A STUDY ON THE EFFECT OF PRIVATE EQUITY FUNDS ON INVESTEE FIRMS PERFORMANCE IN KENYA FOCUSING ON SMES

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D63/68565/2011

RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE AWARD OF THE DEGREE OF MASTER OF SCIENCE IN FINANCE, SCHOOL OF BUSINESS, UNIVERSITY OF NAIROBI

OCTOBER, 2018

DECLARATION

This research project is my original work and has not been presented in any other University.

Signed…………………………………………… Date …………………………………..

KARUGU FRANCIS MUIRURI **D63/68565/2011**

This research project has been submitted for presentation with my approval as University Supervisor.

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ACKNOWLEDGEMENTS

I would like to acknowledge Dr. Josephat Lishenga who painstakingly guided me towards the completion of this work, sometimes having to put up with me on many occasions. His, insightful suggestions, criticisms, and patient encouragement aided the writing of this project in many immeasurable ways. I would also like to thank portfolio managers at the various PE firms who were willing to discuss at length their investment criteria, and going ahead to divulge some data and information that would otherwise be kept close to the chest, but were willing to divulge it for the benefit of academic discourse. I would also like to acknowledge the managers of the SMEs who responded my quest for sensitive data, and their belief that the resultant study will be for the better of the community of practice.

DEDICATION

This work is dedicated to my parents, George and Margaret Karugu for having believed in me since infancy. This project is also dedicated to my son, Jaden Karugu and his generation who will take over from where we will have left.

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ABSTRACT

The purpose of this study was to study the effect of private equity funds on the performance of investee in Kenya with a special focus on SMEs. The study adopted a descriptive research design which involved a sample where both primary and secondary data was collected. The target population of this study composed of all SMEs funded through private equity. The population of this study was the 354 SMEs funded by private equity capital between the years 2010 to 2016 as divulged by portfolio managers. A sample of 133 SMEs was selected upon whom a questionnaire was administered, returning a response rate of 76%. Causal comparative research was used to explore relationships between variables. Descriptive statistical method was used to analyze data using the Statistical Package for Social Scientist (SPSS). The results are presented by use of tables, pie charts and bar graphs. The study revealed that where SMEs seek private equity (PE) capital, the investing PE will in most cases make adjustments in the management and board structure. This is oftentimes a condition after injection of capital. The PE firm also administers rigorous monitoring exercise inform of reporting requirements and frequent board meetings. These two illustrations are among many other things that PE firms do or require of the SME after injecting capital that are aimed at enhancing the performance of the SME post investment. The study revealed there is a positive correlation between Private Equity funding and the eventual firm performance. The regression analysis revealed positive betas in the PE activities namely Financing, Management Support, Technical Support and Portfolio Management, relative to the ROE of the investee firms.

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

In any economy, the private sector is the main driver of economic growth and for this reason, it needs to be capitalized and the private equity financing comes in handy in this regard (Davila and Gupta, 2003). The traditional way of investors increasing their funds is to acquire shares in a company and this has led to the term private equity which is the practice of owning equity in a private company (Fairlie and Alicia, 2012). As an alternative way of raising funds, private equity has been concentrated with the investment of funds in small and medium enterprises so as to grow the companies and exit to get their return on the investments. The rise in the activities of the PE has been witnessed in Kenya with large investments of capital that has generated publicity (Tuimising, 2012).

Both emerging and developing economies in the world focus on growth of their economies. The growth may be seen to be in terms of the Gross Domestic Product of a country which is a function of capital, entrepreneurship, labor and land. The GDP of a country rises when there is increased capital productivity and capacity through advancements in technology and labor productivity through investment in people. With the successful business enterprises comes infrastructure development, signifying GDP growth and this is characterized by increased supply and demand, an export oriented market, business investment and increased development spending by governments. Private equity is an alternative asset class investment which is a rising industry in Kenya and was not previously viewed as a viable investment channel. In the recent years there have been increased investments by the firms in companies and development projects. A research on the role PE firms on the economy is key as the asset class acts as a channel of foreign direct investment in the country which has implications for the emerging states such as Kenya and in international development. If the industry is an avenue for economic expansion in both developed and emerging markets, then it should be adopted and encouraged as vehicle for economic development.

Most of the investments by the PE firms have been in the small and medium companies which play a huge role in industrialization and economic growth. SMEs increase per capita income and output, create employment opportunities, promote effective resource utilization and enhance economic balance. SMEs have challenges in growth and development as they are constrained by inadequate funding and poor management (Boot et al., 2000). Challenges faced by the SMEs come up because of the lack of willingness by financial institutions to fund them as they lack credible information to show their credit worthiness. They lack audited financial statements as opposed to large corporations, they do not have publicly traded equity and lack public ratings that suggest their quality (Microfinance Risk Management L.L.C, 2008).This study looked at the relationship between the portfolio companies and the PE firms in terms how the latter's involvement affects the performance of the investee firm as a result of the willingness of the SMEs to relinquish equity in exchange of investment and the PE firms willingness to invest in these companies.

Kenya is a regional financial hub and a springboard to the larger East African Market that encompasses a total population base of over 200M persons. Because of its capacity as a country with a more developed financial system, Kenya has gained its own status in private equity capital in recent decades. However, before engaging in such a venture with small firms, the local PE firms should identify and adopt effective selection criteria that are associated with superior firm performance.

1.1.1 Private Equity Funds

A private equity fund is a combined scheme of capital/money that is raised and invested in equity or debt form in line with the fund's investment strategy namely venture capital, buyout, and mezzanine and growth capital (Puri, 2002). The structured investments that take the form of equity or equity related instruments are normally invested in unquoted private companies (Sampson, 2011). Therefore, private equity is a means to fund businesses and companies which require substantial capital to drive innovation and growth but lack sufficient funds. In both developed and developing countries, some companies do not have the ability to raise capital due to being overburdened by debt, lack of transparent financial statements and records hence lack accessibility of funds from banks and micro finance firms (Klier, Welge, &Harrigan, 2009).

The traditional way of investors growing their funds is to acquire shares in a company and this has led to the term private equity which is the practice of owing equity in a private company. The objective of the private equity has always been investment of funds in small and medium enterprises so as to grow the companies and exit to get their return on the investments. The rise in the activities of the PE has been witnessed in Kenya with large investments of capital that has generated publicity. PE is investment in a company in the hope of high returns and the target company is usually publicly owned but the PE firm privatizes it. Private sector is the main driver of economic growth according to development research and with sights set on the achievement of the 2030 goals1, the private sector needs to be capitalized and private equity offers this alternative funding. Multi – National Corporation are usually seen as a form of Foreign Direct Investment (FDI) in the country. The Multi-

National Corporations (MNCs) after investing in the emerging markets divest profits to their own home country and these capital outflows from the MNCs may result to the net loss for the developing host countries. The MNCs also have the ability to phase out some of the home grown businesses and monopolize the use of local resources because they often have greater capacity than local businesses. Private equity has been seen as an alternative solution in Kenya and other emerging markets where the foreign investors can come and invest in the local economy in businesses that will continue to recirculate their profits in the local economy. One of the major aims of the this study on the Private Equity activity in emerging markets is to highlight the role this sector plays in the economy.

1.1.2 Nature of Private Equity Investments

Private Equity has become one of the popular asset class investments together with real estate, hedge funds and credit derivatives which are a form of business investment which can be Foreign Direct Investment (FDI). Private equity is usually used in development of new products and technologies, expansion of working capital, making acquisitions, strengthening balance sheets and to resolve ownership- management issues. PE takes different forms and the common ones include venture capital, growth capital, buyouts, leveraged buyouts and management buyouts.

In venture Capital, there is investing by an individual, mostly known as an angel, who is wealthy. The angel in venture capital usually funds new business at the start-up stage before approaching a PE firm to further the business. This first source of funding in the PE circles is usually seen to be highly risky and the probability of failure is concrete (Deloitte, 2012). On the other side the other side, the venture capital can be highly lucrative if a business or a project kicks off successfully as the returns can be high in the long run. Various popular firms especially in the developed markets such as tech firms like WhatsApp and Google benefitted from this type of funding to global brands that they are.

Buy-in management buyout is a compromise or a combination between MBI and MBO. This occurs where outside executives join the existing executive team to buyout a company (Sampson, 2010). Usually there is a continuity of the current management and an addition of key managers specialized with a capability to grow the business through their skills and expertise and also to rise more funding. pany operating in the same sector. Pure MBIs are rare and often fall into the BIMBO category.

1.1.3 Investment Criteria for Private Equity Firms

The selection of an appropriate investment that will result in higher returns is an important exercise to a private equity firm. Baker and Gompers (2013) highlight that for a PE, Screening a potential investment opportunity is both a challenging and risky venture due to the informational asymmetry that exist between the firm and the PE. Development of appropriate criteria in evaluating potential investment will enable a firm select those investments that will result in positive results both in the short-term and long term period. Indeed, Fairlie and Alicia (2012) note that limited studies have been carried out to establish the relationship between performance of ventures and venture capital choice criteria. The study concluded that venture capitalist an integral source of capital for new and medium companies.

As far back as 1970, Akerrlof of made a formal analysis of the investment selection criteria while researching and concluded that efficient trade is influenced by adverse selection in the second-hand car market. Further, Pauly (1974) mentioned that there exit in the labour market and insurance market particularly adverse selection problems. By Grave and Timmons (2002) established that managerial services and monitoring of investments is a role played by venture capitalist. For entrepreneurs need to respond to the advices given by venture capitalists (Barney, 2004).

1.1.4 Private Equity Firms in Kenya

In Kenya pension funds and endowment's dominate the institutional investors in the Equity sector. The institutional investors in the Private Equity sector. The institutional investors are characterized by general and Limited Partners. In addition to the institutional investors include the Buyout investments. In this regard the role of General Partners identifies investment opportunity as well as shouldering distribution of proceeds to the limited partners when the investment is liquidated.The current private equity funds in Kenya have their foundation in Development Finance Institutions (DFIs) that took root in Kenya in the 1970's and 1980's specifically Africa Development Bank and the CDC Group (Tuimising 2012). The international DFIs further spurred the growth of local government controlled DFIs.

Private equity as an alternative asset class remains largely unregulated in Kenya as it is treated as a private company. However the government through the Capital Markets Authority has tried to nurture the venture capital space by offering a ten year tax break as long as they register with the CMA. Since this proposal was passed into law only one fund has registered, Acacia Capital Fund Limited (NSE 2013). Practitioners in the private equity industry in Kenya have formed an association to best push the private equity agenda in Kenya and the region called the East Africa Venture Capital Association. Private equity funds in Kenya are concentrated in the growth capital investment strategy in Small to Medium Enterprise and large corporate. Currently over 32 active private equity funds operate in Kenya with 18 taking up local office space in Kenya.

1.2 Research Problem

According to Learner et al., (2014), the funds under the PE arrangement across the world have grown from $5 billion in 1980 to approximately $950 billion in 2012 and cumulatively totaled over $1.5 trillion over the last 35 years. This huge investment shows the growing interest that private equity as an alternative financing avenue has grown to. However, despite the growing interest in the PE funding, there has been a generally low returns being registered on the investment being undertaken under the PE arrangement.

Guo and Song (2010) lament that despite the growing importance of the PE in the financial intermediation has been under researched especially in the capital venture industry. McMillan (2005) posits that essential factors that bolster the performance of venture capital include stringent principals of leadership and prudent investment decisions. Alemary and martin (205) researched on the relationship between economic affect. Chermanar (2011) sought to establish how private firm performance is influenced by capital financing their study found out that monitoring of the private firms improves financial performance.

In Kenya, Mwirigi (2013) researched on the role of private equity in emerging markets to the Kenyan economy. He found that of the funds raised for the PE investments, 92% of all the funds are foreign meaning only 8% of the funds are raised within the country. There have been some signs of a potential in the local investments as the local fundraising has started to gain ground for the PE activity. Kenya's PE funds are fundraised from development Institutions in the EU, USA, and African Development Finance Institutions and recently from the BRICS. Muriuki (2015) researched on the effect of risk management on the financial performance of private equity funds in Kenya. The study found that there exist a positive relationship between risk management and financial performance in private equity funds. The firms concentrated on risk identification, measurement and monitoring as key steps in the risk management process with risk evaluation and mitigation actively engaged but not heavily concentrated on.

The purpose of this research is to establish the role of Private Equity in Kenya's SMEs over and above the provision of the much needed capital by SMEs. Lack of funds for capital to start, grow and expand business and projects has emerged as a major challenge in the growth of the economy in an emerging market such as Kenya. One of the setbacks to getting capital for businesses has been the lack of security to secure debt capital loans especially in financial institutions such as banks and microfinance institutions. There has been a rise in the number of the SMEs in the country which have grown as a result of the support they have received from the Micro finance institutions but some of the businesses have reached a point where micro credit cannot meet their growth needs. The private equity industry which offers a long term and long value growth, remain unexplored in the continent largely and it is one of the solutions to the capital deficiency for many SMEs. Start-ups and growth stage companies, development projects such as infrastructure development and investment in various sectors such as energy, agriculture and technology have stalled in progress or failed to take off yet private equity offers alternative funding to help these focal sectors to grow. Some have been choked by a combination wrong financing and capital allocation decisions. Private equity is emerging and there has been few studies conducted to explain the growth. There has been research in Kenya on PE by Njau (2013) which sought to establish the effect of selected macro-economic variables. Murithi (2012) set out to establish the link between risks and return trade off and Tuimising (2012), a study that analyzed the institutional and legal issues of the PE industry in Kenya. The authors noted there was an increased activity of the PE firms in the country and it was poised to increase over time as the fund investments are becoming dominant in many sectors of the economy.

However, on the basis of the above studies, one can conclude that there are limited studies that have looked at the effect of private equity on firm performance. This study will seek to fill this research gap by answering the question: What is the role of private equity in Kenya in investee companies over and above provision of capital? It is important to understand this sector that is growing fast and is focal to the economic growth and development, given that SMEs are the biggest source of economic growth in Kenya. This study will seek to answer the role of private in management of investee companies, and in essence the firm performance. The hypothesis used in this study is that private equity is an effective model for investing in SMEs by private equity firms; that private equity backed firms have a high rate of growth; and that the active role of the private equity firms in portfolio companies achieve higher returns.

1.3 Objective of the Study

The general objective of this study is to document the nature and type of private equity financing in Kenya and to determine the role of Private Equity firms and their contribution to investee companies over and above provision of capital. The specific objective is to determine the effect of private equity firm’s activities through their investment criteria on investee firm performance.

1.4 Value of the Study

Private equity investments in the emerging markets in Kenya have realized steady growth. The research sought to analyze the activities of the PR firms in these countries with Kenya as a case study. The research looked at their business practices; role played in the investee firms and the impact the leave to the portfolio firms. The study further sought to establish influence of government policies as well as to create awareness to the public and the business. The study findings therefore presents invaluable information to investors in the emerging markets back by improved returns on investments.

The findings of the study have conclusively informed investors and venture capitalists on determinants of the investors of their investments. It is important to keep on to identify the critical criteria that presently are important in choosing a venture following changes in economic environment. Further, given the important role played by PE in catalyzing economic growth as well as being investment vehicle. This study will be beneficial therefore to the management of the PE firms to rectify the prevalent dwindling performance.

The study will also contribute to investor decision making process, especially for these investors interested in already established private business units in trying to establish the best criteria of selecting these firms as opposed to earlier studies that have majorly focused on startup selection. To academically the study will be used as a basis for further studies on private equity in Kenyan financial sector.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter covers other researcher work on investment criteria applied by private equity intervention in financing gaps in Kenya. The main sections covered in this chapter include; theoretical framework, review of empirical studies, summary of literature review and conceptual framework.

2.2 Theoretical Framework

This section examines the various theories that will be used to inform the study on firm attractiveness given various variables that inform the investment criteria. The study is guided by the following theories; Investment Theory, Portfolio Theory and Agency Theory. The investment theory is hereby relevant to this study because part of investment criteria is establishing the attractiveness for both buy-side and sell-side decisions. Likewise, depending on the investment philosophy of an investor, portfolio management is a key consideration to investors. While some private equity firms will take a controlling stake in businesses they invest in, there is an equal chance that private equity firm will take a minority stake, and there lies the issue of the agency problem.

2.2.1 Investment theory

The concept of investment is normally associated with varied activities majorly the investment notion is to employ capital in a fixed time to better the investors wealth (Kristina, 2010). Sources of money to be invested are normally generated from savings, loans and acquired wealth. Savings is therefore enhanced by foregoing consumption, investors use these savings to better their consumption capacity in the future with a principal focus of doubling their wealth (Wanuri, 2006).Distinguishing between financial investment and real investment is integral in financial decision making. Investments on tangible assets that include plant, land and machinery is termed as real investment while investment in e-stocks and debt instrument while instruments is termed as financial investment.

This study is biased on financial investments; this is basic theoretical investment decisions are considered in this study. For example portfolio theory enables comprehension of study. For example portfolio theory enables comprehension of investment process, more over if elaborates managerial investment decision making. The concept of cooperate finance encompasses long-term and shorterm financing, and capital structure of a company. Corporate finance therefore expounds on the concept of long-term financing and how best is can be utilized in the investment decision making.

2.2.2 Modern Portfolio Theory

The theory of modern equity practice Markowitz (1952) is considered the pioneer authority behind the portfolio theory and posits that investors can reduce variance in their investment when building a portfolio of investment by diversification. His argument posits that by investing in assets whose returns move in varied aspects, seasoned investors can actively eliminate risks that are associated with stocks, and therefore recommends that the parties investing should consider a selection of financial assets in their investment portfolio considering their mean and variance. Hence, the theory of modern portfolio explains how expected return rate of a portfolio can be maximized against single d portfolio risk. Crouhy et al, (2012) Opine based on this position systematic risk. Indeed, according to Kaplan and Scholar (2008), portfolio theory is considered one of the determinants theory n finance and investment.

The theory of modern equity practice defined the notion of an investor considering investing in an alternative asset. This theory therefore advices on how an investor can better the risks management as well as to improve on total asset returns improved by diversification of a portfolio (Bodie et al, 2005) in relations of investing bonds, investment targeted on PE is always delicate. This is explained by the fact that they are invested for long-term purposes (Daumontet al2004).

Further, Barger (2005) attempted to construct and analyze optimal portfolios based on a single period models found not to be satisfactory in the precipitation of actual financial management world which is constantly changing, and varied approaches have been proposed to manage investment portfolio decisions.

2.2.3 Agency Theory

Agency theory defines the association between two parties basically a principal on agent (Eizenhardt, 1989). As a result of this relationship, handling of asystemetry is enabled in the relationship between agents and principals which leads to efficiency being selection criteria (Rungtuzanatham, 2014).

According to Jenszen and Mecling (1976), the potential problems arise from the agency relationship, namely the concept of sharing risk. The agency risk sis realized when there is an on is match on the goals of and agent and the principal. It is normally difficult to evaluate the perfomance of an agent based on the delegated work. Another category of the agency problem is the fact that it is difficult to ascertain the expertise of an agent to perform a task. On the other hand, risk-sharing problems develop especially when agents and principals do not have a common understanding regarding risks (Rungtusanatham, 2014).

Application of portfolio theory in private firms in a way that it will guide a PE (firm in terms of financing, is explained by assystemmetry of information. Information symmetry is released if one party is having an unprecedented advantage of controlling more or better information when engaging in a contract. This means that information asymmetry takes place proceeding in occurrence of a contract. This is explained in the concept of adverse selection. When it takes place when two parties have engaged in a contact the agent –principal problem occurs. (Mas-Colell,1995).

Additionally, Moralhazard happens accepts to take risk on the behalf of the other party. The cost of taking the risk may be partly or wholesome (Consuming &Walz, 2014).

2.3 Determinants of Financial Performance

However, to distinctly isolate the relationship between risk management and value of the company, there is need to control for other factors that could influence firm performance (Hoyt et al, 2008).

Financial performance is a technique used to determine the relationship between an organization profitability, cash flow or shareholder value and organization goals. However, to distinctly, isolate the associate between risk mitigation and value of the company, there is need to control for other factors that could influence firm performance (Hoyt et al 2008).

2.3.1 Level of Interest Rate

Majority of the PE firms use debt as a major component of financing. Interest rate controls the performance of PE financing as well as the opportunity of growth. Globally, when the interest's rates are low and liquidity and saving is favourable investors are motivated to invest. In perfect capital markets, capital structure is not affected by the value of the firm. When reviewing the Modiglian and Miller theory, when taxes are not charged and there is no bankruptcy, the decision of financing a firm does not subsequently determine its value.

Modiglian and Miller theory enables the understanding of workable capital structure. The theory posits that one of the prudent ways of financing a firm is through financial leave rage.

2.3.2 Inflation

Inflation refers to the general increase in the price of commodities over a given duration. Inflation tends to push up the price of commodities without corresponding increase in their real value. Private firms are adversely affected by inflation since they tend to hold investment over duration of time between acquisition and exit (Nielsen, 2011).

A gradual inflation rate which does not distort the value of investment results to financial performance in PE firms. E firms are also extremely wary of government measures to control inflation through currency devaluation since it ultimately affects private equity firm’s illiquid investments which cannot be easily disposed (Parrabernal& Blount, 2011). Inflation has an adverse effect on the exit returns when PE divestor disposes theirs take in an investment (Gilson, and black, 2014).

2.3.3 Exchange Rate

In Kenya PE companies normally have the appetite of ownership collaboration with international LP partners. As result the domestic and International currency exchange have significantly contributed to financial performance (Cumming & Johan, 2010). International Competitiveness is a consistently measured by real exchange rate. Other scholars denote international competitiveness as the index of currency strength. For instance the higher the value the competitiveness of a currency the higher the index in any country.

Azzi and Suchard (2013) carried out a study in China, the study sought to find out the relationship between domestic investors in PE and behavior of the foreign investors. The study findings showed that there is a clear test between foreign investors and domestic investors in china. foreign investor has a strong relationship with investing in firms that are more experienced.

In Malaysia, see and Jusol (2012) studied cowfund performance is affected by fund characteristics. The study sample twenty five Islamic funds and forty four conventional find in a period of five years. The study findings revealed that higher return rate is achieved in high risk environment. Superior returns is also realized in investments with high expenses.

Moreover old funds underperform than young funds. In conclusion there was no relationships between ,fund performance and fund size as well as turnover ratios.

In Kenya Mutuku (2011) researched on the association between risk and returns and portfolio composition among funds firms in Kenya. The study revealed that 89% of the percentage return of the investment portfolio. 72% of the respondents indicated that the methods used by the firms in determining percentage rate of return was geometric or time weighted returns. Another 50% of the respondents indicated that the firms measured return of the investment portfolio return using bet and standard deviation.

Murithi (2012), sought to establish relationship between PE firms and risk return in Kenta. The data was analyzed by the help of French model to certain return and risk of PE investments. A sample of fourteen firms was derived from the target population. The study findings reveled financial crisis in Europe negatively impacted on financial performance. The study concluded that given the fact that PE industry is young in Kenya it still attracts numerous international firms to invest.

Hinchberger (2014) posits corporate expected cash flow is affected by exchange rate volatility, as a result this impact on domestic currency and inter-firm competition. According to Yasuda and Metrick (2007) their study targeted to determine the relationship between private equity financial performance and exchange rates, the study findings revealed that profits affected by the fluctuations. According to Adongo (2012) as a result of policy measure in the exchange rate in Kenya has undergone changes consistently as a result of balance of payment.

2.3.4 Fund characteristics and Fund Performance

The size of the PE is an important feature that determines its performance. This is because it captures evaluation of economy of scales and performance related evaluations. In practice a firm with a smaller fund (Kaplan, 2003). In Europe, PE investors in PE have registered low performance and advance several notions which include firm differences and contract variation. Moreover, outside United States of America PE is younger and exhibits learning curve that is lower. Likewise, some young firms in PE industry exhibit a sequence of successful record, while such move is likely to lead to a negated investment sign. In addition to PE firms has by found by Gompers and Lerner (2000) to negatively impact fund performance.

2.4 Empirical Studies

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2.5 Research Gap

From the reviewed literature studies, there are a few research works undertaken on cow venture proposals become successful. Private equity financing benefits small and new companies financing. Copeland (204), the heterogeneous nature of venture capital makes it unscientific. The concept of private equity, research work has tried to establish the concept of investment decisions while previous on investment decision exists, and no research , especially in Kenya has come to unique conclusions.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

The chapter explains methods utilized carry out this research. Firstly, it commences with an overview of the study design, in addition to target population is presented, as well as description of the data collection instruments, the data validity and reliability and finally the description of data analysis procedures.

3.2 Research Design

A research design entails strategy as well as a structure of investigative that enables determination of answers to the research questions. Research design is the procedure that a study would adopt (Burg and Gall, 1983).the study adopted descriptive research using surveys. For the purpose of depicting accuracy in data collection a descriptive design was adopted.

3.3 Population of the study

Mugenda and Mugenda (1999) define a target population as the population from which a sample can be obtained and conclusion applied on it. The target population of this study composed of all SMEs funded through private equity. The population of this study was the 354 SMEs funded by private equity capital between the years 2010 to 2016 according to KPMG & East Africa Private Equity and Venture Capital Association (2017), as divulged by the portfolio managers. A portfolio manager is identified as the personnel responsible for the overall management and running of the SME that has been funded by a PE firm (Khorana - 2006). For the purposes of this study, the role of portfolio manager ranged in different titles including Senior Associate, Principal and Investment Manager according to the variation of different PE firms that responded to the questionnaire. The figure was arrived at by using directories provided by venture capital firms drawn from Nairobi. The target population appears small given that The World Bank Estimates SMEs make up 28% of the GDP. But literature (Rodgerset al, 2003) shows that for every 100 applicants for private equity capital only 5% may qualify for funding as the rest fall short of the stringent requirements of private equity investors. This study used the 324 SMEs that had been financed by private equity firms (including venture capital) as the target population according to the Private Equity Report, a 2017 Outlook (KPMG & East Africa Private Equity and Venture Capital Association, 2017).

3.4 Sampling Frame and Sampling Techniques

Sampling is the procedure by which a researcher gathers people or things to study Cooper and Schindler (2003). These institutions provide venture capital to various SMEs located in Nairobi. The Fisher formula was used to obtain a sample size for the study. Mugenda and Mugenda (1999) define probabilistic sampling as a method of sampling where each unit of the population has a probability of being selected as a unit of a sample. Stratified sampling method was used in the research study to sample respondents that received funding from various Private Equity investors. Saunder (2003) asserts that stratified random sampling involves dividing population into subgroups and giving a number to every strata of the accessible population, and then randomly selects the final subjects proportionally from the different strata. Stratified sampling was well suited for this study because the population of interest is heterogeneous in terms of type of the business and PE Firms. On ascertaining these SMEs, they were then stratified according to their PE Firms firms and random sampling carried out as indicated in appendix XX. The Fisher (2003) formula was employed to calculate the sample size as follows:

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

where

- n= Sample size
- z= the standard normal deviate value for the level of confidence, for instance 95% level of confidence, z =1.96
- d= margin of error or level of precision at 0.1 for total population at 90%
- p= proportion to be estimated, Mugenda & Mugenda (2003) recommends that where p is unknown, the value is assumed to be 0.5

Therefore, sample size was arrived at as follows:

$$\mathbf{n = \frac{(1.96^2)(0.5)(1-0.5)}{0.1^2} = 133}$$

A sample of 133 firms was selected at random from which data was collected.

3.5 Data Collection

This study was based on primary data collected by way of structured questionnaires. Cooper and Schindler (2003) and Mugenda & Mugenda (2003) noted that questionnaires obtain in depth information as the researcher can model the questions as necessary for ease and clarify and ensure that the responses are properly understood thus improving the quality of the information received. The questionnaires were closed ended and based on the Likert scale. The questionnaires were divided into six sections each section covering the study variables. The questionnaires were administered to the entrepreneurs who are the founders and managers of the enterprises that had received PE funding. This approach enabled the researcher to collect as much information as possible on the topic of study. The research instruments were first tested in the field before being used in the actual data collection (Mugenda & Mugenda, 2003). These research instruments were structured according to the research objectives. Questionnaires were then administered to the sampled 133 portfolio managers or owners in the sampled SMEs via email. Many respondents were comfortable with giving information about their firms, as demonstrated by the high response rate on the questionnaires. Saunder advocates that time should be allowed for requests to be received and considered before a response can be offered or a reminder be sent.

3.6 Validity and Reliability

To establish the validity of the research instruments the researcher sought opinions of experts in the field of study especially portfolio managers in the investment firms. This enabled the modification and revision of the research instruments thereby enhancing validity. To ensure reliability, the study adopted the test-retest technique. This was achieved by testing the questionnaire on one of the respondents before moving on to the others to test its consistency and adjust for any inconsistencies before the real field work can begin.

3.7 Data Analysis

Data analysis is the varied approaches used to manipulate data electronically in the field of social science. (Gay,1992). Before processing the data and test on data consistently was conducted after the coding of data, it was analyzed by the help of SPSS Version16. Descriptive analysis was conducted using standard deviation, mean and frequency distribution. The data was analyzed by the help of the model.

3.8 The Conceptual framework and the Operational variables

The conceptual framework (Figure 1) below represents the independent and dependent variables of the study. The factors affecting the performance of investee firm included industry factors (interest rates and inflation) the duration of investment, the level of controlling stake by the investor and operational efficiency provided by the board quality and management expertise from secondments from the investor.

Table 1 presents the research variables, variable measures and scale. There are two sets of variables; the dependent and the independent variables.

VARIABLE	INDICATOR	MEASURE	SCALE
Independent variables			
Financing Role	PE Financing	Amount of Equity injection (New Equity/Total Assets)	Nominal
Management Support	Change in Management styles.	Number of managers introduced by investor/total number of managers	Nominal
Technical Support	Prudent Management of SMEs	% increase in annual revenue as a result of PE support. (weighted contribution of new products, new markets and new technology to annual turnover)	Nominal
Monitoring/ portfolio management	Monitoring and Evaluation of progress	% increase the number of board meetings, auditing sessions and inquiries due to presence of PE	Nominal
Dependent variable			
Growth of SMEs	Changes in ROE as a result of PE activity	% Increase/decrease in ROE of SMEs	Nominal

Table 1: Model variables

3.8 Model Specification

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

ROE = f (x_1, x_2, x_3, x_4,).

More specifically, the regression will be of the form;

$$Y = \beta o + \beta_1 x_1 + \beta x_2 + \beta_3 x_3 + \beta_4 x_4 + \varepsilon$$

Where

Y	=	% increase in ROE
β_o	=	Pre-PE increase in ROE
x_1	=	Size of new equity as % of Total assets
x_2	=	% of board and management position held by PE in SMEs
x_3	=	% increase in annual revenue as a result of PE support. (weighted contribution of new products, new markets and new technology)
x_4	=	% increase the number of board meetings, auditing sessions and inquiries due to presence of PE
ε	=	error term

β1, β2, β3 and β4 represent the co-efficient of regression for PE financing, Management support, technical support and monitoring respectively.

CHAPTER FOUR

DATA ANALYSIS AND FINDINGS

4.1 Introduction

This chapter focused on the analysis of the data collected and discussions of the findings which are structured according to the questions in the questionnaire and provides discussion of the findings together with their implications. Primary data was collected using a questionnaire that targeted 354 SMEs in Nairobi. These are therefore the results of the analysis and findings of the study with reference to the study objective. The first section gives a summary of the data analysis method used. The second part gives the finding of the study and it includes relevant graphs that help to explain the result of the data analysis. The last part gives the summary of finding and interpretations.

4.2 Response Rate

Primary data was collected using a questionnaire administered to portfolio managers of the 133 sampled SMEs in Nairobi of which 72 questionnaires were returned. This response rate is considered accurate and it reflects its population, the response rate in this case of 54% is fairly good. This high response rate can be attributed to the data collection procedures.

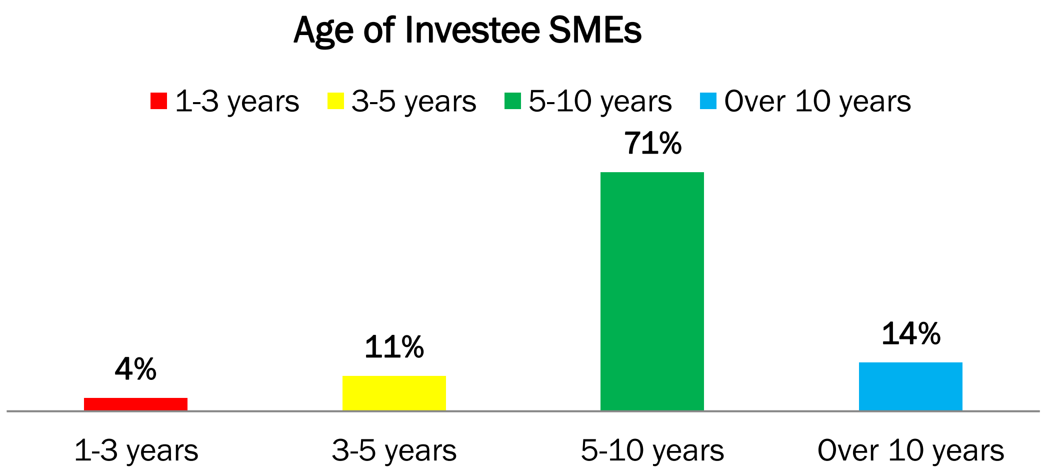
4.3 Pre-Funding Demographic Analysis

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

4.3.1 Age of the SMEs Enterprises

The study sought to determine the age of SMEs. The analysis revealed in Fig.1 below that many firms had been in operations for 5-9 years with some outliers having been in operation for over 10 years by the time of study. These finding imply that PE focus in SMEs point to a preference investing in growth stage enterprises. PE firms prefer to stay away from SMEs.

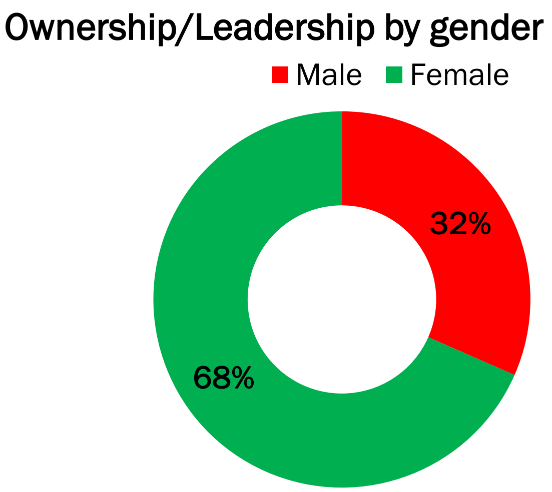
Figure 1: Age of Investee SMES



4.3.2 Business Ownership by Gender

The study sought to determine the type of business ownership. Fig. 2 shows that majority (68%) of the firms were managed by men as opposed to those managed by women. This could have two implications. Either investors shy away from SMEs that are managed by women or a majority of SMEs are owned and managed by men.

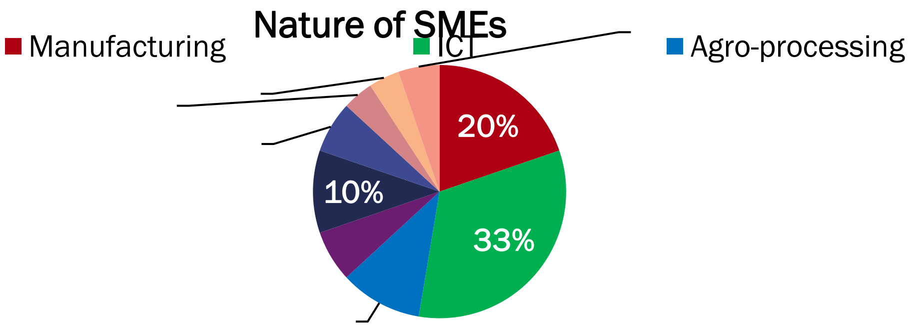
Figure 2: Ownership of Investee SMES



4.3.3 Nature of SMEs

The study sought to determine the nature of the SMEs. Fig. 3 below presents the findings that most of the financed SMEs were in manufacturing and ICT, where other sectors were relatively lower. This means investors find high returns and stability in these sectors relative to the others.

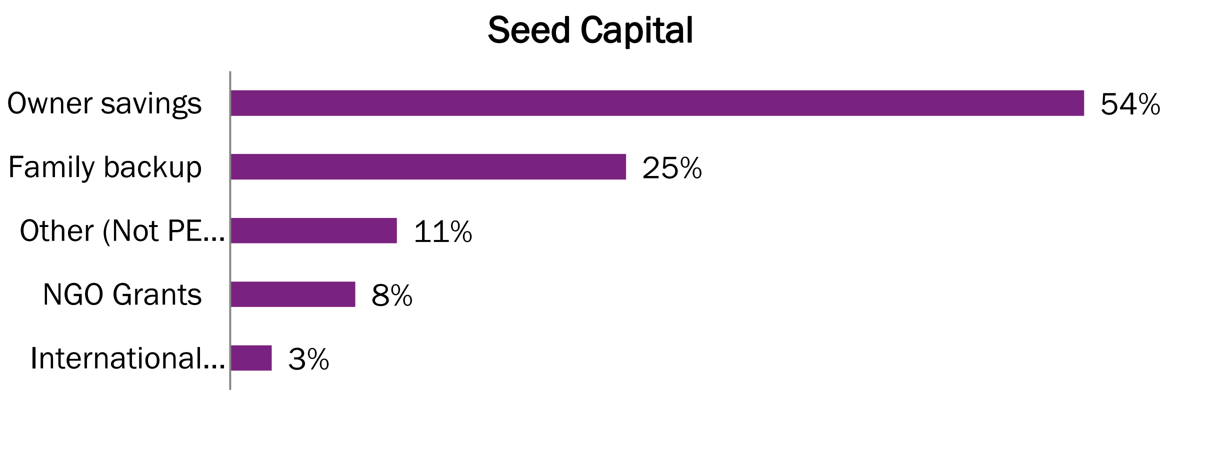
Figure 3: Nature of Investee SMES



4.3.3 Seed capital

This study did not find any SME that got initial funding from Private Equity. Not even one case did this study find from a venture capital, which focuses on SMEs and early growth businesses. The study shows in Fig. 4 that although all the businesses sampled have been funded by private equity, the SMEs started their businesses by sourcing initial capital from other sources such as personal savings 54%, and family back up (25%).

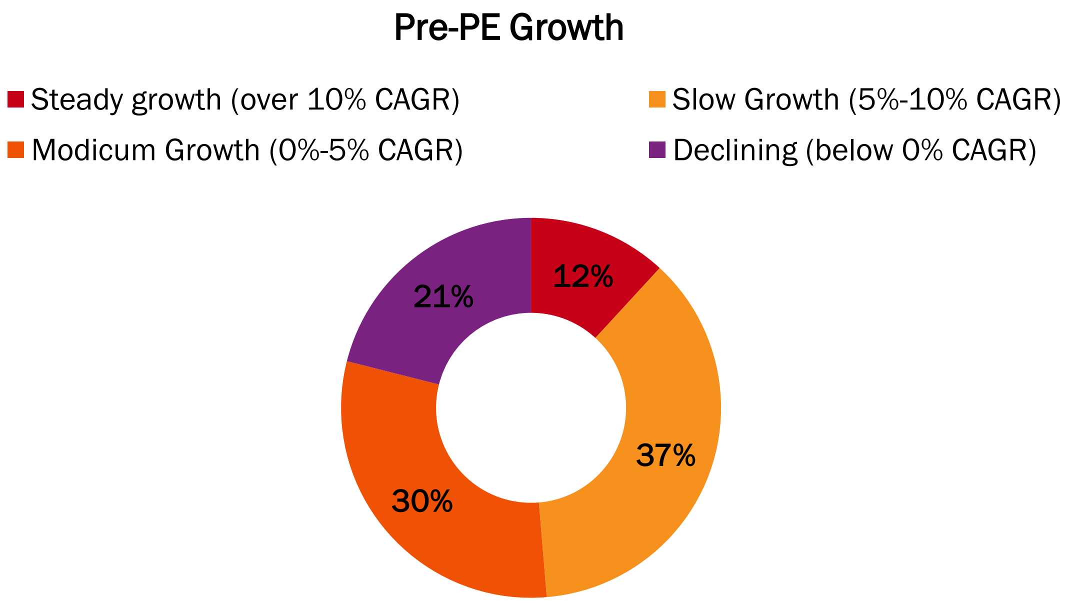
Figure 4: Seed Capital of Investee SMES



4.3.4 Pre-Funding Growth Trends

The study sought to determine the growth trends prior to PE funding. This was meant to establish if the funding was unlocking any growth challenges faced by SMEs. 37% of the respondents indicated that they had slow growth while 21% indicated that their businesses were declines in annual turnovers and profitability. This implies that PE investors look for distressed businesses that have potential for growth that they can get could exit values.

Figure 5: Pre PE Growth of Investee SMES



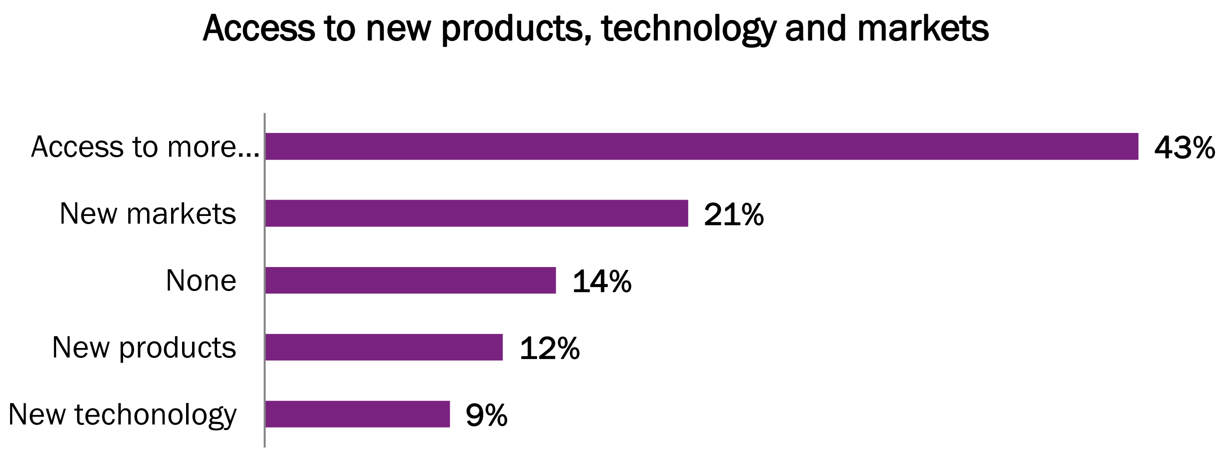
4.4 Post-Funding Demographic Analysis

This section analyzed the post investment scenario behavior of both PE firms and SMEs, including the distribution of board positions, executive secondments and portfolio management activities.

4.4.1 Access to new products, technology and markets

The study sough to know if the SMEs had any beneficial relationship with the PE investors in post investment scenarios in terms of access to new markets, new technology and product development. Fig.6 reveals that 43% of SMEs were had improves access to a combination drawn from new products, new markets and new technology. This indicates that PE helps SMEs in their growth endeavors driven by these three essentials.

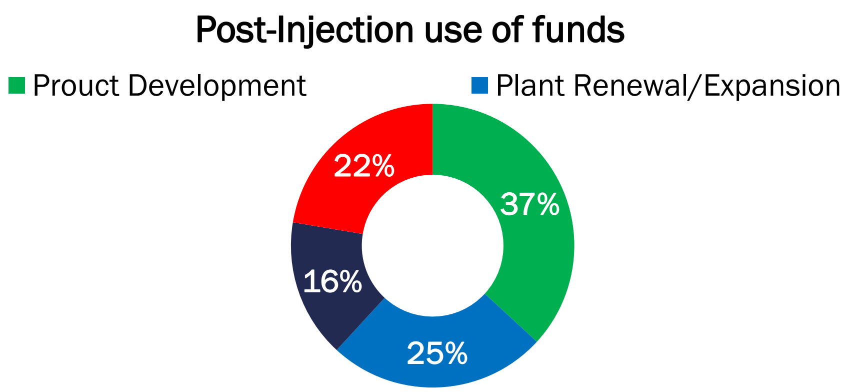
Figure 6: Access to new products technology by Investee SMES



4.4.1 Use of Funds by SMEs after PE injection

The study sought to find out the applications for which funds raised by SMEs from PE were applied. Fig. 7 below shows that 37% of the SMEs used the fund in product development, including introduction of new product lines, while 25% used the funds in capital expenditure to renew and expand capacity. Other uses included marketing and distribution as well other acquisition and other turnaround endeavors.

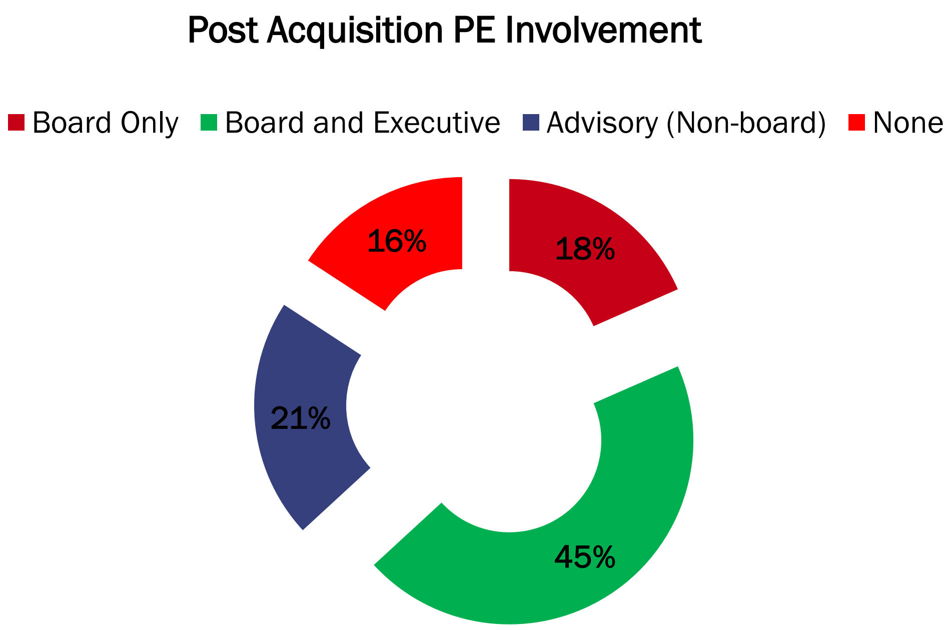
Figure 7: post injection use of funds



4.4.2 Management and governance support

The study sought to establish the involvement of PE firms after funding. Fig. XX and Fig. XX below showed that very few PE did not have exert a certain level of influence in the SMEs they invested in. 45% held both board and executive positions in the SMEs they acquired, while 16% did not have any influence.

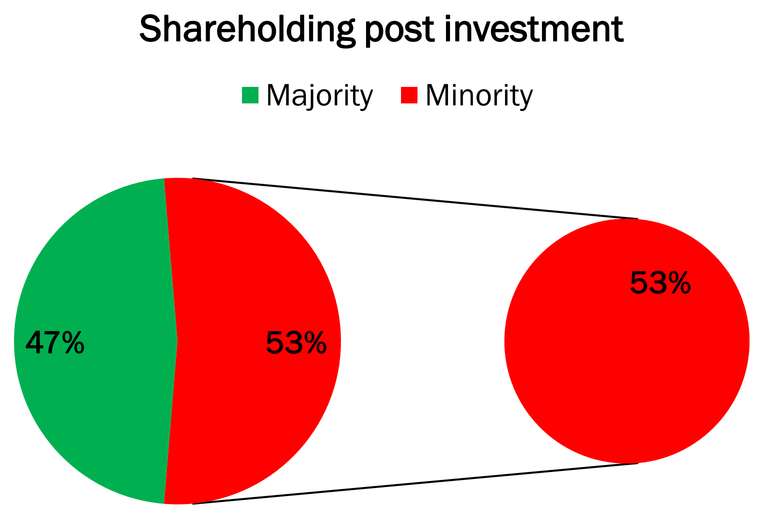
Figure 8: Post acquisition PE involvement



4.4.3 Controllership level

The study sought to establish the extent to which the post-acquisition shareholding would be. The allure for controlling stake was not established by the study. Fig. 9 shows that contrary to popular fallacy, PE firms are not particularly looking to hold a controlling stake in SMEs. However, this varies from one PE firm to the next, and there is no particular pattern, and this is just informed by the investment criteria of each individual PE.

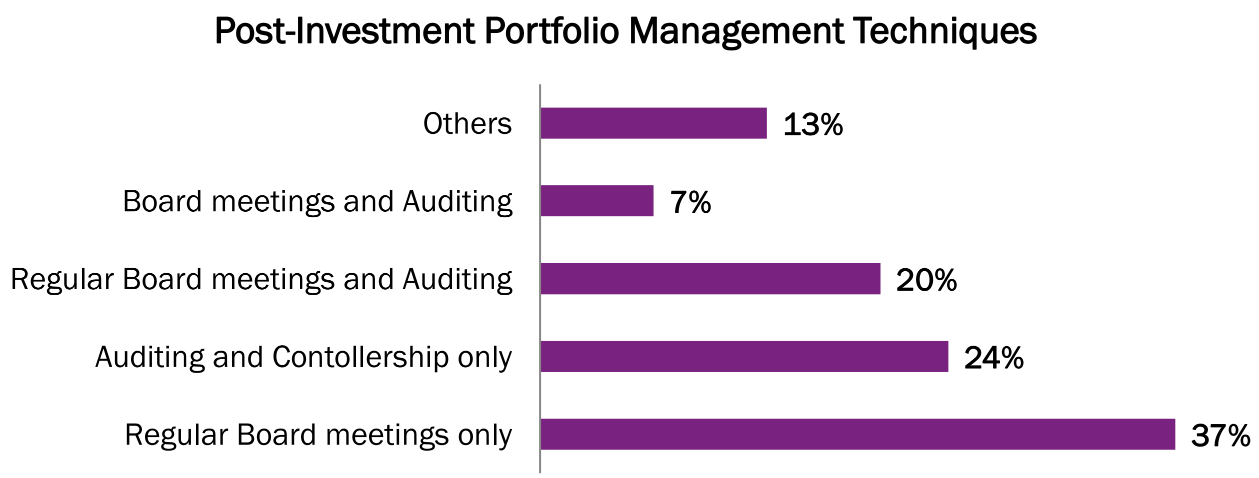
Figure 9: Post injection control stake



4.4.1 PEs portfolio management technique

The study sought to know what techniques PEs use in portfolio management of the investee SMEs. Fig. 10 reveals an active portfolio management regimes applied by PEs. 37% of the PEs demanded regular Board meetings, while 24% exercised regular audits and executive controllership through regular supply in business metrics pack from the SMEs.

Figure 10: Post Investment Portfolio Management techniques



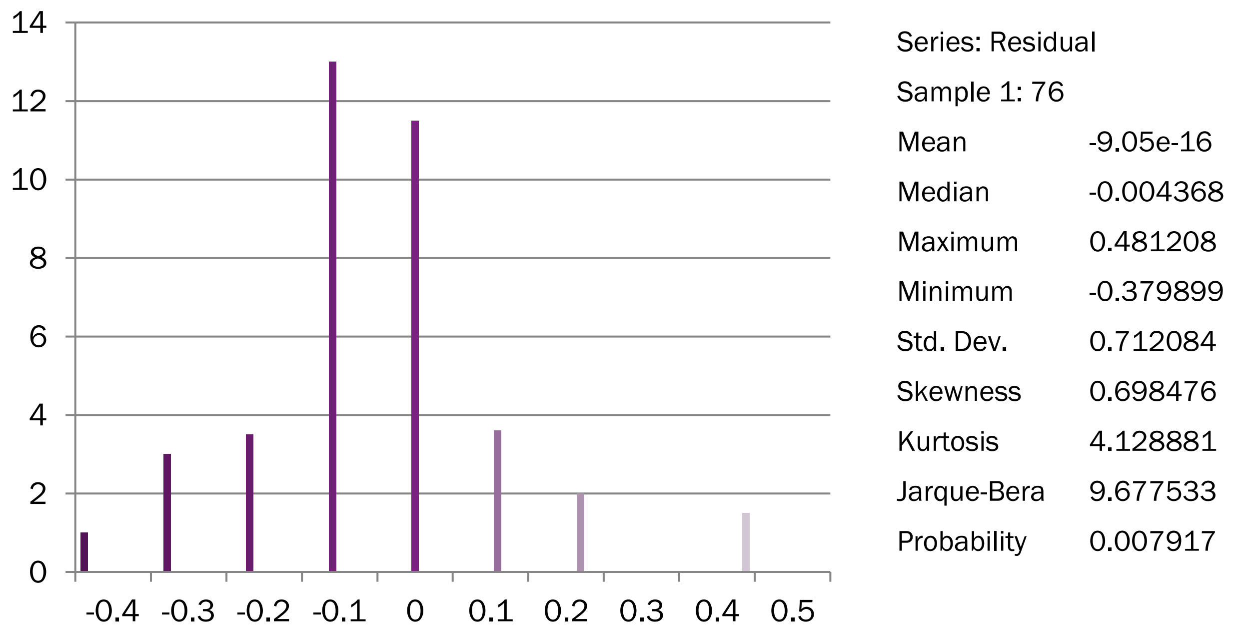
4.5 Diagnostic Tests

To establish the accuracy of the data collected, analyzed and insights therefrom, the research carried out three diagnostic tests namely the Normality test, the Heteroscedasticity Test and the Multicollinearity Test.

4.5.1 Normality Test

The study sought to establish normality tests. A plot of the residual values from the regression model was first obtained to give a graphical outlook of the assumption of normality. As shown in Fig. 11, the data has a normal distribution since it is distributed around the line of fit. These results are confirmed by the Jarque-Bera test for normality in which case a p-value = 0.0079 which is less than 0.05 and hence this indicates that we should accept the null hypothesis that data is normally distributed.

Figure 11: Normal Distribution



4.5.2 Heteroscedasticity Test

The study sought to establish heteroscedasticity in the data. Whites' General test was used to test for heteroscedasticity. These results as presented in table 4.6 below shows that calculated R2 is less than the critical values of R2 (11.34<91.670) hence there is no presence of heteroscedasticity in the observed data.

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

Table 2: heteroscedasticity Test

4.5.3 Multicollinearity Test

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

Table 3: Multicollinearity Test

4.6 Regression Analysis

Variance Inflation Factors
Date: 08/22/18 Time: 07:32
Sample: 1 76
Included observations: 76

Variable	Coefficient Variance	UncenteredVIF	Centered VIF
PE Financing	0.08765100	201.10720000	NA
PE Management Support	0.02167000	674.92630000	19.31728000
PE Technical Support	0.00695400	196.00550000	6.62591500
PE Portfolio management	0.00457500	167.63450000	1.03000000

4.6.1 Variance analysis and presentation

The study also sought to establish whether there are any statistically significant differences between the means of growth of SMEs and the independent variables. Findings from the ANOVA statistics presented in Table 4 were used to present the regression model significance. Levene test results shows that $p < 0.0078$ at 5% level of significance hence the model is significant for the regression analysis. This therefore implies that all the variables are good predictors and has a significant influence on the growth of growth SMEs

Test for Equality of Variances Between Series

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

Sample: 1 76

Included observations: 76

Method	Df	Value	Probability
Bartlett	4	43.30511	0
Levene	(4, 355)	3.520902	0.0078
Brown-Forsythe	(4, 355)	2.546854	0.0392

Table 4: Variance Analysis

4.6.2 Tabulation of the regression model

The study conducted regression analysis on the dependent variable (growth) against the independent variables (PE Financing, PE Management Support, and PE Technical Support & PE Portfolio Management) to determine the role of venture capital in the growth of SMEs enterprises in Kenya.

$$\mathbf{Y = \beta o + \beta_1 x_1 + \beta\ x_2 + \beta_3 x_3 + \beta_4 x_4 + \varepsilon}$$

Where

Y	=	Changes (increase or decrease) in ROE
β_0	=	Pre-PE changes in ROE
x_1	=	Size of new equity relative to total assets
x_2	=	Board and management representation of position held by PE in SMEs
x_3	=	Changes (increase or decrease) in annual revenue as a result of PE support. (weighted contribution of new products, new markets and new technology)
x_4	=	Changes (increase or decrease in monitoring activities) due to presence of PE
ε	=	error term to represent elements that will be created if the model will not fully represent the actual relationship between the independent variables and the dependent variables

Table 5 is an analysis of results for the goodness of fit statistics.

Dependent Variable: GROWTH
Method: Least Squares
09/29/17 Time: 06:55
Sample: 1 76
Included observations: 76

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.06391	0.296060	0.2 15874	0.82970
PE FINANCING	0.61381	0.147208	4.169645	0.00010
PE MANAGEMENT	0.17208	0.083392	2.063508	0.04290
PE TECHNICAL SUPPORT	0.00455	0.067641	0.067299	0.94650
PE Portfolio management	0.26687	0.120138	2.221321	0.02970

R^2	0.93495	Mean dependent var	3.81667
Adjusted R^2	0.93106	S.D. dependent var	0.67469
Regression Std. Error	0.17715	Akaike info criterion	-0.55677
Sum squared residuals	2.10251	Schwarz criterion	-0.39867
Log likelihood	25.04368	Hannan-Quinn criter.	-0.49383
F-statistic	240.73290	Durbin-Watson stat	0.86548
Prob.(F-statistic)	0.00000		

Table 5: Goodness of fit

The specified model was thus attuned as under:

$$\mathbf{Y = 0.064 + 0.614X_1 + 0.172X_2 + 0.005X_3 + 0.267X_4 + 0.177}$$

All the descriptive variables are significant in at 5% level of significance with the exception of PE Technical Support which is insignificant in explaining the variation in SME's Growth. Changes in the independent variables as shown in Table 5 above together describe about 93.5% of the variations in growth of SMEs in Nairobi. With an adjusted R2 of 0.931 indicates that the independent variables in the model have a strong power of explanation on the changes growth of SMEs. Further, the results show F-statistic of 240.7 which is statistically significant at 5% level. This implies that the overall model is significant and well fitted to explain changes in growth of SMEs in Nairobi. From the resultant model, a unit increase in venture capital financing in SMEs would cause an increase in growth of the SMEs by a factor of 0.614, also a unit increase in venture capital management would cause an increase in growth of SMEs by a factor of 0.172 while a unit increase in technical expertise would cause an increase in growth of SMEs by a factor of 0.005.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter is a presentation of the study report, enumeration, and summary of study findings, drawn conclusion, study recommendations and suggestions for further study.

5.2 Summary

The study revealed that independent variables describe about 93.5% of the total variations in the growth of SME's in Kenya. An adjusted R^2 of 0.931 indicates that the independent variables in the model have a strong power of explanation on the changes growth of SME's. The study established an association exists between PE financing and the growth of SME's and PE management support, PE technical support and PE portfolio management. Further, the results show and- statistic of 240.7 that was significant at 0.05 significance level. This implied that overall model was significant and well fitted to explain changes in growth of SME's in Kenya. Moreover, the study findings reveal that there is significant association between PE financing and SME's growth. PE management support and PE portfolio management at 5% significance level. The indicators of SME's were growth in sales, revenue and not assets, and the improvement in liquidity and profitability.

5.2.1 PE financing

The study found out that PE financing affects growth of SME's. A unit increase in SME finding through PE impacts on the growth rate of SMEs by 0.614 factors. The study further established that majority of the findings was meant for expansion and investment in new products. This correlates with Sahlman (2001) that access to external funding helped to ease core fully management, generate more institutional income and increase market share.

5.2.2 PE management Support

The study also established that management support influence the growth of SME's. PE intervention unit increase in management influence SME's growth by factor 0.172. It was established that PE firms offer decision making support, expert opinion and access to excessive information to SME's that they invest in. this correlates to Pori (2002) in their study, concluded that after an investor invests money in the investment, the investor needs to spend time in restructuring of management support to ensure its success.

5.2.3 PE Management Support

The study further established that technical expertise provided by PE firms had significant influence the growth of SME's. The growth of SME's is influenced by factor 0.005 as are result of unit increase of technical expertise. PE investors offer a wide array of advisory, consultancy and networking to capitalize on new market opportunities. The findings are in line with Lerner (2002) that managers influence a firm's performance positively.

5.2.4 PR Portfolio management

From the findings, it was established that portfolio management activities also influence growth of SME's. The growth of SME's is influenced by PE portfolio to many management by factor 0.172. PE investors have an established monitoring evolution system and coil regular process review meetings with SME's that they invest in .They are demand regular reporting as well audit the activities of the SME's. This agrees to Sahlman (1990) that the monitoring and stewardship role of investors is an important corporate governance issue that has gained attention as the portfolio monitoring of the company becomes the key role of the investor.

5.3 Conclusions

The study concludes that there is positive significant assertion between financing through PE and the performance of SME's. This implied that the performance of SME's is influenced by PE financing.

The study concludes that the SME growth has been influenced by varied factors including technological and human resources. When a firm engages proper management in all functions of management the business enjoys steady growth both in the short run and long run. This is buttressed by the fact that firm's growth strategies mitigate business risks.

5.4 Recommendations

Firstly, the study recommends that training should be embraced to enhance skills of recordkeeping and writing financial proposals to enhance importance of determinants of firm performance. The managers in the firms need to technically and tactically viable to enable the growth of the SME's. Thirdly, the organization from PE financing need to identify corporate financing sources. Deal sourcing teams in PE firms should do more to encourage their investors to put their money in SME's as they seek to fundraise as well as spearheading growth of the business.

Policy makers within and without government should provide PE firms with incentives and make more PE firms to come into the Country to support in capital and other areas that SME's need for growth. This government by establishing an SME private Equity guarantee fund, which would encourage PE firms to relax their investment criteria while determining which SME to invest in.

5.5. Limitations of the Study

The research utilized secondary from the private Equity Report, a 2017 outlook (KPMG, 2017) to come up with the population of the study. The researcher did not establish if there were other SME’s outside this KPMG report.as such a similar study with a bigger population may yield different or controlling results.

Another limitation is that a study on a wider scale in the investment companies looking at other capital and the approaches taken by investor in portfolio management may provide different results.

5.6 Opportunities for further research

This study is limited itself of private equity, and it would interest future researchers to see what results debt, mezzanine and other hybrid financing methods would bring. Future studies should therefore explore the influence of ethical policies on financial performance of the SME’s.

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