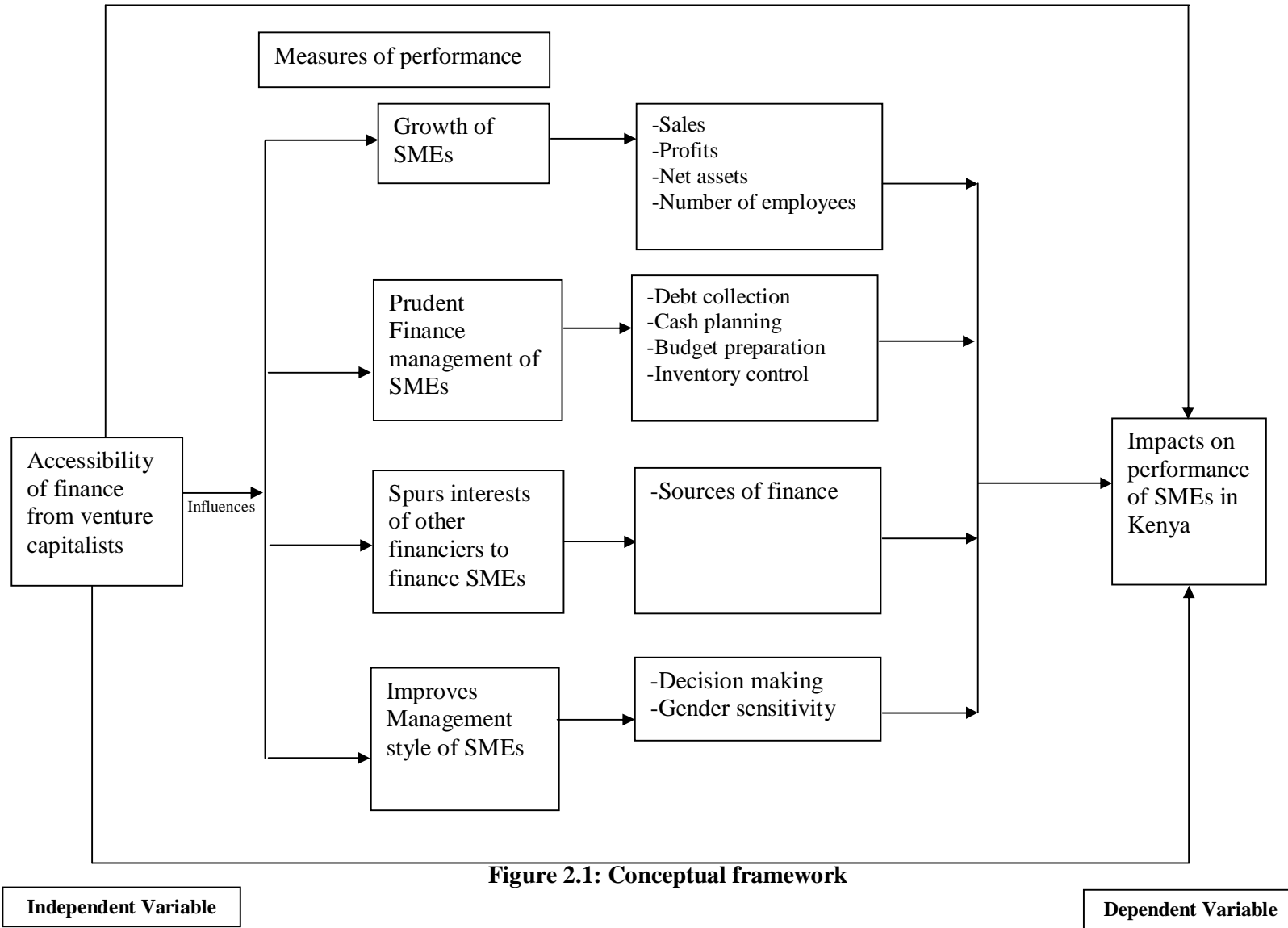


Figure 2.1: Conceptual framework

2.2.2. Finance Impact Assessment Theories

A good impact evaluation is grounded in a conceptual framework that provides a kind of road map to the paths of impact. The finance impact assessment model has been used in this study since venture capital is a type of finance. Finance impact analysis is the process by which one determines the effect of finance as an intervention. The effects examined depend on the outcomes that are sought. Historically, impact assessment has been done to meet donor needs to justify funding. Impact assessment can be used to improve services, increasing impact on poverty and financiers efficiency, to promote good client service and accountability, and to provide accountability to fund providers and other external stakeholders (Small Enterprise Education and Promotion [SEEP], 2000). As indicated by Tsehay and Mengistu (2002) and Ledgerwood (1999), there are two major schools of thought that are prominent in impact assessment of finance. They are:

- i. The financial system approach, also called impact proxies. This approach focuses on changes in the organization and its operations. This line of thinking holds that the success of any program is best measured by its continued growth and its ability to keep clients, and the clients' ability to repay their loan. It also assumes that if clients keep coming back, they value the program and if the program continues to serve the clients effectively and profitably it is obviously doing a good job (SEEP, 2000). Also as discussed by Ledgerwood (1999), this school of thinking advocates certain proxies for impact to address the dilemma of cost and the inherent difficulty of conducting impact analysis. The willingness to pay is one of the proxies used in this approach. The rationale of the willingness to pay test of impact is that

financial services usually require clients to pay the cost of acquiring the services in the form of interest payments and fees as well as the transaction and opportunity cost of the time required to come to group meetings or to deal with other aspects of the loan process. If the clients use the services repeatedly and, therefore, pay for them on time, it is evident that they value the services more than the cost. In general, high repayment rates and low arrears can be taken as primary evidence for the willingness to pay. However, though this approach is a low cost, simple proxy for impact, there are basic weaknesses to this test.

As indicated in many works (Tsehay and Menistu, 2002; Ledgerwood, 1999; Johnson and Rogalley, 1997) however, while the fact that increasing the number of clients is in itself a positive indication, it does not reveal enough of the story about the magnitude of impact, intra-household effects, and long-term development impact of the intervention. Perhaps, the biggest argument against this approach is that it presumes that finance is a product for market place like any other and it considers profit as sufficient evidence of success of the intervention. Finance, however, is intended as a tool for poverty reduction, which is why many experts argue that analyzing impact on poverty is an unavoidable task (Ledgerwood 1999). Thus, it is necessary to investigate further to find out who is using the services. Users should be differentiated by wealth, gender and location; and information should be gathered on how various groups are using the services to support their livelihood activities (Johnson and Rogalley, 1997).

- ii. The second approach, which is currently gaining prominence, is the one that focuses on the intended target group or clients rather than on the

organizations delivering the financial services. Supporters of this idea believe that attempts must be made to access, analyze, and measure direct impacts. The impact assessment should answer to the questions like: who are users of the services? How are the various groups using the services? And how does the intervention affect the life of the beneficiaries? However, the inherent difficulty of conducting such analysis and the dilemma of cost have been persistent problems which have led to general avoidance of the task (Ledgerwood, 1999). Despite the many success stories on venture capital finance institutions in numerous countries and a prove from different case studies that venture capital finance programs have successfully managed to provide financial products on a sustainable basis, different stakeholders are still keen on knowing how and to what extent venture capital have contributed to the reduction of poverty and to what extent have served their purpose. Literature has cited that sustainability alone does not reduce poverty (SEEP, 2000). Tsehay & Menitsu, (2002) for instance argued that impact measurement in finance should not stop at the institutional level. Impact measurement should seek to measure and explain induced changes that occur at the client level in terms of quality, quantity and direction.

Broadly speaking, the impact of finance fall into three categories (Ledgerwood 1999): the first category is economic impact in terms of changes in economic growth in a region or sector. The second category of impact is sociopolitical or cultural impacts. The third category of impact is personal or a psychological impact, which deals with borrowers' sense of self. This study assumes that impact occurs in different arenas namely; at individual level, household level, enterprise (firm) level and at community

level. However its centre of focus is at the firm (SMEs) level and will address the economic impact of enterprises financed by venture capital.

2.4 Performance of Small and Medium Enterprises

2.4.1 Small and Medium Enterprises Defined

There is no globally recognized definition of SMEs but the definition varies from country to country, region to region and sector to sector (Report on Business Advisory group of 2004; Storey, 1994; Bolton Committee Report, 1971; EU Report, 2003). In the Business Advisory Report of 2002, SMEs are defined as businesses with fewer than 20 employees. Copper et al (2005)'s study on textile and clothing manufacturing SMEs in the United Kingdom defined SMEs sector as those that employ less than 250 people and with a turnover of not more than £22.8 million. A Study by Liedholm and Mead (1987) covering developing countries reveals that SMEs are privately owned, in sole proprietorship and in terms of employment, but of this proportion family workers generally form the largest component. According to the statement by United States Committee for Economic Development (1997), a small business has two or more of the following characteristics:

- i) **Management:** the business is managed and operated by the owner(s). The entrepreneur or founder of the business acts as both manager and worker who does decision making.
- ii) **Resources:** A small business often has limited resources. This is especially true for new starts-up due to a lack of track record on the business to convince potential investors and bankers. Thus, it is highly dependent on the ability of the owner to generate resources.

- iii) **Organizational Structure:** For a small business, the structure is often flat and informal. The owner has to do almost everything and the workers are normally expected to be able to function as generalists since there is no clear demarcation of tasks.
- iv) **Flexibility of Change:** The business has more flexibility to adapt to changes in the environment due to its size and informal structure. It is also vulnerable to develop in the business environment. For instance, any changes in technology or government policy might have a great impact on the business because immediate changes normally require additional capital or resources. This might become a constraint to the business to compete and sustain itself in the market.

In Japan small and medium-scale enterprises are defined as: those in manufacturing with 100 million yen paid-up capital and 300 employees, and those in the retail and services sector with 10 million yen paid-up capital and 50 employees (Grey et al., 1996).

As a result of this heterogeneity in the definition of SMEs in different sectors or regions, it is often necessary to modify the various offerings in definition according to particular sectoral, geographic or other contexts in which the businesses in the sector are examined. The implication for research is that researchers are likely to have to continue using their own definitions of small-to-medium enterprises which are appropriate to their particular 'target' group (Storey, 1994). Whilst this research is not one way or the other focused on the 'grounded' definitions of SMEs as presented in the Bolton Committee Report (1971) and EU Report (2003), the study however, acknowledges the different characteristics represented in these reports and sets its target group of businesses in the SMEs sector as those that employ six to fifty people and

with a turnover of not more than Kshs 50 million. This definition has been used by studies ((Grey et al., 1996)) on SMEs in Kenya and this study will adopt it as a working definition.

SMEs have become more important in the economic matrixes as seen in recent years across the globe through increased deliberate government policies and legislation aimed at nurturing SMEs as engines of economic growth and employment creation. It is also estimated that SMEs constitute over 90 percent of total enterprises in most economies with a high rate of employment growth. They are also a vehicle for increased industrial production and exports (Copper et al 2005). . However, there are challenges that they face. A recent study by Wanjohi (2005) reveal that most people in Kenya work in the agricultural sector with majority practicing subsistence farming while a very small number practice large-scale farming. Some people work as wage labourers in coffee farms or tea plantations where they are paid small wages and life become rather unbearable at times. There are all sorts of small businesses related to Agricultural sector and finance is said to be the major challenge in whichever business one undertakes.

SMEs within the manufacturing industry have not seen much development since independence due to financial constraints. Jua Kali Sector, a Kiswahili term for a hot sun, is comprised of low scale artisans who mostly apply appropriate intermediate technology. This sector, given all conditions for growth can bring about industrial revolution in Kenya (Wanjohi, 2005). There are many other areas where SMEs seem to be picking well for instance, with development of information technology in the world, Kenya is slowly and steadily moving towards embracing the technology. It is evident everywhere in the major Kenyan towns with the rate at which cyber café and other information and communication technology businesses are

coming up. According to Ngahu (2009), SMEs are obviously incapable of sourcing, evaluating, and adapting technologies effectively.

Studies by Reid and Jacobson (1988) indicate that SMEs have flexible organizational structures, which are deemed to help mitigate the control, loss and information distortion problems characteristic of large bureaucratic enterprises. SMEs are seen as offering through the residual claimant status of the owner/manager's superior incentives for risk taking. The main basis for this is the rewards flowing from ownership, which give the motivation to undertake acts of entrepreneurship and risk taking. SMEs are also subject to less onerous financial reporting, lower corporate tax rates, laxer employment law, health and other regulatory requirements, all of which are likely to result into significant cost advantage. What then hampers their growth?

Kauffmann (2005) urges that Africa's SMEs have little access to finance, which thus hampers their emergence and eventual growth. Their main sources of capital are their retained earnings and informal savings. Access to formal finance is poor because of the high risk of default among SMEs and due to inadequate financial facilities. Small business in Africa can rarely meet the conditions set by financial institutions, which see SMEs as a risk because of poor guarantees and lack of information about their ability to repay loans. The financial system in most of Africa is under-developed and thus provides few financial instruments. Capital markets are in their infancy, and no long-term financing is available for SMEs. Non-bank financial intermediaries, such as micro credit institutions, could be a big help in lending money to the SMEs but they do not have the resources to follow up their customers when they expand. SMEs in Africa and Kenya in particular require long term source of finance if they have to grow (Ruffing, 2006).

One of the reason entrepreneurs find it difficult to raise investment finance from traditional sources is because the businesses are not well established. They lack collateral and credit history. High administrative costs and high default rates are other problems that make it difficult for small business to get funding (Sowa *et al.*, 1992). SMEs performance is viewed as poor by financiers. The growth plateau for SMEs in Kenya arrives early and most do not graduate to large enterprises for they collapse before the end of their third year.

Dewhurst and Burns (1993) further state that SMEs seeking start up or early stage growth financing encounters similar difficulties. This is because potential investors have little information on how to judge the viability of a project (such as profit and loss accounts and earnings per share ratio). In addition they often cannot judge how good the management team is because there is no track record. This lack of information means that an investment becomes risky and this risk reduces chances of funding.

Despite the significant growth in financial institutions, the needs of SMEs remain largely ignored. The expansion of financial institutions was mainly quantitative with few qualitative changes in services (Mc Cormick, 1996). Criticisms of banks as alternative source of finance are wide ranging and include claims of insensitivity over the handling of small firm finance and overcharging in terms of interest payment. Other criticisms are of applying bank charges without informing the customer, being overly eager in calling in their loans and demanding a high level of security. Despite all this difficulties, Kibiriti et al (2000) says, “Small businesses are our big hope as a vehicle for economic development”. SMEs require financiers who will not only provide funds but also monitor the operations of the business from within that is guide on various policy formulations. Banks are not known to do this as

long as their money is being recovered. It is the researcher's view that if the SMEs are given every attention as regards to funding and management skills, they can contribute significantly to economic growth.

2.4.2 Performance Measurement

Performance refers to a degree of accomplishing a task that make up a specific job. It reflects the degree of fulfilling the requirement of a job and it is measured in terms of results (Joubert, 2002). The word performance is an evasive concept and may be interpreted differently by different people. Performance can be defined as ability to perform or capacity to achieve desired results (Langdon, 2000). Performance then needs to be measured during a time period in line with an expectation, promise or target. Measurement has been recognized as a crucial element to improve business performance (Sharma et al., 2005) particularly focusing performance from a financial perspective to a non-financial perspective.

Neeley et al., (1995) defines performance measurement as the process of quantifying the efficiency and effectiveness of an action. It is the process whereby an organization establishes parameters within which organizations or programs reach desired goals Performance has been measured by growth (turnover, number of employees, market share), profitability (for example amount of profit, return on investment) and survival (Storey, 1994). However, the transformation from the industrial to the information age signaled by increasingly sophisticated customers and management practices, among other things (Johnson & Kaplan, 1987; Kaplan & Norton, 1992) has led to a focus on customers not products, relationships rather than lead times (Atkinson, 2006).

Kaplan & Norton, (1992) devised the balanced scorecard as a measurement framework for strategic, operational and financial measures. Although extensive

research has been carried out to investigate the needs and characteristics of performance measurement in large organizations, there is a distinct lack of published research on issues related to SMEs (Hudson et al., 2000). Fitzgerald (2007), examined the performance measurement in for-profit services, and concluded that performance measures fell within two broad categories: end results and means or determinants. Results were further subdivided into competitiveness and financial measures while means or determinants were subdivided into four broad categories namely quality of service, flexibility, resource utilization and innovation. The discussion above then implies that performance measurement can be looked at from many dimensions and this study considered financial and management governance measures among others.

2.4.3. Models of Performance Measurement

To measure the success of an enterprise and to guide executives through the benefits realization process, an appropriate performance measurement model is needed. It is common practice to measure the performance of any business on a financial scale. Return on Investment (ROI) and Return on Capital Employed (ROCE) sales, profitability among others are the most common ways of measuring the financial success of a business (Kaplan and Norton, 2000; Kaplan and Norton, 1996; Kaplan and Norton, 1992;). However, in this information age, the use of financial measures only to evaluate the success of the organization can be misleading. In order to measure the true effects of an intervention, one needs to understand and measure all organizational impacts; not only financial impacts. Several comprehensive measurement models have been employed to measure overall organizational results (Kaplan & Norton, 2000; Wright, et al 1999; Kaplan & Norton, 1992). These include: Process performance measurement model, Workflow based measurement model, Statistical control method, Self assessment method and Balanced Scorecard method.

Each of these performance measurement models has specific perspectives and advantages and disadvantages, depending on the context in which it is applied. However, it is not within the scope of this paper to discuss each of these models individually. One of the more contemporary and widely applied models is the Balanced Scorecard (BSC) approach. The BSC was created by Kaplan and Norton (1992) and has since been used by many organizations to measure their overall organizational performance. This study used financial and none financial measures to measure performance thus using BSC.

2.5. Theory and Practice of Venture Capital

2.5.1. Venture Capital Defined

Venture capital is one of the least understood forms of financing as some think it is meant for early stage financing of small rapidly growing technology companies. Panday (2003) argues that venture capital is a significant innovation of the twentieth century. It is generally considered as a synonym of high risk capital. It is a commitment of capital, or share holding for the formation and setting up of small-scale enterprises. The focus of the venture capitalist is to see small businesses growing in to larger ones.

Hisrich and Peters (2002) view venture capital finance as a professionally managed pool of equity capital. Frequently the equity pool is formed from resources of wealthy limited partners. Mucherjee (1999) also define venture capital as funding mainly for development of existing businesses with sound management and high growth potential but with especially attractive start-ups. In terms of definition, Wright and Robbie (1997) state that venture capital can be defined broadly as the investment by professional investors of long-term, risk equity finance where the primary reward is the eventual gain, rather than interest income or dividend yield. In another

definition, Lerner (2000) 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. A similar definition, according to Cumming and MacIntosh (2001), is that venture capital investors are financial intermediaries (in essence a kind of specialized mutual fund) which receive capital contributions from institutional investors or high net worth individuals across the economic spectrum, and invest the pooled deposits in small, private and mainly high technology businesses or entrepreneurial firms with potentially high growth.

Venture capital finance is also viewed as early stage financing of new and young ventures seeking to grow rapidly (Ross and Wester, 1990). It is actually an alternative form of equity financing for small and medium term business. William (2002) also looks at venture capital as a process by which investors fund early stage, more risk-oriented ventures. Kibiriti et al. (2000) view venture capital as basic risk capital of an enterprise. Unlike investment in secured debt which tend to be risk averse, venture capital seek 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. These definitions imply that venture capital involves the provision of equity finance to ventures that are typically small in size. Thus the working definition of venture capital in this study is early stage financing of small and medium term business seeking to grow.

William (2004) argues that venture capital differs substantially from 'traditional' financing in the following ways: One, funding provided to new or existing firms with potential of above-average growth. Two, often provided to start-up and

other emerging enterprises because they lack the collateral, track record or earnings required getting a loan. Three, the investment, typically requiring a high potential of return, is structured so that it can be liquidated within a three to seven year period, then an initial public offering may take place, or the business merges or is sold, or other sources of capital are found. Four, the entrepreneur typically relinquishes some level of ownership and control of the business. Five, venture capitalists typically expect a 20-50% annual return on their investment at the time they are bought out. Six, typical investments range from \$500,000 to \$5 million and management experience is a major consideration in evaluating financing prospects. Panday (2003) also notes that conventional financiers generally support proven technologies with established markets, however high technology is not a necessary condition for venture financing.

2.5.2. Business Angels

In the informal venture capital market Ross and Wester (1990) have identified investors referred to as business angels who act as individuals when providing finance. However they should not be viewed in isolation since they have a rich network and continually relying on each other for advice. The term business angel originated from U.S.A and it refers to wealthy individuals who are prepared to help smaller companies by purchasing equity stake in the company. A business angel is a man or a woman that comes to the help of SMEs (Wetzel 1983). Venture capital firms view investing amounts below a certain size as uneconomical but the angels do finance SMEs with any amount of finance (Tashiro, 1999). Business angels are becoming more important as a source of private equity. They can fill up the equity gap left by the bank finance that is often inappropriate and by formal venture capital that is concentrating on later stage and larger business.

Rudy (1996) argues that business angels have several motives, first a higher return on investment; second the opportunity to make a Positive contribution to a successful business start-up. Business angels allocate a maximum of 20% of their entire capital, and usually (in 75% of cases) not more than five hundred thousand euros, to investments in unquoted companies. Their investments are spread across a portfolio of between one and five companies. These companies are either at the seed or the start-up phase. German business angels see the future of the informal investment capital market as very healthy (Wetzel 1983).

According to Sohl (2003), business angels tend to be localized in business sectors in which they have some experience. Individually, their investments may be quite small (around 50,000 Euros) but in their syndication, considerably large sums may be available. The investment pool of business angel finance for Europe is estimated between 10 to 20 billion Euros. This is substantially more than is available for early stage investment sector from formal venture capital source (Sohl 2003).

In addition to the finance they make available, business angels are value-adding investors who can bring significant benefits of their business know-how, industry and contacts to your business venture (Wetzel, 1983). While the business angels, like venture capital firms, are first and foremost motivated by the prospects of a high return on their investment, they also tend to be attracted by the opportunity to be closely involved in guiding the development of the business. They will therefore tend to seek to have 'hands-on' involvement in the company through a position on the board of directors, consultancy work, or even through working on a part-time basis (Freear & Sohl, 2001). Research has also shown that apart from investing just for financial gain only, other motivations include: the fun and excitement of being

involved in early stage growth of a new business, job creation, assisting women and minority entrepreneurs (Farrell 1998).

Farrell (1998) argues that the financial market with angels is a little different than that of dealing with formal venture capitalists. Venture capitalist knows what they want and how to go about getting it. Their primary focus is finance. They invest other people's money and are paid to obtain outrageous returns. Angels on the other hand react to the proposal by determining in their minds if the proposal is fair. While they are also looking for financial return, they frequently are seeking a psychic or intangible reward like helping the minorities, creating jobs, revitalizing urban areas or simply contributing to the society for their success. Angels don't advertise they work quietly (Seymour and Wetzel, 1981).

Professional service providers are always a good place to start looking for angels. Attorneys and accountants are very good network with a potential vested interest. Already successful entrepreneurs or dentists and doctors have been found to be source of finding the business angels. Another source of locating angels is boutique investments, banking firms and some business brokers. They focus on financing start-up and marching angels (Gatso, 1989).

Various surveys and research reports have yielded some interesting characteristics of identifying angels (Freear & Wetzel, 1990): 90 plus percent are male, typical ages are 40 to 60 years old, hold master or multiple advanced degrees, have prior start-up experience, personal income between \$ 1,000,000 and \$250,000 per year, invest minimally once a year; average is 2 1/2 times, invest \$25,000 to \$50,000 per deal, totaling \$130,000 year, seldom take more than 10 percent of a deal, seek a minimum 20 percent compound per annum return, expect liquidation in 5 to 7 years, strong preference for manufacturing deals, like technology they are familiar

with, prefer start-ups, early stage companies, dislike moderate growth, like consulting role, board of directors/advisors, like to invest with other sophisticated investors and invest close to home (50 to 300 miles).

In the literature of informal venture capital there has developed in the last few years a taxonomy or classification of angels (Seymour and Wetzel, 1981). The virgin angels, latent angels, wealth maximizing angels, street walking angels, entrepreneur angels, income seeking angels and corporate angels. Whichever classification is referred to, they have similar characteristics and the main concern of the researcher is the role they play in financing SMEs. This study will consider both formal and informal venture capital.

2.5.2. The History of Venture Capital

The history of venture capital in the developed countries especially in the United States of America can be traced as early as after the Second World War (Hisrich and Peters, 2002). Venture capital has been instrumental throughout the industrialization of United States; however it became institutionalized after the 2nd World War. Before World War II, venture investment was a monopoly led by wealthy individuals, investment banking syndicates and few family organizations with a professional manager (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 the 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). The venture capital market in the USA in particular is wide spread and the market can be grouped in to visible venture capital market and invisible venture capital market where business angels belong (Freear, 2003).

Originating in the US, venture capital firms spread to the UK and Western Europe (Ooghe, et al. 1991) and to Japan. At the same time as developed markets are becoming saturated, many developing nations have undertaken radical regulatory reforms, making them more conducive investment destinations (Gompers and Lerner, 1998). Venture capital markets in Singapore, Taiwan and Hong Kong have become well-established (Kenney et al., 2002), while more recently significant growth is occurring in other Asian countries notably India. In the former centrally planned economies of Central and Eastern Europe, venture capital is emerging, especially in countries such as Hungary and Poland (Wright, Kissane and Burrows, 2004). Most recently, venture capital is growing rapidly in China. The variation in the development of venture capital industries across countries raises important questions concerning the factors driving these developments and the behavior of venture capitalists in different markets, which are increasingly interesting international agencies such as the World Bank and the OECD (Kenney et al., 2002; Baygan and Freudenberg, 2000). Second, a significant element in the global development of venture capital is transnational investment (Aylward, 1998). Foreign venture capital

firms may be an important source of venture capital in countries with limited supply and can help stimulate domestic markets by creating exit opportunities in foreign markets (Maula and Makela, 2003). Cross-border venture capital involves both inflows into funds being raised for investment within a particular country and outflows of funds into investments in other countries. Over time, international venture capital inflows and outflows have become highly significant (EVCA, 1999; Baygan and Freudenberg, 2000).

While the private equity industry is very small in Africa, it has been growing steadily in the past few years. Even the well researched South African market is dwarfed by the American or European private equity industry. At the end of the year 2000, the South Africa private equity industry had approximately ZAR33billion (US\$3.3 billion) under management (Inbona, 2002). The author further observes that there is no data to measure the size of the African private equity market, but it is likely that the SA market would represent at least 50 per cent of the total market estimated at \$6 billion. African venture capital funds are more often than not supported by government agencies and multilateral agencies such as Commonwealth Development Cooperation (CDC), International Finance Corporation (IFC) among others.

The World Bank, through International Finance Corporation helped establish venture capital funds in Kenya, Brazil, Philippines, and in countries of Latin America, Eastern Europe and Asia (Inbona, 2002). The private Venture Capital firms in Kenya 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 (The 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 Corporations that offer Venture Capital includes: Industrial credit and Development Corporation (ICDC) which provide capital directed at profitable existing small and medium sized industrial or commercial projects seeking expansion, modernization, restructuring or diversification of existing activities. They also support business start- ups with firm prospects for financial and technical development. Industrial Development Bank (IDB), which is a subsidiary of ICDC and Commonwealth Development Corporation (CDC). The above literature then shows that venture capital is or has been present in Kenya but what has not been established is its impact on the performance of SMEs they have financed. This study was set to establish the impact of venture capital on SMEs performance

2.5.4. Venture Capital Investment Process

The venture capitalists follow a clearly defined procedure (Tyebjee & Bruno, 1981) in investing their funds in SMEs as given below and also illustrated in figure 2.

- a) Deal origination: venture capitalists require a flow of deal, which may originate in various ways like referral system, active search and intermediaries.
- b) Screening: initial screening of all projects on the basis of some broad criteria is carried out. Venture capitalists obviously seek to attract desirable propositions yet many unwanted proposals are received; these have to be weeded out as quickly as possible. There is broad agreement that proposals are assessed first in relation o the quality of their business plans and the basic

concept of the project and personality and track record of the entrepreneur and/or management team is vital, however venture capitalists are more concerned with market acceptance.

- c) Due diligence: once a proposal has gone through initial screening, it is subjected to detailed evaluation or due diligence process. The aim of this part of the investment cycle is to minimize investment risk by conducting a thorough investigation of the information presented in the business plan, with special attention usually paid to the qualities of the entrepreneur or management team. The quality of an entrepreneur is evaluated before appraising the characteristics of the product, market or technology. Most venture capitalists ask for business plan to make an assessment of the possible risk and return on the venture. The final decision is taken in terms of the expected risk-return trade-off.
- d) Deal structuring: once the venture has been evaluated as viable, the terms of the deal are negotiated, in terms of amount, form and price of the investment. The agreements also include the protective covenants, and earn-out arrangements. Venture capitalists generally negotiate deals to ensure protection of their investment.
- e) Post investment activities: once the deal has been structured and agreement finalized, the venture capitalists assume the role of a partner and collaborator. The capitalist gets involved in shaping the direction of the venture.
- f) Exit: venture capitalists aim at making medium to long-term capital gain within a period of five to ten years and then exit. A venture may exit in any of the following ways; initial public offering, acquisition by another company, purchase of the venture capitalists' shares by promoter and purchase of

venture capitalists' shares by outsider.

Figure 2.2 below illustrates the venture capital investment process as given in the proceedings of African Venture Capital Associations conference (2005):

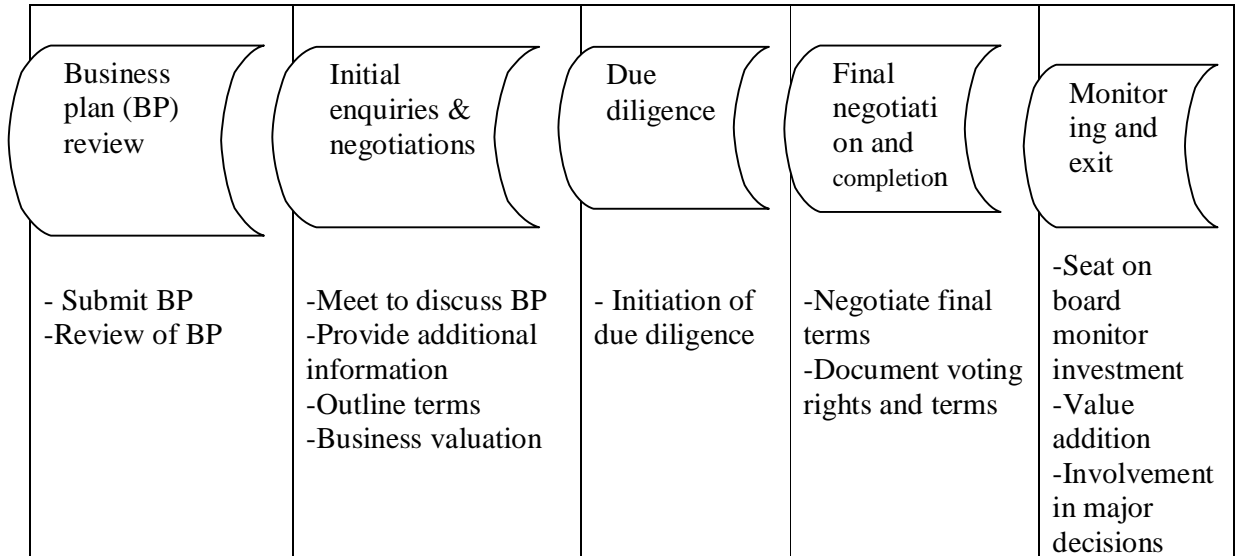


Figure 2.2: Investment processes.

Source: Venture Capital Africa. Annual Conference 2005

Though other researchers like Hisrich and Peters (2002) have identified only four stages in the investment process, it implies that there is a sequence of stages a deal has to undergo before the venture capitalist accepts it. A venture capitalist whether formal or informal will follow the stages outlined above for financing decisions. Sohl, (2003) also noted that for sound management, venture capitalists hardly give a young company all the money it will need all at once. At each stage they give enough to reach the next major check point. Once certified with use of funds in the previous stage they then approve the next fund phase and this has led to sound finance management. After investing, the venture capitalists are reliant upon the efforts of the entrepreneur(s); all parties to the deal are then described as being in the same lifeboat.

2.6. Empirical Literature

This section covers empirical evidence or literature on the impact of venture capital on performance of SMEs. Measures of performance in this study include: growth, finance management, management approach/style and other financiers attract by presence of the venture capital in a firm. The empirical literature then covers the impact of venture capital on the above mentioned indicators of performance.

2.6.1. The Influence of Venture Capital on Growth of SMEs

Empirical evidence from the developed world has shown that a number of countries involved with venture capital targeting small scale industries have experienced significant growth at reasonable cost (McCormick, 1996). In the USA a well developed venture capital market set up partnerships, pooling funds from variety of investors, sought out fledgling businesses to invest in, and then worked with these ventures as they grew in to public traded firms. By 1993 the amount invested by the partnerships grew rapidly to over three billion US dollars. The increase in the amount of money invested by venture capitalists is a clear indication of growth of SMEs.

A survey carried out by European Venture Capital Association in 2001 on SMEs that have received venture capital funding concluded that:

- i. Some 95% of companies stated that without venture capital investment, they could not have existed or would have developed more slowly;
- ii. Almost 60% said, that without venture capital the company would not exist today;
- iii. For start-ups with high growth potential, the venture capital provision is more appropriate than debt financing;

- iv. During several years, these start-ups would not be able to pay back a traditional bank loan: patient capital is needed, and
- v. Each SME following the venture capital investment created an average of 46 additional jobs.

This survey shows that venture capital play a significant role in the growth of SMEs and the European economies at large.

A report by Global insight (2009) on economic impact of venture capital backed firms as reported by USA's National Venture Capital Association revealed the following: In 2008, venture capital-backed companies 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 report further suggests that even though many venture-backed companies have the impetuses to grow faster and generate more jobs than their non-venture counterparts, their success cannot be taken for granted. For this reason, the venture capital industry advocates for public policies that support the entrepreneur. These include intellectual property protection, open trade provisions, immigration support for highly-skilled workers and encouragement of capital formation. In these areas, government supporting capital formation begins with a tax policy that rewards long-term investment and encourages entrepreneurial risk taking. Tax differentials, such as favorable rates for capital gains and carried interest, serve as important tools for encouraging investment in emerging growth companies. In the current financial system, venture capital is the only source of long-term, institutional funding for such companies. When the government increases the tax burden on venture capital, it

inhibits the flow of funds to innovative young start-ups. Venture-backed companies also require a reasonable, efficient and predictable regulatory apparatus.

According to the report on private equity market in Canada (2002) between 1996 and 2002, the Canadian venture capital industry experienced solid growth and improved high-growth-potential SMEs access to venture capital. If the industry can sustain these growth trends, the Canadian venture capital sector should remain a vital component of the business and investment landscape, encourage innovation and productivity, and promote new job and wealth creation. A study carried out by Engel and Keilbach (2002) which compared venture capital financed firms with non-venture capital financed firms in Germany indicated that venture capital financed firms showed high profitability.

A study on the impact of venture capital on the Canadian economy (CVCA, 2009) also revealed that firms that used venture capital employed 1.3% of all private sector employees and contributed 1% of GDP. The impact on growth was notable as venture capital backed firms grew more than 5 times faster than the overall economy.

The SMEs in developing counties especially Kenya, have growth potential if they can make use of venture capital. The recent findings reported by Lindner & Linden (2002) of Business Partners International firm confirmed that SMEs in Kenya have high potential for growth because they are offering services that are of high demand. It was reported that the firm has accepted to invest equity capital worth Ksh. 12.6 billion in SMEs in Kenya.

2.6.2 Influence of Venture Capital on Financial Management of SMEs

There is a saying that “money makes the world go round” (Korah, 2003). Good money or financial management is the key factor which determines whether a business will be successful over the long term. The author further asserts that many

entrepreneurs do not want to involve themselves in financial management because they are extremely tied up with other aspects of business work or they do not have enough knowledge (interest) of maintaining the system.

Financial management is the process of planning and controlling the financial resources, including accounting and financial reporting, budgeting, collecting accounts receivable for the business, risk management and insurance for the business (Brealey et al, 2002). According to Pandey (2003) four managerial finance functions include: investment, financing, dividend and liquidity. Liquidity or short term asset mix deals with current asset management (also grouped under working capital management) and this study will consider the current asset management section of finance management. Barrow (2002) argues that financial management is carried out by:

- i. Addressing cash flow. It is realized that many business owners and managers fail to realize the importance of sound cash management until it is too late. Evidence shows that even profitable organizations get into trouble because of a lack of attention to the need for a positive cash flow (Burts, 1993). Cash outflows and inflows seldom seem to occur together. More often than not, cash inflows seem to lag behind the cash outflows, leaving your business short. This money shortage is the cash-flow gap. Managing cash flow allows the business to narrow or completely close the cash-flow gap. Proper cash flow management policies and procedures will improve profits, reduce the risk of failure and significantly improve the chances of survival, particularly in tough economic times. Cash flow is managed by effectively managing working capital.
- ii. Good record keeping. A small firm should keep 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.

- iii. Financing the business. Whether a firm is starting or expanding it should identify the resources it requires. The least cost source should be used. SMEs owners will have to realize that in future access to external finance (venture capital or lending) will depend much more on a transparent and open exchange of information about the situation and the perspectives of their businesses

Empirical evidence (Pedro & Pedro, 2007) on the effects of working capital management on the profitability of a sample of 8872 small and medium-sized Spanish firms covering the period 1996-2002 revealed that managers can create value by reducing their inventories and the number of days for which their accounts are outstanding hence shortening the cash conversion cycle thus improving the firm's profitability.

Hall and Young (1991) in a study in the UK of 3 samples of 100 small enterprises that were subject to involuntary liquidation in 1973, 1978, and 1983 found out that the reasons given for failure, 49.8% were of financial nature. The positive correlation between poor or nil financial management (including basic accounting) and business failure has well been documented in western countries according to Peacock (1985). There is sufficient evidence that finance management is a challenge to many SMEs. Best marketing in the world are of no avail if the financial side of the business is not adequately managed. This thesis establishes whether venture capital has an impact on financial management of SMEs in Kenya.

2.6.3 Influence of Venture Capital on Management Styles of SMEs

Venture capitalists are usually very keen with the way a venture is managed.

Research conducted globally shows that between 70% and 90% start-ups fail but the intervention of venture capitalists reduced the failure rate down to 15% to 25% (Lindner & Liden, 2007). 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.

Venture capitalists offer a joint provision of both, capital and management support. 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. 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.

Empirical evidence (Brav & Gompers 1997) confirms that superior performance by venture capital-backed firms is often attributed to better management teams and corporate governance structures that help these companies to perform better in the long run. Similar evidence has been reported by Huck and McEwen (1991) from a survey of 54 Jamaican entrepreneurs involved in manufacturing and service businesses using venture capital. More specifically, these researchers

identified competencies in management, planning and budgeting as most crucial for the efficient operation of a small business.

Typjee & Bruno (1981) observed that while venture capitalists like to see a strong management team, sometimes holes in the team particularly in early stage companies is acceptable as improvement is expected with time. The author further argues that some venture capitalists prefer seasoned entrepreneurs with prior operating experience. Often, they prefer to fund people they know, or people their friends know as it is less risk investing in that which one knows. It's easier for a venture capitalist to work with someone who understands investment terms and knows how to hire the right people to accomplish particular goals.

Mason (1996)'s study on the process of accruing funds from venture capital firms observed that that the common approach is first of all to furnish venture capitalists with a copy of a business plan. If they accept the plan then there is an opportunity on what the company has to offer that is management and also to market to them a product service with a lot of potential. It is just like any other sales job, display the wares and convince them that there is something they need. The venture capitalists have to understand your company and gain the feeling for the enthusiasm that backs it. The venture's challenge is to get them personally involved, to buy into their determined dedication. SMEs need to be emotionally involved and not just provide a business plan only. Firms seeking for equity should be cautious about how they present their projections which they are expected to achieve. The projections should be realistic and achievable. A relationship between the company and venture capitalist is established with a strong bond of good faith and that one earnestly attempt to keep all commitments (Sohl, 2003). This shows that transparency is the key to their management style.

There is a notion in the venture capital industry that three most important things in assessing whether to back a project are management, management and management (Pandy, 1995). Management of the client's business is the key to its success or failure and effort should be centered on assessing the key person or people of the management team. Even if a business has a good product or a first rate marketing strategy venture capitalists may not back such a company unless it has an impressive management team. The current literature (Tyepjee & Bruno, 1981) on venture capital decision making suggests that management team is the most important criterion to financing. A successive management team should have:

- i. Personal commitment represented by a financial stake in the business, job security, commercial ambition and the will to become successful.
- ii. Experience in marketing, sales, production and finance that each team member brings to the business and their knowledge and skills that are complimentary
- iii. Personality traits such as determination, honesty, capacity to listen to advise, capacity to get along with others and each other.

Ventures may not necessarily have management with all the above attributes but portraying commitment, honesty and transparency will attract venture capitalists to provide funding. The presence of the venture capital member in the board of management will influence management style and decision making for the better.

2.6.7 Presence of Venture Capital May Attract Other Sources of Finance

The presence of venture capital in the capital structure of a firm is an attraction of other financiers to provide more funding to the SMEs (Mukherjee, 1999). Research has shown that venture capitalists play a critical role in reducing information asymmetries through the collection of critical, private information (Eisenhardt, 1989).

This is the information that banks and other conventional sources lack and hence shy off from financing SMEs.

Empirical evidence (Eisenhardt, 1989) established that financial markets generally are characterized by important information asymmetries between entrepreneurs and investors and hence resulting to agency problems such as goal incongruence, adverse selection and moral hazard. Modigliani and Miller (1958) argue that in perfect financial markets, funds are always available for value creating investment projects and that financing decisions can be separated from investment decisions. However financial markets are not perfect as perceived. Therefore, 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 et al., 1998).

Gompers, (1995)'s study on the role of venture capital established that entrepreneurs of high growth companies often develop products and ideas that require substantial capital, exceeding the internally generated cash flows or entrepreneurs own funds, especially in the formative stage of their company's lifecycle. These companies are typically characterized by large information asymmetries and potential agency problems as highlighted by Admati and Pfleiderer (1994) and hence may also have limited access to more traditional external financing sources. Informed investors, such as venture capitalists (Rajan, 1992), may offer a solution for this type of financing problem. Through their information gathering and processing activities, venture capitalists are able to reduce information asymmetries and potential agency problems, which allow them to invest profitably in projects that uninformed outsiders reject.

Berger and Udell, (1995) observed that venture capitalists play a critical role in reducing information asymmetries through the collection of critical, private information. Admati et al. (1998) confirms that one of the primary reasons for the existence of venture capital companies is their information processing capacities, which may reduce information asymmetries, and hence reduce potential agency problems. Adverse selection problems are addressed through intensive screening before the funds are provided (Lerner, 1995).

Berger and Udell, (1998)'s findings revealed that venture capitalists screen potential investments by collection of information about the business, the market in which it operates, and the entrepreneur or start-up team. A good financing contract can reduce goal incongruence between entrepreneurs and investors (Sahlman, 1990) for example by using convertible instruments. 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). Venture capitalists further provide value-creating services to their portfolio companies (Admati et al., 1998).

According to Lerner (1995)'s study, venture capitalists provide credibility and legitimacy to its portfolio companies apart from offering financing solution for those companies that are unable to attract sufficient funds and also influence further financing of the company. Moreover, because they reduce information asymmetries 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 venture capital has exerted once they have received venture capital funding.

As screening is an important role of venture capital companies (Lerner, 1996) and as venture capitalists are extremely selective, the mere fact that a venture capital

company has invested in an unquoted company conveys positive information about that company. Hence, convincing venture capitalists to invest and increase the potential of portfolio companies to attract subsequent financing from other parties. Moreover, through their roles of screening, contracting and monitoring, venture capitalist minimize the costs of delegating decisions to entrepreneurs or induce them to reveal critical information on their activities (Berger and Udell, 1998; Lerner, 1996). If they perform their roles well, informed investors, such as venture capitalists, might develop an information monopoly on the firm (Rajan, 1992), which enables them to generate substantial profits by providing funds at a higher price. The information monopoly, however, is limited in time.

Meggison and Weiss, (1991) observed that other financing parties observe the performances and creditworthiness of the venture capital backed firm and positively adjust their lending attitude. 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. This should allow companies with a good reputation to attract financing at better conditions (Diamond, 1991). Furthermore, 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 as collateral to acquire additional funds. This and many other reasons make venture capital a dynamic financing strategy for SMEs.

This thesis view venture capital finance as a provider of a variety of sources of finance unlike the micro finance institutions who lend at a given interest rate. The thesis opines that venture capital has a good package for its clients apart from attracting other financiers. The venture capitalist ones they fund a venture, the capital

structure of a venture is of critical concern. The emergency of the informal venture capitalists referred to as business angels play critical role in financing small businesses, and research has shown that they fund a venture at any stage of development unlike the formal venture capitalists Brettel (2000).

2.7. Conclusion

The empirical literature has shown that the impact studies of venture capital on SMEs performance have been done in the developed counties and a few other developing countries. The trend of literature shows a positive impact of venture capital on SMEs. The findings have enabled governments of such counties to make public policies that support the entrepreneur. These include intellectual property protection, open trade provisions, immigration support for highly-skilled workers and encouragement of capital formation. Tax policy that rewards long-term investment and encourages entrepreneurial risk taking is also put in place. When the government increases the tax burden on venture capital, it inhibits the flow of funds to innovative young start-ups (Report on Global Insight, 2009). In Kenya no impact study of venture capital on SMEs performance has been done. This study was set to bridge this gap and provide knowledge to various users for decision making or otherwise.

CHAPTER THREE

3.0. RESEARCH METHODOLOGY

3.1 Introduction

This chapter presents the methodology used for data collection and analysis. It comprises of research design, target population, sampling strategy, data collection tools and data analysis and In doing impact evaluations. The impact methodology that has been used in this study is the before and after basis where data was collected on firms before using venture capital and after using venture capital. Bueselinck and Margnat (2003) argue that there is no “gold standard” (in the sense of a single method that is best in all cases) in impact measurement. However, depending on factors such as the scope, objectives, and design of the intervention, as well as data availability, some methods can be better than others in specific cases. This methodology was adopted from Hafkin and Menou (1995)’s impact study on electronic communication in Africa.

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. According to Gall et al (2003) a research design is a plan for collecting and utilizing data so that desired information can be obtained with sufficient precision or so that a hypothesis can be tested properly. It is a framework that guides the collection and analysis of data.

This study adopted an exploratory research design. Exploratory research design is a flexible design that allows the researcher to consider many different aspects of a

problem hence helping the researcher to gain new insights and ideas about a problem (Kothari, 2003). Saunder et al (2003) further assert that exploratory research is used principally to gain a deeper understanding of something. Newman (1994) also affirms that exploratory research is conducted into an issue or problem where there are few or no earlier studies to refer to. The focus is on gaining insights and familiarity for later investigation. The purpose of exploratory study is to investigate relatively unknown field. This design is commonly used in social science research. Studies on venture capital are few and this justifies the use of this research design. Other scholars such as Melannic (2005) used exploratory design in his study on analysis of venture capital acquisition process in New Brunswick.

This research employed both quantitative and qualitative approaches. Brian (1996) maintains that quantitative research emphasizes the measurement and analysis of casual relationship between valuables. Quantitative approach is also revered to as empirical scientific approach to data collection in analyzable manner (Mugenda & Mugenda, 1999). The implicit assumption is that quantitative research is a rational linear process that does not incorporate metaphysical notions of “feelings” and subjective experiences into realms of social scientific knowledge unless they can be rendered observable (Bryman, 1995)

Qualitative approach on the other hand is holistic in nature and is not numerically analyzable and aims at understanding social life and the meaning people attach in every day life. Qualitative approach is systematic, vigorous, flexible, and contextual and is strategically conducted (Glesen and Peshkin, 1992). Qualitative research is one of the two major approaches to research methodology in social sciences. Berg (1989) urges that qualitative research involves an in-depth understanding of human behavior and the reasons that govern human behavior. Unlike

quantitative research, qualitative research relies on reasons behind various aspects of behavior. Miles (1994) simply puts it that it investigates the why and how of decision-making, as compared to what, where and when of quantitative research. Hence, the need is for smaller but focused samples rather than large random samples.

Several researches (Bryman, 1995; Rossman & Wilson, 1991) suggest that combination of quantitative and qualitative research methods:

- a) Enable mutual corroboration of each other via the use of multiple sources of collecting data
- b) Contextualizes the analysis by providing richer details
- c) Initiates new lines of thinking through attention and surprises, turning ideas around and providing fresh insights

It has been argued (Blalock, 1970) that quantitative research rarely totally denies the utility of qualitative research method but has tended to view it as an essentially exploratory way of conducting social investigations. Qualitative is further portrayed (Bryman, 1995; Blalock 1970) as a means of accumulating hypothesis which can be tested more vigorously by quantitative research method. The discussion above then shows that both methods supplement each other and both have been used in this study.

3.3. Population

Lumley (1994) defines population as a larger collection of all the subjects from which a sample is drawn. Population refers to an entire group of individuals, events or objects having common observable characteristics (Mugenda and Mugenda, 1999). The population of this study consisted of all SMEs in Kenya that have used venture capital which totaled to 400. The figure was arrived at by using directories provided by venture capital firms.

3.3.1 Target Population

Fiat (1995) defines 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 is an estimate of 200 SMEs. This figure was arrived at from directories provided by venture capital firms and venture capital fund managers. Apparently the target population may appear small but literature (Fiat, 1995) shows that for every 100 applicants for venture capital only 2% may qualify for funding as the rest fall short of the stringent requirements of venture capitalists. This study used 200 SMEs that have been financed by venture capitalists as the target population. They were drawn from various major urban centers in the country namely; Nairobi, Mombasa, Nakuru and Kisumu.

3.4 Sampling Frame

A sampling frame is a list of the sampling units that is used in the selection of a sample (Bryman 1995). The sampling frame of this study was drawn from directories of venture capitalists that include: Auroes East Africa, Acacia fund, Kenya Equity and term financing, Preferential Trade Area (PTA), Venture Capital and Credit Ltd., OCTIC Venture Capital, Trans Century and Industrial Commercial Development Corporation (ICDC). These institutions provide venture capital to various SMEs located in Nairobi, Mombasa, Kisumu ,Nakuru and even within the East African Community. The study also considered individual prominent industrialists (business angels) who have financed SMEs. Studies (Wetzel, 1983 and Lumme et al, 1998) have shown that it is difficult to identify business angels since they desire privacy and undocumented nature of their investments. From an international perspective the most popular approach for identifying business angels' investment activity has been through the companies that they have invested in (Wetzel, 1983). This study

established the list of prominent industrialists/ investors by use of snowballing technique. This is a method where participants or informants with whom contact have already been made use their social networks to refer the researcher to other people who could potentially participate in or contribute to the study (Bryman, 1995). The choice of this sampling frame was sufficient as it included most of the institutions that provide venture capital and they provided a list of SMEs they finance.

3.5 Sampling Techniques

Nachmias and Nachmias (1996) define a sample as any subject of sampling unit from a population. A subject is any combination of sampling units that does not include the entire set of sampling. Sampling is the process of examining a representative number of items out of the whole population (Riding & Short, 1993). The purpose of sampling is to gain an understanding about some features or attributes of the whole population, based on the characteristics of the sample (Lucy, 1996).

Probabilistic sampling was used to determine the sample size. Scholars (Panneerselvam, 2006) 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, but this probability varies from one method to another method of probability sampling. Methods of probabilistic sampling include: simple random sampling, systematic sampling, cluster sampling, stratified sampling and multistage sampling (Bryman, 1995). Dooley (1995) asserts that simple random sampling involves giving a number to every subject of the accessible population, placing the number in a container and then picking any number at random. The subjects corresponding to the numbers picked are included in the sample.

This study adopted simple random sampling because the method is free of sampling error or classification error, and it requires minimum advance knowledge of

the population other than the frame. For these reasons, simple random sampling best suits situations where not much information is available about the population and data collection can be efficiently conducted on randomly distributed items, or where the cost of sampling is small. Stratified sampling was used because the population of interest was heterogeneous in terms of type of the business and location. On ascertaining the SMEs financed by venture capitalists the firms were stratified according to their locality and random sampling was carried out using Dooley (1995) method as indicated above. A sample of 100 firms (Nairobi 40, Mombasa 20, Kisumu 15 and Nakuru 25) was picked at random (Table 3.1) from which data was collected. Out of the expected 100 only 65 respondents that fully filled the questionnaire which represented 65% of the sample size. Saunders et al (2003), suggested that a minimum number of thirty (30) for statistical analyses provide a useful rule of thumb.

Table 3.1: Sample Size

Location	Sample Size
Nairobi	40
Mombasa	20
Kisumu	15
Nakuru	25
Total	100

3.6 Data Collection Instruments

In order to empirically study the impact of venture capital on SMEs, a semi-structured questionnaire was developed (appendix 1). A questionnaire is a research instrument that gathers data over a large sample. Bryman (1995) puts it that it translates the research objectives in to specific questions and answers for each question will provide

the data for hypothesis testing. The advantages of a questionnaire over other instruments include, information can be collected from large samples, no opportunity for bias since it is presented in paper form, confidentiality is upheld, and it saves on time. Use of interview as a data collection instrument proved difficult because the firms were not willing to set aside time for interview and the instrument was not used and was dropped after pilot testing.

3.7 Data Collection Procedure

The researcher administered the questionnaire personally (assisted by two research assistants) and through e-mail system to the firms. Many respondents were not comfortable with giving information about the firms they work in and this delayed the data collection as permission had to be sort from the highest office. However 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. This may take time but one must wait patiently. The author also says that one is more successful where there is a friend, relative or student working in the organization. Their knowledge of one means that they should be able to trust stated indentations and assurance given about the use of any data provided. Some firms were difficult to allow administration of the questionnaire and e-mail channel was used through the venture capital fund managers. This is because some firms are rigid in giving any information but they responded though slow when the mails were sent through the venture capital fund managers.

The response was low by mail but the fund managers reminded the firms over and over again. Those who sent their responses did it in a "read only" version to the fund managers however the data could be extracted. 23 out of 30 firms who were sent

questionnaires by e-mail responded at the end of the data collection exercise. 42 out of 70 firms questionnaire were administered to, personally responded. Notwithstanding the slowness with which data was provided the firms gave sufficient data. Secondary data was collected from manuals, review news letters provided by the venture capitalists, libraries, internet among others. Venture capitalists keep record of data of a firm before their intervention which was provided to the researcher and thus minimised chances of errors on recall.

3.8 Pilot Testing

Upon preparation of the questionnaire, pre testing / pilot testing was carried out with SMEs which, assisted in identifying the problems, minimised errors, and refined the instruments for data collection. According to Pennearselvan (2006) pilot testing refers to mini versions of a full-scale study (also called 'feasibility' studies), as well as the specific pre-testing of a particular research instrument such as a questionnaire or interview schedule. Pilot studies are a crucial element of a good study design. In this study a pre testing was carried out for one month on a few of the businesses financed by venture capital and after which the instrument was refined for data collection. Since it was necessary to test for the reliability of the study instruments the questionnaire was piloted in Nairobi on 10 SMEs whose names were withheld due to confidentiality. This exercise was meant to measure the internal validity of the questionnaire that is to examine the degree to which these instruments would measure the constructs under investigation (Bohrnstedt, 1983). The aim of piloting the questionnaire was:

- a) Identify problems associated with understanding and interpreting the instruments on questions such as: Q7. Rank the following reasons you think

contributed to the improvement in turnover in terms of importance (1- for very important to 4-for irrelevant)

- b) Solicit ideas and recommendations to be included in the final questionnaire
- c) Test the internal validity of the questionnaire itself.

Teijlingen and Vanora (2001) also assert that pilot testing is useful in research in the following ways: developing and testing adequacy of research instruments, assessing the feasibility of a (full-scale) study/survey. Pilot test help design a research protocol, assess whether the research protocol is realistic and workable and establish whether the sampling frame and techniques are effective. The pilot study showed that the questionnaire needed adjustment since some questions were not answered and this was done to make them more of subjective. Open ended questions which were many were not fully filled as respondent said that they were time consuming and so some of them were made closed ended. Data was analyzed on a scale of 0.0000 (not reliable) to 1.0000 (perfectly reliable) alpha coefficients with the help of SPSS computer software. To increase reliability the questionnaire was adjusted accordingly. Conducting a pilot study increased the likelihood of success though it does not guarantee success in the main study. The essence of pilot testing is to increase the reliability and validity of the instruments.

3.9 Data Processing and Analysis

Data analysis refers to examining what has been collected in a study and making deductions and inferences. Before the actual analysis is done, data organization was done. Data was keyed in to excel spreadsheet and was then copied in to SPSS for organization. Data organization is orderliness in research data (Bryman, 1995). It is putting data in a systematic form. The organization involved correcting errors in data (editing), coding the data and sorting it in an appropriate form. According to the

literature given by Sekaran (2003); Somekh and Lewin (2005), editing involves checking and adjusting any errors or omissions on questionnaires. Its purpose ensures completeness, interpretation of ambiguous answers, consistence and elimination of unusable data (Mugenda and Mugenda, 1999).

Upon carrying out data organization, analysis was done by use of statistical techniques (correlation, ANOVA, and Chi-square). Computer packages Microsoft excel and Statistical Package for Social Sciences (SPSS) was used to facilitate analysis as they have in-built formulas. SPSS is a comprehensive system for data analysis and can take data from any type of file and use it to generate tabulated reports, charts, compare means, correlation and many other techniques of data analysis (Microsoft Corporation, 2003). These packages were used to carry out descriptive statistics like the measures of central tendency, extract frequency graphs and tables. Run tests of hypothesis like ANOVA and chi-square; carry out a correlation and regression analysis where applicable.

Correlation measures the extent of interdependence where two variables are linearly related (Lucy, 1996). If variables are correlated then a change in one variable is accompanied by a proportionate change in another variable. Correlation coefficient (R) is a measure of correlation between two variables. If variables are independent $r = 0$, if dependent then $r = 1$. The formula used to calculate correlation is given as:

$$R = \frac{N\sum XY - \sum X \sum Y}{\sqrt{N\sum X^2 - (\sum X)^2} \times \sqrt{N\sum Y^2 - (\sum Y)^2}}$$

If the value of R is close to one then it shows a strong correlation between the variables. If the value of R is close to zero then the association is weak.

The Chi-square (χ^2) test is a statistical test which helps to test whether the difference observed is significant or is just by chance (Gupta, 2005). The formula used is given as:

$$\chi^2 = \sum \frac{(O-E)^2}{E}$$

Where O refers to the observed frequencies and E refers to expected frequencies. Chi-square (χ^2) test is usually much easier to compute and can be used to treat data which have been measured on nominal (classificatory) scales. Such data cannot, on any logical basis, be ordered numerically, hence there is no possibility of using parametric statistical tests which require numerical data. Thus data that was nominal was analyzed by use of χ^2

Analysis of variance (ANOVA) is a statistical technique specially designed to test whether the means of more than two quantitative populations are equal (Levin and Rubin, 1994). This is done via the mechanism of the F test for testing for the significance of the difference between two variances. This study used this test because it allows one to analyze two or more groups and thus test for significant difference between means. Compared with using multiple *t*-tests, ANOVA require fewer measurements to discover significant effects. ANOVA is a powerful tool for determining if there is a statistically significant difference between two or more sets of data (Pattern, 2002). ANOVA test is also useful in measuring variations within group.

However, with the help of the SPSS software results for the above statistical tests were automatically computed and displayed in tabular form. Ratio analysis was also used to test if there has been change in performance of SMEs before and after introduction of venture capital. The type of ratio used was Return on Asset (ROA) which is helpful in comparative analysis of the performance: With the help of ratio analysis a company may have comparative study of its performance to the previous years (Gupta, 2005). In this way firms comes to know about its weak point and be able to improve them

CHAPTER FOUR

4.0. RESEARCH FINDINGS AND DISCUSSION

4.1. Introduction

This chapter presents the results of the present study on the impact of venture capital on SMEs performance. The presentation of the results has been done in five main sections:

- a) Profile of the respondents.
- b) The influence of venture capital finance on growth of SMEs.
- c) The Influence of venture capital on finance management of SMEs.
- d) Influence of venture capital on management style/approach used by SMEs.
- e) Other sources of finance attracted by SMEs upon use of venture capital.

The above named sections b; c, d and e arise from the research objectives that address the study. The study focused on firms that have accessed venture capital and data was collected before use of venture capital and after. 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 The Profile of the Respondents

The aspects covered under this section included: location of the businesses, type of the businesses, age of the enterprises, respondents designation, the ownership, main sources of finance, year when venture capital was first used, nature of venture capital, amount invested by venture capitalists and the period venture capitalists will stay in the firms they have invested in. This study considered this section important as it provided information on the nature of businesses under study and the respondents. The findings in this section provide oversight on the type of businesses (manufacturing, service, agriculture or merchandising) that venture capitalists prefer

to finance. Such information help to understand the venture capital firms better. The business name has been coded for confidentiality purposes as requested by the firms. One hundred respondents were issued with questionnaires but only 65 fully filled questionnaires were returned.

4.2.1 The Designation of the Respondents

Data was collected from various categories of the respondents namely; finance managers, accountants, human resource managers, and others respondents drawn from various firms. Figure 3 shows that majority of the respondents were accountants (32%), finance managers were 22%, human resource managers were 20% and 26% from other categories namely secretaries and supervisors. This classification of the respondents is significant as the present study was able to collect data from various categories of professionals who gave reliable data as they work in the sections that have the custody of relevant database. Much of the data was given by accountants, finance managers and human resource managers (32 % +22% + 20% =77%). Literature (Saunders, 2003) on data collection asserts that data that is considered confidential can best be gathered from employees on managerial level like the ones used in this study.

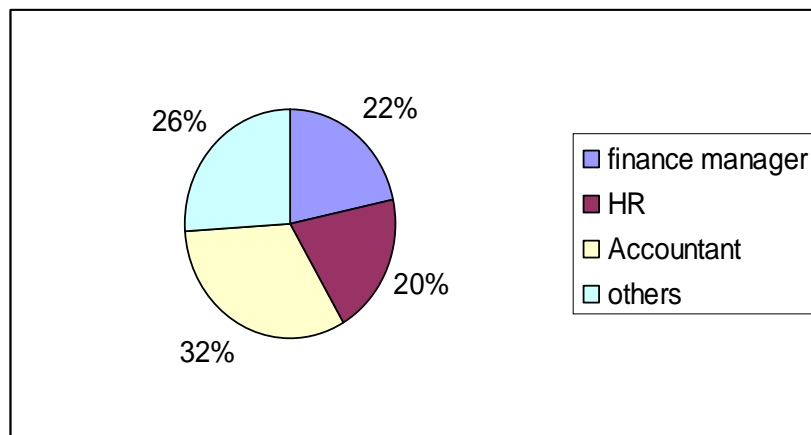


Figure 4.3: Respondents Designation

4.2.2 Location of Businesses

It was interesting to note that firms using venture capital are well distributed in the country's urban centers. As Table 4.2 indicates, 65 firms that are using venture capital, 33 of them were from Nairobi, 12 from Mombasa, 11 from Kisumu and 9 from Nakuru. Of the 33 firms from Nairobi, 12 were in manufacturing type of businesses, 14 in the service sector, 5 in the merchandizing and 2 in the agricultural sector. In Mombasa 4 firms were in manufacturing, 3 in merchandizing, 4 in the service sector, and 1 in agriculture. In Kisumu, 4 firms were in manufacturing, 5 in service, 1 in both agriculture and merchandizing. In Nakuru 5 firms were in manufacturing, 2 in the service sector and 1 in both merchandizing and agriculture.

This finding indicates that many of the firms using venture capital are located in Nairobi due to availability of excellent infrastructure which contributes to cost minimization. Keith (2007) affirms that location is an important factor to consider when venture capitalists invest their funds in SMEs. Venture capitalists manage the risk/reward ratio by only investing in businesses that only fit their investment criteria including location of businesses. Although venture capitalists finance firms located out of urban centers they are also keen on the costs involved in provision of amenities.

Table 4.2: Location of Business and Type of Business Cross Tabulation

		Type of Business				Total
		Manufacturing	Service	Merchandizing	Agriculture	
Location:	Nairobi	12	14	5	2	33
	Mombasa	4	4	3	1	12
	Kisumu	4	5	1	1	11
	Nakuru	5	2	1	1	9
Total		25	25	10	5	65

4.2.3 Type of Businesses

The study revealed that venture capitalists finance any type of business. However, manufacturing and service sectors had high percentages of venture capital financing 39% and 38% respectively as shown in Figure 2.4. Agriculture had 8% and Merchandising 15% of venture capital finance. The findings indicate that many firms in the manufacturing and the service sector have used venture capital hence an induction that venture capitalists have a preference of these sectors. Puri & Zarutskie (2008) found that venture capitalists fund firms in sectors with “hot” initial public offering and public market opportunities in the hope of early cashing out. Keith (2007) also agrees that venture capitalists prefer firms in the service and manufacturing industry as they adopt new technology faster than those in other sectors. Although recent findings (Devila et al, 2003) reveal that venture capitalists have a type of industry focus; they analyze various types of risk involved in an investment and compare this to the likely potential returns of the investment. The higher the potential returns compared to the risks the better the investment opportunity irrespective of the type of industry.

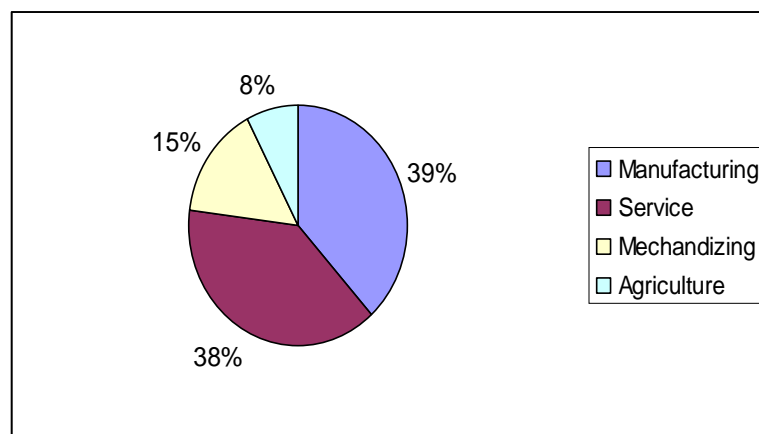


Figure 4: Type of Businesses

4.2.4 Age of the Firms Under Study

The analysis (Table 4.3) revealed that the average age of the firms under study was 17 years with the oldest having been in operation for 50 years by the time of study. Surprisingly, the oldest firm was from merchandizing sector, which according to Puri (2008) is not a preferred sector for venture capitalists, however the firm qualified for funding. The most recent firm was 8 years since establishment. These findings imply that a firm could be in business for many years but still remains in the category of small business due to lack of finance to expand its operations. The findings also indicate that despite the age of an SME, venture capitalists are still willing to give funds if only a venture can meet the stringent requirements. Duchesneau and Gartner (1990) affirm that SMEs that had remained small for many years needed the attention of venture capitalist.

Table 4.3: The Age of the Firms

	N	Minimum	Maximum	Mean	Std. Deviation
AGE IN YEARS	65	8	50	17	10

Figure 4.5 further shows that old firms reported a profit growth rate of close to 0% while young firms reported high profit growth rate (78%). The graph for firms that were between 500 months to 600 months (41 to 50 years) shows minimum profits while younger firms had relatively high profits. The reasons surrounding poor profits for old firms could be lack of proper management for both finance and other resources. The firm could be old in age but with poor governance it is likely to remain static for many years only able to pay fixed costs (Mandeto, 2005). Empirical studies by Wijewardena and Tibbits (1999) indicate that old firms in general have poor

growth performance compared to younger ones. A possible reason for this may be that the management of younger firms in the small-scale sector are more dynamic and innovative embracing new technology. This finding is also compatible with the results reported by three other studies of small enterprises in India, Sweden, and Singapore (Little, 1987 & Davidsson 1991).

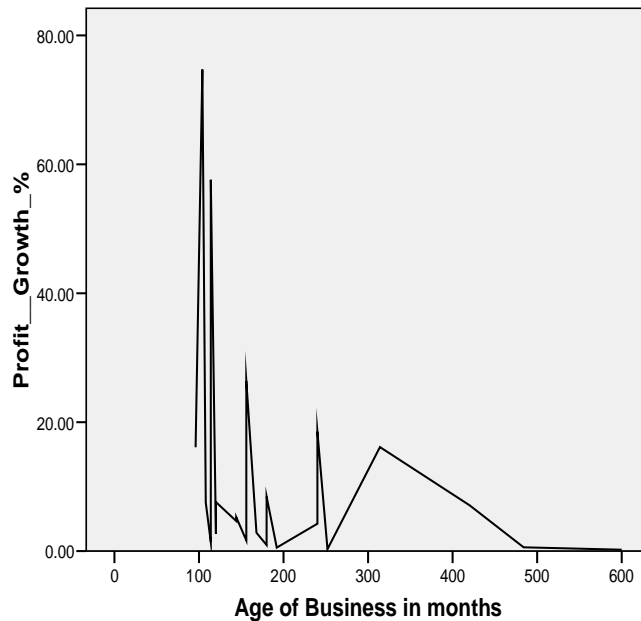


Figure 4.5: Growth in Profits in Terms of age of Businesses

4.2.5 Business Ownership

Majorities (92%) of the firms were limited liability companies and only 8% were under partnerships as shown in Figure 4.6 below. This means that an overwhelming majority had registered as limited liability companies with family members forming the company membership. This finding is not surprising as it concurs with Wijewardena and Tibbits (1999)'s study on 142 SMEs in Australia that used equity capital. The study revealed that majority of the firms (64%) operated as limited liability companies and the rest were under sole proprietorship and partnership.

Literature (Keith, 2007) asserts that venture capitalists are usually put off by complex corporate structures without a clear ownership and where personal and business assets are merged. In this study there were more limited liability companies whose structures are clear and defined by law. Firms that are registered as partnership have advantage of not paying corporation tax that is paid by every limited liability companies (Hellmann & Puri, 2002). Whenever venture capitalists invest in SMEs, they form a limited partnership or limited liability company. However in other developed countries (Fang, 2007) venture capitalists do not put weight on the form of ownership of a business in order to fund it. They will consider even a one man business, partnership or limited liability company as long as all other criterions are fulfilled.

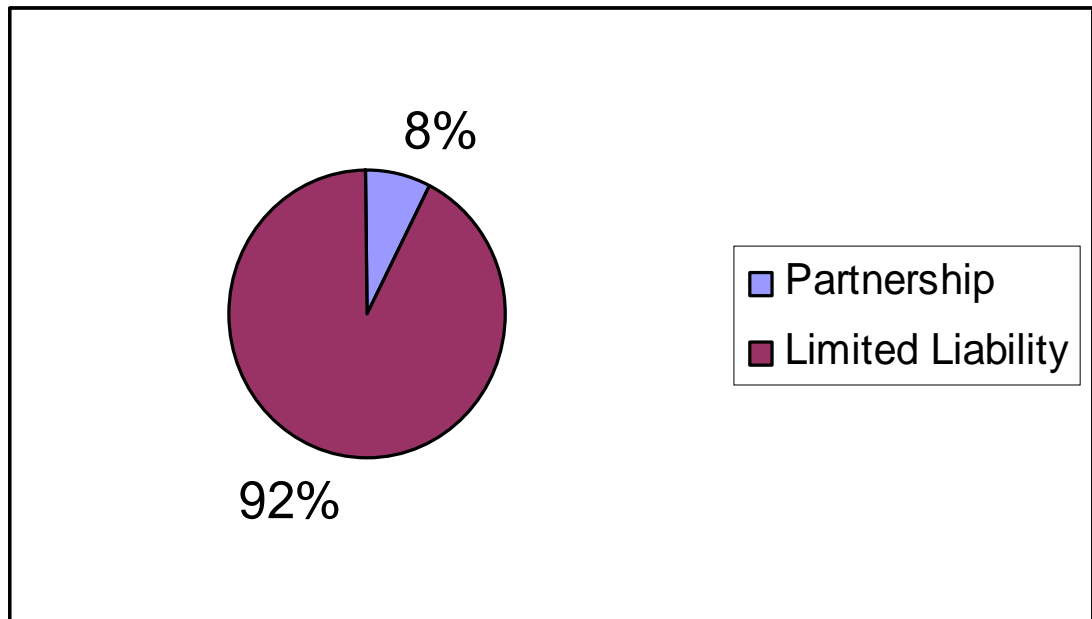


Figure 4.6: The Businesses Ownership

4.2.6 Year Venture Capital was first used

Figure 4.7 reveals that majority (17) of the firms under study used venture capital in the year 1998, in the year 2000, 11 firms used venture capital, and only 2 firms used venture capital in the year 1990. This information as to when venture capital was first

used is vital to enable the study make other conclusions related to its impact in the economy. However venture capital was not popularly used until 1990s yet the fund was in existence.

Literature (Mc Cormick, 1996) indicates that although significant growth in financial institutions in Kenya has been going on, the needs of SMEs remained largely ignored especially in the early 1990s. This expansion of financial institutions was mainly quantitative with few qualitative changes in services. The securities markets grew slowly and remained unable to address the financial needs of SMEs. The existing venture capital organization created to provide funding to SMEs moved the lending to large scale firms. This revelation justifies the small number of firms that succeeded in using venture capital at the beginning of the period. The years 1996, 1997, 1999, 2001 and 2002 seem to have similar frequency in terms of attracting venture capital. Within this period private venture capital firms increased their participation in the venture capital market and invested in many of the firms as compared to year 1990. The Arabic numbers inside the bar show the SMEs that used venture capital in each year.

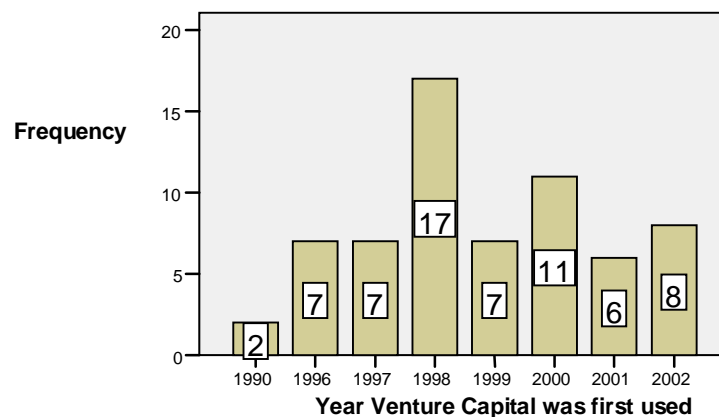


Figure 4.7: Year Venture Capital was First Used.

4.2.7 Nature of Transactions

Venture capitalists enter into various transaction agreements with firms they finance. Data collected revealed that 75% of the firms financed said the funds were for expansion purposes, 10.8% for placement, 9.2% for startup and 4.6% for management buyout (Table 4.4). This finding shows that venture capitalists availed a larger portion of their funds for expansion purposes. Gompers (1995) observes that expansion financing provides working capital for initial expansion or for major growth of a company expecting to go public. Venture capitalists provided fewer funds to start up businesses and none for seed financing. Seed financing involves small amounts of capital to an investor or entrepreneur to prove a concept (Hellman & Puri 2001). A study by Ngigi (1996) revealed that venture capitalists did not provide seed financing. This study also made observations that no funding was given for seed financing. Although literature (Greene et al, 2001) confirms that seed financing has been left to business angels, many of them are keen on the risks involved in such finance and are selective on the SMEs they fund. However, this study feels that seed financing is very significant and venture capitalists should not ignore it. If more entrepreneurs should emerge into the industry, seed financing is necessary.

Table 4.4: Nature of Transactions

Transactions	Frequency	Percent
Startup	6	9.2
Expansion	49	75.4
Placement	7	10.8
Management buy out	3	4.6
Total	65	100.0

4.3 Accessing Whether or not Venture Capital Leads to Growth

To address the above research objective, a number of variables were considered to determine if use of venture capital by firms lead to growth. Some studies (Liao *et al*, 2001) define enterprise growth as a unidimensional construct operationalized by a variety of growth measures. They include sales, profit, number of workers, value of net assets and market share among others. In this study the variables that were used to measure growth included: sales per annum, net assets, profit per annum and number of workers among others. These variables were analyzed on a before and after venture capital basis.

4.3.1 Sales Before and After use of Venture Capital

As Table 4.5 indicates, the minimum sales increased from Ksh 290,000 to Ksh 4,000,000. The maximum sales increased from Ksh 70, 800,000 to Ksh500, 000,000. The mean sales after use of venture capital are Ksh 139, 043, 076 up from Ksh10, 349,661. Generally there was improvement in sales volume after use of venture capital. This finding is in conformity with the studies by Steiner and Solem (1988), Cuba, et al (1983), Khan and Rocha (1982), and the United States Small Business Administration (1980) which has used sales growth as a key indicator of small business success and overall performance. Their study reported that there was substantial sales growth by firms that used venture capital. However availability of finance is no guarantee to increase in sales. Cook (2000) observed that proper marketing strategy, pricing policy, research and development, proper management among others contribute to sales growth. The presence of venture capitalists in a firm provides guidance to all the above hence sales growth.

Table 4.5: Sales Before and After use of Venture Capital

	N	Minimum	Maximum	Mean	Std. Deviation
Sales before (KSH)	65	290,000	70,800,000	10,349,661	17,281,467
Sales after (KSH)	65	4,000,000	500,000,000	139,043,076	137,616,652.

A correlation test (Table 4.6) was run to test the extent of interdependence of the two variables considered above. The result indicates that there is a significant relationship between the sales before and sales after use of venture capital. The correlation coefficient, $r = 0.933$ and $r^2 = 87\%$ which means that 87% of the variation in sales can be explained by variation in the use of venture capital. 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 European Venture Capital Association (2001) has also established that venture capital backed firms report a high growth in sales as compared to other firms. The result reveals that venture capital leads to growth on sales of the firms that use these funds.

Table 4.6: Correlations of Sales Before and After use of Venture Capital

		Sales per annum Before	Sales per annum After
Sales per annum before	Pearson Correlation	1	0.933(**)
	Sig. (2-tailed)		0.000
	N	65	65

** Correlation is significant at the 0.01 level (2-tailed).

The chi-square test was used to test whether improvement in sales was independent of management style used by firms after use of venture capital. The test revealed (Table 4.7) that sales improvement was associated with change in management style that was used by the venture capitalists.

For sales to grow the management recommended brand development, effective marketing and product differentiation among other things. According to the literature (Porter, 1980), firms that pursue one of the three generic strategies: differentiation, cost leadership, or focus will experience sales growth. Differentiation attempts to create a distinctive competence by offering products that are perceived to be unique by customers because of innovativeness, style or quality. This creates brand loyalty that renders customers less sensitive to price and allows larger profit margins (Mouristen, 1998). To be successful, differentiation strategies require that a company distinguishes itself from its competitors along a dimension which is valued by customers (Porter, 1985). The venture financed firms through differentiation of products survived and improved their performance in the competitive market.

Table 4.7: Chi-Square Test

	Change in management style
Chi-Square	61.062
Degrees of freedom	1
Significant.	0.000

4.3.2 Profit Before and After use of Venture Capital

The study indicated that 81% of the respondents reported that profit before use of venture capital was poor (Figure 4.8) and only 5% reported that profit was good. The rest of the respondents (14%) said that they made fair profits.

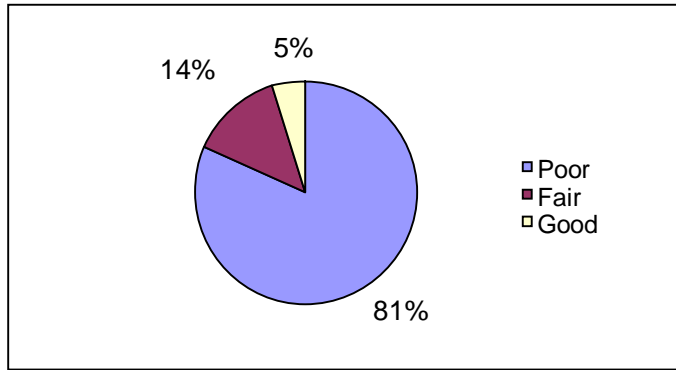


Figure 8: Respondents on Profitability Before Venture Capital

However, after utilizing venture capital majority (98%) of the respondents indicated that profit was showing an upward trend as shown in the Figures 4.9. The 2% of the respondents confirmed that profit was stagnant. The reasons for the stagnant profit were due to restructuring operations and policies. At initial stages some firms may not experience change in profit

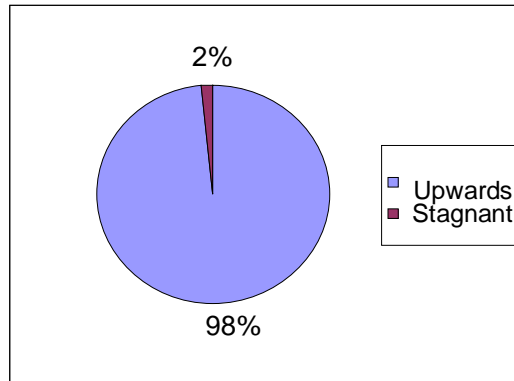


Figure 4.9: Response on Profitability Trend After Venture Capital

A descriptive statistic analysis was carried out on annual profit figures provided by respondents from the field to further prove that profit upon use of venture capital has shown any change. This analysis showed that the increase in profitability is significant in business growth (Table 4.8). The minimum profit before use of venture capital was Ksh 34, 866. Upon use of venture capital, the minimum profit increased to Ksh 600, 000. This shows an increase in minimum profit of 94%. The maximum profit respondents reported before use of venture capital was Ksh 38,

567,951 which increased to Ksh 62, 864,152 an increase of 63%. The average profit also increased by 69% (from Ksh 7,204,653 to Ksh 12, 202,775). This finding then implies that firms that use venture capital experience growth in profit. Similar trend was reported by Chaganti and Mahajan (1983) in Indian SME that used venture capital. The important aspect here is not just the finance the venture capitalists provide value creation in the venture. Empirical evidence (Brav and Gompers 1997) confirms that increase in profit by venture capital-backed firms is often attributed to better management teams and corporate governance structures that help these companies to perform better in the long run.

Table 4.8: Profit Before and After use of Venture Capital

	N	Minimum	Maximum	Mean	Std. Deviation
Profit before Ksh)	65	34,866	38,567,951	7,204,653	11,544,019
Profit after (Ksh)	65	600,000	62,864,152	12,202,775	18,860,127

The present study also considered the growth in profit in relation to the period a firm has used venture capital. Figure 4.10 shows that profit growth was high (80.6%) in firms which have used venture capital for a period ranging from 5 years and 10 years, followed by 16.5% of profit growth by firms that have used venture capital for a period of between 10 to 15 years and for those which have used venture capital for 15 to 20 years growth in profit was 2.8%. This finding is in line with the theory of economies of scale as given by Todaro (1982). These are economies of growth resulting from expansion of the scale of productive capacity of a firm leading to increases in its output and decreases in its costs. For the period 5 years and below, no profits were realized as the firm was restructuring its operations and policies and costs were high. Studies (Lerner, 1995) show that venture capitalists are patient at least

during the first five years after a firm receives funding as the profits made are negligible or nonexistent. The period between 5 to 10 years the firms realized high profit growth due to increased output and low costs. The firms were enjoying economies of scale. Profits declined in the period 10 years and above as Puri (2008) also asserts that profits of firms using venture capital declined at later stages before the exit although the firms had healthy cash flow.

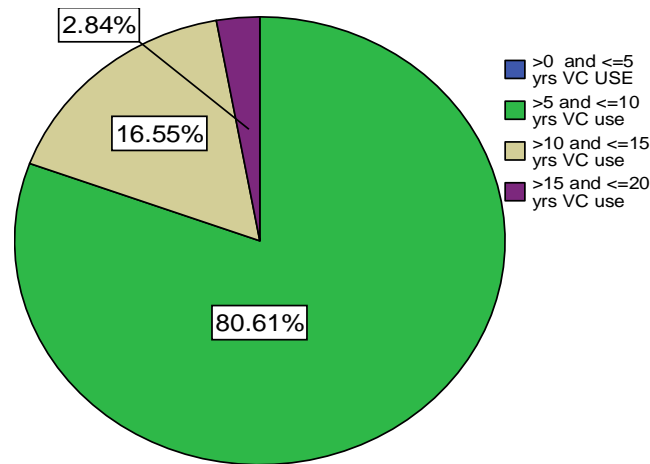


Figure 4.10: Growth in Profit in Relation to Period of Venture Capital

This study also sort to find out if the growth in profit had any bearing with types of business. Table 4.9 displays findings in relation to type of business and the profit margin growth rate. Merchandizing types of business reported an average growth in profit margin of 18.2%, followed by agriculture 14.4%, service 12.8% and manufacturing 9.3%. This implies that all the businesses from whatever sector they belong realized growth in profit as a result of use of venture capital. While merchandizing is considered a low technological sector that venture capitalists are careful in investing their money (Puri & Zarutskie, 2008), it seems to have a high (18.2%) average growth rate compared to manufacturing which is a preferred type of business with high chances of initial public offering (Gompers & Lerner, 2001). This

finding relating to high profit margin for merchandising in relation to other types of business is interesting and could have been related to cost saving and increased efficiency in use of recourses and cross monitoring by venture capitalists. This result suggests that venture capitalists focus on scale or potential for scale rather than profitability. However each type of business has shown that profit margin grew upon use of venture capital indicating that venture capital has an influence on performance of SMEs.

Table 4.9: Growth in Profit Margin by Business Type.

Type of business	N	Minimum	Maximum	Mean	Std. Deviation
Manufacturing	25	.31	26.40	9.3	7.8
Service	25	.58	74.70	12.8	23.7
Merchandizing	10	.22	57.61	18.2	27.2
Agriculture	5	7.53	16.14	14.4	3.8

The test of ANOVA was also carried out (Table 4.10) to test whether use of venture capital has any influence on profits. When the test was run at 0.05 significance level, the p value was 0.000. If p value (0.000) is less than α (0.05) then the result is significant implying use of venture capital does have a significant difference between profits before and after use of venture capital. A study carried out by Engel and Keilbach (2002) which compared venture capital financed firms with non-venture capital financed firms in Germany indicated that venture capital financed firms showed high profitability. In this study, the findings also indicate that firms that use venture capital realize a general increase in profits.

Table 4.10: ANOVA Test Annual Profit After / Before use of Venture Capital

	Sum of Squares	Degrees of freedom	Mean Square	F	Sig.
Between Groups	2.27616	23	9.89614	11736.382	0.000
Within Groups	3.45712	41	8.43210		
Total	2.27716	64			

4.3.3 Net Assets Before and After use of Venture Capital.

Net assets were used as measure of growth. Liao, et al (2001) define enterprise growth as a unidimensional construct operationalized by a variety of growth measures which include sales, value of net assets, profit, number of workers, and market share among others. Barmes (1990) also observed that assets are particularly useful indicator of impact because their level does not fluctuate as greatly as others. Thus net assets are indicators of growth. Table 4.11 shows that assets of firms grew by a significant amount after use of venture capital. The maximum value of net assets reported increased from Ksh 600 million to Ksh 640 million. The average net assets also increased from Ksh 75.2million to over Ksh 102.5 million. This increase in value of net assets after use of venture capital is a worthy evidence to say that there is growth. Literature (Brigham and Houston, 2001 and Pandey, 2003) confirms that growth in assets can be directly linked with availability of funds as the business expands. Since venture capital is equity capital to the business then net assets also increase.

Table 4.11: Net Assets Before and After use of Venture Capital

	N	Minimum	Maximum	Mean	Std. Deviation
Assets Before (Ksh)	65	4,000,000	600,000,000	75,205,056	136,940,638.
Assets After (Ksh)	65	8,000,000	640,000,000	102,547,692	163,907,711.

Return On Assets (ROA) which is a financial ratio that shows how efficient a firm is in generating returns in the business was also calculated. Table 4.12 shows the return on assets before use of venture capital and after use of venture capital. The minimum returns reported before use of venture capital was 0.2% and the maximum reported was 84 %. After use of venture capital the minimum reported was 0.9% and the maximum was 123%. The financial returns on asset on average increased from 17% to 20%. This finding then implies that firms were efficient in use of assets and this led to growth in returns after use of venture capital. The increase in efficiency may be as a result of the presence of the venture capital member in the board of management. Similar findings have been reported by Huck and McEwen (1991) from a survey of 54 Jamaican entrepreneurs involved in manufacturing and service businesses using venture capital. More specifically, these researchers identified competencies in management, planning and budgeting as most crucial for the efficient operation of a small business.

Table 4.12: Return on Assets Before and After use of Venture Capital

	N	Minimum	Maximum	Mean	Std. Deviation
ROA Before %	65	0.2	84.	17	17
ROA After %	65	0.9	123.	20	22

It was also necessary to measure the efficiency with which the firm is using its total assets to generate sales. The higher the ratio the more efficient firms are in generating sales hence growth (Van Horne, 1983). Total asset turnover ratio was calculated and the findings are displayed in Table 4.13. The study showed that the maximum turnover before use of venture capital is 0.9 times and after is 18.25 times. The mean turnover increased as well from 0.03 to 2.92 times. This financial ratio shows that after use of venture capital firms were efficient in using their total assets to generate sales and hence growth in sales.

Table 4.13: Assets Turnover Before and After use of Venture Capital

	N	Maximum	Mean
Assets turnover before	65	0.09	0.03
Assets turnover after	65	18.25	2.92

4.3.4 Employees Before and After use of Venture Capital

The present study considered employees as a measure of economic growth of SMEs. This variable was also used by Gompers and Lerner (2001) in their study on the influence of venture capital on SMEs performance. Data collected on employees of the firms under study covered three categories namely; employees on permanent, contract and casuals terms (Table 4.14). It can be observed that the total number of employees before use of venture capital was 9,404 of which 3,922 were permanent, 4,304 were casuals and 1,178 were on contract. The average number of total workers was 145. The study reveals that the SMEs were only able to employ an average of 60 permanent workers and this may be due to lack of finance. Kauffmann (2005) and Saleemi (2009) confirms that SMEs in Africa have little access to finance, small local market and difficult business conditions which make expansion of both physical and

human resource difficult. This is the environment that SMEs in Kenya face and hence the limited number of employment opportunities.

Table 4.14: Number of Employees Before use of Venture Capital

No. of Employees Before use of Venture Capital	N	Sum	Mean	Std. Deviation
Total Employees before	65	9404	144.7	127.7
Permanent Employees before	65	3922	60	52.1
Casual employees before	65	4304	66	81.8
Employees on contract before	65	1178	18	24.2

Upon use of venture capital, findings (Figure 11) indicated that the 65 firms employed a total of 24, 802 workers (10174 + 7766+ 1857 + 5005) of different categories. The sector that employed majority of the workers (10,174) was the manufacturing sector, while 7,766 were in the service sector and 5,005 were hired in the agriculture with merchandizing hiring 1,857 workers (Figure 4.11). The number employed depended on the number of firms in each sector. There were more firms in the manufacturing and service sectors (25 in each) than in merchandising and agriculture hence the high number of employee recorded. The observation made is that the 65 businesses that used venture capital contributed significantly to creation of employment opportunities. Overall, upon use of venture capital there was a tremendous increase in total number of workers by 186%. The increase could have been attributed to the expansion that venture capitalists are keen on.

This finding is in agreement with Kenya Economic Survey (RoK, 2005) which recommended that SMEs are among major contributors of eradicating poverty through employment creation. Therefore availability of funding sources especially venture capital seem to make employment creation possible. This employment creation is felt greatly and impact on every level ranging from the firms, individual

workers to the community at large. As more employment is available the standard of living is improved as also discussed in the Kenya economic survey (2005) and also propounded in the Annual Report (2006) on steering SMEs development in Malaysia which revealed that equity financed SMEs are the major source of employment, providing employment for over 5.6 million workers and accounting for 56% of total employment.

This finding was not surprising as other scholars (Astrid and Bruno 2004) also observed that SMEs that were using venture capital showed higher employment growth rates than those that were not. Other studies (EVCA, 2001) have also shown that in 2004, portfolio companies held by European private equity and venture capital funds employed close to six million people. The inference to be deduced is that if SMEs are given every attention as regards to funding and management skills, they can contribute significantly to economic growth hence improved performance.

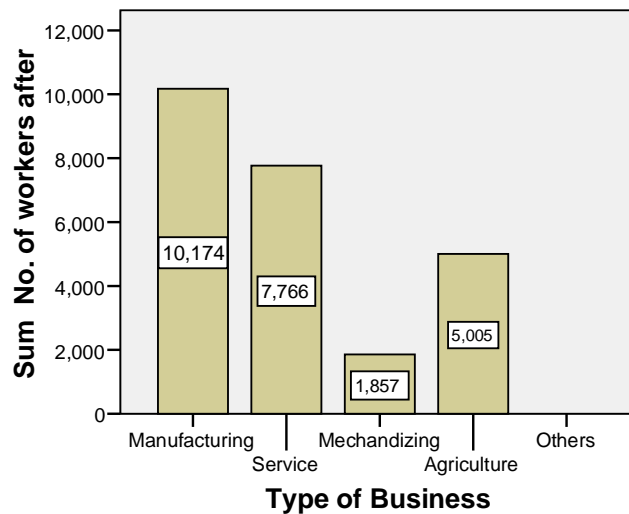


Figure 4.11: Number of Workers After use of Venture Capital

4.4 Influence of Venture Capital on Financial Management

This research objective was addressed using a number of indicators of sound finance management namely: cash planning, debt management, inventory control and

preparation of budgets. Financial management being a wide area, a portion of it (working capital management) that deals with liquidity aspects of a firm has been considered. Working capital is an accounting strategy that ensures an adequate supply of cash flows to enable a venture to meet its current obligation and as well as enable the business to fulfill its long term obligations in the future. Hence this section of finance management which has been used is adequate.

4.4.1 Preparation of Budgets Before and After use of Venture Capital

Before use of venture capital, the present study showed that preparation of budgets was not carried out in most firms. From table 4.15 below, 96.9% of the respondents confirmed that firms did not prepare budget estimates as a gadget of sound financial management. Only 1.5% of the SMEs prepared budget estimates. The study by Price water House, (2005) vindicates this finding that in many SMEs the relationship between budgeting, strategy and capital expenditure is initially either non-existent or tenuous. In-depth findings during the interviews indicated that there was no financial planning and so capital expenditure was unplanned. This obviously leads to poor performance by SMEs

Table 4.15: Preparation of Budgets Before

Response	Frequency	Percent
Yes	1	1.5
No	63	96.9
N/A	1	1.5
Total	65	100

However, after use of venture capital results were different (Table 4.16). From the table 96.9% of the respondents indicated that budget preparation was mandatory and all departments had to present their estimates to be approved by the board of

management where the venture capital firm is represented. This is because venture capitalists work with the firm to ensure that financial planning is integrated into the decision making process (Mandato, 2005). The finding reveals that upon use of venture capital finance management improved. The mere 3.1% of the respondents said that their firms upon use of venture capital do not prepare budgets. This may be as a result of some entrepreneurs restricting the support, mentoring and intervention of the venture capitalists in running the affairs of the business (Barrow, 2000). Manigart, et al., (2003) also noted that there are venture capitalists that merely supply the capital to ventures but are not involved in day-to-day management of the business although they may be represented in the board of management.

However the study reveals that majority (96.9%) of the SMEs prepare budgets upon use of venture capital. Fried and Hisrich, (1995)'s study supports this finding that financial position of firms financed by venture capitalists are relatively sound.

Table 4.16: Preparation of Budgets After use of Venture Capital

Response	Frequency	Percent
Yes	63	96.9
No	2	3.1
Total	65	100

All (100%) respondents (Table 4.17) indicated that their management boards included a representative of the venture capital firm. For every firm financed by venture capitalists there must be a member in the board as confirmed by 100% of the respondents. Literature on venture capitalists show that they are not solely an injection of funds into a new firm but they also make an input of the skills needed to set up the firm, design its marketing strategy, organize and manage it (Mason, 1996). Venture capitalists also assist in making investment decisions which are superior to

those of their partners hence making the venture to succeed (Lefton, 1998). Thus the presence of venture capital member improved financial management.

Table 4.17: Presence of Venture Capital Members in the Board of Management

Response	Frequency	Percent
Yes	65	100
Total	65	100

4.4.2 Cash Planning Before and after use of Venture Capital

Majority (94%) of the respondents from various firms confirmed that there was no cash planning done by the businesses as indicated in Figure 4.12. No cash budgets were actually prepared. Only 6% of the respondents said that they carried out cash planning. This finding implies that before use of venture capital, symptoms of poor cash management were commonly experienced hence difficulties in meeting obligations as they fall due. Brealey et al (2002) confirms that cash planning in small firms can be sophisticated due to non availability of information. This includes lack of cash planning which leads to poor cash management and characterized by insufficient cash or excess cash in hand (Pandy, 2003). Korah (2005) also observed that success of young business is challenging if not properly managed financially. Venture capital is therefore very important since it influences cash planning which was not a necessary requirement for SMEs engaging venture capitalists (Figure 4.12).

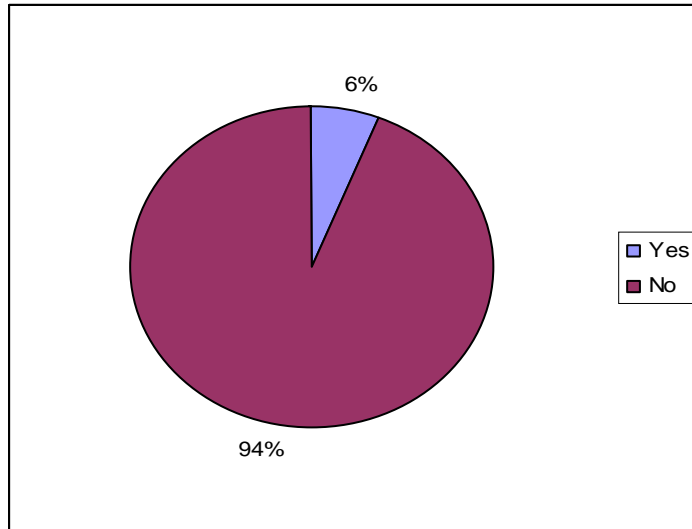


Figure 4.12: Cash Planning Before use of Venture Capital

In Figure 4.13 below, 49 % of the respondents recorded that they were extremely satisfied with the way cash planning was carried out with the use of venture capital. A similar percentage (49%) of the respondents was also satisfied with cash planning. Only a small number of respondents (2%) were dissatisfied with cash planning. The finding indicates that 98% were satisfied with cash planning (49% +49%) upon use of venture capital. Although there is sufficient evidence (Pandy, 2003) that poor cash position of the firm can be corrected if its cash needs are planned in advance, this underscores the importance of venture capital in SMEs as it enables firms to carry out cash planning with great success as shown in Figure 4.13. A study by Chaganti and Mahajan (1983) concluded that managerial competence particularly in the management of cash flow is important for sound financial management of small businesses.

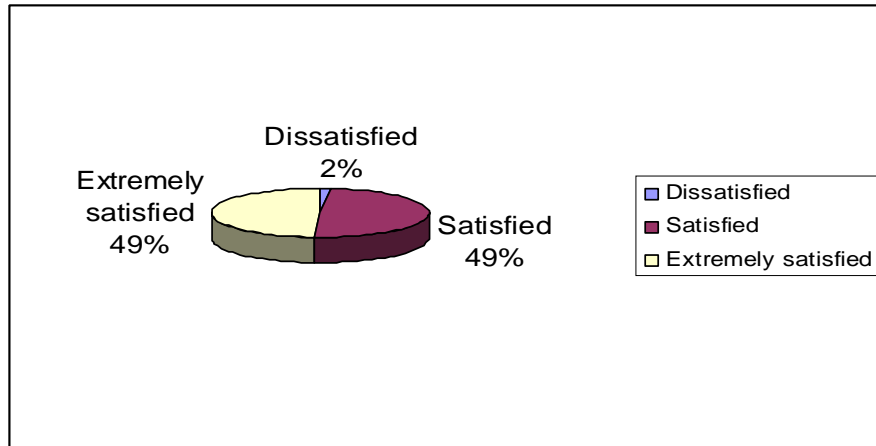


Figure 4.13: Cash Planning After use of Venture Capital

4.4.3 Debt Collection Before and After Venture Capital use

Before use of venture capital (Table 4.18) the findings showed that debt collection was poor (53.8%), fair (36.9%) and very poor (3.3%). This trend explains why there was cash shortage as addressed in the foregone sections of this work. This finding is in line with a study carried out by Bowen et al (2009) on management of business challenges among SMEs in Kenya which revealed that 25 percent of respondents ranked debt collection among the top three challenges they face in their businesses. Wilkes et al (1998) argues that for sound financial management to be realized there has to be good debt collection policy put in place. Once goods have been sold on credit, debtors are expected to pay within a given period so as to enhance cash-in flow in the enterprise. With poor debt collection, cash-in flow will be low and hence cash shortage.

Table 4.18: Debt Collection Before use of Venture Capital

Response	Frequency	Percent
V. Poor	2	3.1
Poor	35	53.8
Fair	24	36.9
N/A	4	6.2
Total	65	100

After SMEs engaged in venture capital the findings (Table 4.19) revealed that majority (75.4%) of the respondents were satisfied with debt collection. Other respondents (21.5%) were extremely satisfied and only 3.1% were dissatisfied. This finding indicates that upon use of venture capital debt collection improved. Davila et al (2003) in their study revealed that the presence of venture capital member in the board of management formulate clear credit policy which improve debit collection. This may be as a result of the venture capitalists being keen on who is to be awarded credit and who is not. Florida and Kenny (1988) emphasized the usefulness of venture capital in firms and observed that venture capitalists are well connected to specific industry, they help to recruit key personnel, they negotiate with suppliers and customers, and they are even involved in day to day running of the businesses. Venture capitalists can often leverage their network to help the company hire the right people (Typjee & Bruno, 1981).

This is further amplified by Hall and Young (1991) who argues that for a firm to succeed in sound debt collection there should be a sound credit policy. Credit policy is a combination of credit standards (criteria to decide the type of customer to sell to), credit terms (duration of credit and terms of payment) and collection effort (actual collection period). This may be the reason why there was improved debt

collection and also indirectly improved turnover, liquidity and profit when firms started using venture capital.

Table 4.19: Debt Collection After use of Venture Capital

Response	Frequency	Percent
Dissatisfied	2	3.1
Satisfied	49	75.4
Extremely satisfied	14	21.5
Total	65	100

A correlation analysis to determine whether there was a relationship between debt collection (accounts receivable) after use of venture capital and percentage change in sales after use of venture capital was determined. The result (Table 4.20) shows that there is a significant relationship between debt collection and percentage change in sales. The correlation coefficient (r) which is a measure of correlation between variables is -.327 that is as debt reduces sales increase and vice versa.

Table 4.20: Correlations Analysis

		Debt collection	Percentage change in sales
Debt collection	Pearson Correlation	1	-0.327(**)
	Sig. (2-tailed)		0.008
	N	64	64

** Correlation is significant at the 0.01 level (2-tailed).

4.4.4 Inventory Control Before and After use of Venture Capital

Inventories are stocks of the product a firm is manufacturing for sale and components that make up the product. They constitute the most significant part of current assets. The respondents were asked to give their views on inventory control in the firms they

work for and the findings are shown in the Table 4.21. The findings indicated that 93.8% of the respondents confirmed that there was no inventory control practiced, but only 4.6% agreed that inventory control was in use. This implies that the firms had either over or under investment in inventory. As pointed out by Pandy (2003) there are dangers of over investment which include unnecessary tie up of the firm's funds and loss of profit, excessive carrying costs and the risk of liquidity. This can affect the performance of SMEs business seriously. The consequences of under investment in inventory may lead to production holds-up and failure to meet delivery commitments.

Wilkes et al (1998) also argue that uncontrolled inventory adversely affect a company's growth. Saleemi (2009) also explains that SMEs in East Africa have poor inventory control which affects their operations. This may happen when sales suddenly take a dive and the business ends up with large amounts of finished products in hand and the cash is all invested in the ballooned inventory. Some businesses are forced to lay off workers as they cannot pay them. This is a sign of poor finance management. The present study has already revealed above that there was shortage of cash (liquidity problem) before use of venture capital (Table 4.15). The study then reveals that there was no inventory management hence poor financial management.

Table 4.21: Inventory Control Before use of Venture Capital

	Frequency	Percent
Yes	3	4.6
NO	61	93.8
N/A	1	1.5
Total	65	100

The respondents were asked for their views on whether they were extremely dissatisfied, dissatisfied, satisfied or extremely satisfied using a likert scale and the findings are shown in Figure 4.14. After use of venture capital 60% of the respondents were satisfied with inventory control, 26% were extremely satisfied, 12% were dissatisfied and only 2% were extremely dissatisfied. Generally the percentage of the respondents satisfied was 86% (60+26). This study thus reveals that inventory control improved when firms used venture capital. This finding is further amplified by Bygrave & Timmon (1992) who asserts that venture capitalists helps SMEs to plan and to minimize the impact of anticipated changes in exogenous variables such as consumer demand or availability of factor inputs and hence firms are able to optimize debt management and inventory control. He explains that venture capitalists add value to finance management of a business they invest in. The observations made in this study are that inventory control was well carried out with the presence of venture capitalists.

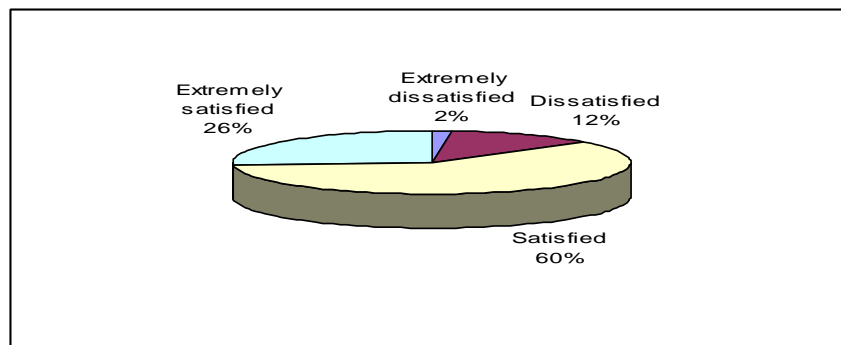


Figure 4.14: Inventory Control After use of Venture Capital

From the findings of this study on this research question it was observed that there was improvement in financial management when the firms started using venture capital. Literature has shown that venture capital investors can create value for entrepreneurial firms through intensive monitoring (Korah, (2005) and Lerner 1995) which thus ensures that cash management, proper strategies of debt collection and

inventory control policies are in place and enforced. Financial institutions hardly concern themselves as to how the fund is utilized and the management of the venture when they provide finance and thus many firms experience financial mismanagement. 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 polices for sound finance management are in place

4.5 Influence of Venture Capital on Attracting Other Sources of Finance

This research objective was addressed by considering the type of finance used by the firms under study before use of venture capital and the financiers that were willing to finance the firms after use of venture capital.

4.5.1 Sources of Finance Before and After use of Venture Capital

Before the firms used venture capital, the main source of finance was personal savings (64.6%). Another 7.7% of the respondents explained that their firms approached commercial banks for funds; however, the fund processing period was long. 1.5 % used finances from Micro Finance Institutions and 4.6 % sourced funds from friends to finance the enterprises. Table 4.22 reveals that 21.5% of the respondents approached and used all the four sources of finance before they could get a better funding alternative. Finance from personal savings constituted a large percentage (64.6%). Abuodha (1996) has also noted that SMEs major source of finance is personal saving which is insufficient as they have a number of credit needs.

It was surprising to find out that a very small percentage of SMEs received funds from banks (7.7%) and Micro Finance Institutions (1.5%) possibly due to lack of creditability or ignorance. Kauffmann (2005) also confirms that access to formal finance is poor because of high risk of default among SMEs and inadequate financial

facilities. This finding is also in agreement with the literature given by Mukherjee (1990) which argues that SMEs in developing countries face the dilemma in expanding their enterprises because of the negative attitude towards them by banks and other conventional sources of finance. As a result SMEs have few alternatives of accessing financing other than relying on their retained earnings to finance investments. Ruffing (2006) also observed that micro finance institutions though rampant in Africa do not provide sufficient funds for expansion as they are suspicious of non repayment of such funds. The institutions also require that investors form groups, save some money with the institutions before any lending can be effected. This may discourage investors who require large fund for immediate expansion.

Table 4.22: Sources of Finance Before use of Venture Capital

Respondents	Frequency	Percent
Bank loans	5	7.7
Friends	3	4.6
Personal savings	42	64.6
Micro Finance	1	1.5
All of the above	14	21.5
Total	65	100.0

Data collected in relation to the respondents views on interest rates charged by banks revealed that 93.8% were of the opinion that the rates were high, 3.1% indicated that rates were average and a similar percentage (3.1%) said that the rates were low and affordable as shown in Table 23. This study reveals that SMEs in Kenya have difficulties of accessing both credit finance and equity from conventional sources of finance. It is possible that the high interest rate charged on SMEs is a scheme to put them off and hence firms could not afford to use bank finance. This is one of the

financial constraints (Kauffman, 2005) that affect business creation and improvement.

Table 4.23: Bank Interest Rate

Response	Frequency	Percent
High	61	93.8
Average	2	3.1
Low	2	3.1
Total	65	100

In Table 4.24, 47.7% of the respondents reported that accesses to bank loan was very difficult, 47.7% indicated that it was difficult and only 4.6% confirmed that it was easy to assess loans. It could take an average of 4 months or longer to get the loan approved, which discourages SMEs. This finding concurs with the literature by Modigliani and Miller (1958) who indicated the fact that in perfect financial markets, funds are always available for value creating investment projects and SMEs are viewed by conventional financiers as not being value adding hence the long period of loan approval. Similar studies by Braham, Boucher and Carter (1996) in Ghana showed that a good majority (81 %) felt fully constrained in accessing funds.

The 4.6% that indicated that it was easy to get bank loans are those that might have got it through relationship lending (one of the technologies banks use for lending). Petersen and Rajan (1994) analyzed data on small business loans of all types from bank and non-bank lenders and they found that longer-standing relationships between lenders and borrowers increased the availability of credit, but did not decrease the interest rate on loans. The interest rates charged by banks were then hindrances for SMEs to get funds.

Table 4.24: Accesses to Bank Loan Before

Response	Frequency	Percent
Easy	3	4.6
Difficult	31	47.7
Very difficult	31	47.7
Total	65	100

4.5.2 Reasons why Bank Loan was Difficult to Accesses

The respondents gave various reasons why bank loan was difficult to access (Table 4.25). 61.5% outlined the following reasons why they could not use bank loan:

- i. Banks have many procedures to follow before a loan can be authorized,
- ii. The period between application and receipt of funds takes long,
- iii. SMEs lack collateral security that banks can recognize for negotiation and that
- iv. Banks are suspicious of SMEs and so disqualify their applications.

16.9% gave lack of collateral as the reason they do not use bank loan. 9.2% said that banks suspect that applicants of SMEs class may not repay the loan and that they may divert the funds for social reasons instead of business purpose. The findings of this study explain that SMEs are disadvantaged and do not attract funds from banks for expansion and hence low rate of growth. Sowa et al. (1992) in their studies carried out on SMEs have shown that entrepreneurs find it difficult to raise investment finance from traditional sources because the businesses are not well developed. They lack collateral and credit history, have high administrative costs and high default rates.

Table 4.25: Reasons why Bank Loan was Difficult

Reasons	Frequency	Percent
Many procedures	3	4.6
Long waiting period	5	7.7
Lack of collateral	11	16.9
Bank suspicious of Applicants	6	9.2
All above	40	61.5
Total	65	100

From Table 4.26 below data collected to determine other sources of finance that were willing to finance SMEs after use of venture capital indicated that 39.5% was bank loans, micro finance and friends 3.1% and 15.4% was personal saving or owner's equity as funds from friends and relatives constituted 43%. Comparing the before and after use of venture capital, the result reveal that the presence of venture capital in the capital structure of a firm is an attraction of other financiers to provide more funding to the SMEs (Mukherjee, 1999). It would appear that venture capital finance elevates SMEs performance to automatically meet the criterion of bank finance. Research has shown that venture capitalists play a critical role in reducing information asymmetries through the collection of critical, private information (Eisenhardt, 1989). This is the information that banks and other conventional sources lack and hence shy off from financing SMEs. The financing by banks increased from 7.7% to 39.5% after use of venture capital. The findings in this study then confirm that once an SMEs uses venture capital other financiers are ready and willing to provide more funding when required.

Table 4.26: Sources of Finance After use of Venture Capital

Sources	Frequency	Percent
Bank loans	25	39.5
Micro finance	2	3.1
Friends & relatives	28	43
Personal savings	10	15.4
Total	65	100.0

The role of venture capital member in the board of management influenced financing of SMEs by other financial institutions. The chi-square test (Table 4.27) shows that chi-square calculated (0.000) is less than p (0.05) value hence there is an association between the two attributes.

Table 4.27: Chi-Square Test

	Role of venture capital member	Institutions that funded SMEs After use of venture capital
Chi-Square	72.769	107.108
Degrees of Freedom	4	2
Asymp. Sig.	0.000	0.000

4.5.3. Reasons for Financing by Other Sources upon use of Venture Capital

Figure 4.15 shows the responses in relation to reasons why financiers were willing to provide funds after use of venture capital. 95% of the respondents indicated that reasons to receive finance include presence of security, business credit worthiness and confidence had been build by financiers (all the above). Only 5 % gave confidence as the only reason. Diamond, (1991) underscores the fact that presence of security increases with the presence of venture capital in the capital structure of enterprises.

This finding is an indication that funding provided by venture capitalists can be used to buy tangible assets, such as buildings, which can in turn be used as collateral to acquire additional funds from banks.

Manigart (1999) also confirm that financiers develop confidence in firms that are financed by venture capitalists because they reduce information asymmetries through screening and monitoring, their portfolio companies which will be more attractive to other investors. Other parties may therefore free ride on the efforts that the venture capital has exerted once they have received venture capital funding. The mere fact that a venture capital company has invested in an unquoted company conveys positive information about the company and hence other investors are now willing to provide more funds.

This study confirms that presence of venture capital in the capital structure of SMEs attracts other financiers. Therefore it is important for any growing firm to combine both debt and equity in their capital structure. Since debt is payable on a certain date, it bears interest and tends to be passive compared to equity. Equity finance (like venture capital) has no specific maturity, bears no maturity contractual rate of return and affords the holder certain rights which make him an active participant in the management (Bouairdchnis, 1990). Distinguishing the two, does not make debt finance unfit for use. It has its own advantage and firms should combine both equity and debt.

Panday (2003) asserts that since debt is tax deductible it is a better source of finance and that low gearing is not an indication of a financial health. However absence of debt does not imply sound resource allocation. The use of cash flow for capital expenditure can be unhealthy hence need for debt capital (long term finance) for expansion. He further suggests that the use of fixed charges capital like debt with

equity capital in the capital structure increases owner's returns though if the decision on proportion of debt to equity is not well made the risks may be high. Venture capitalists do actually advise the SMEs they invest in to use other sources of finance especially debt for expansion purposes. This study has provided interesting data that has confirmed that SMEs using venture capital easily attract other sources of finance especially bank loan.

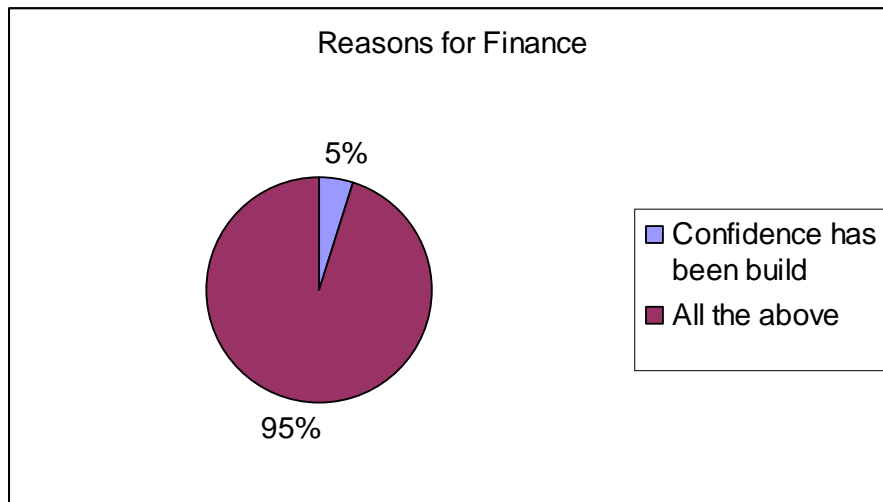


Figure 4.15: Reasons for Finance Upon use of Venture Capital

4.6 The Influence of Venture Capital on Management Style

Under this objective, two indicators of measuring management were considered which included: decision making and gender sensitivity. The variables were considered on before and after use of venture capital as illustrated in the sub sections below.

4.6.1 Employees in Decision Making Before and After Use of Venture Capital

The result shown in the frequency Table 4.28 reveal that 96.9% of the respondents were not involved in any way in decision making before use of venture capital. Only 1.5% of the respondents confirmed that they were involved in decision making. This finding is in conformity with Barrow (2002)'s study which found that management

style used in many SMEs, particularly in family-owned business is initially very poor. A study by Ibrahim and Goodwin (1986) revealed that in many instances corporate governance is poor among SMEs such that management and decision making are a making of a family affair with misguided perceptions that opaque governance enhances control and the fear that openness and information sharing may lead to employees' transgression such as theft. This study reveals that before venture capital was used employees had no part to play in decision making of the organizations they work for.

Table 4.28: Employees in Decision Making Before

Response	Frequency	Percent
Yes	1	1.5
No	63	96.9
N/A	1	1.5
Total	65	100.0

Table 4.29 presents the findings after use of venture capital. A big number (98.5%) of the respondents confirmed that employees at lower levels were actually involved in decision making, and only 1.5% denied the involvement. Such change imply that venture capital involvement in SMEs changed management style and was all team work such that even employees at lower levels were involved or consulted through their representatives on matters that touch on their responsibilities. Moreover, it would appear that with the use of venture capital, capitalists' alert management on the fact that improvement in corporate governance derives greater transparency and accountability initiated from senior management level (Attahir, 1995).

After use of venture capital subordinate staff were incorporated in decision making process, the management advocated team work and not a one man show as

reported by Lefton (1998). Before use of venture capital many, investees initially lack transparent and accountable subordinates who are essentially needed to support management. Frequent audit, remuneration and staff representative committees are absent at the time of investment in SMEs. This is because many entrepreneurs believe that opaque governance enhances control. Venture capitalists ensure that such committees are present and this improves transparency of a business and encourages a sense of entrenchment and empowerment among many junior staff as they feel part and parcel of the business (Aureos Capital Development Review, 2004). It is noteworthy that employees at lower levels should be allowed to make operational decisions which translate policies into specific actions (Bowen et al, 2009). The findings reveal that management approach of entrepreneurs especially SMEs change positively with the presence of venture capitalists. The marriage of the skills and experience which are brought by the venture capitalist and the entrepreneur is a classic example of creating synergies in an economic environment where their respective abilities and talents complement one another

Table 4.29: Employees in Decision Making After use of Venture Capital

Response	Frequency	Percent
Yes	64	98.5
No	1	1.5
Total	65	100.0

4.6.2 Gender Sensitivity

The respondents were asked to indicate whether the firms they worked for were gender sensitive. The findings (Figure 4.16) confirm that only 43.4% were gender sensitive and 56.6% were not. The current management practices require that management should be gender sensitive when recruiting.

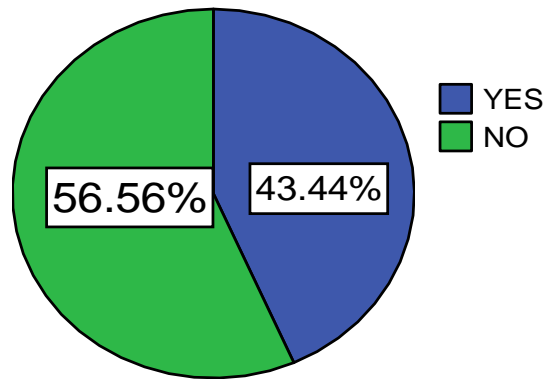


Figure 4.16: Gender Sensitive

According to literature (Zider, 1998) the presence of a venture capital member in the board of management enhances superior decision making compared to those made by the entrepreneur alone with regard to gender. Effectively, once the venture capitalists invest; they usually take an active role in the governance of their portfolio companies by contributing their business experience and industry knowledge gained from other young companies they helped (Gompers, 1995; Hellman & Pari, 2001).

Table 4.30 discloses that before use of venture capital, the percentage of female to total workforce was 0%, this means that there was no female worker in a particular firm. The maximum was 50% and 26.6% as average. The situation however, changed after the firms used venture capital. The minimum female percentage is 2%, maximum 64% and average is 36.5%. The minimum male is 36%, maximum 98% and an average of 63.5%. The result shows that there is a big change in terms of the hire policy the management was using after engaging venture capital as more female workers were absorbed. This study then concludes that the use of venture capital influence performance of the firms and the impact can be felt even at individual level. The hiring of more female workers after use of venture capital

implies that their standard of living was improved as a result of access to regular income.

Table 4.30: Percentage of Male and Female to Total Workforce

Respondents	N	Minimum	Maximum	Mean	Std. Deviation
Male to total workforce in percentage before	65	40	100	72.4	20.1
Female to total workforce in percentage before	65	.0	50.0	26.6	18.7
Female to total workforce percentage after	65	2	64	36.5	23.7
Male to total workforce percentage after	65	36	98	63.5	23.8

The present study also found out that the type of gender the firms hire depends on the type of the business (Table 4.31). The chi-square test shows that the chi-square calculated (0.000) is less than the p value (0.05). This means that the percentage of male to total workforce depends on the type of business.

Table 4.31: Chi-Square Test

	Percentage of Male to Total Work Force	Type of Business
Chi-Square	43.000	19.615
Degrees of freedom	31	3
Asymp. Sig.	0.000	0.000

This study confirms that upon use of venture capital firms' management style / governance improved, which then results to good performance. The data further agrees with the findings of Analoui and Karami (2002), which revealed that successful SMEs do analyze environmental factors in formulating business strategies;

that strategic awareness of the chief executive officers play an important role in the firm's performance; and that where the officers exhibits distinct lack of strategic awareness, firm performance was low.

CHAPTER FIVE

5.0. SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter summarizes the main findings, conclusion and recommendations emanating from the results of this study. The summary is presented on a question per question basis. The research questions of this study were:

- i. Does access of venture capital finance lead to growth of SMEs?
- ii. Does the presence of venture capital in a firm attract other sources of finance?
- iii. How do venture capitalists influence the management style of SMEs?
- iv. Does the presence of venture capitalists improve finance management of SMEs?

To examine the impact of venture capital on performance of SMEs the variables used were growth, finance management, management styles or approaches and other financiers after use of venture capital. These variables were analyzed before and after use of venture capital.

5.2 Summary

5.2.1 Does Access of Venture Capital Lead to Growth of SMEs?

The findings revealed that before use of venture capital average sales were Ksh 10,349,661, average Profit was Ksh 7,204,653 and 81% of the respondents confirmed that profits were poor. Average net assets were Ksh 75,205,056 and asset turnover was 0.3 times. Firms employed a total of 9,404 workers. Upon use of venture capital average profits almost doubled (Ksh 12,202,775) and 98% of the respondents indicated that profitability trend was upward in majority of the SMEs. The value of assets (Ksh 102,547,692) improved drastically (approximately 36% increase) as funds were available for expansion or for diversification and also asset turnover increased to

2.9 times on average. Sales drastically increased (Ksh 139,043,076) as was employment in the firms where a total of 24,802 workers were absorbed (163% increase). The findings therefore revealed that there was growth in profits, sales, assets and employment opportunities. These findings concur with the United States Small Business Administration (1980); Chaganti and Mahajan (1983) and the Annual Report of 2006 on steering SMEs development in Malaysia. The correlation test revealed that there were relationships between annual profit after use of venture capital and type of business as $r = 0.703$ and $r^2 = 49\%$. Thus use of venture capital influences growth in SMEs thus improved performance.

5.2.2 Does the Presence of Venture Capital Improve Financial Management?

The findings revealed that before use of venture capital budget preparations were almost absent (97%). Cash planning was poor as indicated by 94% of the respondents and also debt collection was poor (54%) an implication that there was cash shortage. Majority (94%) of the businesses did not maintain inventory control before use of venture capital.

Upon use of venture capital budget preparation was mandatory (96.9%) planning was incorporated and 97% of the respondents were satisfied with debt collection and inventory control was confirmed present by 86 % of the respondents who were both satisfied and extremely satisfied. For every SME (100%) under study their boards of management had a venture capital member in attendance. The presence of a venture capital member in the board of management incorporated new strategies on sound financial management. Venture capital participation is far more extensive than that of a traditional banker. While the latter serves as the “finished intermediary” the venture capitalists plays the role of a resource manager for business development. In their role as intermediaries venture capitalists add value and justify

their existence (Bygrave, 1987). This implies that with the intervention of venture capitalists in the management board crucial financial management procedures had to be followed and budget preparation is one of them.

5.2.3 How do Venture Capitalists Influence the SMEs Management Style?

The findings on influence of venture capital on management style used by SMEs indicated that employees were not involved (97%) in decision making. Wanjoi (2005) confirms that management fear employee involvement in decision making and that decision making is a duty of the core management which in most cases consists of family members. Upon use of venture capital, 99% of the respondents confirmed that they participated in decision making through their representatives. Baker and Gompers (2003) argue that a successful management team will possess personality traits such as honesty, determination and capacity to get along with each other including lower level workers. The venture capitalists influence the management of the investees to appreciate and involve all employees on basic decision making. This research question can then be answered that presence of venture capital improves management style of SMEs. Empirical evidence (Brav and Gompers 1997) confirms that superior performance by venture capital-backed firms is often attributed to better management teams and corporate governance structures that help these companies to perform better in the long run.

5.2.4 Does the Presence of Venture Capital Attract Other Sources of Finance?

The findings in this study revealed that before use of venture capital the major source of finance was personal saving (64.6%). The business relied on funds that an entrepreneur provided. Banks provided only 7.7% of the funds employed in the firms while 21.5% of the SMEs used a mix of funds from banks, personal savings, micro

finance institutions and friends. The interest rates charged by banks were high (98%) and floating and the studies revealed that it was difficult (95%) to process and qualify for bank loans. Reasons cited included lack of collateral (16.9%), many procedures to follow before a loan can be authorized (4.6%), long waiting period (7.7%) and that banks are suspicious of SMEs (9.2%) and so disqualify their applications. However, majority (61.5%) of the SMEs indicated all the reasons as given in the questionnaire accounted for why bank loan was difficult for SMEs.

Upon use of venture capital all (100%) respondents confirmed that other sources of finance were willing to provide funding including banks which were initially difficult to consider SMEs for funding. The findings revealed that 39.5% of the funds were sourced from banks. Majority (95%) of the respondents cited reasons such as presence of security, credit worthiness and confidence had been built by financiers who have contributed to SMEs attracting other sources of finance. Use of venture capital attracts other sources of finance and a business is in a position to gain access to not only additional capital for expansion but also cash flow when need arises. The presence of venture capital in the capital structure of a firm is an attraction of other financiers to provide more funding to the SMEs as propounded by Mukherjee (1999) which thus supports this finding.

5.3 Conclusion

The impact of venture capital on performance of SMEs is real and practical as established by this study. The SMEs under study experienced growth, improvement in financial management, use of better management approach and attracted more finance from other sources including the banking industry. Venture capital's investment in SMEs has facilitated wealth creation in ways that people's lives have been improved. This study reaffirms the correlation between SMEs development and poverty

alleviation. A considerable contribution to economic growth has been logically witnessed and measured. The study has demonstrated that use of venture capital can be profitable in Kenya even in an inauspicious political and economic climate. The impact touched on both economic and social-economic factors.

The economic impact of venture capital has been realized by SMEs in sales growth, profit, asset and improvement in management of finance and other resources. The social impact from venture capital perspective include the employment opportunities created which has improved people's lives and alleviated poverty among the employees. The increased profits imply revenue collection for government expenditure through collection of tax. Also venture capitalists do not just provide funds but add value to SMEs, that is, they are not only involved in financing but also spur entrepreneurs who are responsible for economic growth. Venture capital involvement has demonstrated that the partnership implicit in equity capital is as important as the finance and that these two aspects of the relationship are mutually reinforcing.

Venture capital not only assists SMEs in the provision of funds but also in the internal operations of the business especially in policy formulation. Therefore venture capital has demonstrated the business case for SMEs investment. They nurture SMEs at crucial junctures in their development and lay the foundation for an emerging generation of locally owned large enterprises. Venture capital has potentials of assisting Kenya to achieve vision 2030 which advocates for strengthening SMEs to become key industries of tomorrow.

5.4 Recommendations

Since this study has provided meaningful data showing that SMEs excelled in businesses when in partnership with venture capitalists, SMEs in Kenya should be

encouraged to partner with venture capitalists for greater successes. The partnership is healthy and there is proof that capitalists exit smoothly at the expiry of the contract period. However the government should level the playing field for SMEs in the economy. Small businesses are often disadvantaged when it comes to accessing finance or lobbying the government to incorporate their views with regard to taxation. SMEs using venture capital should be given tax concession to attract other SMEs to use venture capital. This study has shown that the impact of venture capital has been seen and felt and so more businesses should be encouraged to use this type of finance for economic development. This fund if fully used by entrepreneurs is capable of creating and employing one in ten of the required jobs in Kenya before the end of the second quarter of this century. This is the vision of this study.

More local institutions and individuals should be encouraged to join the venture capital fund to build the fund capacity for more investment. Private venture capital fund is more active as compared to public venture capital as it has financed many of the firms under study. Currently, the contributors to the fund are foreign citizens who know that private equity has worked well in their countries and they are hopeful it can work for Kenya as well.

Government owned venture capital firms need to be privatized to serve entrepreneurs better. The youth fund which sounds like a venture capital fund (but is really not as interest is paid and no monitoring of businesses) should be privatized to become a true venture capital fund to serve young entrepreneurs better.

5.5 Suggestions for Further Study

Based on the findings in the present study, there are areas which require further research. A study need to be carried out on sustainability of economic growth of the firms financed by venture capital. How lasting is the growth that they have

experienced? Growth comes with a number of challenges and hence a study needs to be done on the environmental impact of venture capital fund on SMEs they finance. The study will establish if there are positive or negative externalities such as pollution to the neighboring community.

It was established that more financiers are willing to provide funding to SMEs who have used venture capital. A study need to be carried out on how venture capitalists screen their clients and are able to separate between symmetrical and asymmetrical information. A comparative study needs to be done on the economic contribution of government based venture capital firms and the private venture capital firms. Finally, a survey needs to be carried out to determine the other SMEs not considered in this study that have potential for venture capital finance and be encouraged to approach the venture capitalists for funding.

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APPENDICES

Appendix 1: Questionnaire

The information to be given in this questionnaire will be confidential and purely for academic purposes.

SECTION A 1: BACKGROUND INFORMATION

(Fill in the blank spaces and tick once in the below given choices of all questions).

Name of the business (optional) -----

Location -----

Respondent's designation -----

Type of Business Manufacturing Service

Merchandising

Agriculture Other (Specify)

How long have you been in business? -----

What is the type of your business ownership?

Sole trader Partnership Limited liability other (specify)

SECTION II: THE BUSINESS BEFORE INTRODUCTION OF VENTURE CAPITAL

Other sources of finance

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

Personal savings Friends/ relatives

Commercial Bank loans Bank overdraft

Grants/ donor funds Microfinance All

2. If a bank loan was used, how was the interest rate?

High average low

3. How long did it take to receive the funding applied for from banks? Please state the period. -----

4. How easy was it to qualify for a bank loan?

Very easy easy difficult very difficult

5. If your answer above is difficult, kindly give reasons-----

Economic Growth

6. Before use of venture capital what was the annual turnover i.e. sales?

_Ksh. _____

7. How was the profitability of the business before the introduction of venture capital?

- Poor Fair Good Very Good Excellent

Please indicate the estimated profit figure Ksh-----

8. Kindly give reasons for your response in (7) above-----

9. Kindly approximate the value of the assets of the firm before use of venture capital.

Ksh. -----

10. How many workers were employed by the business before the venture capital was introduced? -----

11. How many of the above workers were employed on permanent basis? -----

12. How many of the above workers were employed on contract basis? -----

13. How many of the above workers were employed on casual basis-----

Kindly estimate the % of:

Males to total workers-----

Females to total workers-----

14. How were the operations of the business before the introduction of venture capital?

- Capital intensive Labour intensive Combination of both

Finance management

15. How was the business managed?

- By the proprietor Team work Professional Managers

16. Were all employees at all levels involved in decision making?

- Yes No Not applicable

17. If your answer is yes, please explain how they participated. -----

18. Was the business carrying out cash planning?

- Yes. No.

19. Did the business experience cash shortages before venture capital was introduced?

- Yes No Not applicable

If your answer in 19 above is yes, please explain how you solved such cash shortage-----

If your answer is no, what was done with excess cash in hand?-----

20. Was the business selling on credit?

- Yes. No

If yes how was your debt collection?

- V. Good Good Excellent Fair Poor V. Poor

21. Was inventory control exercised before use of venture capital?

- Yes No

SECTION III: THE BUSINESS AFTER USE OF VENTURE CAPITAL

1. When was venture capital first used in your business? -----

2. What was the nature of venture capital that funded your business?

- Individual (business angel) corporate firm Not applicable

3. How much money was put in business by venture capitalist? KSH-----

4. What were the requirements of venture capitalist?

- Business plan Balance Sheet Cash flow statement Profit and Loss Statement All of the above

5. Does the board of management of your business include members of venture capital firm?

- Yes No Not applicable

If yes, please outline their role. -----

Economic Growth

6. Has there been improvement in annual turnover of your business?

- Yes No Not applicable

7. If your answer in 6 above is yes, rank the following reasons you think contributed to the improvement in turnover in terms of importance (1- for very important to 4-for irrelevant)

Reason	Very important	Important	Slightly important	Irrelevant
Diversification				
Change in marketing strategy				
Management involvement				
Marketing research				
Pricing strategy				

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

- Upward Stagnant Downward

Please estimate the latest annual profit figure Ksh-----

9. Have the total net assets of the business grown?

- Yes No.

If yes, kindly estimate the value. Ksh -----

10. What is the total population of employees in the company? -----

Casuals -----

Contract -----

Permanent -----

11. Is the company giving equal employment chances to gender?

- Yes No

Kindly estimate the % of:

Male to total workforce -----

Female to total workforce-----

Other sources of finance attracted due to use of venture capital

12. Have you ever solicited any funding from elsewhere after use of venture capital?

- Yes No

13. If your answer above is yes, where did you solicit this funding?

- Micro-finance Banks loan Personal savings

Has it been easy for financiers to extend credit than before?

- Yes No Not applicable

If your answer in 13 above is yes, go to 14 if no go to 15

14. Why do you think it has been easier for them to finance you?

- Presence of security Business is credit worthy
 Confidence has been built all the above

Finance Management

16. Do departments prepare budgets every year?

- Yes No

If yes how do employees participate in budget preparation? Please explain. ---

17. Besides each of the statements presented below, please indicate whether you are extremely satisfied, satisfied, neutral, dissatisfied or extremely dissatisfied.

How satisfied are you with

- a) Cash planning 1 2 3 4 5
b) Investment of excess cash 1 2 3 4 5
c) Debt collection 1 2 3 4 5
d) Credit decision 1 2 3 4 5
e) Inventory control 1 2 3 4 5

KEY

- 1 = Extremely dissatisfied 4. Satisfied
2 = Dissatisfied 5. Extremely satisfied
3 = Neutral

18. How long will your contract with venture capitalists last? -----

19. Is the venture capitalist represented in the board of management?

- Yes No Not applicable

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

- Yes No.

Kindly explain your response in 20 above -----

21. Kindly explain the role of subordinate staff in decision making? -----

22. Does your company intend to go public?

- Yes No N/A

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