THE EFFECT OF VENTURE CAPITAL ON FINANCIAL PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN NAIROBI , KENYA.

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DECLARATION

This research proposal is my original work and has not been submitted for examination in any university or institution of higher learning for the award of a degree or an academic certificate.

Signature.................................... Date 9th Nov. 2012

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This research project has been submitted for examination with my approval as the university supervisor.

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DEDICATION

This project is dedicated to my beloved wife Elizabeth, my children, Salome, Ann and Erick for their moral support during the entire MBA program.

ABSTRACT

Venture capital has been one of the sources of finance, which is more prevalent in developed financial markets, for small scale and start up firms. In Kenya Venture capital has been there for long but little used due non-awareness. It has had a significant effect on the financial performance of Small and Medium Enterprises (SME) in the developed countries. Small businesses have been used as stepping stone to industrialization in the developed countries.

Many SMEs in Kenya remain small due to lack of working capital and funds for expansion, hence industrialization has been slow. SMEs lack finance due to discrimination from the formal financial institutions especially banks. SMEs have few alternatives of accessing finance other than relying on their retained earnings to finance their investments. Among the developing countries, Kenya has had venture capital since independence yet, development of SMEs has been too slow.

The primary data was collected by administering structured questionnaire to the sample respondents. The questionnaire was used since the level of understanding of a the questions by the respondents was expected to be relatively high.The questionnaire was considered effective since it was not time consuming, considering that the respondents are based in Nairobi county.

The data was analyzed using descriptive statistics. Statistical Package for Social Sciences (SPSS) was used to aid in the analysis .The researcher preferred SPSS because of its ability to cover a wide range of common statistical and graphical analysis. It is also very systematic. Computation of frequency in tables and graphs as was used in data presentation. The information was presented and discussed as per the objective and research question of the study. The findings of the study indicate that venture capital has an effect on financial performance of SMEs.

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LISTS OF ABREVIATIONS

BSC	Balance Score Card
CBD	Central Business district
CVCA	Canadian Venture Capital Association
GDP	Gross Domestic Product
IEA/SID	Institute of Economic Affairs and Society for National Development
KIPPRA	Kenya Institute of Policy and Research Association
KNBS	Kenya National Bureau of Statistics
KPSA	Kenya Private Sector Alliance
NBO	Nairobi
ROCE	Return on Capital Employed
ROI	Return on Capital Invested
ROK	Republic of Kenya
SME	Small and Medium Enterprise
SPSS	Statistical Package for Social Sciences
UK	United Kingdom
UNDP	United Nations Development Programme
USA	United States of America
VC	Venture Capitals

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CHAPTER ONE

INTRODUCTION

1.1 Background to the Study

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 Kenya Economic Survey (RoK, 2010) 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, 2010). 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.

1.1.1 Venture Capital in SME Financing

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, Lemer (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.

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, Sigara, (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, Sohl (2003*)*. Measures of performance may include both financial and non financial.

1.1.2 Small and Medium Enterprises in Kenya

The concept of Small and medium-sized enterprises (SMEs) is used to denote a heterogeneous group of businesses mostly a mixture of the self-employed and "micro" enterprises, with less than 10 employees. Irrespective of the level of development of an economy, a significant proportion of micro and, sometimes, small enterprises are found in the informal sector or the shadow economy (Schneider 2003). SME's are found in a wide array of business activities, ranging from the single artisan producing agricultural implements for the village market, the coffee shop at the corner, the internet café in a small town to a small sophisticated engineering or software firm selling in overseas markets and a medium-sized automotive parts manufacturer selling to multinational automakers in the domestic and foreign markets. The owners may or may not be poor; the firms operate in very different markets (urban, rural, local, national, regional and international); embody different levels of skills, capital, sophistication and growth orientation, and may be in the formal or the informal economy.

SMEs contribute 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. This implies 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.

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 nongovernmental 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 Abuodho (1996), 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.

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.

1.2 Research Problem

Many SMEs in Kenya remain small due to lack of working capital and funds for expansion. Such businesses do not provide the much needed 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) 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.

A study on the impact of venture capital on the Canadian economy (CVCA, 2009) 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.

Although a number of studies have been done in this area, few of them, if any have undertaken to study the effect of venture capital financial on performance of SMEs in Kenya. However, there are SMEs that have received venture capital funds in Kenya. What is the effect of this finance on financial performance of SMEs that have used these funds? An observation of past studies show that though venture capital firms have been present in Kenya as early as 1970s their effect 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. Therefore the purpose of this study will be to establish the effect of venture capital on financial performance of SMEs in Kenya.

1.3 Objective of the Study

The objective of this study is to establish the effect of venture capital on financial performance of SMEs in Kenya.

1.4 Importance of Study

This study will bring in to record the effect of venture capital on SMEs financial performance in Kenya which will be useful to various stake holders. This is on the premise that entry of venture capitalists will boost the performance of the SMEs by provision of the much needed capital, leading to the growth of the SMEs.

The government will gain an understanding of the role played by both formal and informal venture capital markets 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 effect of venture capital on financial performance of SMEs, the venture capitalists will review the need to provide seed financing which will lead to establishment of many such businesses. These financers 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.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter explores the theoretical and empirical literatures underpinning with the objective of finding what other scholars have researched on or written regarding venture capital. The chapter also develops a conceptual framework, which will underlie the study.

2.2 Financial Impact Assessment Theory

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 (Tsehay and Mengistu, 2002). According Ledgerwood (1999), there is one major school of thought that is prominent in impact assessment of finance.

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.

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. Sustainability alone does not reduce poverty (Bronwyn,1995). For instance argue 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.

2.3 Performance of Small and Medium Enterprises

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. The informal sector 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 cafe and other information and communication technology businesses are coming up. According to Ngigi (1996), 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.

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 financers. 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 Bums (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 (McCormick, 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 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.

2.4.1 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.

2.4.2 Theory and Practice of Venture Capital

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 into larger ones.

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.

2.5 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.

According to Farrell (1998) 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 startup 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).

2.6 Venture Capital Investment Process

The venture capitalists follow a clearly defined procedure (Tyebjee & Bruno, 1981) in investing their funds in SMEs. They includes, deal origination, due diligence, deal structuring, post investment activities and exit. Though other researchers like Hisrich and Peters (2002) have identified only four stages in the investment process, it implies that there is s 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 ones. At each stage they give enough to reach the next major check point. Ones 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.

2.6.1 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).

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.

2.6.2 Influence of Venture Capital on Financial Management of SMEs

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 financial management. Barrow (2002) argues that financial management is carried out by 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.

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 (Pedro & Pedro, 2007).

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. 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 (Peacock, 1985).

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.

Mason (1996)'s study on the process of accruing funds from venture capital firms observed 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 then-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.

2.7 Empirical Studies

A number of Scholars have done studies on Venture capitals and SME financing locally and abroad. Studies done abroad include; Berger and Udell, (1995), who studied the role of venture capitalist in the reduction of information asymmetric in The UK, and established that venture capitalists play a critical role in reducing information asymmetries through the collection of critical, private information. Admati et al. (1998), explored the primary reasons for the existence of venture capital companies is their information processing capacities in Finland and indicated in their findings that adverse selection problems are addressed through intensive screening before the funds are provided.

Gompers, (1995) studied the role of venture capital established that entrepreneurs of high growth companies in Malawi and found out that VCs 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. Local studies include; Lindner & Linden (2002) of Business Partners International studied the role of SME's in economic growth and established 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.

Engel and Keilbach (2002) compared venture capital financed firms with non-venture capital financed firms in Germany indicated that venture capital financed firms showed high profitability. (Okongo, 2001) focused studies venture capital market in Kenya and focused on formal venture capital firms and their requirement in financing SMEs especially institutionalized venture capital firms. Ngigi (1996) studied the role of venture capital in financing technology based SMEs. 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.

Gakure, (2005) studied the factors affecting credit accessibility among SME's in Kenya and indicated the following factors as pertinent: lack of managerial skills, lack of finance, poor financial management, lack of technological knowhow. Wanjohi (2005) in his study 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. None of this study has focused on the impact of venture capitals on SMEs performance in Kenya. Therefore this study intends to bridge this important area.

2.8 Summary

The 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 will therefore seek to bridge this gap and provide knowledge to various users for decision making or otherwise.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter outlines the overall methodology that will be used to carry out this study. It includes the research design, population under consideration, sampling design that will be engaged, sampling frame, sampling techniques, sample size, data collection methods and instruments, data analysis and presentation.

3.2 Research Design

According to Kothari (2003), research design provides the link that holds the research project together. Descriptive survey design will be used to structure the research and show how all of the major parts of the project and methods of the research work together to address research questions. A descriptive survey will be undertaken. It designs results in a description of data either in words, pictures, charts or tables or describes whether data analysis shows statistical relationship.

3.3 Population

The target population will comprises of SMEs operating in Nairobi County that is made of the top 100 companies by KPMG in year 2011. See Appendix II.

3.4 Sampling

Riding and Short, (2003), define sampling as the process of examining a representative number of items out of the whole population. Stratified sampling will be applied to pick 25 respondents such that each of the regions will be adequately represented in the study. The target respondents for this study will constitute the heads of SME's and other staff who have adequate understanding of the variables being studied. The target population will also be the same with the total population being 100 (Refer to Appendix II), from which a sample of 25% will be taken from a target population of 100 giving a sample size of 25.

3.5 Data Collection

A combination of data collection methods will be used in this study. To collect primary data a structured questionnaire consisting of both open and closed ended questions will be used to in order to allow for neutrality and provide rational responses. While secondary data will be extracted from existing literature such as Company financial reports, journals, articles, research papers, magazines, statistical reports, catalogues and books etc. The Questionnaires will be administered on a drop and pick basis.

3.6 Data Analysis

The completed questionnaires will be inspected for completeness, edited for errors and omissions before being coded and the data captured. The data will then be organized and summarized using a combination of descriptive statistics. Statistical tools like frequency distributions, measures of central tendencies like means, medians and modes; and measures of dispersion like range and standard deviation will be used to summarize quantitative variables. Data measured on nominal and ordinal scales will be summarized using frequency distribution with mode measuring central tendency.

Financial ratios like ROI, ROCE will be calculated for the period before and after the use of venture capital to determine their financial performance. Equally trend analysis will be calculated to determine and predict the movement of the revenues before and after the use of venture capital. Content analysis will be used to analyze qualitative information collected in the survey. This will be used to support the results of quantitative analysis in drawing conclusions and recommendations. The results and findings of the analysis will then be presented using tables, graphs and charts.

A regression model will be applied to determine the impact of each of the variables with respect to venture capital financing adoption and financial performance of the Small and Medium Enterprises. This is in an effort to establish the extent to which each independent variable affects the dependent variable as shown by the size of the beta coefficients. This regression model will be used because we have only one independent variable.

The regression equations: $\mathbf{Y = \beta_0 + \beta_1 X_1 + \varepsilon}$):

Whereby Y = Financial performance which is measured by Net profits,

X_1 = the independent variable which is measured by ROCE

β = the constant or parameters to be estimated.

ε = the Error term,

Regression analysis is preferred as it enables the researcher to measure the relationship in consideration. A regression model having only one independent variable will be used. The model is used because it is believed that there is linear relationship between one independent variable and one dependent variable. For a relationship financial performance and adoption of venture capital by SMEs, a regression model can be constructed using financial performance as the dependent variable and adoption of venture capital as the independent variable.

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter presents analysis, interpretations and findings of the study as set out in the research methodology. The analysis is both quantitative and qualitative. The chapter is structured according to the questions in the questionnaire and provides discussion of the findings together with their implications. The results are presented on the effect of venture capital on financial performance of SME's in Nairobi county. The data was gathered exclusively from questionnaire as the research instrument. The questionnaire was designed in line with the objectives of the study. Moreover the additional data and observations, gained from the survey have been incorporated into the discussion. 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 and ANOVA tests, were used to analyze the data guided by the research questions in reference to study objective.

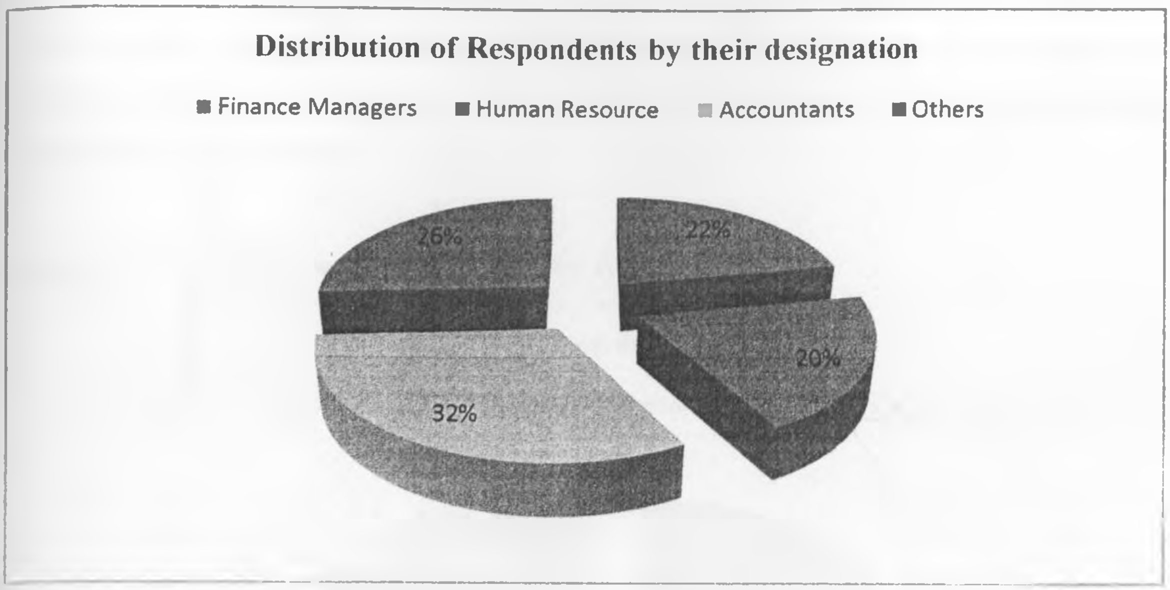
4.2 The Profile of the Respondents

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 business names have been coded for confidentiality purposes as requested by the firms. One hundred respondents were issued with questionnaires but only Sixty Five fully filled questionnaires were returned. This translated to 65% response rate. According to Nassiuma (2002) only a response rate above 35% is robust enough for statistical sensible analysis. This response rate was considered statistically sufficient for further analysis.

4.2.1 Distribution of Respondents by their Designation

Data was collected from various categories of the respondents namely; finance managers, accountants, human resource managers, and others respondents drawn from various firms. Figure 4.1 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.

Figure 4.1 Respondents' designation



4.2.2 Location of Businesses

From the analysis of table 4.1, firms using venture capital are well distributed in the country's urban centers. The findings of the study indicate that, 65 firms that are using venture capital, 33 of them were from Nairobi North, 21 Nairobi East, 12 from Nairobi Central Business district (CBD) and 9 from Nairobi South. This finding indicates that many of the firms using venture capital are located in Nairobi North due to availability of excellent infrastructure which contributes to cost minimization.

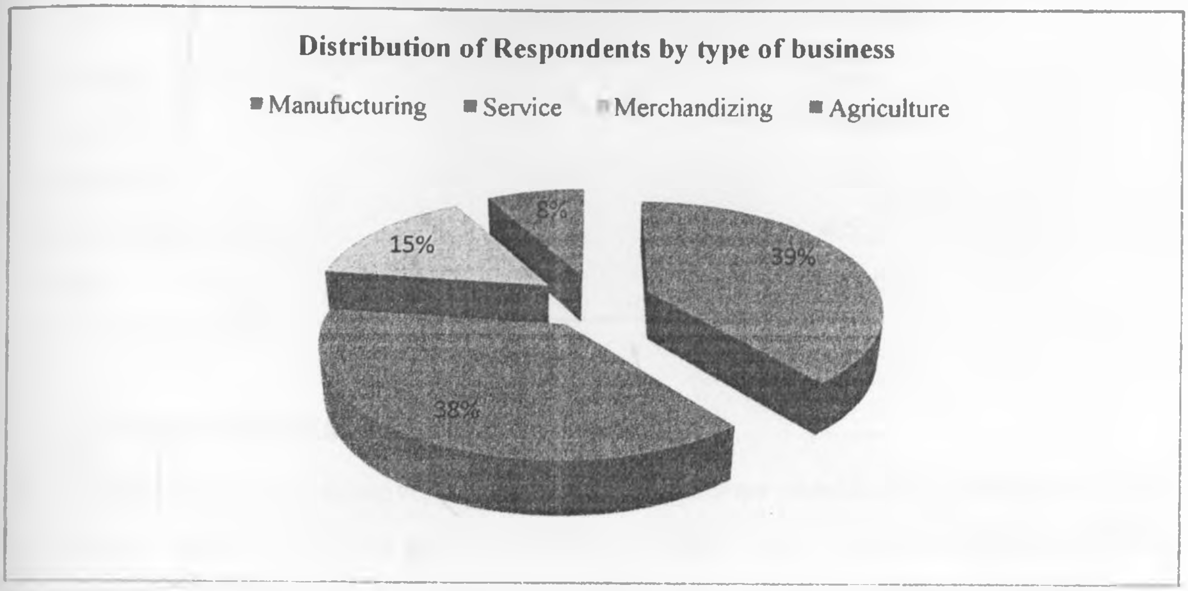
Table 4.1: Location and type of business

Location	Manufacturing	Service	Merchandizing	Agriculture	TOTAL
NBO NORTH	12	14	5	2	33
NBO EAST	4	3	3	1	21
NBO CBD	4	5	2	1	12
NBO SOUTH	5	2	1	1	9
TOTAL	25	24	11	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 4.2. 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.

Figure 4.2: Distribution of respondents by type of business



4.2.4 Business Ownership

Majority (92%) of the firms was limited liability companies and only 8% were under partnerships. This means that an overwhelming majority had registered as limited liability companies with family members forming the company membership. This finding concurs with Wijewardena (1999)'s study on 142 SMEs in Australia that used equity capital. According to the study, majority of the firms (64%) operated as limited liability companies and the rest were under sole proprietorship and partnerships.

4.2.5 Use of Venture Capital

Majority of the firms under study used venture capital. In the year, 1998, 17 firms used venture capital, in the year 2000, 11 firms used venture capital, and only 2 firms used venture capital in the year 1990.

4.2.6 Nature of Transactions

Venture capitalists enter into various transaction agreements with firms they finance. Data collected revealed that 75.5% of the firms financed said the funds were for expansion purposes, 10.8% for placement, 9.2% for startup and 4.5% for management buyout (table 4.2). 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.

Table 4.2: Nature of transactions

Transactions	Frequency	Percentage
Start up	6	9.2
Expansion	49	75.5
Placement	7	10.8
Management buyout	3	4.5
Total	**65**	**100.0**

4.3 Venture Capital and SME Growth

To address the above objective, a number of variables were considered to determine if use of venture capital by firms lead to growth. Growth is a one-dimensional construct operationalized by a variety of growth measures like 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 4.3 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 Ksh 10, 349,661. Generally there was improvement in sales volume after use of venture capital. The study reported that there was substantial sales growth by firms that used venture capital.

Table 4.3: Sales trend before and after use of venture capital

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

A correlation test as depicted in table 4.4, 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. The result reveals that venture capital leads to growth on sales of the firms that use these funds.

Table 4.4: Correlations of sales before and after use of venture capital

		Sales P.a before VC	Sales P.a after VC
Sales Per annum before use of VC	**Pearson correlation** **Sig.(0.01)**	1	0.933(**)
	N	65	65

**** Correlation is significant at the 0.01evel**

4.3.2 Simple Regression Analysis

In addition, a simple regression analysis model was applied to determine the impact of each of the variables with respect to venture capital financing adoption and financial performance of the Small and Medium Enterprises. This is in an effort to establish the extent to which each dependent variable affects the independent variable as shown by the size of the beta coefficients.

To be able to quantify the reliability of the estimates the research made assumption of linearity, the assumption of independence (Durbin Watson test indicated a result of 2.123 meaning that there was no auto-correlation between the residual values), the assumption of constant variance (there was no outliers in the independent variables as the results were less than 0.50) and the assumption of normality (sample size was more than 30; hence met the central limit theorem). These assumptions were met to a significant extent as the results obtained were consistent to the assumptions made and hence positive.

Table 4.5: Coefficients of the effect of venture capital on SME performance

Mode	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta	B	Std. Error
SME Performance	2.869	1.279		2.243	.040
Venture Capital	.541	.577	.255	.938	.363

The equation $\mathbf{Y = (\beta_0 + \beta_1 X_1 + \varepsilon)}$ becomes:

$$Y = 2.869 + 0.541X_1 + 0.292$$

Whereby Y = Small and Medium Enterprises performance,

X_1 = venture capital adoption,

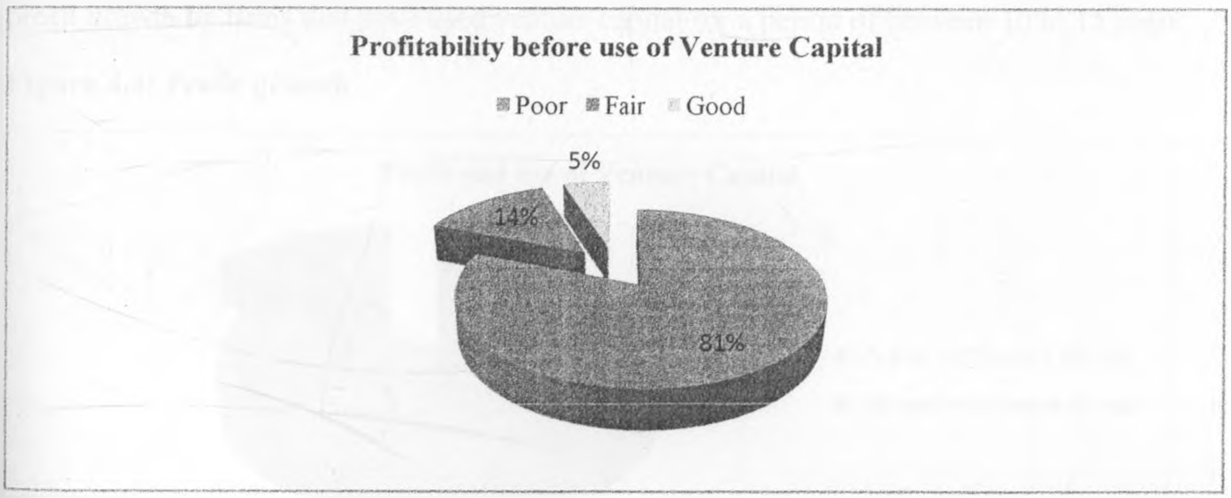
β = the constant or parameters that were estimated

ε = the Error Term

4.3.3 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 4.3) and only 5% reported that profit was good. The rest of the respondents (14%) said that they made fair profits.

Figure 4.3 Profitability before use of venture capital



However, after utilizing venture capital majority (98%) of the respondents indicated that profit was showing an upward trend. 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

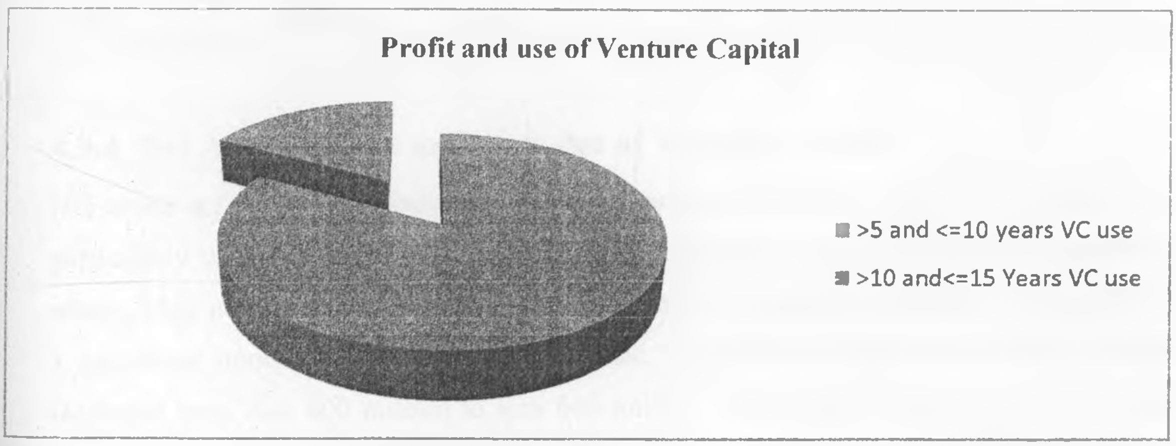
A descriptive statistic analysis was carried out on annual profit figures provided by respondents from the field to further prove that profit upon use of venture capital has shown any change. This analysis showed that the increase in profitability is significant in business growth (Table 4.6). The minimum 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.

Table 4.6: 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 study also considered the growth in profit in relation to the period a firm has used venture capital. Figure 4.4 shows that profit growth was high (83.4%) in firms which have used venture capital for a period ranging from 5 years and 10 years, followed by 16.6% of profit growth by firms that have used venture capital for a period of between 10 to 15 years.

Figure 4.4: Profit growth



This study also sort to find out if the growth in profit had any bearing with types of business. Table 4.7 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.

Table 4.7: 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 and was captured in table 4.8, 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 a (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.

Table 4.8: ANOVA Test

	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		
Totals	2.27716	64			

4.3.4 Net Assets Before and after use of Venture Capital.

Net assets were used as measure of growth. Barnes (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 4.9 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. Since venture capital is equity capital to the business then net assets also increase.

Table 4.9: 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	75,205,054	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 4.10 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 98%. 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.

Table 4.10: 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	98	20	22

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter presents the summary of the findings from chapter four, and it also gives the discussions, conclusions and recommendations of the study based on the objective of the study. The objective of this study was to establish the effect of venture capital financing on SMES' financial performance among SMEs in Nairobi County.

5.2 Summary

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

5.2.1 Venture Capital Versus SME Growth

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. 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.

5.3 Conclusion

The effect of venture capital on financial performance of SMEs is real and practical as established by this study. The SMEs under study experienced growth, improvement in financial management and use of better management approach. Venture capital's investment in SMEs has facilitated wealth creation in ways that peoples' 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 effect touched on both economic and social-economic factors.

The economic effect of venture capital has been realized by SMEs in sales growth, profit, asset and improvement in management of finance and other resources. The social effect from venture capital perspective include the employment opportunities created which has improved peoples' lives and alleviated poverty among the employees. The increased profits implies 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 lobbing 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 investors 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.

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.

5.5 Limitation of the study

The respondents were considered as a preventatives of all players in the SMEs sector, however they vary in terms of experience and role they play in management of the SMEs.

Out of the 100 SMEs polled, only 65 (65%) responded to the questionnaire. This was in spite of aggressive follow up via telephone, email and personal visits.

Several respondents cited questionnaire fatigue and declined to participate in the research while others considered filling in the questionnaire as waste of their valuable time.

5.6 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.

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APPENDICES

APPENDIX 1: Questionnaire

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

SECTION 1: BACKGROUND INFORMATION

(Fill in the black 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 overdrafts

   ☐ Grants /donor funds ☐ Microfinance

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.

   ☐ Very easy ☐ Easy ☐ difficult ☐ very difficult

4. If you answer above is difficult, kindly give reasons...................................

   ....

   ....

   ....

Economic growth

5. Before use of venture capital what was the annual turnover i.e sales?
   Ksh…………………………………………………………………………………

6. Please indicate the estimated profit figure Ksh………………………………………
   ……………………………………………………………………………………

7. Kindly approximate the value of the assets of the firm before use of venture capital.
   Ksh…………………………………………………………………………………

8. How many workers were employed by the business before the venture capital was introduced?………………………………………………………………………

9. How many of the above workers were employed on permanent basis?……………………
   ……………………………………………………………………………………

10. How many of the above workers were employed on contract basis……………………
    ……………………………………………………………………………………

11. How many of the above workers were employed on casual basis………………
    ……………………………………………………………………………………

Financial management

12. How was the business managed?
    ○ By the proprietor ○ Team work ○ Professional managers

13. Were all employees at all levels involved in decision making?
    ○ Yes ○No ○Not applicable

14. If your answer is yes, please explain how they participated ……………………………
    ……………………………………………………………………………………
    ……………………………………………………………………………………

15. Was the business carrying out cash planning?
    ○ Yes ○No

16. Did the business experience cash shortages before venture capital was introduction?
    ○ Yes ○ No ○ Not applicable

17. If your answer in 16 above is yes, please explain how you solved such cash shortage…………………………………………………………………………
    If you answer is no, what was done with excess cash in hand? ……………………
    ……………………………………………………………………………………
    ……………………………………………………………………………………

18. Was the business selling on credit?
    ○ Yes ○No

If yes how was your debt collection?

○ Very good ○ Good ○ Fair ○ Poor ○ Very poor

19. 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?

Kshs..

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 Kshs…………………………

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

   ○ Yes ○ No

   If yes, kindly estimate the value in Kshs………………………………………

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

    ○ Yes ○ No

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

    ○ Micro-Finance ○ Banks loan ○ Personal saving

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

    ○ Yes ○ No ○ Not applicable

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

    ○ Presence of security ○ Business is credit worthy

    ○ Conference has been built ○ All the above

Finance Management

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

	extremely dissatisfied	dissatisfied	neutral	satisfied	extremely satisfied
Cash planning					
Investment of excess cash					
Debt collection					
Credit decision					
Inventory					
Other					
Other					

14. How long will your contract with venture capitalists last?

....

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

○ Yes ○ No ○ Not applicable

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

○ Yes ○ No

Kindly explain your response in 16 above ....

....

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

....

18. Does your company intend to go public?

○ Yes ○ No

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

APPENDIX II: LIST OF KPMG's TOP 100 SME's IN YEAR 2011

1 JUNGLE MACS EPZ LTD

2 PENTAPHARM LTD

3 KEMA E A LTD

4 PG BISON KENYA LTD

5 MUKURWEINI WAKULIMA DAIRY

6 SOFTWARE TECHNOLOGIES LTD

7 KENTONS LTD

8 SBO RESEARCH LTD

9 LEE CONSTRUCTION LTD

10 SATGURU TRAVELS AND TOURS SERVICES LTD

11 DAWA LTD

12 TRANS BUSINESS MACHINES

13 UNES LTD

14 HEALTH CARE DIRECT

15 PRINT FAST LTD

16 GAP MARKETING LTD

17 RADAR LTD

18 SPICE WORLD LTD

19 VICTORIA FURNITURES LTD

20 MURANGA FORWARDERS LTD

21 INVESTEQ CAPITAL LTD

22 CANON ALUMINIUM FABRICATORS LTD

23 KENBRO INDUSTRIES LTD

24 LANTECH AFRICA LTD

25 CHEMICALS & SCHOOL SUPPLIES LTD

26 OASIS LTD

27 SEASONS RESTAURANTS & HOTELS LIMITED

28 CHARLESTON TRAVEL LTD

29 SHEFFIELD STEEL SYSTEMS LTD

30 SUNPOWER PRODUCTS LTD

31 BISELEX KENYA LTD

32 PLANNING INTERIORS LTD

33 FURNITURE INTERNATIONAL

34 MASTER POWER SYSTEMS LTD

35 BBC AUTO SPARES LIMITED

36 TRANSPORT & LIFTING SERVICES

37 GENERAL ALUMINIUM FAB LTD

38 COMPUTER PLANET LTD

39 VAJRA DRILL LTD

40 AVTECH SYSTEMS LIMITED

41 TYREMASTERS LTD

42 COMPLAST INDUSTRIES LTD

43 HEBATULLAH BROTHERS LTD

44 OPTIWARE COMMUNICATIONS LIMITED

45 GANATRA PLANT & EQUIPMENT LTD

46 AFRICA TEA BROKERS LTD

47 SAI PHARMACEUTICALS LTD

48 SILVERBIRD TRAVEL PLUS

49 WARREN ENTERPRISES LTD

50 PELICAN SIGNS LTD

51 NAIROBI GARMENTS ENTERPRISES LIMITED

52 CHEMSERVE CLEANING SERVICES LIMITED

53 GINA DIN CORPORATE COMMUNICATIONS

54 MADHUPAPER KENYA LTD

55 KEVIAN KENYA LTD

56 BIODEAL LABORATORIES LTD

57 VIVA PRODUCTLINE LTD

58 CAPITAL COLOURS CREATIVE DESIGN LTD

59 KINPASH ENTERPRISES LIMITED

60 FARAM EA LTD

61 THE PHOENIX LTD

62 KANDIA FRESH PRODUCE SUPPLIER LTD

63 DALCO KENYA LTD

64 UNION LOGISTICS LIMITED

65 CREATIVE EDGE LTD

66 MARKETPOWER INTERNATIONAL LTD

67 WAUMINI INSURANCE BROKERS LTD

68 STOIC FLEET WATCH

69 R & R PLASTICS LIMITED

70 AST AFRICAN ELEVATOR COMPANY LIMITED

71 ALPINE COOLERS LTD

72 SPECIALIZED ALUMINIUM RENOVATORS LIMITED

73 PANESAR'S KENYA LTD

74 NATIONWIDE ELECTRICALS INDUSTRIES LIMITED

75 TOOLCRAFTS LIMITED

76 CIRCUIT BUSINESS SYSTEMS

77 SAHAJANAND ENTERPRISES LTD

78 WINES OF THE WORLD LTD

79 AIRTOUCH COOLING SYSTEMS

80 HARDWARE AND WELDING SUPPLIES

81 LIMELIGHT CREATIONS LIMITED

82 AXEL ENGINEERING AND MANUFACTURING LTD

83 VIRGIN TOURS LTD

84 SKYLARK CREATIVE PRODUCTS LTD

85 EGGEN JOINEX LTD

86 DESBRO ENGINEERING LTD

87 TIGER BRANDS KENYA LTD

88 CATALYST TRAVELS LIMTED

89 PROFESSIONAL CLEAN CARE LTD

90 PREMIER INDUSTRIES LTD

91 CHUMA FABRICATORS LIMITED

92 PRAFULCHANDRA & BROTHERS LTD

93 PARAPET LIMTED

94 RONGAI WORKSHOP & TRANSPORT LIMITED

95 ZAVERCHAND PUNJA LTD

96 TRAVELSHOPPE COMPANY LTD

97 EUROCON TILES PRODUCTS LIMITED

98 GLOBAL TRADE MARKET PLACE

99 RANGECHEM PHARMACEUTICALS LTD

100 VARSANI BRAKELINING LTD