UNIVERSITY OF NAIROBI
Faculty of Commerce

FACTORS AFFECTING VENTURE CAPITAL FINANCING IN KENYA

A research project submitted in partial fulfillment of the requirements for the award of Masters of Business Administration (MBA) degree Faculty of Commerce, University of Nairobi

PRESENTED BY

Henry Njoroge
D/61/P/8848/98

November 2003

DECLARATION

This research project is my original work and has not been presented for a degree in any other university

Name: Henry C. Njoroge
Registration No D/61/P/8848/98
Faculty of Commerce
University of Nairobi

Signed:..

Date:.....6/4/02...

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

Name: Angela Kithinji (Mrs)
Lecturer, MBA
Faculty of Commerce
University of Nairobi

Signed:..

Date:.....7/11/2003...

DEDICATION

This research project is dedicated to my dear wife and friend Lucy, who inspired me to start my masters program and my daughters Valentine, Agnes and Ashley, who had to endure my moments of absence.

ACKNOWLEDGEMENTS

Most importantly, I acknowledge my wife Lucy, for her encouragement throughout my studies, and for sharing knowledge from her MBA classes.

I am forever grateful to my parents for instilling in me a culture of continuous learning.

A special thank you to Amolo Ng'weno for her encouragement during my last year of study.

I sincerely thank Tom Waiharo, my elder brother, for the encouragement throughout the project and also for the "interest-free loans" to during those hard times.

I thank my lecturer and project supervisor Mrs Kithinji for ever being available for consultations, patient and open to ideas. You made the project that much easier.

Last, but not least, I give thanks to God for being there for me all the time.

TABLE OF CONTENTS

LIST OF TABLES AND FIGURES

ABSTRACT

This study is a survey of the Venture Capital firms and their related target enterprises in Kenya to determine the factors affecting the Venture capital industry in the country.

The objectives of the study were to:-

i) Identify the factors that venture capitalists consider when funding enterprises in Kenya.
ii) Identify the factors that affect venture capital as a funding source in Kenya.
iii) Identify the characteristics of the various enterprises that venture capitalists find attractive in order to determine if certain venture capitalists cluster around enterprises with certain characteristics and therefore if the choice of the venture capitalist plays a part in the successful application for funding.

Primary data was obtained using questionnaires, which are attached as Appendix A. The target enterprises were identified through a search at the Nairobi Stock Exchange, the Capital Markets Authority and the registrar of Companies at the Attorney General's Office. The questionnaires were sent to all identified companies, as shown in table 1, but a number did not respond. The respondents also helped identify the target enterprises, of which 14 were interviewed as indicated in table 2. The data was analysed using SPSS, which provided tabular data with frequencies. The data was manipulated to bring out the relevant factors as shown in the data analysis section. The analysis was then interpreted to show the relationships, trends and factors that emerged as key in the Venture capital industry in Kenya.

In conclusion, the study reveals that Venture capital in Kenya is still in the infant stage with no formal structures and that Venture capital companies are risk averse in their approach to the market. Two major trends are identifiable, the first being that certain Venture capital companies cluster around certain type of financing instruments and certain industry segments. This indicates that the financing decision is a highly personal one, leading us to conclude that there is information inefficiency in the Venture capital industry in Kenya.

CHAPTER 1: INTRODUCTION

1.1 Background

This research project was aimed at investigating the factors that affect the venture capital industry in Kenya.

Venture capital as a financing discipline is relatively new in the world, having emerged as a unique industry less than twenty years ago. Despite its relative infancy, Venture capital has had a profound effect on the economies of the developed countries by providing a rapid medium of transferring resources from the rich investors to the economic sectors that can make the quickest and highest returns on this investment.

Indeed, Venture capital has been credited as the single most important factor in growing the Information technology and communications industries from virtually non-existent to some of the foremost industries in the world, thereby creating immense wealth. However, this globally powerful financial sector is not visible in the Kenyan Market.

A look at the local financial market reveals an economy burdened by huge debt portfolios and very expensive credit, as well as a conservative lending system that is largely based on collateral even where the financially eligible entrepreneur has no assets. This asset-based lending by the banks means that most start-up enterprises are forced to grow organically, thus stifling growth to the internally available cashflow within the infant enterprise.

Despite these factors, there is little evidence of a strong Venture capital industry in Kenya, which appears to be a paradox in the context of the supply and demand theory. It is this paradox that has led to this study.

Economic activity is moving from large, incumbent firms toward small, new ones. The speed of this industrial transformation process has varied considerably across countries and industries. Increasingly, evidence is becoming available that this transformation has to be promoted. Empirical evidence shows that those countries and industries that are lagging behind in this process experience lower growth and productivity levels and higher levels of unemployment. (The Economist, September 2000). Entrepreneurship seems to be a major driving force in economic development.

However, entrepreneurship itself cannot be a determinant of growth. It is an ill-defined, at best multidimensional concept. Understanding its role requires the decomposition of the concept. Dimensions of entrepreneurship are smallness, competition, deregulation, innovation, co-operation, variation, turbulence and motivation (The Ecomonist, September 2000). Deregulation and variation are essential dimensions. Low barriers should enable a broad variety of entrepreneurs to enter the market. Diversity in terms of products, processes, forms of organisation and targeted markets should lead to a selection process where customers are at liberty to choose according to their preferences. This process where entrepreneurs seek better products, processes, forms of organisation and markets can only thrive under enabling rather that constraining public policies and financial environments. In the right political-legal and financial environment, no group of potential entrepreneurs should experience any barrier for starting or developing a business, including access to financing when and where they need it (The Red Herring, December 2001).

Entrepreneurs may come across several obstacles when starting a business like unexpected or fierce competition, delayed customer payments and limited access to financial resources. Indeed, acquiring financial capital is often referred to as an important problem for entrepreneurs especially in developing countries (OECD Report, 1998). It is important to investigate whether the impact of general barriers, like the acquisition of financial resources differs between developed and developing countries such as Kenya.

Entrepreneurs starting up a business usually have little equity to finance their business, while debt capital is difficult to acquire. Banks are often reluctant to lend money to small businesses because of low expected profit margins, asymmetrical information and high risks (Aboudha, 1998). Most starting entrepreneurs use their own money for financing their business. However, when the amount of financial capital required by the enterprise is higher, more external capital is needed beyond the intrinsic financing capability of the entrepreneur. External capital is therefore an important source of capital for small enterprises and bank loans in particular are much relied upon. This is emphasized by Riding and Swift (1990), who state that "It is well known that small businesses rely heavily on banks for both short- and long-term debt capital" . Other important sources of external finance are family members, suppliers and other business partners. In Kenya, due to the high cost of commercial borrowing, bank financing is often not a suitable or even available option for entrepreneurs.

Venture Capital is an important source of funding for enterprises especially those where the growth potential is high. In the United States, Venture Capital has been instrumental in the growth of the Internet, communications and biotechnology sectors. In India, the software development industry has mushroomed due to the availability of seed capital (Fortune Magazine, 2001). In Israel, businesses regularly gamble on communications companies with the resulting high growth of the communications technology companies in the country (Network World Magazine, 2001). Britain has introduced laws and incentives to encourage Venture capital to boost the information technology sector as the engine for future growth in the UK (Fortune Magazine, 2001). All these examples indicate that venture capital is a key and growing source of financing all over the world. However, when we look at the sources of finance in Kenya for small enterprises, we hardly see any venture capital. This study investigates the factors that affect venture capital financing for enterprises in Kenya.

1.2 Statement of the Research Problem

In finance, there are three key decisions an investor or an enterprise has to make to survive and/ or increase wealth. These are the investment decision, the decision on which security to best place your cash in, the financing decision, the decision on which source of funds to use for maximum return and the dividend decision, the decision on how best to distribute the returns on the investment to the respective owners of the enterprise.

In the case of Venture capital, the investment decision on the one hand and the financing decision on the other come into play between the investor and the enterprise that the investor is targeting. The relationship is unique in the sense that there is a high degree of risk involved in investing via venture capital as opposed to the traditional methods used by the banks. Among the challenges cited in the literature, are aspects such as moral hazard, agency theory and window dressing (Maier and Walker, 1987). The author believes that there are other unique factors that come into play in developing countries such as Kenya with inefficient markets and imperfect market information.

Kenya is well known in the region for entrepreneurship. Indeed the small scale and young companies, those that are less than five years old, abound in Kenya and represent a significant part of the economy. A survey has shown that almost all these companies have started with the founder's savings and the contribution of friends and family members (Commonwealth Development Corporation Report, 1999). Banks rarely lend to these enterprises, and even then, only if they have the necessary collateral in terms of cash or over the entrepreneur's property. Those enterprises that can meet all the set conditions engage in bank financing in the form of loans or overdraft facilities. In contrast, new enterprises in the United States are routinely funded by venture capitalists, especially if they are engaged in a high technology or high growth business ventures.

This paper investigates and analyses the factors that affect venture capital financing in Kenya in the context of these documented controversies to identify if the same factors are applicable in the local environment and if there are other additional factors that are significant in Kenya.

The answer to this question is significant in that it will point out the factors that affect Venture capital in Kenya as an industry and the possible solutions for academicians, the government, entrepreneurs and financiers as well as other stakeholders such as the donor agencies.

1.3 Statement of the Hypothesis

Hypotheses can be formulated relating differences between developed and third world entrepreneurs to the amount, conditions, cost and timing of venture capital transactions. Here we define our hypothesis as follows:-

H_0 = There are no adverse factors affecting the conclusion of venture capital transactions between financiers and viable enterprises in Kenya and any enterprise is potentially able to obtain Venture capital financing.

H_1 = There are significant adverse factors affecting the conclusion of venture capital transactions in Kenya and further enterprises which are successful exhibit certain characteristics to attract Venture capital firms.

1.4 Objectives of the study

The objectives of this study are:-

1. To identify the factors that venture capitalists consider when funding enterprises in Kenya.
2. To identify factors that hinder the growth of the Venture capital industry in Kenya.
3. To determine whether certain Venture capital firms cluster around enterprises with certain characteristics.

1.5 Importance of the Study

Several factors have been cited in both theoretical models and empirical studies as to why venture capital investors shy away from investing in various enterprises. Among the reasons are agency problems, moral hazard issues and window dressing among others (Maier and Walker, 1987). This study is important in that it will:-

- Point out the factors that cause the low levels of venture capital in Kenya.
- Provide possible solutions for entrepreneurs and venture capitalists alike.
- Add to the body of knowledge in this growing field by the general public.

The following are the likely beneficiaries of this research:-

Investors

Both local and international private investors will gain in-depth knowledge of the factors likely to affect venture capital, thereby make more informed decisions, ensuring higher returns and reduced risk and the resulting appetite to invest.

Entrepreneurs

Entrepreneurs will benefit by implementing better corporate governance structures as well as more refined approaches to writing proposals for funding from venture capital sources, thus increasing their chances of successful funding applications.

Researchers/ Academics

Academics and researchers will have a locally researched paper on the subject of venture capital to refer to in future studies as the industry grows in Kenya.

Government and Donor Agencies

The government may use this paper in encouraging and regulating the industry to boost the level of venture capital available to enterprises in Kenya. Donor agencies, especially those engaged in private sector funding such as the Commonwealth Development Corporation (CDC) and the US Import Export Bank (EXIM) among others will be able to better assess their options and products.

CHAPTER 2: LITERATURE REVIEW

2.0 Introduction

In the literature much attention is paid to financial problems of small entrepreneurs. In developed countries, considerable sums of public money are spent to diminish alleged debt gaps, particularly for small expanding firms and start-ups. Subsidised loans and loan guarantees are the most common instruments of government assistance programs to support small and new businesses. The idea is that capital markets do not provide adequate funds for small and new businesses (Bergman and Hege, 2001).

It is often reported that the start-up size of businesses run by third world entrepreneurs is smaller than that of businesses run by their counterparts in the first world. A variety of reasons is brought forward for the smallness of these enterprises. First, third-world entrepreneurs usually have a smaller amount of equity capital available because of lower salary payments in earlier jobs or because family property is usually not registered properly. Second, the amount of start-up capital may also be related to the sector where an entrepreneur operates. Most people often start in sectors with low capital requirements like the service sector. Banks are often reluctant to lend money to the sectors characterised by high entrepreneur mobility (Ondiege, 1993).

2.1 Venture Capitalists:

Venture capitalists are full-time professional investors that invest for their partnership funds. Venture capitalists tend to follow closely the technology and market developments in their area of expertise to stay in the deal flow and to make an informed investment decision. Before making an investment they carefully scrutinize the founders and their business concepts. When making the investment, they bring financial expertise to structuring the deal and setting appropriate incentive and compensation systems (Sahlman, 1988). After the initial investment, venture capitalists tend to be very active in the process of raising additional funds for their portfolio companies. They also continuously monitor their companies both formally through participation at the board level and informally (Lerner, 1995). As monitors and through their access to private information, like banks, they can help provide certification to outside stakeholders (Puri, 1998). They can provide valuable mentoring and strategic advice for the entrepreneurs and they frequently assist companies in providing business contacts and recruiting senior managers (Bygrave and Timmons, 1992). They tend to play an important role in corporate governance, frequently replacing the original founder from the position of the CEO (Hellmann, 1998). They often take an active role in guiding the exit decision, such as influencing a company's initial public offering (Lerner, 1994, Gompers, 1995).

The main alternatives to venture capital financing are the so-called 'angels' (private individuals), corporations, banks, government and self-financing (Sahlman 1990).

2.2 Sources of Funding and Capital Structure

Apart from the amount of start-up capital, any two entrepreneurs, one being in the developed world and the other in the third world may differ with respect to the capital structure of their business. Obviously, a distinction should be made between equity and debt capital. Finance theorists have argued about whether there exists an optimal capital structure for small firms in terms of both debt and equity (Myers and Majluf, 1984). Market imperfections like taxes, bankruptcy costs, agency costs (monitoring) and the signaling effect (information asymmetry leading to information costs) have been brought forward as determinants of the firm's optimal capital structure. In practice, market imperfections lead to a trade-off between equity and debt financing (Grewald, Stiglitz and Weiss, 1984).

The trade-off theory describes the optimum in terms of a trade-off between tax advantages of debt and the increase in expected bankruptcy costs. The agency theory gives an alternative explanation, independent of taxes and bankruptcy costs, which is based on minimising agency costs (Pandey 1996). The Myers Pecking Order theory uses elements from both the trade-off theory and the agency theory. According to the Myers hypothesis the financing of projects is undertaken first by using internal resources, then debt and equity as a final resort. Holmes and Kent have developed a 'Restricted Pecking Order Theory'. This theory can be applied to small firms by assuming that small firms usually are not able to issue shares and owner-managers want to be in control of their business. Furthermore, this theory is applicable only in case entrepreneurs have a genuine choice between equity and debt capital in the sense that they have personal equity available and relevant access to credit. One of the important sources of financing under the restricted Pecking Order theory, after the owners funds and retained earnings, is venture capital (Pratt, 1987).

2.3 Venture Capital Agency Issues

Enterprises backed by venture capitalists are typically characterized by great uncertainty and high failure risk (Lerner and Gompers, 1999). As such, they find it difficult to obtain financing from traditional sources, such as banks. Lerner and Gompers (1999) provide an overview for the reasons why traditional sources of financing are not suitable for such projects, and stress that the tools employed by venture investors should be seen as responses to their special nature.

Typically, when decisions are made to start a new project or venture, much uncertainty exists about the time and capital needed until the project is self-sustaining and cashflow positive. This uncertainty is a potential source of conflict between the two parties involved, the entrepreneur and the investor (s). The two parties may make it difficult to define mutually agreeable and enforceable contract terms and therefore encumber the efforts to secure funding for the project (Hellman and Puri, 1999).

Let's take the example of the development of a new drug. The idea for a new project is based on some initial and very preliminary research. The project itself requires substantial investments before the value of the initial idea can be assessed. More information will be produced over time as to whether the project will be successful or should be abandoned due to poor results. The time and money spent until the research is completed successfully remains uncertain.

And as the entrepreneur obtains negative results, he may decide to withhold the information, either because he is over-confident of the chances of success of the venture, or because he rationally tries to prolong the search (Bergman and Hege, 2001).

Contracting problems of this nature are likely to create funding obstacles as detailed in the three cases below:

1) Empirical research reveals that venture capitalists are well aware of these contracting problems, and they go to great lengths to build possible safeguards into their contracts. These include extensive control rights, in particular the right to claim control on a contingent basis and the right to fire the founding management team. They often keep hard claims in the form of convertible debt and preferred stock, underpinning the right to claim control and abandon the project. They also engage in staged financing and the inclusion of specific performance benchmarks makes it possible to fine-tune the abandonment decision (Lerner and Gompers, 1999).

2) The optimal financing of a start-up project within a firm is also of concern in the Research and Development capital budgeting expenditure process within the firm.

3) The problems highlighted here arise for governments, research institutions, universities, and other organisations that sponsor research. They need to continually evaluate research projects and to determine the timing for grant renewal or the decision to abandon.

Project uncertainty is represented by a simple probability equation. If the project is promising and funds are injected, then there is positive probability that the project will be completed successfully. The probability is zero if the project is a failure. However, if funds are not injected, the probability of success is zero as well.

For each venture, the entrepreneur can ask for funds continuously at every stage and the time horizon is infinite as long as the project is alive. However, continued lack of success will lead to a downgrading of the belief about the nature and chances of success of the project. The project eventually becomes a success, or is eventually abandoned in light of persistent negative news (Bergman and Hege, 2001)

2.3.1 Control of Venture Funds

The entrepreneur controls the allocation of funds. He can chose to invest the funds efficiently into the project or divert them to his own private ends. This creates a potential moral hazard problem brought about by the agency conflict especially due to the dynamic nature of the investment problem given the uncertainty of success at every stage.

When diverting funds for personal or other use, the entrepreneur not only enjoys the immediate benefit of consuming the cash meant for the investment, but can also secure additional funding since nothing can be learned from the project when the funds are not invested as planned, meaning that the information that the investor was presented to get the 'misused' funds remains the same (Lerner, 1995). We can therefore conclude that the entrepreneur's discretion over the funds is intimately linked to the abandonment decision.

2.3.2 Control Under Relationship Financing

There are two main classes of venture capitalists, the active investor and the passive investor. The active investor engages in relationship financing in which case the entrepreneur's allocation of funds is observable while the passive investor engages in arms length financing in which case the entrepreneur's allocation of funds is unobservable.

If the entrepreneur's action is 'observable' the information about the future likelihood of success is shared between the entrepreneur and the investor and there is always symmetric information. This situation is similar to relationship financing where the investor has a hands-on approach to the situation. Here funding renewal is negotiated under a situation of symmetric information (Admati and Pfeiderer, 1994).

For the entrepreneur, the project represents an opportunity to win a large single prize. Yet, as long as he can attract funds, the project also constitutes a stream of cashflows provided by the funds, which he can divert for private use. The conflict between investing and diverting the funds is enhanced by the fact that successful completion of the project automatically stops the flow of funds. The direct incentives for the entrepreneur then have to be adequate to offset the possible loss of future funding cashflows; i.e. they have to be larger than the funding at equilibrium (Lerner, 1995).

On the other hand, as the funding goes on and the outlook becomes less promising, the decreasing participation appetite of the investor eats more and more into the expected cashflow of the project thus reducing the entrepreneur's incentive to the point where the residual will fall below what is needed to provide incentives. The next step is the investor slowing down the release of funds. This reduces the investor's option value of prolonging the project, creating a counter incentive constraint for the entrepreneur. Due to these negative factors, the funding stops altogether too early relative to the efficient stopping point and the project fails (Bergman and Hege, 2001).

2.3.3 Control Under Arms-length Financing.

In arms-length financing, the entrepreneur's actions are unobservable. When the entrepreneur's actions are 'unobservable', there potentially exists a moral hazard problem brought about by asymmetric information and the investor is unlikely to have an indication of the probability of future success under arms-length financing. The moral hazard problem translates into an adverse selection problem about the beliefs in future periods based on the entrepreneur's decisions in the current period. This is because the private beliefs of the entrepreneur and the investor about the project can diverge. It is important to note here that the entrepreneur controls not only the investment flow but also the information flow (Maier and Walker, 1987).

While the conflict cited earlier between the immediate incentives and the funding cashflows remains for the entrepreneur, with unobservable action, the investor will automatically downgrade his belief after a deviation from the promised results and insist to be compensated on the basis of his belief, which is always more pessimistic than warranted due to the asymmetric information. This change in belief limits the maximum financing horizon.

It has been observed that the financial constraints will typically become tighter over time under relationship financing and tighter under arms length financing. The trade off is that while relationship financing may require smaller information flows, arms length financing in itself implies a finite source of funds or timelines. The lack of a finite funding horizon under relationship financing on the other hand implies that the sustainable release of funds eventually slows down. Surprisingly, arms length contracts are found preferable (Bergman and Hege, 2001).

However, in most venture capital transactions, the basic reason for failure of the project is the fact that funding stops too early relative to the efficient stopping time in both arms length and active financing. This is because the uncertainty about future success gradually diminishes with additional funding and eventually disappears at a certain turn-around stage when the enterprise or project is stable. The entrepreneur controls the funding and can divert it at any time during the project and this creates a moral hazard and the investor has to put in place safeguard mechanisms.

2.4 Stage Financing and Convertible Securities

A widely used financing technique by venture capital companies is the infusion of capital over time. The venture capitalist who provides the funds retains the option to abandon the venture at any stage whenever the forward looking net present value of the project is negative. Financing rounds are usually related to significant stages in the development process such as completion of design, pilot production, first profitability results, or the introduction of a second product. At every stage, new information about the venture is released (Sahlman 1990). Also widely used in venture capital backed projects are convertible securities issued by entrepreneurs in exchange for funds.

Stage financing is appealing to venture capitalists for two reasons. First, the option to abandon is essential because an entrepreneur will almost never stop investing in a failing project as long as others are providing capital (Admati and Peiderer 1994). Second, the threat to abandon creates incentives for the entrepreneur to maximize value and meet goals. But this threat has the potential drawback that it might induce the entrepreneur to focus only on meeting the immediate hurdle of the next stage.

To illustrate, the entrepreneur can make the conditions under which a project will be evaluated more favorable, whether it is the test of a prototype or a market test, increasing the likelihood of good interim performance. This phenomenon is commonly described as "window dressing" (Gorman and Sahlman, 1989).

The venture capitalist then has to decide whether to continue investing in the project on the basis of interim performance that has been artificially improved. Stage financing thus creates a conflict of interest between the venture capitalist, who provides the funds, and the entrepreneur, who wants to continue with the project.

Window dressing can be modeled as follows:-
The venture capitalist and the entrepreneur commonly observe the interim performance of the project. We can term the interim performance the "signal." Before the signal is realized, the entrepreneur can manipulate its distribution so that a good signal realization is more likely to appear, without affecting the actual quality of the project. Empirical studies have shown that this change in the distribution of the signal should not be thought of as "adding noise" to the signal or as "reducing" the amount of noise in the signal.

The reason is that neither type of signal manipulation constitutes a conflict of interest: increasing the amount of noise in the signal is undesirable to both the venture capitalist and the entrepreneur while reducing the amount of noise in the signal is desirable to both. It is often hard to specify in absolute terms what is meant by "good interim performance." For instance, when evaluating whether a "working prototype" indeed works, or when evaluating the responses of consumers to a market test, a great deal of subjective judgment must be exercised. To capture this feature, we assume that although the venture capitalist and the entrepreneur commonly observe the interim performance signal, it is non-verifiable (Sahlman, 1990).

Empirical studies have shown that with debt-equity financing the entrepreneur will always window dress. However, convertible debt financing can be designed so that the advantage to the entrepreneur from reducing the likelihood of liquidation is more than offset by the increased likelihood of debt conversion if conditional on refinancing. This is because although window dressing renders low quality projects harder to identify , it renders high quality projects easier to identify. This, in turn, increases the probability that in the event of refinancing the venture capitalist will exercise the debt conversion option becoming the owner of a substantial fraction of the venture and appropriating much of the project's value. If the terms of conversion are set in advance to be sufficiently favorable to the venture capitalist, this effect dominates in terms of payoffs, and the entrepreneur will not engage in short-term window dressing. The winning formula involves the determination of an appropriate conversion ratio and a suitable amount of convertible debt that will ensure that the project is financed, but at the same time will deter the entrepreneur from engaging in window dressing (Cornelli, 2001).

Convertible preferred equity is also commonly used in venture capital financing. The above analysis is virtually unchanged if the entrepreneur issues convertible debt. Convertible preferred equity has similar features to convertible debt, but is special in several respects. Until conversion, a convertible preferred stock promises a fixed dividend and hence is similar to convertible debt. Unlike debt, failure to pay the dividend does not trigger liquidation; rather, the unpaid dividends accrue and must be paid before any dividends are paid out to common stock holders, thus reducing the risk of the financier.

CHAPTER 3: RESEARCH DESIGN

3.1 Population of Study

The population of the study constituted all registered venture capital companies operating in Kenya as defined by the Registrar of Companies, the Capital Markets Authority and the Nairobi Stock Exchange and a sample of both their successful applicants and unsuccessful applicants for the last twelve years.

2.2 Sampling

For the enterprises, cluster sampling was used with clusters based on industry sectors such as manufacturing, services and technology as outlined in Appendix B. Cluster sampling was selected for this survey since literature has shown that venture capital financiers, by virtue of being active participants in the management of the firm, tend to gravitate towards the sectors that they are familiar with traditionally (Hellman and Puri 1999). Random sampling was applied within the clusters chosen for each financier with the aim of getting a total population of at least twenty enterprises around the venture capital firms.

2.3 Data Collection

Both primary and secondary data was employed in this study. The main data analysis was performed on the primary data while the secondary data was used to augment the report and findings. Semi structured questionnaires were used to collect the primary data while secondary data was obtained from various publications on venture capital financing. Sample questionnaires are attached as Appendix A.

2.4 Data Organisation and Analysis

Before processing the responses, the completed questionnaires were edited for completeness and consistency. Data was tabulated and then classified according to their common characteristics. The responses were then coded as outlined in Appendix B. This enabled the basic statistical analysis to be carried out. Descriptive statistics such as frequency distribution, means, modes, percentages, proportions and percentages were used.

In addition, measures of both central tendency and spread were used to compare certain characteristics of the venture capital firms and the recipient enterprises for these funds. These graphs are used throughout chapter 4.

The study also sought to identify significant factors affecting the Venture capital industry in general by designing a questionnaire to collect views on the factors common and significant to the various venture capital companies. This was done in order to determine whether there are common significant factors that the industry considers and whether certain venture capital firms favor financing enterprises with certain characteristics.

Chapter 4: DATA ANALYSIS AND INTERPRETATION OF FINDINGS

In this chapter, the results of the research are analysed, interpreted and discussed. The data collected from the study was mainly descriptive though there was a fair amount of quantitative data, which was analysed first to get an indication of the broad macro and demographic information. Extensive use of tables and graphs has been employed to enhance the readability of this report.

4.1 Summary of Firms Interviewed

The analysis was undertaken for the two players in this study, namely the financier, in the form of the Venture Capital firm, and the recipient, in the form of the target enterprise.

4.1.1 Venture Capital Company Data Collection

The population of the study constituted all registered venture capital companies operating in Kenya as defined by the Registrar of Companies, the Capital Markets Authority and the Nairobi Stock Exchange and a sample of both their successful and unsuccessful applicants for the last ten years. A total of twelve Venture Capital Companies were identified as indicated in Table 4.1.1 below. There were also a number of stockbrokers, whose licences and business category showed that they offered venture capital financing. However, it was established through telephonic interviews that they are intermediaries between the enterprises and the Venture Capital firms. There are five such organisations, namely, Suntra Stocks, Kestrel Capital, Faida Stock Brokers, Dyer and Blair and Shah Munge and Partners. These firms were not considered eligible for the primary data collection as it was felt that their inclusion would result in a duplication of data and therefore skew the results.

The questionnaires used are attached as Appendix A.

Table 4.1-1 – Response Rate for Venture Capital Companies Identified

Category	Number of Firms	Percentage
Interviewed	6	50%
Not Willing to discuss	2	16%
No Appointment	3	25%
Too Busy	1	9%

Source: Research Data

Of the surveyed venture capital firms, six, representing 50% of the total population were interviewed. Of the balance, 16% were not willing to divulge the information after seeing the questionnaires, while 34% were too busy to schedule an appointment. A detailed listing of the Venture Capital companies is given in appendix B.

4.1.2 Enterprise Data Collection

Random sampling had been proposed for the enterprises, since literature has shown that venture capital financiers, by virtue of being active participants in the management of the firm, tend to gravitate towards the sectors that they are familiar with traditionally (Hellman and Puri, 1999). However a census survey was conducted when it became apparent that the number of enterprises were few and that not many were willing to divulge the required information for reasons of confidentiality. A total of 25 questionnaires were sent and only fourteen firms managed to respond positively as shown in table 4.1.2.

Note : In the data analysis and interpretation, the firms in the survey were randomly coded so as to maintain confidentiality, which was one of the conditions of obtaining some of the financial information contained in the questionnaires.

Table 4.1 - 2 – Status of Target Enterprises Interviewed

Category	Number of Firms	Percentage
Successful in obtaining funds	11	78.6%
Unsuccessful applicants	3	21.4%
Total	14	100%

Source: Research Data

Of the 14 respondents, 11, representing 78.6% of the total respondents were successful, while 21.4% were unsuccessful.

4.2 Findings for Venture Capital Companies

4.2.1 Ownership of Venture Capital Firms

Of the 6 respondents, none of them is 100% locally owned, but three are 100% foreign owned. All Venture Capital Companies appear to have a component of foreign ownership. As indicated in section 4.2 -1 below, three of the companies have both local and foreign ownership aspects, whereas two firms are 30% and 40% owned by the government and 70% and 60% owned by foreigners respectively.

Table 4.2 –1: Ownership of Venture Capital Companies

FIRMNAME	Year Established	LOCAL	DONOR	GOVT	FOREIGN
Firm VC 01	1983	0	0	0	100
Firm VC 02	1983	0	0	0	100
Firm VC 03	1994	0	0	40	60
Firm VC 04	1995	60	0	0	40
Firm VC 05	1992	25	0	0	75
Firm VC 06	1982	0	0	30	70

Source: Research Data

4.2.2 Companies Financed by Industry Sector

The objective of this section of the study was to investigate the distribution of venture capital transactions by industry sector. Venture capital funds are attracted to high technology high growth sectors in the US (Maier J. and Walker D, 1987), .In this study we seek to find out which sectors of the economy attract venture capital funds. The sectors were split as follows for the purposes of this study:-

1. Manufacturing: Firms manufacturing goods from various raw materials
2. Financial Services : Firms offering banking, insurance and brokerage services
3. Other Services: A general sector lumping firms that do not fall in any identified sector; eg transport and education
4. Technology: Firms offering computing, communications and Internet services
5. Food and Beverages: Firms in the restaurant and hotel industry
6. Retail Business: Firms such as supermarkets and retail chains, and
7. Medical Services: Firms in the managed healthcare, hospital and medical insurance business

The surveyed VC companies financed a total of 65 enterprises. Of these, 21 were in manufacturing representing 32.3% of the total, followed by 14 in financial services representing 21.5% of the total and another 14 in "other services". There were 9 firms in technology representing 13.8% of the total and 3 in retail and medical services representing 4.6% respectively with one firm in Food and Beverages representing 1.5% of the total.

Table 4.2 -2 – Companies Financed by industry sector

No	Sector	No of Transactions	Percentage
1	Manufacturing	21	32.3%
2	Financial Services	14	21.5%
3	Technology	9	13.8%
4	Food and Beverages	1	1.5%
5	Retail Business	3	4.6%
6	Medical Services	3	4.6%
7	Other Services – not defined by client	14	21.5%

Source: Research Data

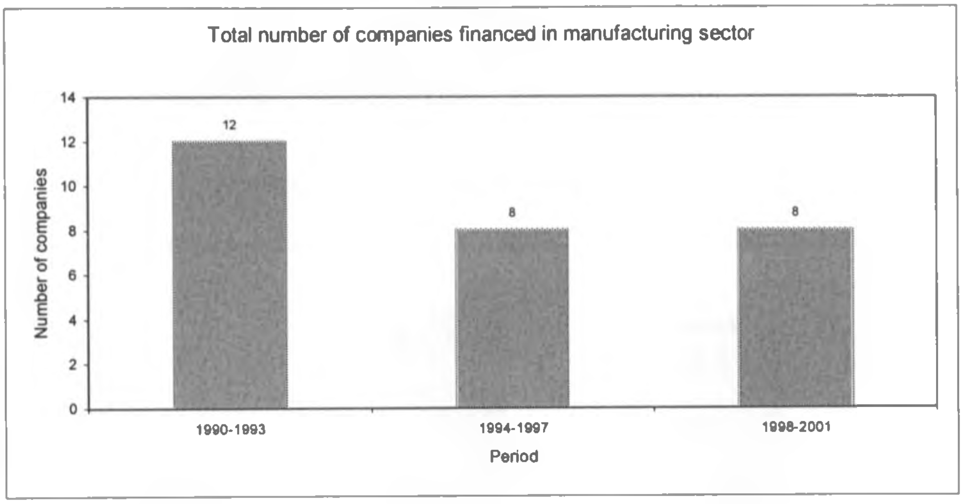
The results show that VC companies favour enterprises in the manufacturing and financial sectors with 53% of the financing transactions going to these sectors. The "other Services" sector is broad and can therefore not be considered a 'real' sector. It includes firms in the business of vehicle services, dry cleaning, transport and education.

In addition, trend analysis covering three broad periods between 1990 and 2001 was carried out for these enterprises and the results are as follows:

Manufacturing

Table 4.2 -3 below shows that the number of transactions in the period for manufacturing firms remained relatively stable. This indicates that the transaction appetite towards this sector did not change significantly over the ten-year period, probably an indication that the manufacturing sector is a significant player in the Venture Capital industry as it is both leading and stable.

Table 4.2 –3: Transaction Trends in Manufacturing Sector

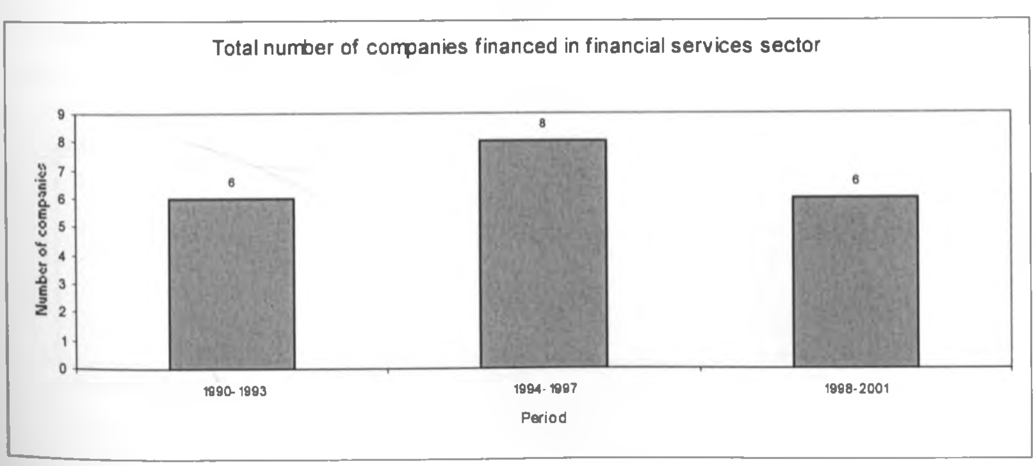


Source: Research Data

Financial Services

Table 4.2 -4 shows that there was a rise in the number of transactions between 1994 and 1997 but the number fell again in 1998-2001. This indicates that the transaction appetite changed positively in the middle of the ten-year period, but reverted to the original state towards the end of the period, indicating that there were factors after 1997 that hindered the growth of the sector. This may be related to the banking crisis around the same time.

Table 4.2 – 5: Transaction Analysis in Financial Sector

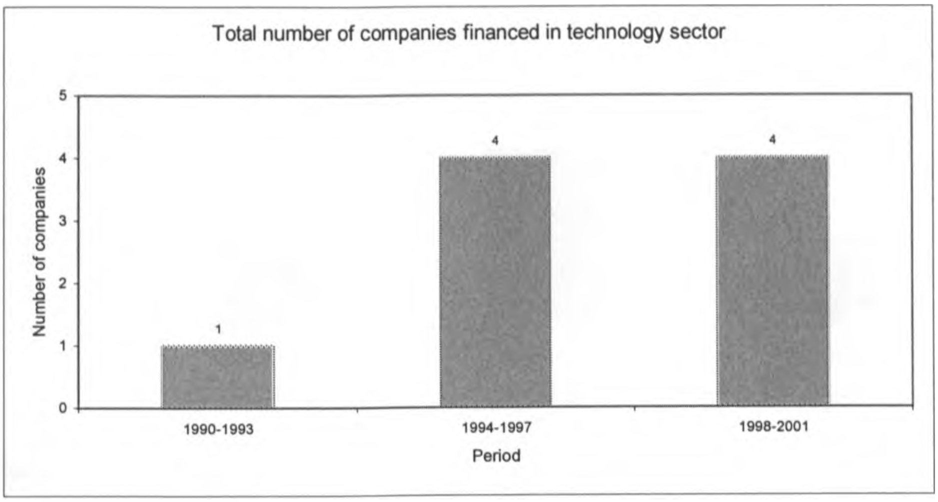


Source: Research Data

Technology

Table 4.2 -6 shows that there is a steady increase in the transaction appetite for the technology sector over the ten year period to 2001. This is probably due to the growth of the size and importance of the technology sector in Kenya over the period.

Table 4.2 – 6: Transaction Analysis in the Technology Sector

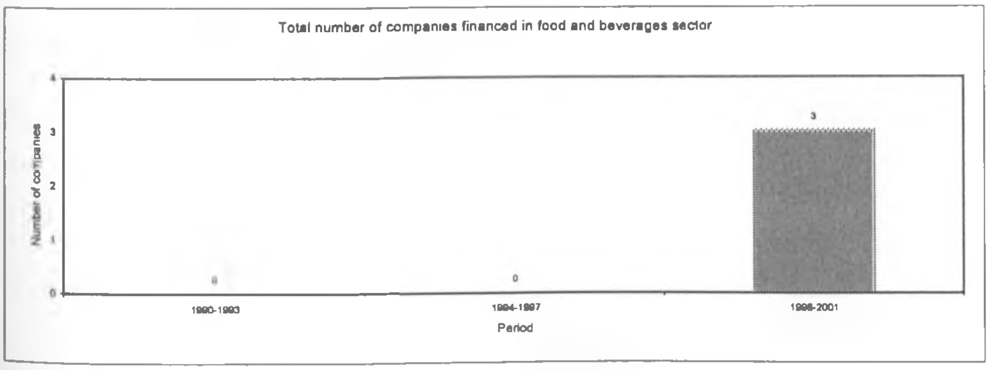


Source: Research Data

Food and Beverages

Table 4.2 -7 shows that this sector recorded only one transaction in the period of 1998-2002 among the firms surveyed. This makes it the worst performing sector in terms of venture capital financing transactions.

Table 4.2 –7: Transaction Analysis in Food and Beverages Sector

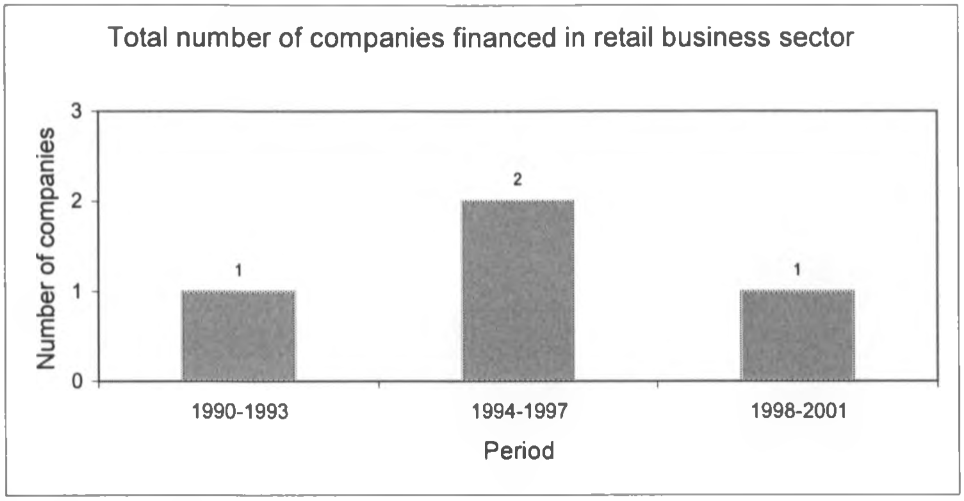


Source: Research Data

Retail Business

Table 4.2 -8 shows that this sector recorded a steady but very low rate of transaction in the ten-year period, indicating that the sector is not a significant player in the industry.

Table 4.2 –8: Transaction Analysis in Retail Sector

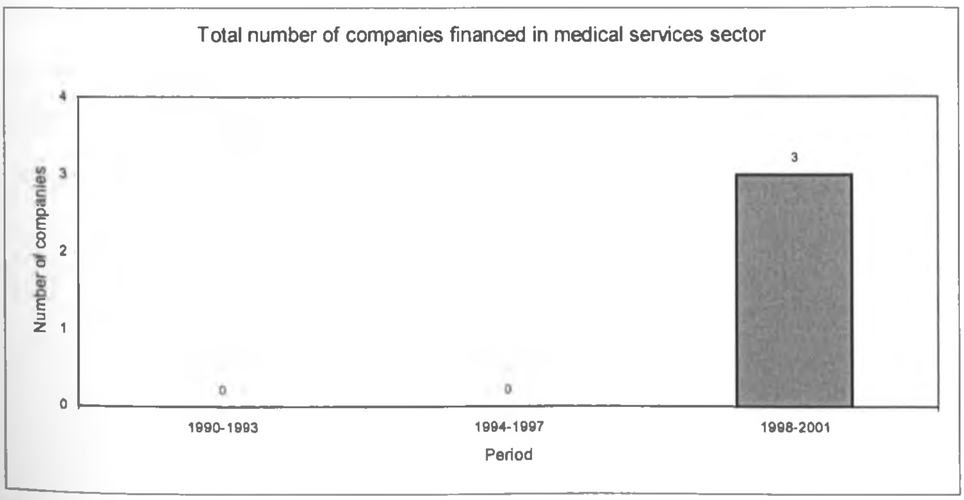


Source: Research Data

Medical

Table 4.2 -9 shows that the medical industry sector recorded three transactions in the period 1998-2001. It is significant to note that these transactions were in the healthcare and healthcare insurance companies, popularly known as HMO's, which are also a relatively new but very fast growing sector of the economy.

Table 4.2 – 9: Transaction Trends in Medical Services Sector

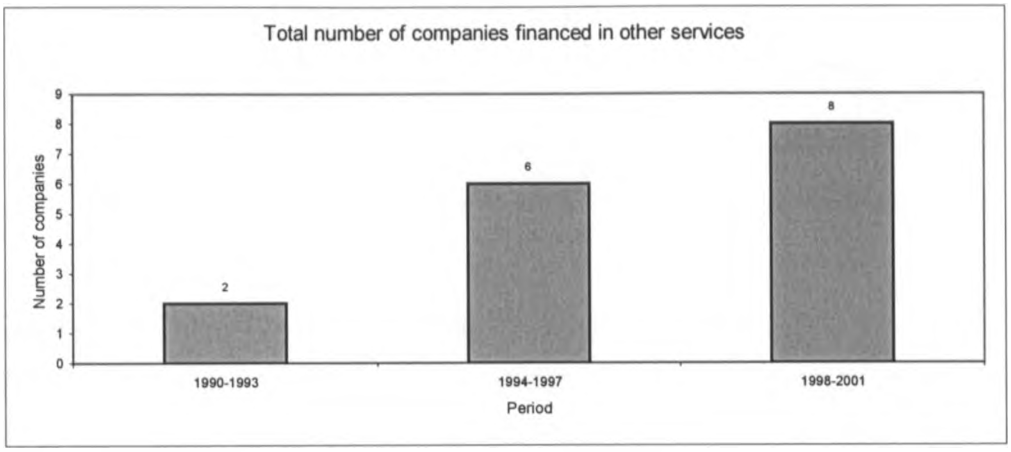


Source: Research Data

Other services

Table 4.2 - 10 shows that there is a sharp rise in the transactions in this sector(s) as we approach 2001, meaning that there is a significant appetite for transactions in this sector with time over the ten year period. This indicates that Venture capital firms are looking more towards the non-traditional sectors such as education and transport.

Table 4.2 – 10: Transaction Trends in 'Other Services' Sector



Source: Research Data

4.2.3 Companies Financed by Age

This section sought to investigate if the age of the organisations financed is a significant factor in Venture capital financing. The ages of the companies financed by the respondents is analysed. The companies were grouped into age bands with the bands being; 'less than three years', to represent start-up enterprises, 'three to six years' to represent young enterprises, 'seven to ten years' to represent relatively mature enterprises, and 'over ten years' to represent mature enterprises.

Table 4.2.3-0: Companies Financed by Age: Summary

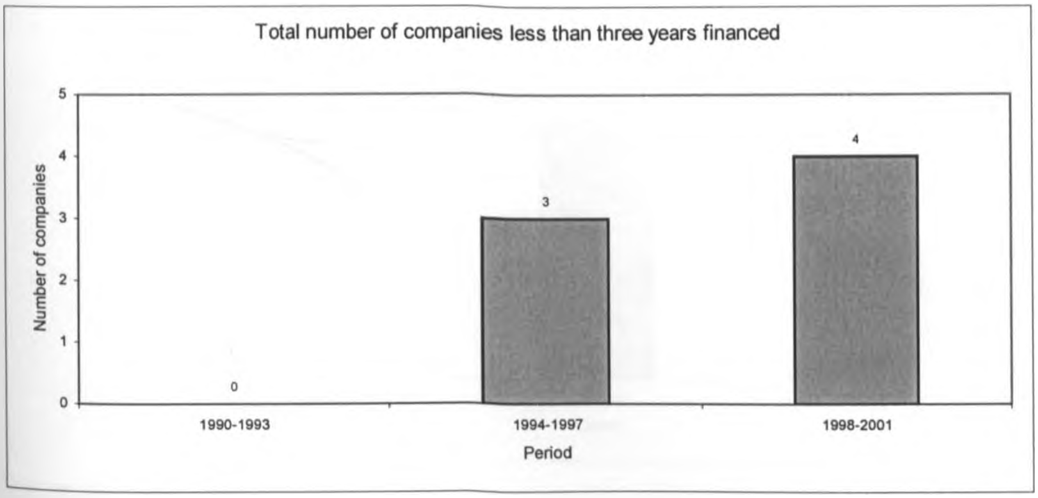
Firm code	No of Companies less than three years (1998 – 2001)	No of Companies less than 3 years (1994 – 1997)	No of Companies less than 3 years (1990 – 1993)
VCFirm 01	0	0	0
VCFirm 02	0	0	0
VCFirm 03	0	0	0
VCFirm 04	0	0	0
VCFirm 05	4	3	0
VCFirm 06	0	0	0
Total	**4**	**3**	**0**

Source: Research Data

Companies financed by age: Less than three years

Table 4.2.3-1 shows that of the total 65 companies financed, there were seven of less than three years representing 10.8% of the total transactions recorded. This shows that start-up companies do not form a significant part of the Venture capital industry. This is completely in contrast with the facts presented in the developed world where start-up companies form a significant part of the venture capital industry.

Table 4.2.3 -1: Number of Companies Financed by Age

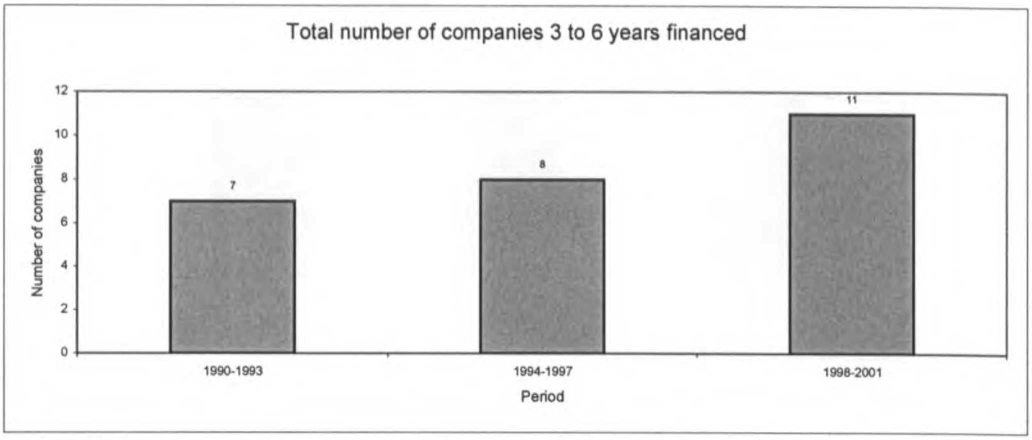


Source: Research Data

Companies financed by Age: three to six years

Table 4.2.3-2 shows that there were 24 companies represented in this Age band which represents 36.9% of the total recorded. This makes the 3-6 year bracket the most significant sector financed by the Venture capital industry.

Table 4.2.3 –2: Companies Financed by Age: 3-6 years

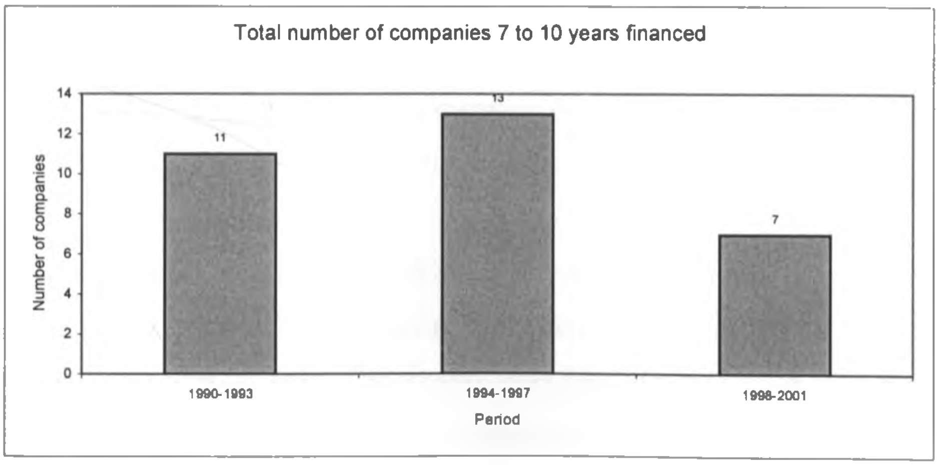


Source: Research Data

Companies financed by age: Seven to ten years

Table 4.2.3-3 shows that there were 22 companies in this age band representing 33.8% of the recorded total. This indicates that the 7-10 years is also a significant sector of the Venture capital industry.

Table 4.2.3 – 3: Companies Financed by Age: 7 – 10 years

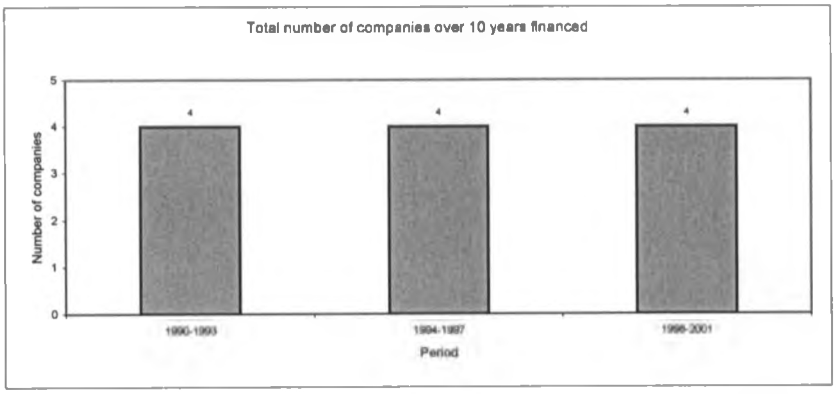


Source: Research Data

Companies financed by Stage: Over ten years

Table 4.2.3 –4 shows that there were five transactions in this age band representing 7.7% of the total recorded. This indicates that the 'over 10 years' enterprises do not play a significant part in the venture capital industry in Kenya.

Table 4.2.3 – 4: Companies Financed by Age: Over 10 Years



Source: Research Data

Trend Analysis on Age of Company Financed

Figure 4.2.3-1 shows that the under three years category grew from zero in 1990 to four in the period 1998-2001, the three to six years category also grew substantially with time from 1990 while the 7 –10 years category remained stable throughout. Of significant note is that all transactions on the under three years category were financed by one particular Venture capital firm as shown in table 4.2.3 – 2.1.

4.2.4 Analysis by stage of financing

In this section, we analyse the financed companies by the stage of financing the received. The stages were defined in the questionnaire as follows:-

Start-up: *Business is in conceptual stage and product/ service has not started.*

Early-stage: *Enterprise developing product but has not started realizing revenue.*

Expansion: *At least one product/ service is being delivered and revenues realised.*

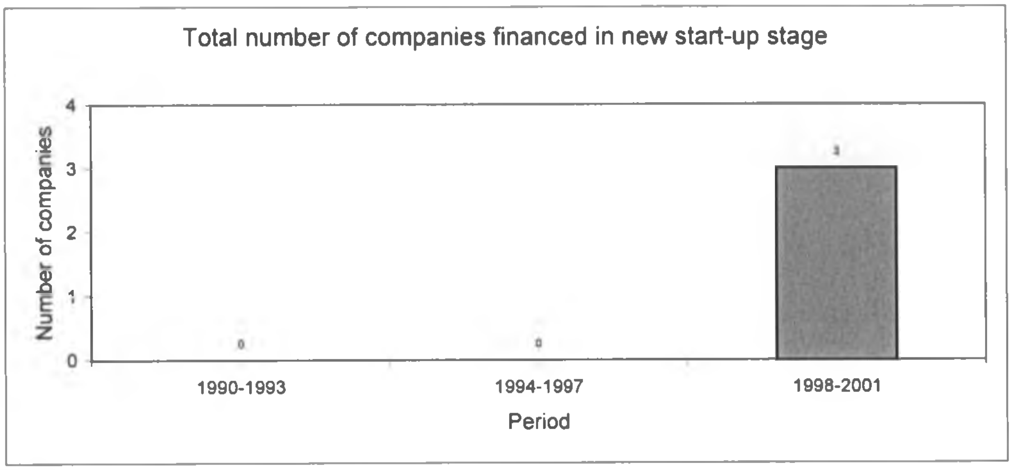
Profitable: *The company is generating profits from sale of products or services.*

Restart: *A new financing round causing the dilution of existing investors due to a change in business or strategy.*

Start-up

There were three companies in this sector. They are most probably the same firms in the under three years sector as they were financed by the same single Venture capital firm that financed the under three years sector. We can therefore conclude that this firm financed businesses at the conceptual stage.

Table 4.2.4 –1: Financing by Stage in Company Growth: Start-up

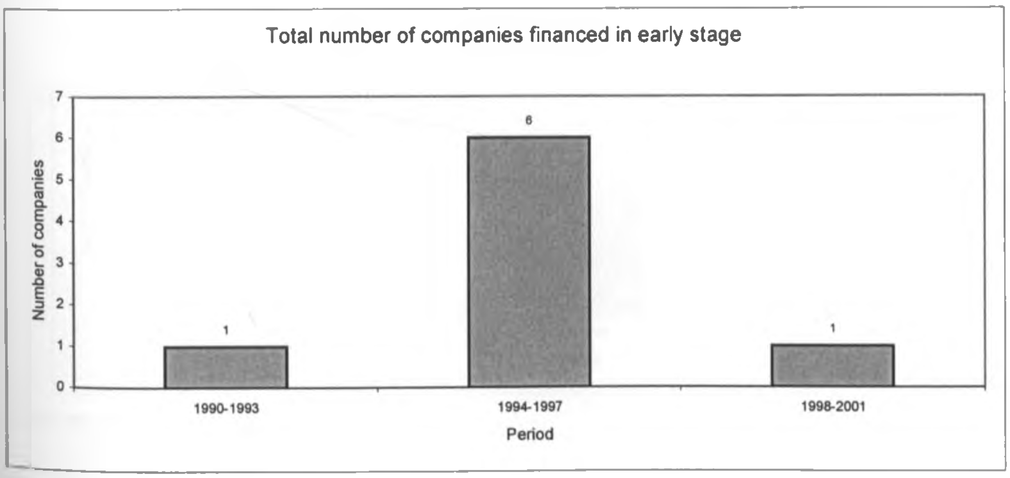


Source: Research Data

Early stage

There were eight firms financed in the early stage of operation representing 7.7 % of the total recorded. This indicates that Venture capital financing is not very significant in early stage target companies.

Table 4.2.4 –2: Financing by Stage in Company Growth: Early Stage

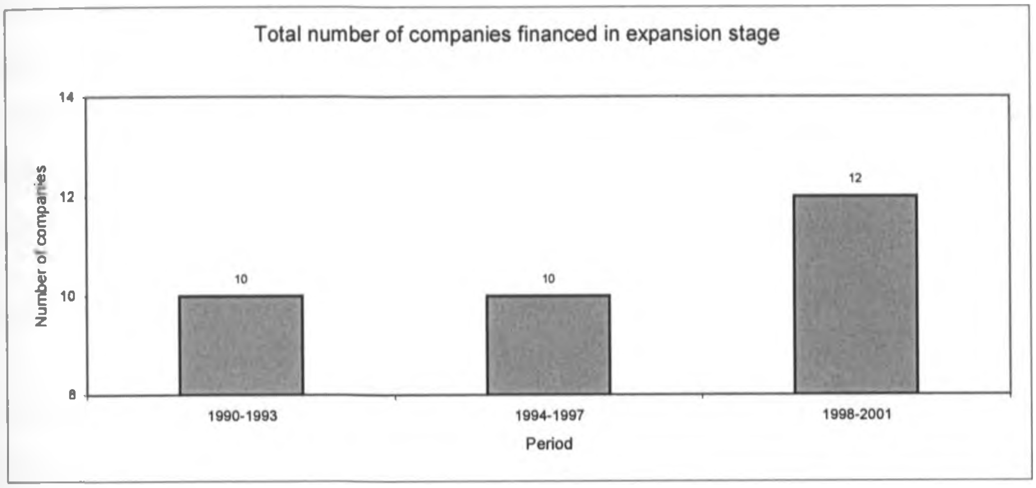


Source: Research Data

Expansion stage

There were 32 firms representing 44.6 % of the total recorded. This is a significant and indeed the largest sector financed by the industry. This indicates that Venture capital financiers prefer companies that are already operational and profitable.

Table 4.2.4 –2: Financing by Stage in Company Growth: Expansion Stage

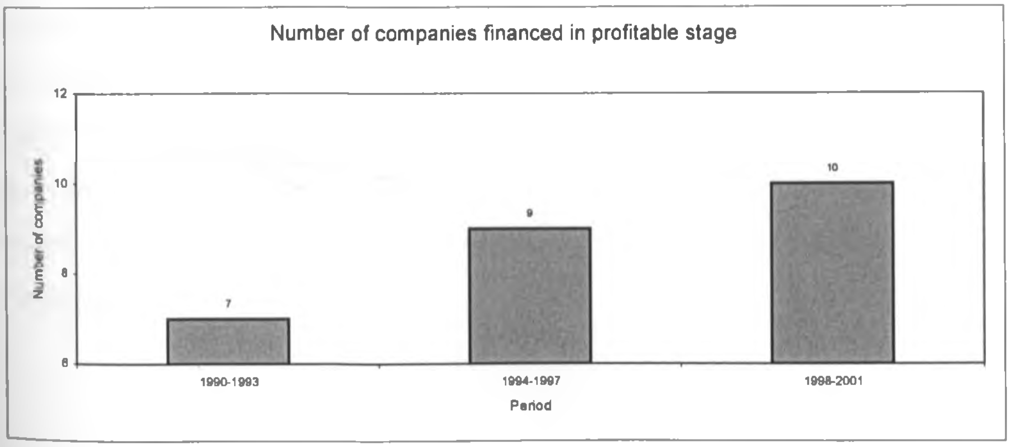


Source: Research Data

Profitable stage

There were 12 firms representing 18.5% of the total recorded. The results show that enterprises in the profitable stage of financing rank second to those in the expansion stage in accessing Venture Capital funds.

Table 4.2.4 –4: Financing by Stage in Company Growth: Profitable Stage



Source: Research Data

There were no transactions recorded in the restart and 'other' stages indicating that Venture capital firms adopt a somewhat risk averse attitude to investing in these firms.

Trend Analysis

It was only after 1998 that transactions of a start-up nature were financed by the industry. Early stage financing seemed to surge in the period 1994-1997 but faced a sharp decline in the ensuing period, which may indicate problems with the cases financed in the prior period. Transactions in the expansion period were relatively stable with slight growth towards the latter years, which shows that there is increasing confidence in this stage of financing in Kenya. Profitable stage financing shows strong growth in the latter years as well showing that the industry favours firms in the profitable stage.

4.2.5 Analysis by round of financing

This section analyses the transaction by round of financing to investigate whether this is an important factor for the venture capital industry. Often times, financiers will look for the presence of another financier in the target enterprise as a way of automatically mitigating the problem of window dressing (Gorman and Sahlman, 1989). In this section, we endeavor to find out if Venture capital firms are concerned about this problem and want to solve it in this manner.

The rounds of financing were defined in the questionnaire as follows:-

Seed Financing: *Initial round of financing to a startup enterprise..*

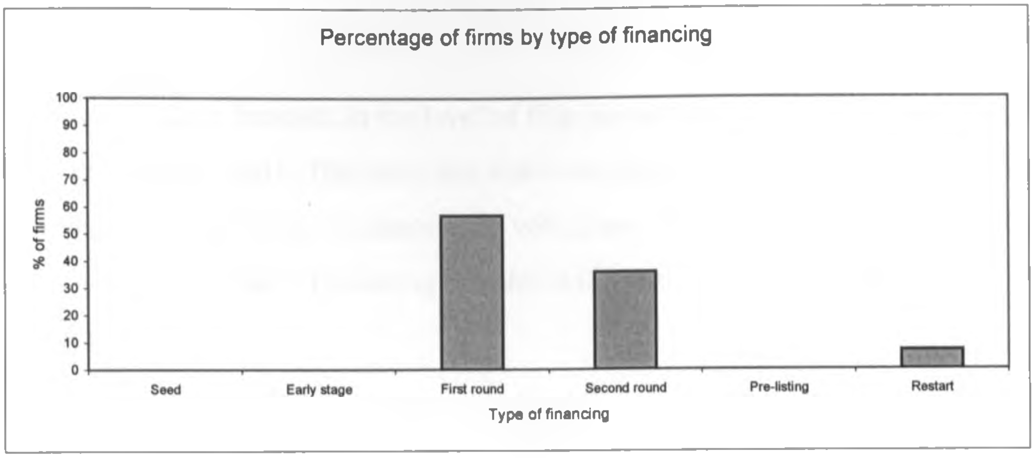
First Round: *This is the first main venture capital transaction to the enterprise.*

Second Round: *This is the subsequent major round of financing.*

Pre-listing: *This is the venture financing prior to launching a public offering.*

Restart: *This is the new financing round causing the dilution of existing investors due to a change in business or strategy.*

Table 4.2.5.- 1 Financing Data by Stage of Financing



Source: Research Data

Seed Financing

There were no transactions recorded for this round of financing among the firms surveyed.

First round financing

There were nine firms in this category representing 9.2% of the total. This shows that this round of financing is not significant.

Second Round of Financing

There were 31 firms in this category, representing 47.7% of the transactions. However, a validation of this data indicated that the interpretation of the prior financing was not strictly as indicated in the questionnaire but rather, that the respondents also considered bank loans to be a round of financing. Therefore, there is noise introduced in the responses. That notwithstanding, there is still useful information contained in the responses since it does indicate the presence of another financier, in whatever form, at the time of disbursement of the venture capital funds.

Restart Financing

There were five firms in this category representing 7.7% of the total. This shows that this stage of financing is not a major factor in the industry. However, there may also be noise in this category as section 4.2.4 above indicates that there are no firms financed in the restart stage. This has been noted and highlighted as one of the shortcomings of the questionnaire in a later chapter.

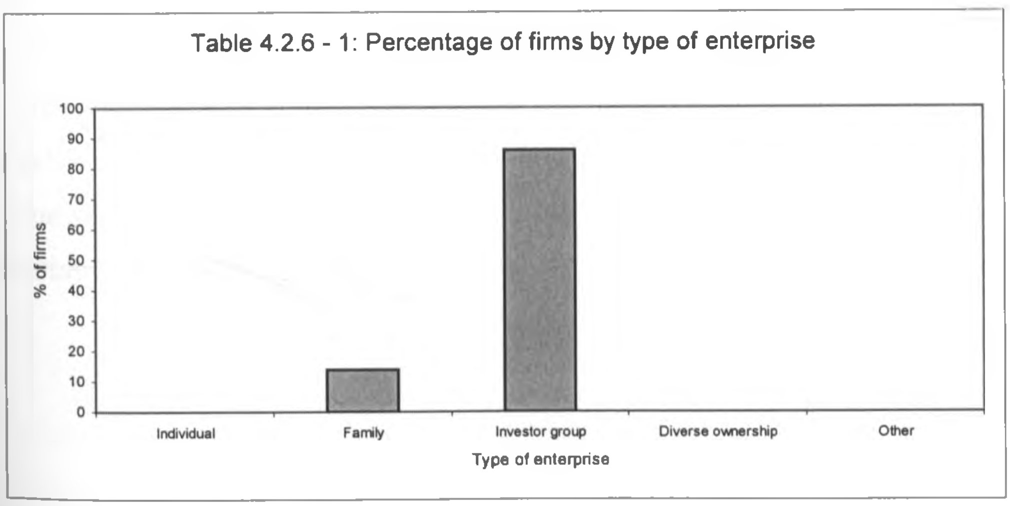
Trend Analysis

There was a sharp increase in the level of first round financing in the latter years of the ten year period to 2001. This indicates that even though this round of financing is not significant, it is set to rise in importance with time. The trend with the second round of financing is fairly stable indicating that this will continue to be a predominant round in the future.

4.2.6 Ownership Structure of the company

This section was intended to investigate if the ownership structure of the company is a significant factor in the Venture capital financing decision. The common ownership structures found in organisations in Kenya are one individual owner or a family business, an individual owner with a technical partner, a small investor group (less than five people), a large investor group (more than five people) and a multinational organisation with a foreign parent.

Table 4.2.6 – 1: Financing Data by Ownership Structure



Source: Research Data

Individual Owner/ Family business

There were six firms in this category representing 9% of the total companies which indicates that individual or family businesses are not an important target sector for the venture capital industry.

Individual Owner/ Family business with technical partner

There were two firms in this category representing 3 % of the total transactions which indicates that individual or family businesses are not an important target sector for the venture capital industry.

Small investor group

There were sixteen firms in this category representing 25 % of the total transactions, which indicates that this sector is somewhat important in the venture capital industry.

Large investor group

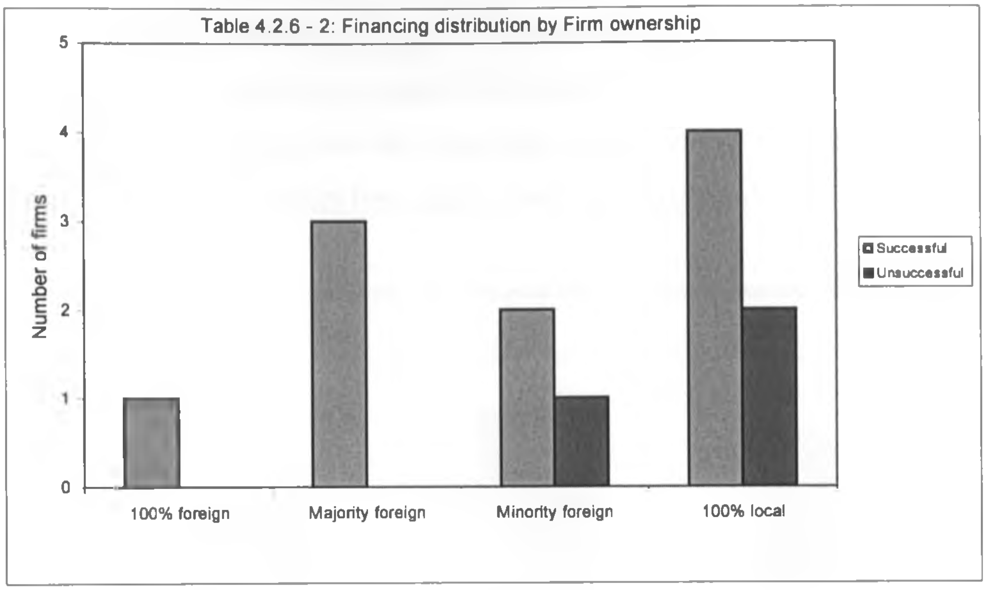
There were 27 firms in this category representing 42 % of the total transactions, which indicates that this sector is the most important in the venture capital industry.

No multinationals were recipients of Venture capital funds in the period.

Trends

The trends over the ten year period ending 2001 indicate that there was a sharp increase in the transactions within the family owned business group especially given that there were no transactions in this category prior to 1994. There was also a sharp rise in the small investor group category from 1994 and this investor group has stabilized at a somewhat significant level. The large investor group is very stable and is expected to continue dominating this industry.

Table 4.2.6 – 2: Financing by Ownership Structure of the Company: All firms



Source: Research Data

A look at the data for all companies, both successful and unsuccessful applicants shows that there are more unsuccessful applicants in the local and minority foreign owned meaning that the higher percentage shown above for the financed companies may be skewed by the nature of the applicants themselves. This shows that the results may be limited by this skew in the input data.

4.2.7 Financial Instrument Used

This section investigates whether the Venture capital industry in Kenya favours a certain set of instruments. The instruments investigated were derived from the literature review and their application is meant to address problems such as Agency theory and the moral hazard problem and stem the transfer of wealth from the financier to the manager of an enterprise or the enterprise itself.

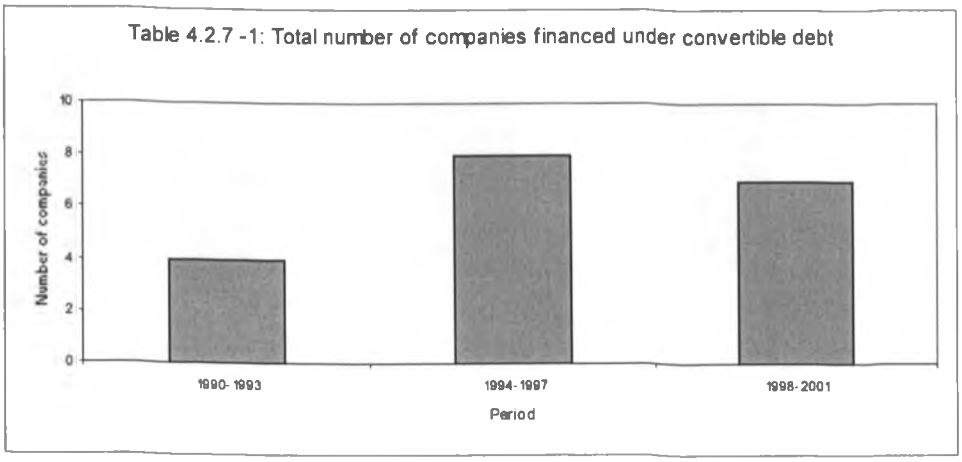
Straight debt

There were no transactions in this category, which is consistent with the definition of venture capital.

Convertible debt

Table 4.2.7 – 1 shows that there were twelve companies in this category, representing 18.5% of the total. This category does not appear important in the Venture capital industry. However, of particular note here is that the transactions are from two firms only with the post 1994 transactions all being done by one firm.

Table 4.2.7 – 1: Financing by Instrument Used: Convertible debt

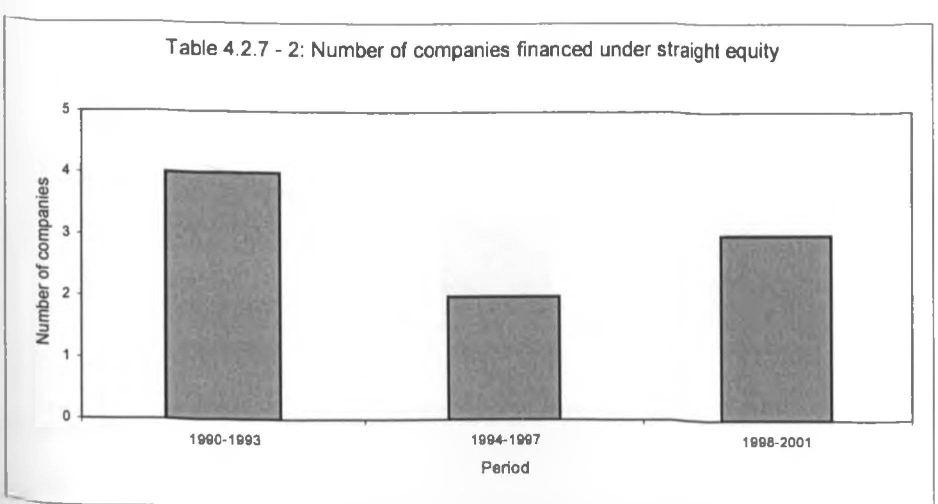


Source: Research Data

Straight Equity

Table 4.2.7 – 2 shows that there were nine firms in this category representing 13.8% of the total. This means that this instrument is not of major importance in the industry. Again here the transactions are from two firms only.

Table 4.2.7 – 2: Financing by Instrument Used: Straight debt

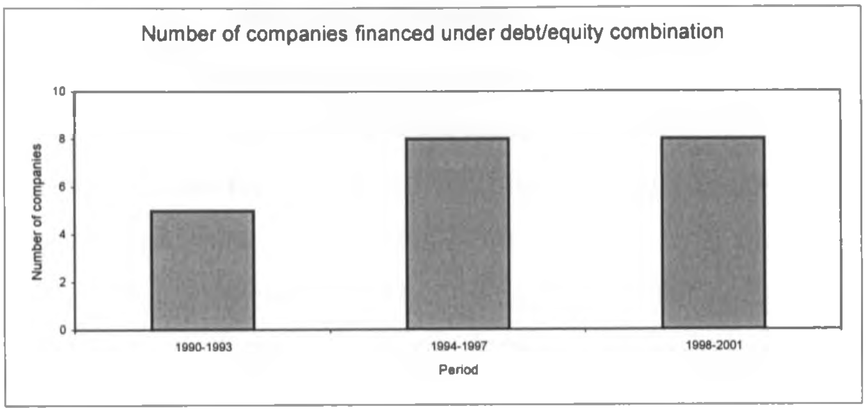


Source: Research Data

Debt/ Equity combination

Table 4.2.7 – 3 shows that there were twenty one firms in this category representing 32.3% of the total. This instrument is of major importance in the industry and looks predominant. Again here the transactions are from one firm only.

Table 4.2.7 – 3: Financing by Instrument Used: Debt/ equity combination

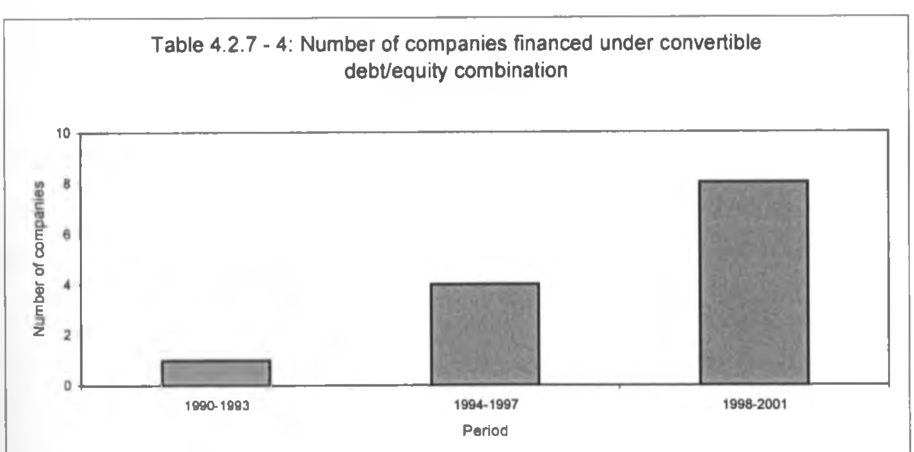


Source: Research Data

Convertible debt/ Equity combination

Table 4.2.7 – 4 shows that there were nine firms in this category representing 13.8% of the total. This instrument is not of major importance in the industry. Again here the transactions are from two firms only.

Table 4.2.7 – 4: Financing by Instrument Used: Convertible debt/ equity combination



Source: Research Data

Trends

The trend here is difficult to pick out as it appears that the trend closely tracks the number of transactions financed by a particular venture capital firm.

4.3 Findings for Enterprises participating in the VC industry

4.3.1 Demographic information

Of the 14 respondents, six of them are 100% locally owned, while only one is 100% foreign owned. The rest are split between local, foreign and public ownership as shown in table 4.3.1 -1 below. Later, we will investigate whether the ownership of these enterprises is a factor in the financing decision. Table 4.3.1 – 2 shows that 2 firms are family owned representing 14.3% of the total, while twelve, representing 85.7% of the total are owned by an investor group. This probably indicates that Venture Capital companies do not favour family owned firms.

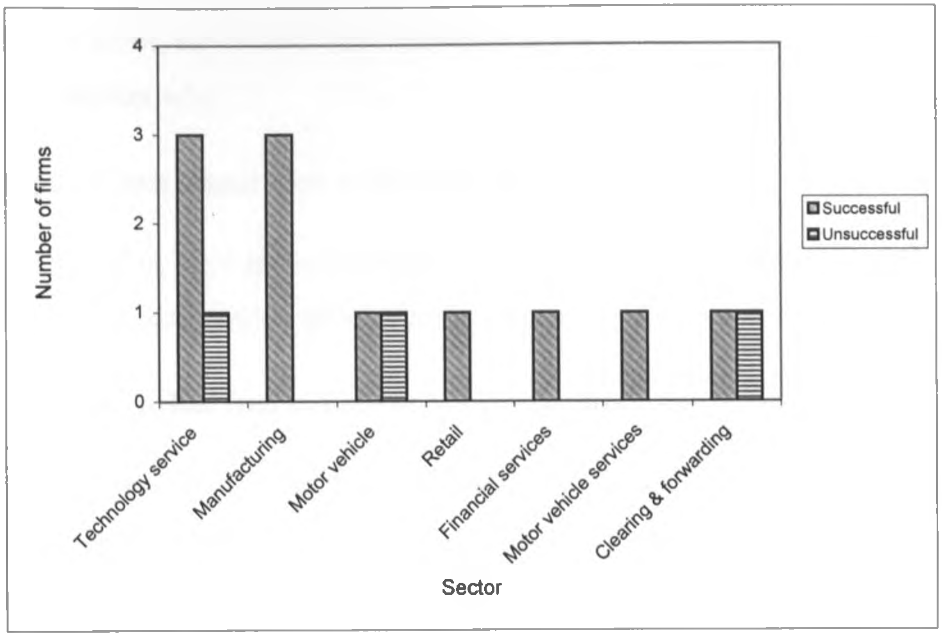
Table 4.3.1 – 1: Coded Enterprise Data for All Successful Companies

FIRM NAME	LOCAL	DONOR	GOVT	FOREIGN	PUBLIC	OTHER
Ent 01	100	0	0	0	0	0
Ent 02	100	0	0	0	0	0
Ent 03	100	0	0	0	0	0
Ent 04	75	0	0	25	0	0
Ent 05	100	0	0	0	0	0
Ent 06	25	0	0	75	0	0
Ent 07	20	0	0	80	0	0
Ent 08	0	0	0	100	0	0
Ent 09	100	0	0	0	0	0
Ent 10	70	0	0	30	0	0
Ent 11	100	0	0	0	0	0
Ent 12	65	0	0	0	35	0
Ent 13	40	0	0	60	0	0
Ent 14	60	0	0	40	0	0

Source: Research Data

Though the responses from unsuccessful companies were few, they were mainly from the technology, motor vehicle (manufacturing) and cleaning (services) sectors.

Table 4.3.1 – 2: Breakdown of Firms by Industry Sector



Source: Research Data

4.3.2 Transactions financed by stage of financing

Data collection from the firms themselves shows that, of the total 14 firms, one is in the restart stage. This contradicts the data presented in section 4.2.4, but further validation of the respondent's data revealed that this particular firm was denied financing by one of the respondents but later got Venture capital financing from abroad. This is an interesting case as it indicates that the risk attitudes of the Venture capital firms operating in Kenya may differ from those operating outside Kenya that would give rise to a situation where a transaction is rejected locally only to be funded by another external financier. This is not conclusive, because another theory would be that the investor repackaged the application based on the feedback from the first application to the local investors. This is an area suggested for further research.

4.3.3 Presence of other financier at time of VC funding

Of the total 14 firms, eleven had other financing in place, which collaborates the data presented in section 4.2.7

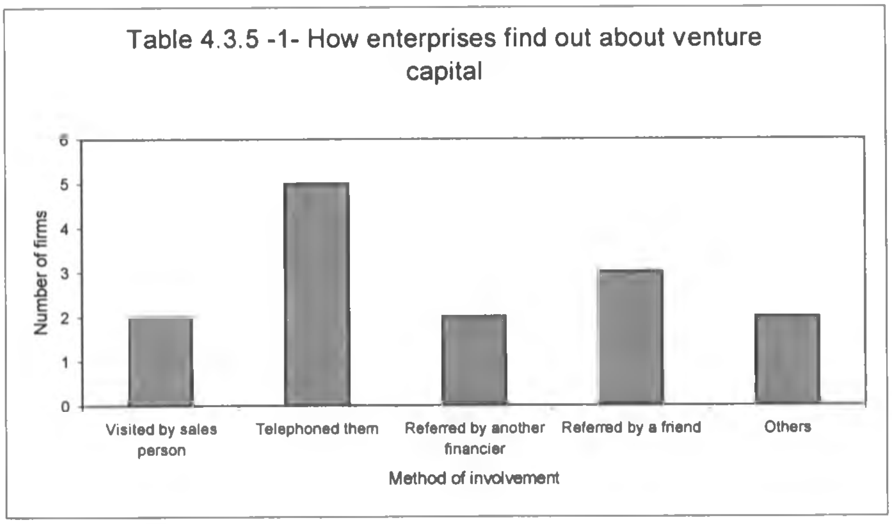
4.3.4 Type of Instrument used in the transactions

Of the total 14 firms, eight had convertible debt as the financing instrument while two had a debt/ equity combination which closely collates the data presented section 4.2.8.

4.3.5 How enterprises find out about Venture capital

Table 4.3.5 – 1 shows that of the total 14 firms, five were telephoned by the venture capital firm, while three were referred by a friend or business associate. The cases of sales persons visiting and referenced from other financiers were less.

Table 4.3.5 – 1: Method of Contact with Financing Company

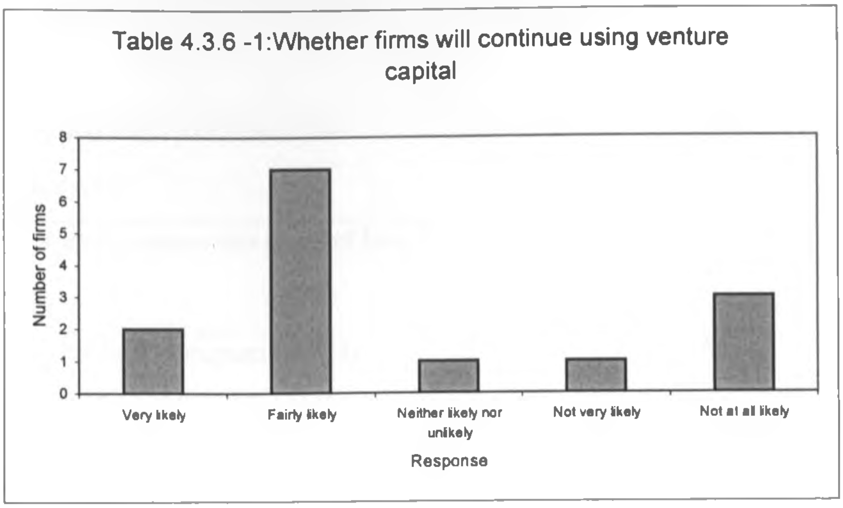


Source: Research Data

4.3.6 Likelihood of using Venture capital in the future

Table 4.3.6 – 1 shows that of the total 14 firms, 71.4% were likely to use Venture capital in the future, which indicates that Venture capital is acceptable and useful to the enterprises in Kenya.

Table 4.3.6 – 1: Likelihood of Firms to Continue Using Venture Capital

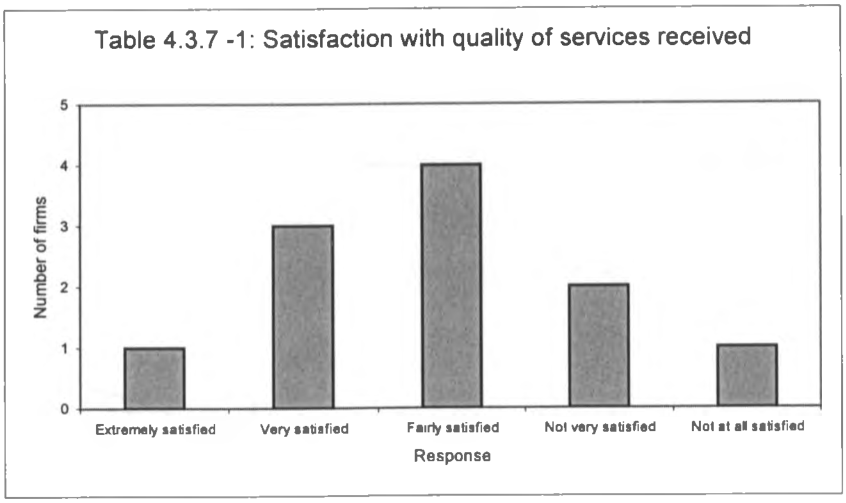


Source: Research Data

4.3.7 How satisfied enterprises are with the services

Table 4.3.7 – 1 shows that of the total 14 firms, 72.7% were satisfied with the services of the Venture capital firms after disbursement of the funds.

Table 4.3.7 –1: Satisfaction Levels of Existing Users of Venture Capital



Source: Research Data

4.3.8 Reasons for Choosing Venture capital as a source of funding

The questionnaire provided an unstructured section where the enterprises could indicate the reasons for choosing venture capital financing. The responses were coded as indicated in Appendix B. Table 4.3.8 –1 shows the results of this section.

Table 4.3.8 – 1: Reasons for Choosing Venture Capital Financing

Code No	Factor	Frequency	Percentage	Comments
1	Needed cash to expand the business	3	21.5%	Significant
2	Wanted to enter the market in a big way	1	7%	
3	VC looked cheap and easily available	3	21.5%	Significant
4	VC seemed to fit with our plans	1	7%	Irrelevant
5	VC represented minimal risk	1	7%	Irrelevant
6	We had a relationship with the financier	2	14%	
7	Had an existing bank loan and needed more financing	2	14%	
8	Business had stagnated	1	7%	Irrelevant

Source: research data

4.3.9 Problems encountered during application for Venture Capital financing

The questionnaire provided an unstructured section where the enterprises could indicate the problems encountered during the application for venture capital financing. The responses were coded as indicated in Appendix B. Table 4.3.9 –1 shows the results of this section.

Table 4.3.9 – 1: Problems Encountered During Application for Financing

Code No	Factor	Frequency	Percentage	Comments
1	Too many legal procedures	2	14.3 %	
2	The process took too long	5	35.7 %	Significant
3	Too many details required in due diligence process	3	21.5%	Significant
4	The process is very expensive	1	7 %	Not Significant
5	Lack of trust and arrogant attitude by investors	1	7 %	Not significant
6	None in particular	1	7 %	Not Significant

Source: research data

4.3.10 Problems encountered after disbursement of Venture Capital financing

The questionnaire provided an unstructured section where the enterprises could indicate the problems encountered after disbursement of venture capital financing. The responses were coded as indicated in Appendix B. Table 4.3.10 –1 shows the results of this section.

Table 4.3.10–1: Problems Encountered after Disbursement of Financing

Code No	Factor	Frequency	Percentage	Comments
1	Too many demands from the financier for data and reports	3	27.3 %	Significant
2	Too much interference in the management of the firm	2	18.2 %	Not Significant
3	Too much money on consultancy and professional services	1	9.1 %	Not Significant
4	None in particular	5	45.5%	Significant

Source: research data

4.3.11 Factors hindering the growth of the Venture capital industry

The questionnaire provided an unstructured section where the enterprises could indicate the factors, which in their opinion are hindering the growth of the venture capital industry. The responses were coded as indicated in Appendix B. Table 4.3.11 –1 shows the results of this section.

Table 4.3.11–1: Factors Hindering the Growth of the Venture Capital Industry

Code	Factor	Frequency	Percentage	Comments
1	Lack of information on Venture Capital	5	35.7 %	Significant
2	Process takes too long	3	21.4%	Significant
3	Lack of trust on both sides and poor legal system in Kenya	4	28.6 %	Significant
4	Poor state of the economy	1	7.1 %	Not Significant
5	Poor management structures and talent in local companies	1	7.1 %	Not Significant

Source: research data

4.4 Variable factor Analysis

Variable factor analysis was carried out to determine the factors that are considered significant in the consideration of financing proposal and to determine if there is a relationship between various venture capital companies and the organisations that they fund.

Various factors were investigated, and the respondents were asked to list what in their opinion were the factors that were considered important when evaluating a request for funding for a certain venture capital transaction. This was done using 30 predefined criteria as shown in appendix 1, where the respondents were requested to rank the factors in importance using Likert scale methodology. The results of this section of the questionnaire are shown below in table 4.4.1.

The data brought out a number of significant factors including the legal enforceability of the financing contract, the profitability prospects, the presence of a technical partner, possibly to reduce risk, and a written business plan with financial projections. The profile of the chief executive and top management also emerged as an importance consideration in venture capital financing.

In summary, VC companies prefer companies in general that have the following:-

1. Prospect of profitability within a short time.
2. A well articulated and written business plan
3. The presence of technical expertise and in particular a technical partner
4. A high profile chief executive and a strong management team.
5. A high projected market share in the market within the business plan
6. A clearly defined exit plan for the VC financier.

In addition VC financiers require a financial and legal environment where there is proper legal recourse in case the financing contract is contravened.

A more detailed analysis of the significant factors is presented in section 4.4.1.

Table 4.4.1– 1: Analysis of Importance of Factors Considered by VC Financiers

Code	Description	Factor	Position	Comments
1	Enforceability of financing contract	Rank	1	Significant
2	Prospects of profitability within three years	Rank	2	Significant
3	Presence of a technical partner	Rank	2	Significant
4	Written Business Plan	Rank	3	Significant
5	Profile of chief executive	Rank	3	Significant
6	Projected market share in business plan	Rank	4	Significant
7	Profile of top managers	Rank	4	Significant
8	Written financial plan and projections	Rank	4	Significant
9	Clearly defined exit plan for investor	Rank	4	Significant
10	Track record of success in the industry	Rank	5	Somewhat significant
11	Market conditions at time of evaluation	Rank	6	Somewhat significant
12	Industry growth prospects	Rank	6	Somewhat significant
13	Market share at time of evaluation	Rank	7	Somewhat significant
14	Profitability of the firm in the past	Rank	8	Somewhat significant
15	Technology of products or service	Rank	9	Somewhat significant
16	Innovation in the products or service	Rank	9	Somewhat significant
17	Board composition of the company	Rank	10	Somewhat significant
18	Health of the target market	Rank	11	Not Significant
19	Written risk assessment document	Rank	12	Not Significant
20	Presence of oligopoly in the industry	Rank	13	Not Significant
21	Willingness of the founder to exit in future	Rank	14	Not Significant
22	Retaining of a transaction advisor/. broker	Rank	15	Not Significant
23	Presence of a technology patent for products	Rank	15	Not Significant

Source: research data

4.4.1 Detailed Factor Analysis

Table 4.4.1 summarises all factors together with their level of significance as follows:-

4.4.1.1 Enforceability of financing contract

This refers to the ability of the VC investor to enforce the law of the contract within the legal system prevailing in the country. Investors felt that this is one of the most important factors that significantly affect the risk of the transaction.

4.4.1.2 Prospects of profitability within three years

The VC financiers were quite keen to know if the enterprise will be profitable within three years. Indeed the trend seems to be to move away from the start-up enterprises where the certainty of future returns is unknown to the growth phase enterprises where it is easier to predict future returns.

4.4.1.3 Presence of a technical partner

VC financiers felt that it is important for the target enterprise to have a technical partner present in the enterprise. This can be seen as an effort to reduce the risk of the enterprise failing due to technical problems.

4.4.1.4 Written Business Plan

The presence of a written business plan was considered significant and those companies who had a well articulated business plan in writing had a significant advantage over their counterparts without a proper written business plan at the time of application.

4.4.1.5 Profile of chief executive

The chief executive's profile featured as a significant factor when evaluating the viability of a VC application. The financiers felt that the enterprises needed the right person at the top to effect the plans and provide a return for the Venture Capitalist. Therefore particular emphasis is put in the profile of the chief executive. This worked against some local enterprises that are family owned and operated.

4.4.1.6 Projected market share in business plan

The majority of Venture Capital companies indicated that they were interested in analysing the future market share post-funding. Comments included that fact that market leaders are able to influence the industry and more quickly recover from adverse market conditions.

4.4.1.7 Profile of top managers

VC companies are interested in the profile of the senior managers of the enterprise at the time of funding and indeed most stated that this is one of the due-diligence exercises that the Venture Capital companies usually carry out.

4.4.1.8 Clearly defined exit plan for investor

VC companies in general are very concerned with the exit plan for their investments and rate this as a significant factor in making the funding decision. Enterprises with a well-defined and workable exit plan in general ranked higher than those without one. In some cases difficulty arose due to the weak regulatory environment in the country.

4.4.1.9 Other Factors considered somewhat important

Other factors that seem significant in other countries were not seen as very important in Kenya from the study. These include the track record of past successes of the enterprise, the market conditions at the time of evaluation, the industry growth prospects, the enterprise's market share at the time of evaluation, the profitability of the firm in the past, the technology of the products or services, the innovation of products and the composition of the board of directors.

4.4.1.10 Other Factors considered non- important

A number of surveyed factors that seem significant in other countries were not seen as important in Kenya from the study. These include the health of the target market, a written risk assessment report by an expert analyst, the presence of an oligopoly in the industry, the willingness of the founders to exit in the future, the retention of a transaction advisor or broker.

Chapter 5: SUMMARY OF FINDINGS AND CONCLUSIONS, RECOMMENDATIONS, LIMITATIONS OF THE STUDY AND SUGGESTIONS FOR FURTHER RESEARCH

5.1 Summary of Findings and Conclusions

The literature review reveals that Venture capitalists are full-time professional investors that invest their partnership funds. Venture capitalists tend to follow closely the technology and market developments in their area of expertise to stay in the deal flow and to make an informed investment decision. Before making an investment they carefully scrutinize the founders and their business concepts. When making the investment, they bring financial expertise to structuring the deal and setting appropriate incentive and compensation systems (Sahlman, 1988). Enterprises backed by venture capitalists are typically characterized by great uncertainty and high failure risk (Lerner and Gompers, 1999). As such, they find it difficult to obtain financing from traditional sources, such as banks.

These are the conditions prevailing in Venture capital markets in the developed economies and our research sought to find out if the conditions remain the same or differ in Kenya, given that Kenya has a relatively underdeveloped financial market. The findings from the research are varied as detailed below.

5.1.1 Viability of the Industry in Kenya

First it was noted that Venture capital financing is an acceptable and useful financing method in Kenya and that the services given by the Venture capital firms are acceptable to the recipients. This indicates that fundamentally there is nothing wrong with the pricing of the financial packages or the terms under which they are offered. However, it was noted that despite these findings, the incidences of Venture capital financing in Kenya were low compared to those in other parts of the world such as the Silicon Valley in the United States where there are thousands of Venture capital firms within one state. In Kenya, there are less than twenty active Venture capital firms.

5.1.2 Risk/ Return Attitudes within the Industry

The data analysed indicate that Venture Capital firms prefer manufacturing and financial sectors and enterprises, and those firms that are more than three years old. Furthermore, the presence of another financier is a factor in considering the funding request. This leads to the conclusion that the Venture Capital industry may not have the capacity to carry out it's own risk assessment and therefore tends to rely on the banking sector to provide 'collaborative' qualification of the enterprises' risk.

We can conclude that the Venture Capital industry in Kenya is risk averse. This is in contrast with the Venture Capital industries in other parts of the world, which recognise that they have to deal with enterprises which are risky but which promise superior returns. As an example, the majority of Venture capital firms prefer to use a convertible debt or a convertible debt/ equity combination to fund the enterprises. This indicates that Venture Capitalists in Kenya are willing to forgo some of the superior returns promised by the enterprise by accepting a lower return instrument such as debt as opposed to equity which has a higher potential return.

This conclusion is further strengthened by the findings that Venture Capitalists in Kenya prefer enterprises in the profitable or expansion stages of growth. When a company reaches this stage, it is in most cases beyond the exponential growth stage that follows the startup stage. Therefore, by investing in this stage of an enterprise, Venture Capitalists are forgoing the opportunity of gaining above average returns on equity. This trade-off suggests that the Venture capitalists view the risk of entering the enterprise at the exponential growth stage as greater than the expected returns, which strengthens the conclusion that they are risk averse in general.

5.1.3 Information Efficiency

Enterprises are generally not aware of the specific services and financial tools used by the Venture Capital industry. There is very little public information on the Venture Capital industry in Kenya. Hardly will one find a publication or a register giving information on the industry or the industry players.

The study shows that the information on Venture capital was either passed by word of mouth or through selective telephone calls from the Venture capital financier to the enterprise. This indicates that the flow of information is inefficient in the Venture Capital industry. This has been identified as one of the key factors affecting the industry in Kenya as a lot of eligible enterprises often seek funds elsewhere due to lack of adequate Venture Capital information.

5.1.4 Industry Structure

The study revealed that the Venture Capital industry in Kenya is not really an industry but rather it can be viewed as a sub-sector of the financial services industry. This study was not able to identify any government office that deals with the Venture Capital industry except the registrar of companies meaning there is no authority that can regulate or promote the activities of the venture capital industry in Kenya. This is in sharp contrast with the developed world where governments actively promote the industry.

5.1.5 Growth Stage of Target Enterprises

It appears from the data that the firms seeking funds at the expansion stage are the most important part of the Venture capital industry followed by those in the profitable stage. Transactions involving startups is not significant at all and yet in the developed economies, this is the single largest recipient of venture capital financing. Venture capital firms also appear to adopt a risk averse attitude by not investing in firms in the restart stage given that these are sometimes undervalued assets which can be made productive by replacing management and eliminating agency conflicts. The conclusion from these findings is that there may be a deficiency of tools and expertise to value start-ups and companies in the restart stage.

5.1.6 Target Enterprise Profile

The data shows that the Venture capital industry favours firms with a large investor group. However, the data also indicates that there is a shift in the latter years to the small investor group and the family owned businesses simply because even though the transactions increased in general over the ten year period under study, there was no increase in the large investor group category. This finding is consistent with the increasing sophistication of family owned businesses in Kenya, which are now major industries in the country, with some family owned businesses surpassing multinationals in turnover and profitability. The Venture capital industry has identified these firms as now eligible for funding.

5.1.7 Financing Instruments

The data indicates that the debt/ equity combination instrument dominates the industry. A closer look at the data shows that it only does so by virtue of the fact that the particular Venture capital firm that favours this instrument is predominant in the market. There is a clear correlation between the number of transactions concluded by a particular firm and the instrument used by that particular firm. In other words, each Venture capital firm in the industry clearly seems to favour a particular set of instruments, which may be explained by the competencies that the particular firm possesses. Therefore we can conclude that the particular competencies within certain Venture capital firms dictate the instruments used meaning that the recipient enterprises normally do not have a say in the financing instrument. From the study we conclude that even the recipient enterprises lack a deep understanding of the various tools and their risk/ return characteristics.

5.1.8 Factors leading to successful funding

From the study six factors were identified as significant to the industry and these highlighted in section 4.4. The conclusion from these factors is that the Venture capital industry in Kenya operate within the same principles as those of the developed world leading this study to the conclusion that if the various limitations highlighted above can be overcome, then we are likely to see a venture capital industry as vibrant as that found in the developed world.

In the meantime, and until this happens, this study predicts that the industry will be characterized by a clustering of Venture capital industry players around certain industries, where the risk and returns can be accurately forecasted and certain firms who have a predefined profile that reduces the risk of financing.

5.2 Limitations of the Study

This study was aimed at investigating the factors affecting the venture capital industry in Kenya. It is felt that the results from the data collected and analysed are relatively accurate and do provide a list of factors that can be used by the various identified groups to further develop the industry in Kenya. However, the author faced a number of challenges in the conducting the study.

5.2.1 Definition of the industry

The first limitation was in the definition of the Venture capital industry. The academic definition did not seem familiar to the respondents and therefore it was difficult to clearly identify all the industry players. The problem arose due to the absence of a central registration or accreditation board for the Venture capital industry similar to the Kenya Bankers Association, the Association of Kenya Insurers or the Institute of Certified Public Accountants. A search at the capital markets authority revealed that the listing available was outdated, while the Nairobi stock exchange does not maintain a comprehensive register of Venture capital firms.

Due to this, the data collection was done by category at the Registrar of companies. The results of this search were considered sufficient for this study, but did not cover all the possible firms due to the loose classification method used by the registrar. In addition, there were a number of firms, as highlighted in section 4.2 which are registered as Venture capital firms but do not conduct any Venture capital business.

5.2.2 Structure of the Questionnaire

The questionnaires were designed to obtain both quantitative data as well as qualitative data from the respondents. The questionnaire had number of shortcomings as follows:-

Complexity
Almost all respondents indicated that the questionnaire was complex and not all questions were understood. Indeed none of the respondents was able to complete the questionnaire alone and face-to-face or telephonic interviews had to be conducted to fill in the

questionnaires. The use of technical terms such as 'seed capital' and start-up" which did not appear to have substitute terminology were not understandable by some of the to the respondents and this meant that the research took longer as more time was spent clarifying terminology.

Monetary Information

The Questionnaires demanded some quantitative information which most respondents felt was confidential to the organisation and sensitive. This was especially the case with the Venture capital firms, which resulted in a response rate of only 55%.

Historical Information

The questionnaire requested for detailed historical information. This was especially in the trends of transactions by period and by sector. This information was not readily available from the respondents and it took a number of persistent efforts to get this information.

5.2.3 Cluster Analysis

The research intended to use correlation analysis to investigate if certain venture capital firms prefer to fund firms with certain characteristics such as ownership structure, age, industry sector and so on, but the number of enterprises clustered around a particular venture capital company were not in sufficient numbers, and moreover the numbers were not consistent to use tools such as chi square analysis.

This was felt to be a significant limitation of this study because the author strongly believes that the relationship that would arise from this analysis would reveal important information on the factors affecting the Venture capital industry in Kenya.

5.3 Recommendations

The situation currently prevailing in the venture capital industry is similar to that found in the micro finance sector five years in the early 1990's. There should therefore be initiated a debate in the academic and financial circles as to the merits and demerits of structuring and regulating the Venture capital industry. In addition, there needs to be a government department to specifically deal with the Venture capital industry in Kenya.

5.4 Suggestions For Further Research

The author suggest that further research be carried out in the following areas:

5.4.1 The role of the government in the Venture capital industry

This will bring out the activities that government authorities in other developed countries undertake to foster the development of the industry, to regulate it and to ensure equitable distribution of funds.

5.4.2 Information efficiency of the Venture capital Market

The other major area requiring further research is the impact of market efficiency in the development of the venture capital industry in order to bring out the market structure and the information flows required to foster the growth of the industry in Kenya.

5.4.3 Case studies of various Venture capital companies

Case studies should be conducted of the major venture capital firms and their beneficiaries to better understand the factors that lead to the lending decision in order to disseminate this information to the public so that more firms can make themselves eligible for venture capital financing. These insight will be useful for the government, academics and the Venture Capital firms themselves in future transactions.

5.4.4 Risk Analysis of the various Venture Capital instruments

A study can be conducted on the risk/ return relationship for the various instruments used by Venture capital firms in disbursing financing in order to better understand if the instruments are suitable for the local market given that there is generally a high risk of failure of infant enterprises who are the primary recipients of Venture Capital funds. It is the authors believe that the introduction of more flexible instruments can stimulate the growth of the industry in Kenya.

REFERENCES

- Admati, A and Pfleiderer P (1991), "Robust Financing, Contracting and the Role of the Venture Capitalist" –Journal of Financial Economics, Issue 4.
- Abuodha C, (1996), "Small Scale Industrial Financing in Kenya. A Case for Venture Capital" Longhorn Kenya Publishers.
- Bergman D. and Ulrich H, (2000), "Financing Innovation, Learning and Stopping" Journal of Financial Ecomonics.
- Bergman D. and Hege U, (1991), "Venture Capital Financing, Moral Hazard and Learning" – Journal of Banking and Finance, Vol 22.
- Cornelli F, (1999), "Stage Financing and the Role of Convertible Securities" London Business School press.
- Fortune Magazine, (May 2000)
- Gompers P, (1995), "Optimal Investment, Monitoring and the Staging of Venture Capital" – Journal of Finance, Issue 50.
- Gorman M and Sahlman A, (1989), "What do Venture Capitalists Do" – Journal of Business Venturing, Vol 4.
- Greenwald B, Stiglitz J, Weiss A, (1984), "Information Imperfections and Macro Economic Fluctuations" American Economic Review Papers No. 74.
- Hellman T and Puri M, (1999), "How Venture Capital Professionalises a Firm" GSB Research Paper.
- Hellman T, (1998), "The Allocation of Control Rights in Venture Capital Contracts" Rand Journal of Economics.
- Lerner J, (1995), "Venture Capitalists and the Oversight of Privately-held Firms" – Journal of Finance, Vol 50.
- Maier J. and Walker D, (1987), "The Role of Venture Capital in Financing Small Business" – Journal of business venturing.
- Myers S. and N. Majluf, (1984), "Corporate Financing and Investment Decisions When Firms Have Information that Investors Don't Have" – Journal of Financial Economics, Issue 13.

- Ondiege C.(1993), "Empirical Study on Sources of Capital for SME's" MBA Unpublished project paper.
- Pandey I. M, (1996), " Financial Management" 7th Edition, Ram Printograph, Delhi
- Pratt S.E, (1987), "Introduction to the Venture Capital Industry" – Guide to venture capital sources, 10th Edition,
- PriceWaterHouseCoopers, Global Moneytree Report, (2001)
- Sahlman A. (1988). " Aspects of Financial Contracting in Venture Capital" – Journal of Applied Corporate Finance, Vol 1.
- Verhuel I and Thuric R, (2000), "Startup Capital" Research in Management Series.
- The Red Herring (Sept 2000), The Red Herring Press NY,
- The Economist, (June 1987)

Appendix A – Questionnaires Used to Collect Primary Data

QUESTIONNAIRE

SECTION I: VENTURE CAPITAL COMPANY DATA

Name of the firm...
Year when the firm was established...
Company Ownership
Local [ ] % Donor [ ] % Government [ ] %
Foreign [ ] % Public [ ] % Other [ ] % Detailed.....................
Local/ Foreign Affiliation..

SECTION II: GENERAL FINANCING INFORMATION
Please give the number of transactions financed in the following sectors;

Category	1998-2001		1994-1997		1990-1993	
	Number Financed	**%age of total**	**Number Financed**	**%age of total**	**Number Financed**	**%age of total**
Manufacturing						
Technology						
Food and Beverages						
Retail Business						
Financial Services						
Medical Services						
Other- please specify (......................)						

Age of Companies financed: How many companies in each category?

Legal age of Company	1998-2001		1994-1997		1990-1993	
Less than 3 years	Number Financed	%age of total	Number Financed	%age of total	Number Financed	%age of total
3 – 6 years						
7- 10 years						
Over ten years						

Stage of Companies financed: How many companies in each category?

Stage of Financing	1998-2001		1994-1997		1990-1993	
	Number Financed	%age of total	Number Financed	%age of total	Number Financed	%age of total
New Start-up						
Early Stage						
Expansion stage						
Profitable stage						
Restart Stage						
Other. Please specify						

Key:

Start-up: *Business is in purely conceptual stage and product/ service development has not started.*
Early-stage: *Enterprise currently developing product but has not started realizing revenue.*
Expansion: *At least one product/ service is being delivered and revenues realised.*
Profitable: *The company is generating profits from sale of products or services.*
Restart: *A new financing round causing the dilution of existing investors due to a change in business or strategy.*

How many transactions represented the following rounds of financing?

Stage of Financing	1998-2001		1994-1997		1990-1993	
	Number Financed	%age of total	Number Financed	%age of total	Number Financed	%age of total
Seed Financing						
First round financing						
Second round financing						
Pre-listing financing						
Restart Financing						
Other. Please specify						

Key:

***Seed Financing**: Initial round of financing to evaluate the soundness of the startup enterprise..*

***First Round**: This is the first main venture capital transaction to the enterprise.*

***Second Round**: This is the subsequent major round of financing.*

***Mezzanine**: This is the venture financing prior to launching a public offering.*

***Restart**: This is the new financing round causing the dilution of existing investors due to a change in business or strategy.*

What is the distribution of the ownership structure of the company before financing?

Stage of Financing	1998-2001		1994-1997		1990-1993	
	Number Financed	**%age of total**	**Number Financed**	**%age of total**	**Number Financed**	**%age of total**
Individual/ Family owned						
Individual with technical partner						
Small investor group (less than five investors)						
Large investor group (more than five investors)						
Multinational						
Other. Please specify						

What is the form of financial instrument used for these firms?

Financing Instrument	1998-2001		1994-1997		1990-1993	
	Number Financed	**%age of total**	**Number Financed**	**%age of total**	**Number Financed**	**%age of total**
Straight debt						
Convertible Debt						
Straight equity						
Debt/ Equity combination						
Convertible debt/ equity combination						
Other. Please specify (......................)						

SECTION III: VARIABLE FACTOR INFORMATION

Please grade the importance of the following variable factors on evaluating a funding proposal. Please assign 1 to the least important and 5 to the most important.

Very Important Somewhat Important Important Less important Not important
5........................4........................3...............2................1

Item	**Factor**	**Importance level**	**Comments**
1	Legal composition of company		
2	Industry Sector of the Company		
3	Board Composition of the company		
4	Technology of the products or service		

5	Market conditions at the time of evaluation		
6	Written business plan		
7	Coherence and consistency of business plan		
8	Written financial plan and projections		
9	Retaining of a financial advisor		
10	Retaining of a transaction broker		
11	Ownership structure of the company		
12	Presence of a technical partner		
13	First mover advantage in the industry		
14	Market share at time of evaluation		
15	Projected market share in business plan		
16	Profile of the Chief Executive Officer		
17	Profile of top managers		
18	Track record of success in the industry		
19	Presence of an oligopoly in the industry		
20	Innovation in the products or service		
21	Industry growth prospects		
22	Presence of patents for new technology		
23	Presence of other investors in enterprise		
24	Profitability of the venture in the past		
25	Prospects of profitability within three years		
26	Enforceability of financing contract		
27	Written risk assessment document		
28	Health of the target market		
29	Clearly defined exit strategy		
30	Willingness of founder to exit in future		
	Other factors (Please specify)		
1			
2			
3			
4			
5			

What challenges do you face when processing a funding application?

Item	Challenge	Severity (High, Medium, Low)
1		
2		
3		
4		
5		

What additional information or comments would you have on this subject?

____

____

____

____

QUESTIONNAIRE FOR COMPANIES WITH SUCCESSFUL APPLICATIONS

SECTION I: ENTERPRISE COMPANY DATA

Name of the firm...
Year when the firm was established..
Company Ownership
Local [ ] % Donor [ ] % Government [ ] %
Foreign [ ] % Public [ ] % Other [ ] % Detailed.....................
Local/ Foreign Affiliation...

SECTION II: GENERAL FINANCING INFORMATION
Industry Sector ....
Date of Venture financing disbursement..
Type of enterprise
Individual [ ] Family [ ] Investor group [ ] Diverse ownership [ ] Other ....
Stage of enterprise at time of financing
Start-up [ ] Early Stage [ ] Expansion [ ] Profitable [ ] restart [ ]
Key:
Start-up: Business is in purely conceptual stage and product/ service development has not started.
Early-stage: Enterprise currently developing product but has not started realizing revenue.
Expansion: At least one product/ service is being delivered and revenues realised.
Profitable: The company is generating profits from sale of products or services.
Restart: A new financing round causing the dilution of existing investors due to a change in business or strategy.

Type of financing granted
Seed [ ] Early Stage [ ] First round [ ] Second round [ ] pre-listing [ ] restart [ ]
Key:
Seed Financing: Initial round of financing to evaluate the soundness of the startup enterprise..
First Round: This is the first main venture capital transaction to the enterprise.
Second Round: This is the subsequent major round of financing.
Pre-listing: This is the venture financing prior to launching a public offering.
Restart: This is the new financing round causing the dilution of existing investors due to a change in business or strategy.

Did the company have any other financing at the time of disbursement of venture capital funds? Yes [ ] No [ ] If yes: What proportion after disbursement [ ]%
Type of financial instrument used
Debt [ ]% Equity [ ]% Debt/ Equity [ ]%Convertible debt [ ]% Other.........%

SECTION III: VARIABLE FACTOR INFORMATION
1. How long have you been a venture capital customer? (Please tick one)

Less than three years	2	
Three to six years............	3	

Seven to ten years.................. 4 [ ]
Over ten years..................... 5 [ ]

2. Which of the following best describes how your Company actually first became involved with venture capital.(Please tick one)

A sales person visited you 1 [ ]
You telephoned them ... 2 [ ]
Trade show or event...... 3 [ ]
Referred by another financier 4 [ ]
Referred by a friend 5 [ ]
Others 6 [ ]
(Specify)..................

3. How likely are you to still be using venture capital 5 years from today? (Please tick one)

Very likely	1	☐
Fairly likely	2	☐
Neither likely nor unlikely	3	☐
Not very likely	4	☐
Not at all likely	5	☐
Don't know	6	☐

4. Would you recommend a colleague to use Venture capital? (Please tick one)

Very likely	1	☐
Fairly likely	2	☐
Neither likely nor unlikely	4	☐
Not very likely	5	☐
Not at all likely	6	☐
Don't know	3	☐

5.Overall, how satisfied are you with the quality of the financing Services you receive from the venture capital firm? (Please tick one)

Extremely satisfied	1	☐
Very satisfied	2	☐
Fairly satisfied	3	☐
Neither satisfied nor dissatisfied	4	☐
Not very satisfied	5	☐
Not at all satisfied	6	☐
Don't know	7	☐

7. Why did you choose Venture capital as a source of financing?

1.

2.

3.

4.

8. What problems did you encounter during the application for venture capital?

1.

2.

3.

4.

9. What problems have you encountered after disbursement of the venture capital?

1. 2. 3. 4.

10. What factors do you think are hindering the growth of the venture capital industry in Kenya?

1. 2. 3. 4.

QUESTIONNAIRE FOR FIRMS WITH UNSUCCESSFUL APPLICATIONS

SECTION I: ENTERPRISE COMPANY DATA

Name of the firm...
Year when the firm was established...
Company Ownership
Local [ ] % Donor [ ] % Government [ ] %
Foreign [ ] % Public [ ] % Other [ ] % Detaild.......................
Local/ Foreign Affiliation...

SECTION II: GENERAL FINANCING INFORMATION
Industry Sector ....
Date of Venture financing application..
Type of enterprise
Individual [ ] Family [ ] Investor group [ ] Diverse ownership [ ] Other ....
Stage of enterprise at time of application
Start-up [ ] Early Stage [ ] Expansion [ ] Profitable [ ] restart [ ]
<u>Key:</u>
Start-up: Business is in purely conceptual stage and product/ service development has not started.
Early-stage: Enterprise currently developing product but has not started realizing revenue.
Expansion: At least one product/ service is being delivered and revenues realised.
Profitable: The company is generating profits from sale of products or services.
Restart: A new financing round causing the dilution of existing investors due to a change in business or strategy.

Type of financing applied for.
Seed [ ] Early Stage [ ] First round [ ] Second round [ ] pre-listing [ ] restart [ ]
<u>Key:</u>
Seed Financing: Initial round of financing to evaluate the soundness of the startup enterprise..
First Round: This is the first main venture capital transaction to the enterprise.
Second Round: This is the subsequent major round of financing.
Pre-listing: This is the venture financing prior to launching a public offering.
Restart: This is the new financing round causing the dilution of existing investors due to a change in business or strategy.

Did the company have any other financing at the time of application for venture capital funds? Yes [ ] No [ ] If yes: What proportion after disbursement [ ]%

SECTION III: VARIABLE FACTOR INFORMATION
1. How long ago did you apply for venture capital funding? (Please tick one)

Less than three years	2	
Three to six years............	3	

7. Why did you choose Venture capital as a source of financing at the time of application?

1.
2.
3.
4.

8. What problems did you encounter during the application for venture capital?

1.
2.
3.
4.

9. What factor do you think led to the denial of the venture capital financing?

1.
2.
3.
4.

10. What factors do you think are hindering the growth of the venture capital industry in Kenya?

1.
2.
3.
4.

Appendix B

List of Venture Capital Companies identified and interviewed

No	Venture Capital Company	Comments
1	Loita Capital Partners	Interviewed
2	Bridges Capital	Interviewed
3	Investment and Commercial Development Corporation (ICDCi)	Interviewed
4	First Africa Capital	Interviewed
5	East African Development Bank (EABD)	Interviewed
6	Industrial Development Bank (IDB)	Too Busy
7	Kenya Capital Partners (KCP)	Interviewed
8	Investment Promotion Services (IPS)	Not Willing
9	Department for International Development (DFID)	Not Willing
10	International Finance Corporation (IFC)	No Appointment
11	Preferential Trade Area (PTA) Bank	No Appointment
12	Development Bank of Kenya (DBK)	No Appointment

Source: Research Data

List of Target Enterprises identified and interviewed

No	Venture Capital Company	Successful or unsuccessful	Comments
1	3 Mice Interactive	Successful	Interviewed
2	D. T. Dobie and Company	Successful	Interviewed
3	Simba Technology	Successful	Interviewed
4	Software Distributors	Successful	Interviewed
5	Mastermind Tobacco	Successful	Interviewed
6	Triple A credit	Successful	Interviewed
7	KWIK Fit	Successful	Interviewed
8	First Computers	Successful	Interviewed
9	Athi River Mining	Successful	Interviewed
10	African Cargo Handling	Successful	Interviewed
11	Ansper Beverages	Successful	Interviewed
12	Interfreight Ltd	Unsuccessful	Interviewed
13	Lantech Ltd	Unsuccessful	Interviewed
14	Mashariki Motors	Unsuccessful	Interviewed

Source: Research Data

Appendix C – Coding of Unstructured Sections of Data

CODE	CHOICE	PROB1	PROB2	FACTORS
1	Cheap and easily available	Arrangement of paperwork and instruments	None	Lack of trust on both sides
1	Family owned bank			Kenyan's mentallity of wanting to control
1				Lack of information on venture capital
2	Seemed to fit well with our plan	Too much legal procedures	Lost interest after the process took too long	Process too long
2	Needed cash to expand the business	The process took too long		Unrealistic demands from financiers
3	Needed cash to expand the business	Arrogant attitude by financiers	No trust between the two parties	Financiers not understanding the need of local investors
3		Lack of trust by financiers	Financier wanted to take over the business	Europeans do not trust Africans with their money
4	Needed cash to expand the business	Too much details required	Lack of trust by the financier	Poor record keeping by local companies
4	Had bank loans that were expensive		Too much demands from the financier	Risk attitude by financiers
4			Unrealistic expectations from the business	
5	Cheap and easily available	Too much details required	Too much interference	Lack of information on venture capital
5	Seemed to fit well with our plan		Investors did not understand the business	Past experience poor
5			Too much spent on consultancy	
6	Business had stagnated	The process took too long	None	Local investors not willing to give up part of the company
6	Needed cash to expand the business	Process was expensive for the company		Foreign financiers do not understand the local environment
6				The process paints a negative picture of Kenya's economy
7	Wanted to enter the market in a big way	None	None	Not easy to win the confidence of investors

7				Lack of trust on both sides
7				Lack of information on venture capital
8	Needed cash to expand the business	Process was expensive for the company	None	Lack of knowledge of the business environment in Kenya
8				Lack of information on venture capital
9	Needed cash to expand the business	The process took too long	Too much demands from the financier	Lack of investor confidence
9	Cheap and easily available			Lack of information on venture capital
9				The poor state of Kenyan economy
10	Cheap and easily available	Due diligence expensive	Too much demands from the financier	Lack of planning and patience by managers
10	Needed cash to expand the business	The process took too long		Most companies lack innovative business ideas
11	Cheap and easily available	Too much details required	None	Lack of local venture capital firms
11	The risk is minimal	The process took too long		Banks not willing to lend to local firms
11		Process was expensive for the company		Lack of good advisors
12	Needed cash to expand the business	None	Too much interference	Lack of businness knowledge by financiers
12			Unrealistic expectations from the business	Finance is too expensive in the long run
12			The financier did not understand our business	Too much control by financiers
13	Cheap and easily available	Too much legal procedures	Too much money on consultancy	Finance is too expensive in the long run
13	Needed cash to expand the business			The process takes too long
14	Cheap and easily available	The process took too long	Too much investor input confuses managers	Finance is too expensive in the long run
14	Had personal relationship with financier		Pressure to grow at expense of profitability	The poor state of Kenyan economy
14				Too much competition