THE USE OF VENTURE CAPITAL INSTRUMENTS AND OTHER CONTROL MECHANISMS BY VENTURE CAPITALISTS IN KENYA

BY

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D61/8022/02

A MANAGEMENT RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILLMENT FOR THE REQUIREMENT OF THE AWARD OF MASTER OF BUSINESS ADMINISTRATION DEGREE, SCHOOL OF BUSINESS, UNIVERSITY OF NAIROBI

2008

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DECLARATION

I hereby declare that this project is my original work and has not been presented for a degree in any other University

Signed Date 19/9/08

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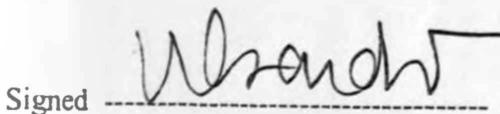
The project have been submitted for examination with my approval as University Supervisor

Signed  Date 17 October, 2008

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DEDICATION

This study is dedicated to my parents for their support in all aspects of my life

ACKNOWLEDGEMENT

I wish to thank my supervisor Mrs. Winnie Nyamute for the invaluable guidance, advice and patience in bringing this project into fruition.

I further wish to thank my wife Lily and children, Marianne and Michael for the support and encouragement while I was undertaking this project

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ABSTRACT

Venture capital has become a major vehicle for the funding of start-up companies in many countries, most notably the United States. Venture capital is now the financing mode of choice for projects where "learning" and "innovation" are important. Because of their innovative nature, venture firms carry a substantial risk of failure. Only a minority of start-ups are high-return investments. This is due to shortcomings associated with information asymmetry, Moral hazard and agency costs.

The study was a survey carried out to determine the financial instruments used by the venture capitalist in Kenya, and the factors that influence the choice of the instruments. The study further sought to determine the control and monitoring mechanism employed by the venture capitalist to ensure success of venture investments.

The target population included investment banks, development financial institutions, venture capital funds and special private equity organisation identified as the major venture capital investors in the country. Nineteen venture capitalists, which included seven companies incorporated as venture capitalist by the Registrar of Companies under Companies Act, seven listed in the African Venture Capital Association (AVCA) directory as venture capital funds operating in Kenya and five listed in Association of African Development Finance Institutions (AADFI) as providing venture capital as part of their development agenda were approached during the study. Seventeen Fund / Equity Managers of fifteen venture capitalists were interviewed and consequently nineteen venture capital deals were reported on.

The data on financial instruments used by the venture capitalist and the reasons for use was obtained through a researcher-administered questionnaire. The questionnaire was structured such that data on the specific control and monitoring mechanism were also collected. The data collected from the field was classified according to their common characteristics to enable both qualitative and descriptive methods of

statistical analysis to be carried out. The data was presented through tabulation and charting techniques

The study concluded that venture capital in Kenya is operated within the same concept as those overseas. Majority of the companies in which venture capitalist invest in are in seed/start-up stages of development. These are companies, which cannot get loans or even supplier's credit. The venture capitalist uses various financial instruments as a vehicle of investment. They include redeemable preference shares preferred equity, common equity, combination of debt and common equity and pure common equity. Like overseas venture capitalists, majority of Kenyan venture capitalists use preferred equity as an instrument of choice to invest with in an investee company.

The venture capitalist gave various reasons/combination of reasons for choosing particular instruments. Maximization of returns of funds to funds invested was ranked the first in the level of importance. The tax incentive reasons was found not to be important in Kenya as there is no particular instrument, which provided tax incentives to venture capitalists.

Notably, development finance institutions use combination of debt and common equity. This is because as public-private partnership agencies, they are traditionally supporting the financing of startups and medium sized firms by publicly guaranteed loans in order to promote regional development.

Majority of the contracts give the venture capital the right to demand some level of performance from the investee company. Some of the control mechanism being practise include staging of funding against predetermine milestones, board representation and being involved in the running of the investee company.

The venture capital industry in Kenya should further be developed to enhance economic development especially in technology-oriented industries. There is

therefore a need for government support in regulating the industry and providing mechanisms and incentives that will support domestic resource mobilization into private equity.

CHAPTER ONE

INTRODUCTION

Background

There is no strict regulatory definition of the venture capital industry, unlike commercial banking or insurance but venture capital firms provide privately held "entrepreneurial" firms with equity, debt, or hybrid forms of financing, often in conjunction with managerial expertise. Wright and Robbie (1998) defined venture capital as the investment by professional investors of long-term, unquoted, risk equity finance in new firms where the primary reward is an eventual capital gain, supplemented by dividend yield.

Unlike investments in quoted companies, there are only a few investors involved in the funding, all of whom are presumed to be sophisticated. Therefore the terms of the funding need not be simple. In fact, they tend to be quite complicated so as to best address the various aspects of each particular case. Even a casual inspection of a typical term sheet reveals a strikingly large number of features, such as convertible and preferred securities, warrants, staged investment with milestones, anti-dilution ratchets, voting arrangements, liquidation preferences, and vesting arrangements (Cuny and Talmor, 2002).

The venture capital industry is a particularly good example of an institution that prides itself on nursing' companies, rather than just financing them(Hellman, 1998). Venture capitalists add value to their companies by providing a variety of services: they help shape strategies, provide technical and commercial advice and attract key personnel (Byers, 1997; Bygrave and Timmons,1992; Gorman and Sahlman,1989; Sapienza ,1992).

For decades, venture capitalists have nurtured the growth of America's high technology and entrepreneurial communities resulting in significant job creation, economic growth and international competitiveness. Companies such as Digital Equipment Corporation, Apple, Federal Express, Compaq, Sun Microsystems, Intel, Microsoft and Genentech are famous

examples of companies that received venture capital early in their development (National venture capital Association, 2007).

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 famous industries in the world, thereby creating immense wealth (Ngigi. 1997).

Kenya has had a venture capital sector from independence. Six parastatals are engaged in venture capital. They include AFC DFCK.ICDC, IDB, KIE, and KTDC. Each of these institutions is slowly moving away from equity financing towards provision of loan alone. They have an informal way of selecting projects as they look for partners, accounting for domination of foreign partners. It is not surprising that a number of institutions, after experiencing major loses, are moving away from venture capital altogether (Ngigi, 1997). Reasons are the high risk, the severe asymmetric information issues as well as the various moral hazard problems that come hand in hand with such an investment.

The asymmetry information associated with startup companies makes project governance extremely important. During the screening process, venture capitalists review business plans of young companies and design contracts with entrepreneurs that minimize potential agency costs (Gompers, 1995).

Akerlof (1970) is normally taken as the starting point of the formal analysis of informational asymmetry. Akerlof describes a situation where sellers of used cars have private information about the quality of their cars, but buyers cannot discern quality differences before purchase. In this setting, low-quality cars or "lemons" dominate the market, thus the market "selects" adversely. Akerlof showed that this adverse selection is inefficient in that potentially efficient (i.e., Pareto-improving) trades will not take place.

Adverse selection problems can arise in many circumstances. For example, in insurance markets. buyers may know their true risk better than insurance companies (as in Pauly (1974)), and in labor markets, workers may be more aware of their abilities than potential

employers are (as in Spence (1973)). Spence points out that one natural market response to adverse selection is "signaling," where an informed party (usually the seller of the high-quality item) provides some signal of high quality. Thus, for example, product warranties may be signals of high quality. Rothschild and Stiglitz (1976) emphasize the role of screening, under which the uninformed party offers a contract or set of contracts that cause informed parties to self-select into different groups.

Hidden action and moral hazard was first discussed in insurance markets, where insured parties can take actions that either decrease or increase the risk of hazard. For example, after purchasing auto insurance, the insured party can either drive safely or dangerously. Early influential work on moral hazard includes Arrow (1974) and Pauly(1974), who showed that moral hazard causes market failure. Moral hazard problems are particularly important in many situations where one party acts as an agent for another party, such as when a client hires a lawyer, or the seller of a house hires a sales agent. In these situations, the "principal" cannot perfectly observe the effort (or other actions) of the agent. Jensen and Meckling (1976) argue that agency relationships are the key to understanding the modern firm. Thus, for example, the managers of the firm can be viewed as the agents of the owners, who might in turn be viewed as the agents of other investors in the firm.

Adverse selection and moral hazard are often viewed as crucial determinants of venture capital financing. Sahlman (1990), for example, postulates that contracting practices in the venture capital industry reflect informational asymmetries between venture capitalists and entrepreneurs, and argues that the lack of operational history aggravates the adverse selection problem. MacIntosh (1994) also asserts the basic idea that informational asymmetries are fundamental in the venture capital sector, and this point is also emphasized in Amit, Glosten, and Muller (1993). Various other papers implicitly recognize the importance of informational issues. For example.MacMillan, Zemann, and Narashima (1987) provide a valuable discussion of how venture capitalists screen new projects.

Chan (1983) highlights the role of venture capitalists in reducing the adverse selection problem in the market for entrepreneurial capital. He shows that an adverse selection result derives from the absence of any informed venture capitalists in the sense that only inferior projects are offered to investors. Sahlman (1990) describes venture capital in terms of control mechanisms employed in managing agency costs. Three control mechanisms are common to all venture capital financing: 1) the use of convertible securities; 2) syndication of investment; and 3) the staging of financial infusion.

Sahlman (1990) notes that staged investment, which creates an option to abandon the project, is an important means for venture capitalists to minimize agency costs. In addition, the active involvement of venture capitalists in the operation of their investee companies might mitigate the moral hazard problem. The empirical significance of the role of venture capitalists as monitors is supported by Barry et al. (1990) and by Lerner(1995). In addition, Lerner (1995) suggests the use of syndication (coordinated investment by two or more venture capitalists) as a method of reducing problems caused by informational asymmetries. Two other useful papers that describe actions that venture capitalists can take to reduce problems arising from informational asymmetries include Tyebjee and Bruno (1984) and Fried and Hisrich (1994).

Chan *et al.*(1990) seek to explain various "rules of thumb" in venture capital contracting practices as a response to informational asymmetries and, in a related paper, Hirao (1993) assumes that the entrepreneur's unobservable actions affect the venture capitalist's learning process, and uses this context to study the effects of different contracts.

Kaplan and Stromberg (2002) find that Venture Capitalists help overcome principal-agent contracting problems through sophisticated contracting, pre-investment screening and post-investment monitoring and advising.

The Research Problem

It is now difficult to envision grooming of technology-based start-up firms without venture capital backing. Some of the private companies in Kenya which are currently financed by Venture capital include Brookside Dairies, Mount Elgon Orchards and Micro Kenya (Africa Venture capital association, 2007).

Traditionally, such young innovative firms have difficulties in obtaining capital. Reasons are the high risk, the severe asymmetric information issues as well as the various moral hazard problems that come hand in hand with such an investments. Venture capital investments are peculiar in nature. First, they are mostly private, unquoted companies, with little pressure to divulge information, no financial analysts monitoring them and potential investors knowing considerably less about them than about publicly quoted companies. Second, venture capital investments are highly illiquid as they cannot be sold easily at any point in time (Sahlman, 1990). Potential buyers have to be sought and some value for the business has to be agreed upon. This makes trading in private stocks a costly and time -consuming process. Further, venture capital investments are typically long term investments: for early stage projects it takes approximately five years before investments are mature enough to be sold and often several investment rounds are required before harvesting is possible (Sahlman, 1990). Third, it is more difficult to fully diversify a portfolio of unquoted investments than one of quoted investments. High information and transaction costs will only be economical when the potential gains from the investment are substantial, resulting in a need for relatively large investments. The amounts invested in a venture capital project are often a significant part of the total amount of funds at the disposal of the Venture capitalists, thus restraining its ability to diversify (Robinson, 1987). Finally, Venture Capital investments are more risky than investments in quoted companies due to the high business risk faced by this type of companies (Schilit, 1993).

Mitigation strategies commonly used to control and monitor venture capital investments are: First, venture capital investments are typically concluded with a set of contracts that include a stock purchase agreement, a certificate of designations (or restated certificate of incorporation), a shareholders' agreement, and a registration rights agreement collectively referred to as "venture capital contracts" (Halloran, 1998). Second, the improvement of the

information quality at the pre-contracting stage through signaling and a carefully conducted due diligence can potentially reduce adverse selection. Third, deal syndication reduces the cost of information gathering and post contract monitoring. Fourth, stage financing reduces the risks inherent in ventures and makes financing cheaper. Fourth, the deal structure, especially the securities used and contractual clauses, can realign interests.

The study seeks to answer the following questions:

i) What financing instruments are used by Venture capitalist in Kenya?

ii) What factors/reasons influence the choice of financial instruments used by venture Capitalists?

iii) What control and monitoring mechanisms are used in Kenyan venture capital industry.

The Research Objectives

i) To determine financial instrument used by Venture Capitalist in Kenya.

ii) To determine the important consideration in choosing financial instrument.

iii) To determine the control and monitoring mechanisms used by Venture capitalist in Kenya to ensure success of the venture.

Importance of the Study

The research findings may be useful to:

i. The venture capitalists on how to successfully identify appropriate financial instruments, control, monitor and gainfully divest from venture capital investments.

ii. Government in providing information which may assist in coming up with policies that would enable financial innovations in venture capital industry and encourage growth in the industry. Policymakers debate ways to nurture the growth of domestic venture capital industries, while businessmen are already busily starting venture capital firms. Such public policies are more likely to succeed if their designers understand what makes the venture capital industry tick.

iii. Stakeholders, donors and other interested parties to enable them to make informed decisions.

iv. Academicians in creating a pool of information upon which further studies on venture capital can be developed.

v. Investors/entrepreneurs in understanding the role venture capitalists play in entrepreneur/venture capitalist relationship and the importance of venture capital as one of the sources of capital.

vi. Financial analysts in understanding the intrinsic issues in venture capital that may affect the value of a venture capital backed companies..

CHAPTER TWO

0 LITERATURE REVIEW

1 The Concept of Venture Capital

Wright and Robbie (1998) defined venture capital as the investment by professional investors of long-term, unquoted, risk equity finance in new firms where the primary reward is an eventual capital gain, supplemented by dividend yield. In addition, venture capitalists are usually actively involved in their investment steering their development towards desirable outcomes (Sahlman1990).

A common misconception about venture capital is that it is mainly a matter of spotting a promising startup, giving it a small sum of money in exchange for a big chunk of company and rushing to take to public so that the venture capitalist can 'cash out' reaping good returns. The reality is that venture capital is mostly a matter of managing and nurturing firms (The Economist, 1997).

Venture capitalists add value to their companies by providing a variety of services: they help shape strategies, provide technical and commercial advice and attract key personnel (Byers, 1997; Bygrave and Timmons, 1992; Gorman and Sahlman, 1989: Sapienza, 1992). The true situation on the ground however, is that many people still do not understand the concept enough to undertake it (Atieno, 2007).

Venture capitalists are actively involved in management of the venture they fund, typically becoming members of the board of directors and retaining important economic rights in addition to their ownership rights (Sahlman, 1990). Venture capitalists often hold extensive control rights over entrepreneurial companies, including the right to fire entrepreneurs. This provides the correct incentives for the venture capitalists to search for a superior management team. Wealth-constrained entrepreneurs may give up control even if the change in

management imposes a greater loss of private benefit to them than a monetary gain to the company (Hellmann, 1998).

Venture capitalists will generally obtain ownership in the newly formed company for a limited period of time and sell that interest back to the owner as soon as they are able to recover the investment with reasonable interest usually relatively higher than what can be earned by investing in the stock market (Atieno, 2007).

The venture capitalist doesn't make her investment all at once. Instead, funds are always provided in stages, and the entrepreneur receives only enough funding to reach the next stage (Berlin, 1998). Ideally their money should only be needed in a few chunks each meant to knock down a specific barrier to the company's rapid growth. For start ups, the first financing is to let the company develop a prototype. A second round of financing might fund marketing and sales. A third stage, usually once the company has some sales, lets it grow more quickly than sales alone could allow. By then, the company could be ready to go public, putting financing in the hands of the markets (The Economist, 1997).

Information Asymmetry and Agency problems in Venture Capital Finance

In economics, financial contracts are incomplete since they are entered into in uncertain environments, and they fail to exploit even available information (for example, probability distributions) because of two obstacles. First, some information is observable by only one party (the entrepreneur) who cannot credibly communicate it to others (information asymmetry).Second, the parties cannot control post-financing behavior by contract because either the behavior itself or future states of the world cannot be verified by third party arbiters (agency problems) (Triantis, 2002).

Essentially the information asymmetry that exists between the poor venture capitalist and information savvy entrepreneur is a situation subject to many factors. These include but not limited to, the desire to keep the company secrets secret and simple lack of trust in the entrepreneur's behalf and venture capitalist desire to know everything about the business before investing equity in the company. Due diligence such as industrial analysis, checking

entrepreneurs estimates and assumptions and reviewing expansion and growth initiatives and tax consequences all attempt to reduce the risk of investment, however information asymmetry still exists(Akerlof, 1970).

In a situation where the entrepreneur controls the venture funds, he can choose to invest the funds efficiently into the project or divert them to his own private ends. This creates potential moral hazard problems brought about by the agency conflict due to the dynamic nature of investment problem given uncertainty of success in every stage. When diverting fund for personal use 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 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).

2.3 Contracting and financial instruments in Venture Capital

Venture Capitalists structure their investments using a mix of various types of contractual securities and contractual clauses to mitigate their risks and maximize their potential return. Each type of security offers a different mix of property and control rights. Property rights define the possible claims on shares of the company and consequently on the ultimate cash benefits of the venture, while control rights influence more the behavior of the entrepreneurs or the venture and the available recourse against possible improper deeds. Control rights matter either because they allow one party to make a decision in the presence of conflict of interest, or because they affect the threat points in any renegotiation. Control is important since it affects the non-contractible behavior of the two contracting parties (Hellmann, 1998).

A distinguishing characteristic of venture capital investment contracts is their extensive and very sophisticated use of positive and negative covenants. These are contract clauses that mandate certain things that the portfolio firm's managers must do (*positive covenants*) and must not do (*negative covenants*). Some of these covenants are found in many standard bond and loan financing contracts, such as covenants which specify maximum acceptable leverage

and dividend payout ratios, require the firm to carry certain types of business insurance, and/or restrict the firm's ability to acquire other firms or sell assets without prior investor approval. (Megginson ,2001).

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 right to claim control on a contingent basis and the right to fire the founding management team. They often keep hard claims in form of convertible debt and preferred stock, underpinning the right to claim control and abandon the project (Lerner and Gompers, 1999).

Venture Capital investments arc typically concluded with a set of contracts that include a stock purchase agreement, a certificate of designations (or restated certificate of incorporation), a shareholders' agreement, and a registration rights agreement collectively referred to as "venture capital contracts" (Halloran, 1998).

Bienz and Hirsch (2005) came up with four categories of financial instruments: pure equity, pure debt, debt-equity mixes and convertibles which take into account the existence of liquidation preferences. The most fascinating and distinguishing feature of venture capital investment contracts, however, is unquestionably their almost exclusive reliance on convertible securities (particularly convertible preferred stock) as the investment vehicle of choice (Megginson, 2001).

Kaplan and Stromberg (2002) find that convertible securities are used in majority of venture financing and show that the allocation of redemption rights is commensurate to the performance of the company.

Venture investments are almost never funded with common stock or with non-convertible preferred stock or debt. Instead, venture capitalists almost invariably fund their investment with either convertible debt or (much more frequently) convertible preferred stock, for several reasons. First, since corporate law requires that all shareholders be treated equally,

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venture capitalists would only be able to exercise effective voting control with common stock if they were to purchase a majority of a firm's common shares, and to purchase these at the same price as other investors. This would be both extremely expensive and would place far more of the firm's business risk on the venture group than on the entrepreneur. Since convertible debt or preferred stocks are separate class of security from common stock, contract terms and covenants specific to that issue can be negotiated. Furthermore, since multiple classes of convertible debt or preferred stock can be created, extremely complex and sophisticated contracting arrangements can be worked out between the firm and many different investor groups (Gompers, 1995).

Cumming (2005) predicts that straight preferred equity is used for firms in startup stage and convertible debt and straight preferred equity is used for firms in expansion stage of development. At the varying stages of company development, the type and actual dollar amount of agency costs defer and Cummings argues that this influence the type of instruments used. Plausible instruments which the venture capitalist can use when investing are anything from common equity to preferred equity, to debt, to options and then we need to consider availability, the convertibility and target set for conversion and any hybrid of this choices.

Triantis (2002) gave the advantage of using convertibles over pure debt. A pure debt claim restricts the ability of the entrepreneur to obtain new capital without the consent of its creditors, particularly if it is senior or secured. On the other hand, a pure equity claim makes subsequent financing too easy. Convertibles offer a third approach between giving discretion entirely to the entrepreneur and requiring renegotiation with the holders of outstanding debt. If the venture succeeds in its early stages, it can compel the conversion of the venture capitalist's claim into equity (for example, by meeting performance targets or executing a successful IPO). Upon the extinction of the debt, the entrepreneur is relieved of periodic interest payment obligations and gains new capacity to borrow in order to finance his operations. Therefore, while the debt component of the security may serve to minimize the initial discount upon issue of the security, the prospect of subsequent conversion restores the ability of the entrepreneur to obtain future debt financing in good states of the world from

other sources. Of course, if the venture fails, the debt claims remains and may induce liquidation and termination of the start-up firm.

Venture capital contracts contain extensive provisions regulating exit by the venture capitalists. Venture capitalists typically control the exit decision of their investment companies, and a financial exit strategy is typically part of the term sheet (Fenn, Liang and Prowse (1995); Sahlman (1991); Testa (1997)). It can be done through Put options, requiring management or the investee company to buy the venture capitalist's shares if no exit is achieved within a defined period (Testa 1997).

According to (Megginson, 2001) Venture Capitalists are not long-term equity investors; their objective is to add value to a private company and then to harvest their investment once the company is mature enough. There are three principal methods of exiting an investment: (1) through an initial public offering (IPO) of shares to outside investors; (2) by selling the portfolio company directly to another company and (3) by selling the company back to the entrepreneur/founders [the *redemption option).*

Controlling and monitoring of the venture investments

Venture capitalists add value to their companies by providing a variety of services: they help shape strategies, provide technical and commercial advice and attract key personnel (Byers, 1997; Bygrave and Timmons, 1992; Gorman and Sahlman, 1989: Sapienza, 1992).

Venture capitalist is actively involved in management of the venture they fund, typically becoming members of the board of directors and retaining important economic rights in addition to their ownership rights (Sahlman, 1990). Venture capitalists hold effective control over the board, typically through a voting majority, and sometimes through explicit contractual agreements (Sahlman, 1988).

Triantis (2002) purports that the main differences between venture capital contract design and that of other financial industries is that venture capitalist concentrate on bargaining for

voting rights, Board positions and other monitoring techniques rather than placing restrictive covenants on investee such as sale of an asset, quitting of the venture or acquiring another. According to survey by Gorman and Shalman(1989), lead venture investors visit each portfolio company an average of 19 times per year and spend 100 hours in direct contact(on site or by phone) with the company.

Sweeting and Wong(1997) make an important observation : "The reason behind the venture capitalist's 'unscientific' method seems to grow mainly on the inherent belief that that entrepreneurial quality and potential successful investment outcome can not be predicted simply by processing figures through a mathematical formula. Many human factors are involved in venture investments and must reliance is place in venture past capitalist experience subjective evaluation and foresight". The venture capitalist might argue that this is reason enough to require an entrepreneur to provide timely detailed management and financial reports, a tasks that entrepreneur frequently rejects as a waste of resources.

Sapienza *et al.* (1996) finds that the venture capitalist spend more time helping and advising those ventures that performed well as opposed to those that did not. The simple argument should predict that the venture capitalists should spend greater time with those investees that have their going concern status threatened. If a venture capitalist has a choice between helping an ailing portfolio company and or consolidating a successful one, Sapienza *et al.* (1996) predict the venture capitalist would go for the later. It is somewhat bemusing that the venture capitalist would not spend time with those ventures that are struggling, applying their business knowledge to avert any outright failures in the portfolio. They could let the successful companies continue to be successful. However, venture capitalist are subject to their own human emotion, and it appears that the choice between being associated with the winner(rather than a loser) investee company results in the venture capitalist spending more time in the winning company and concentrating their efforts in maximizing returns on that investment.

Kirilenko(2001) reports that in early rounds of financing the venture capitalist will require a disproportionate high level of control through control rights than their investment deserves and then in later rounds of financing, they will begin to relinquish control.

One way of monitoring venture capital investments is by staging the funding. Staging Venture capital funding is commonly provided to start-up firms on a piecemeal basis over numerous stages. One way in which this can be implemented is through milestone financing, where a venture capitalist commits upfront to providing additional future funding contingent upon the firm meeting certain conditions, or milestones. Alternately, the firm can operate without a firm commitment in place, still reasonably expecting to be able to receive additional rounds of funding after goals are met (round financing)(Cuny and Talmor, 2002).

Stage financing is appealing to venture capitalist 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 Pfleider, 1994). Second, the treat to abandon create incentives to maximize value and meets goals.

At every stage of a company's financing, new information about the venture is released (Sahlman, 1990; Kaplan and Strömberg, 2002). Sahlman (1988) describes how the entrepreneur may try to improve short-term performance reporting in order to make sure that the project gets refinanced at improved conditions.

The advantage of staged financing is pointed out in Neher (1999) who shows that as human capital is gradually transformed to physical capital, the venture increases the value of its collateral, hence makes outside financing more affordable. Staging should coincide with significant economic developments in the enterprise.

Gompers (1995) provides detailed statistics on staging of venture capital investments and explores factors that influence the amount invested in a round and the duration between rounds. He finds that that staging of capital infusions allows venture capitalist to gather information and monitor the progress of firms maintaining the option to periodically abandon the projects.

Other suggested solutions engineered by venture capital industry to overcome problems arising from information asymmetry include the use of syndication. Syndication involves more than one venture capital firm investing in an entrepreneurial venture. Syndication

facilitates risk avoidance through risk sharing (Wilson, 1968), enables better and more informed investment decisions (Sah and Stiglitz, 1996), and mitigates the hold-up problem inherent with a single supplier of capital (Rajan, 1992). A syndicated investment will not require as lengthy an investment as non-syndicated investments, ceteris paribus, because informational asymmetry between the new owners and the firm is mitigated. The greater the number of investors, the better the signal to the new owners that there exists less informational asymmetry associated with investing in the venture (Cumming and MacIntosh, 2000, 2002).

Bygrave (1987) reported that reason for syndication among venture capital firms is to reduce the financial risk by sharing the risk with other investors. It is reported by Norton and Tenenbaum (1992) that risk and exposure of venture capitalist is minimized through the participation in syndicates and use of preferred stock. Syndication is an obvious way of spreading the risk among the financiers. The less a firm has stake in an investee, the lower is the risks in a portfolio of an investment.

Venture Capital in Kenya

Market Infrastructure in Kenya is still not fully developed. A well organized market will include an organized exchange as well as over the counter markets and venture capital arrangements. The later two are lacking in Kenya. There is also lack of market information since it only reaches a few people i.e. those in urban areas (Masinde and Kibua ,2005).

Many firms in Kenya cannot get bank loans, and some do not even get supplier credit. These barriers to credit have an effect on investment in two ways: directly when firms cannot invest in profitable projects; and indirectly when they refrain from expanding to avoid running into liquidity problems. Both effects are present in the Kenyan data. In a case study by the World Bank, One third of the case study firms report that at least once they were unable to incur a lumpy investment they thought profitable because of the lack of funds. Kenyan-African firms are much more likely to be affected by barriers to credit directly: more than 80% of them were at least once unable to purchase equipment or vehicles because of lack of funds. The investment capacity of small and particularly micro firms is more affected by barriers to credit than that of medium and large firms (The World Bank, 1994).

To bridge the gap, Venture capital can be used as a financial tool for development, within the range of small and medium enterprises (SME) finance, by playing a key role in business start-ups, existing small and medium enterprises and overall growth in developing economies. Venture capital acts most directly by being a source of job creation, facilitating access to finance for small and growing companies which otherwise would not qualify for receiving loans in a bank, and improving the corporate governance and accounting standards of the companies. Some of the private companies which are currently financed by Venture Capital include Brookside Dairies, Mount Elgon Orchards and Micro Kenya. These Venture Capital-backed companies have had a profound impact in generating informal and semiformal markets for basic goods and services in a part of Kenya with high unemployment and low wages. Informal small-holder farming, kiosk trading, and local transport and distribution networks have all sprung up in the firms' environs, providing important linkages for the rural poor with the cash economy (Africa Venture capital association, 2007).

It is therefore necessary, to put the case more specifically for venture capital and private equity investments. Enterprises, including Small and medium-sized enterprises (SMEs), supported by venture capital and private equity investment are vital in bringing economic growth and sustainable development in Kenya. Venture capital and private equity financing can add significant advantages to the investment recipient, such as access to a national and international networks of suppliers, producers and consultants, gain of critical mass, attraction of world class management and facilitation of regional and international business expansion(Africa Venture capital association, 2007).

There are several venture capital institutions operating in Kenya. It may be noted, that the minimum lending platforms of these institutions are high, therefore the reach to the public is very limited. Furthermore, being private organizations whose primary objective is profit on capital invested, participation in the industrialization process is only guaranteed where a significant return is expected and there is minimal risk (KTDC, 2007).

The regulations for the Venture Capital industry are yet to be formalized and the Acacia Fund remains the only venture capital firm licensed by the CMA. But there are other players such as ICDCI, investment advisers, investment companies, and entities like Transcentury who can arrange equity-based financing for viable companies. Given the archaic company laws and endless court processes, entrepreneurs in Kenya have to be very careful about who they let in as equity partners. (Bankelele, 2007).

Olaka(2007) provides some of the challenges to growing private equity and venture capital funds in Kenya. The challenges include limited exit opportunities, tax inefficiencies, scarcity of viable deals, lack of information about the asset class and shortage of experienced managers. There are less than five cases where private equity firms have successfully exited from investments in Kenya through Nairobi Stock Exchange.

Six parastatals are engaged in venture capital. They include AFC DFCK,ICDC, IDB, KIE, and KTDC. Each of these institutions is slowly moving away from equity financing towards provision of loan alone (Ngigi, 1997).There is therefore a need for creative exit strategies, government support to market, innovations and mechanisms that will support domestic resource mobilization into the private equity and provide the incentives to attract foreign investors (Olaka, 2007).

CHAPTER THREE

RESEARCH METHODOLOGY

Population and sample

A total of nineteen Venture capitalists were approached to provide the required information. They include seven companies incorporated as venture capitalist by the Registrar of Companies under Companies Act, seven in the African Venture Capital Association (AVCA) directory as venture capital funds operating in Kenya and five listed in Association of African Development Finance Institutions (AADFI) as providing venture capital as part of their development agenda.

Data Collection Methods

Data was collected with the help of a questionnaire, which was developed in line with the research objective (Annex 1). The researcher administered the questionnaire by filling the questionnaire according to the respondent response. This assisted the researcher to not only clarify on the spot any doubt the respondent had on any question but also get an opportunity to discuss additional information about the research topic.

The researcher interviewed seventeen fund / equity managers of fifteen venture capitalists who reported on nineteen venture capital deals.

The questionnaire was structured into three main pages with first being introduction while second and third were designed to capture data on the control mechanism employed by venture capitalist in a specific venture and the financial instrument used and the reason for choosing the instrument.

After introduction questions , the second lot of questions was designed to collected data on areas such as stage financing, syndication of investment, Board representation, involvement

in investee company management, board representation and whether the venture capitalist had exercised controls rights as per subsisting contracts.

The third lot of questions was designed to find out the financial instruments used by the venture capitalist while investing in the company and the reasons for choosing the instrument. When asking venture capitalists for reason for choosing a particular financial instrument it was imperative to give them enough variety of options so that the limited number of option did not skew their response. This meant searching the finance landscape for as many reasons as humanly possible.

Data Analysis Techniques

The data collected from the field was classified according to their common characteristics to enable both qualitative and descriptive methods of statistical analysis to be carried out. The data was presented through tabulation and charting techniques.

The data about what instruments or combination of instruments used by venture capitalist were presented on a bar chart in order to show the frequency of a particular or combination of instruments used by venture capitalists. Matrix table was used to analyze survey results on the survey question that asked the respondent to rank a series of possible explanation for using the particular instrument. From the matrix table, bar charts were used to further determine the relationships between the financial instruments used and the reason for use.

The data collected concerning controlled mechanisms exercised by venture capitalists were summarized in bar charts. Percentages and charts were used to summarize responses about the whether the venture capitalists were involved in stage financing, syndication of investments and board representation. The plausible control rights which a venture capitalists could exercised were also summarized and presented by use of a bar chart

Correlation between how the investee company performed and the number hours a venture capitalist spent in an investee was done and the results presented in a tabular form

CHAPTER FOUR

4.0 DATA ANALYSIS AND FINDINGS

To facilitate understanding and comparison, the presentation is largely in tabulated and chart format. The presentation of the key findings is followed by a more detailed discussion of the specific data collected within selected question.

The findings of the study is detailed below:

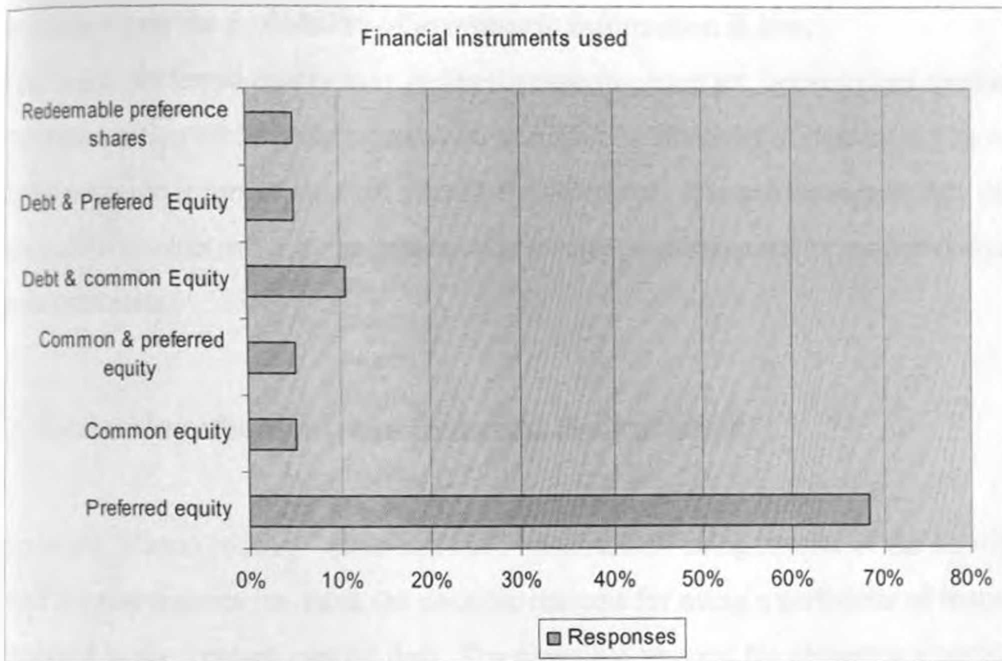
4.1 Venture Capital Instruments, the use and the intention

4.1.1 Choice of the Financial Instrument

Venture capital deals are negotiated and concluded with a set of contracts which determines the instrument or combination of instrument with which the venture is going to be funded
Bienz and Hirsch (2005) came up with four categories of financial instruments: pure equity, pure debt, debt-equity mixes and convertibles, which take into account the existence of liquidation preferences

The **Chart 4.1.1** below shows that 68% of the deals were concluded with preferred equity as an instrument of choice, while another 10% used preferred equity in combination with other instruments. In fact, preferred equity was used solely or in combination with other instruments in 78% of the deals surveyed.

Chart 4.1.1 **Instruments used or combination of instruments used**



Further investigation showed that preferred equity where used as a sole instruments in 79% of the deals entered into while the company was in seed/startup stages while a combination of debt and preferred equity or combination of debt and common equity were used in the deals entered into when the company were in expansion stages of development

Redeemable preference shares and common equity were each used in 5% of the deals entered into. 11% of the respondents had a combination of debt and common equity as an instrument of choice. Further analysis showed that all of the venture capitalist which use a combination of debt and common equity as instruments of choice were development finance institutions. This is because public-private partnership agencies are traditionally supporting the financing of startups and medium sized firms by publicly guaranteed loans in order to promote regional development. As they do not face the same extent of agency problems as private venture capitalists, they are more likely to use rather low powered incentive compatible financing instruments such as debt and silent partnerships in the form of common equity.

The results demonstrate that preferred equity is the dominant contract in early stage financings, and that debt and common tend to be used far less frequently—generally at later stages and under conditions where the probability of asymmetric information is low.

In particular, preferred equity may be the dominating contract, because this contract eliminate foreclosure option while preserving some seniority in the event of bankruptcy to current liabilities should information turn out to be asymmetric. It is can be argued that this asymmetric information mechanism may be responsible for the predominance of preferred equity in venture capital contracts.

4.1.2 Reason for choosing the financial instruments

The below 'reason matrix' table has been constructed using results of the survey questions that asked the respondents to rank the possible reasons for using a particular of instruments that was employed in the venture capital deal. The plausible reasons for choosing a particular instrument were gathered from venture capital literature and considerable consultation with industry specialists.

Table 4.1.2 Reason matrix Table

		level of Importance				
Rank	Reason	extremely	very	relatively	minor	Not
1	To maximise return for your fund investors	37%	42%	11%	0%	11%
2	Provides voting rights and control	5%	63%	5%	5%	21%
3	Provides modalities for exit	5%	47%	11%	0%	37%
4	To provide your firm the ability to call for liquidation	5%	16%	11%	11%	58%
5	Provides avenue for monitoring the investee	0%	16%	5%	5%	74%
6	Minimises risks	0%	16%	11%	0%	74%
7	To maximise return in case of liquidation	5%	5%	16%	5%	68%
8	Provide incentive to the investee company to perform optimally	0%	11%	5%	0%	84%
9	Provides a deal that the management would accept	5%	0%	5%	0%	89%
10	Provide a forum for providing advice	0%	0%	5%	0%	95%
11	Previous covenants with the investee are considered.	0%	0%	5%	0%	95%
12	Tax incentives	0%	0%	0%	0%	100%

Table 4.1.2 above shows that 79% of the respondents consider maximization of return to venture capital investor as the main reason for choosing an instrument to invest with. 37% of the respondents consider maximization of return as extremely important while 42% consider it as very important. The ability of the venture capitalist to exercise controlled was ranked as the 2nd most important reason for choosing an .instrument with 68% placing at 'very' and 'extremely' category.

Other reasons which were ranked highly include the ability of the instrument to allow for liquidation and exit strategy. The reasons given for choosing each instrument are further analyzed and discussed below:

4.1.2(a) Maximization of return to venture capital investment and voting rights.

As stated above, maximization of return attracted the highest response rate among the venture capitalists with 77% of the respondents nominating it at some level of importance. The table 4.1.2(a) below shows the type of instruments where maximization of return was nominated as a reason choosing the instrument to invest with.

While 68% of the respondents (reported earlier) nominated preferred equity as the sole instrument of choice, 77% of them reported that the use of preferred equity was either very important or extremely important in maximizing investors return. Further analysis of those respondents that did not rate investor return as important (23%) show that in all the cases voting rights and control purposes and/or exit reasons was nominated as important factors in choosing the financial instrument. In most of the cases where maximizing investor return is not deemed as important, a level of control over the company was most important driving factor.

Table 4.2.1(a). Financial instruments in relation to maximization of return to venture capital investors

	Preferred	Convertible redeemable preference shares	Preferred equity and Debt	Preferred & common equity	debt	Common equity
Extremely important	5	1				
Very important	5	0		1	1	
Relatively Important	0	0	2			
Minor considerati on	0	0				
Not important	3	0				1

1.2(b). Voting rights and control purposes

The second most important factor in financial instrument choice as cited by venture capitalist was 'Voting rights and control purposes'. Table 4.1.2(b) below shows that voting rights and control purposes was deemed important in 68% of the deals and of these citation, 92% were in very and extremely important categories.

Voting rights and other control mechanism are a venture capitalist's method of structuring a level of security into their investment. Unlike ordinary bank loans where hard assets are available to take security over, venture capital cash injection primarily rely on financial instrument as quasi-security structure. The best structure will inhibit the ability of unscrupulous managers to unfairly extract private benefits whilst minimizing reporting that the entrepreneur has to undertake to abide by the venture capital structure covenants.

The study therefore concluded that when choosing financial instruments, voting rights and how the entrepreneur shall be controlled are highly regarded by the venture capitalist.

Table 4.1.2(b).Voting rights and control purposes

	Preferred	Convertible redeemable preference shares	Preferred equity and Debt	Preferred & common equity	debt	Common equity
Extremely important	1	1				
Very important	8	0	1			1
Relatively Important	0	0	1			
Minor consideration	1	0				
Not important	2	0		1	1	1

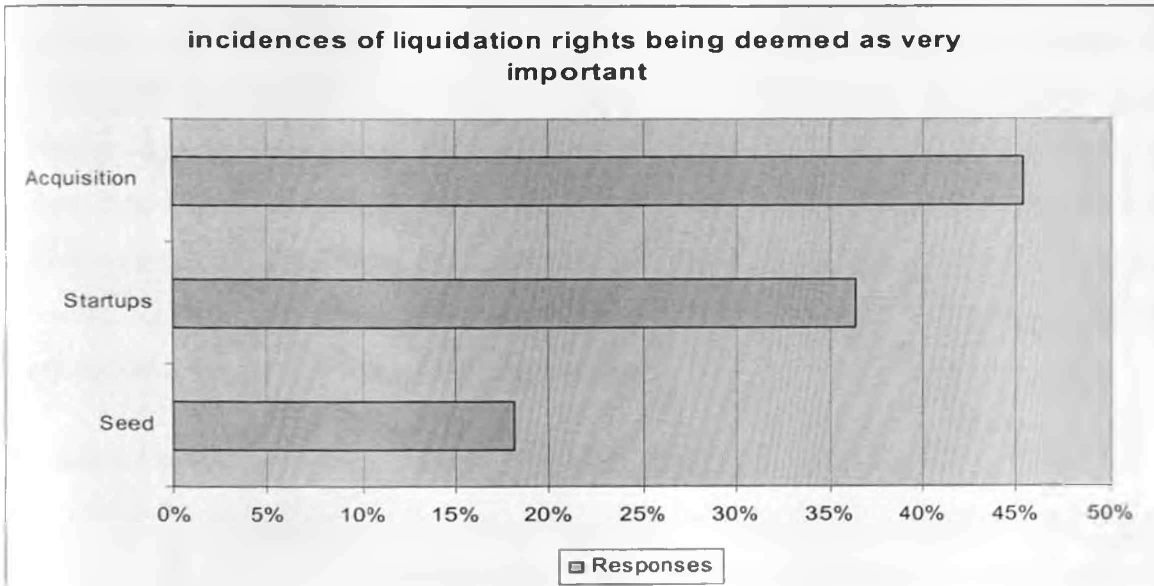
4.1.2(c) Liquidation explanation Vs stage in the company life cycle

By definition, a company liquidates when it become apparent that it can not continue as a going concern i.e. there are not enough liquid assets to pay liabilities as and when they fall due.

Chart 4.1.1(c) shows the type of deals that attracted liquidation as a reason for using a particular instrument. 45% of the incidences of liquidation rights being deemed very important are in those deals entered into when a company was in acquisition stage. These firms have a proven product with high sales growth, but are either unprofitable or marginally profitable, and require external capital to finance further expansion. Later-stage firms generally have collateral in the form of patents, marketing rights of existing products, fixed assets, inventories and receivables that might be seized in the event of liquidation. Instruments used in this stage are a mixture of debt and common equity or preferred equity and debt.

On the other hand, 55% of the deals that attracted liquidation as a reason for using a particular instrument were in seed capital/ startups. Of those incidences that used liquidation explanation, all but one used preferred equity in some form or another. Preferred equity is therefore is important if the there is a risks that the investee company will in one way or another not continue as a going concern.

Chart 4.1.1(c)



4.1.2(d) Exit Strategy Reasons

Choosing a financial instrument based on the ability to allow venture capitalist to exit was the third most important reason for choosing the particular instrument to invest with.

A venture capitalist respect in the industry is based on various factors, their ability o negotiate effectively, their ability to capitalize on their opportunities, as they present themselves and ability to structure a deal are some examples. However it is the exit from the venture deals that is really the venture capitalist' worth in the industry. Venture capital firms require employees and principals with best-in-industry talents in the areas of mergers and acquisitions, deal restructuring, debt and equity markets knowledge and portfolio management. Venture capitalist is continually positioning their fund's investment and therefore the investee for lucrative exit by way of trade sale or initial public offer. It is final

public step in the venture capital process that that the industry uses to judge the venture with. It is therefore no surprise that the study finds that the strategy for exiting the investee company is an important consideration in choosing financial instrument to invest with.

Table 4.1.2(d) below show 47% of the venture capitalist considers exit option as important when choosing the instrument to invest with. In addition, 46% of those respondents who nominated preferred equity as the sole instrument of choice, listed exit strategy as not important. Further investigation reveals that all them relates to investments deemed seed/startups. This is quite an interesting point in that venture capitalist using preferred equity in the earliest stages of venture capital do not rate exit strategy as important when choosing preferred equity as the financial instrument to invest with. This implies that seed /startups that use preferred equity are viewed as long term investments. As stated earlier, of those respondents who nominated preferred equity as the sole instrument of choice, 77% of them noted maximizing of returns to the funds investors as important This is logical in that venture capitalist see these startup investments as risky and therefore need to instill some controls but also see them as potentially lucrative

Table 4.1.2(d) exit strategy reasons

	Preferred	Convertible redeemable preference shares	Preferred equity and Debt	Preferred & common equity	debt	Common equity
Extremely important	1	1	0			
Very important	5	0	1	0		1
Relatively Important	1	0	1			
Minor consideration	0	0				
Not important	6	0		1	1	

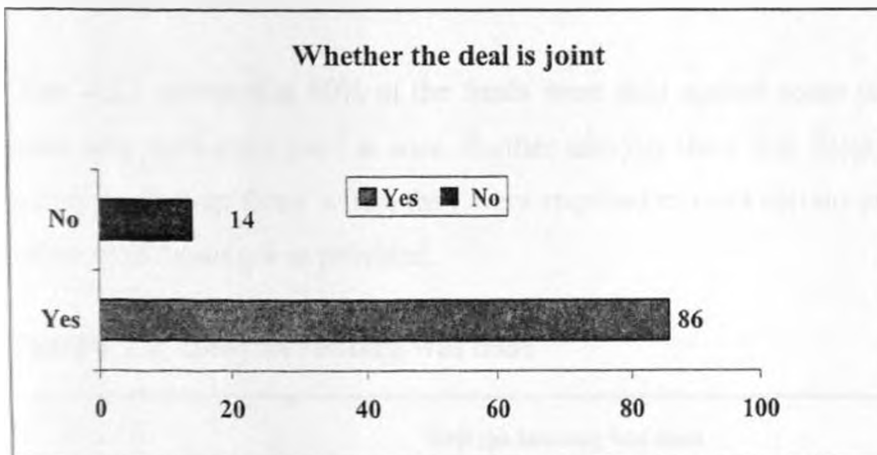
:Controlling and Monitoring of Venture Investments

:.1 Syndication of Investments

Syndication involves more than more than one venture capital firm investing in entrepreneurial venture. A syndicated investment will not require as lengthy screening as non-syndicated investments, ceteris paribus, because informational asymmetry between the new owners and the firm is mitigated. The greater the number of investors, the better the signal to the new owners that there exists less informational asymmetry associated with investing in the venture (MacIntosh, 2000).

Chart 4.2.1, below shows that 86% of the venture capital investments were done jointly with others investors (syndicated) while only 14% did not involve syndication.

Chart 4.2.1: Jointly funded deal with other investors



The study therefore shows that most of the venture capitalists prefer financing a project with one or more venture capitalists. This is because there might be an advantage to having more than one venture capitalist evaluate a project before it is selected for investment or, in a staged investment setting, before additional investments are made. Syndication is a way for the first, or *lead*, venture capitalist to bring other venture capitalists into the selection process. Even after its own evaluation of a venture investment, a venture capitalist might still be very unsure about the venture's prospects and might prefer to get the opinion of another

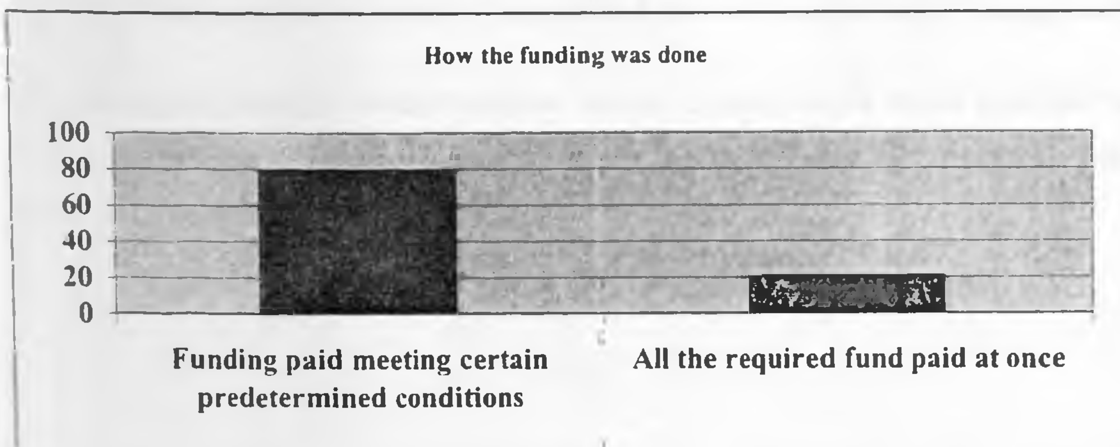
venture capitalist. In effect, two (or more) independent venture capitalists might screen projects more effectively than one, because each learns something from the others' evaluation. This process could occur at the time of first investment by a venture capitalist in the firm, or it could occur when additional or continuation investments are being considered by a venture capitalist. Thus syndication would lead to improved venture selection or continuation decisions. The use of syndication is a method of reducing problems caused by informational asymmetries. Syndication also facilitates the spread of risks and brings together more expertise and support.

2 Staging of Financing

Stage financing refers to a method by which a company is funded in stages, i.e. is provided incrementally with money as it passes milestones. Staging is also used to control errand entrepreneur who will almost never stop investing in a failing project as long as others are providing the capital.

Chart 4.2.2 shows that 80% of the funds were paid against some predetermined conditions while only 20% were paid at once. Further analysis show that Staging of funding was done mainly to start-up firms where they were required to meet certain predetermined conditions before next funding was provided.

Chart 4. 2.2 How the funding was done



They study therefore showed that majority of the venture capitalist prefer staging their funding especially when the investee is in the early stages of its life cycle. Staging of the investment is a mutually beneficial arrangement: it gives the venture capitalist the option to reinvest or abandon the project, but also provides the investee firm with gradually cheaper funding, as the sources of uncertainty are progressively removed.

Staging the commitment of capital also helps reduce the uncertainty typically surrounding small ventures. As time passes, the venture capitalist is able to gather more information about the team, the market and the product, thus reducing major risks and uncertainties considerably (Sahlman, 1988).

4.2.3 Board Representation.

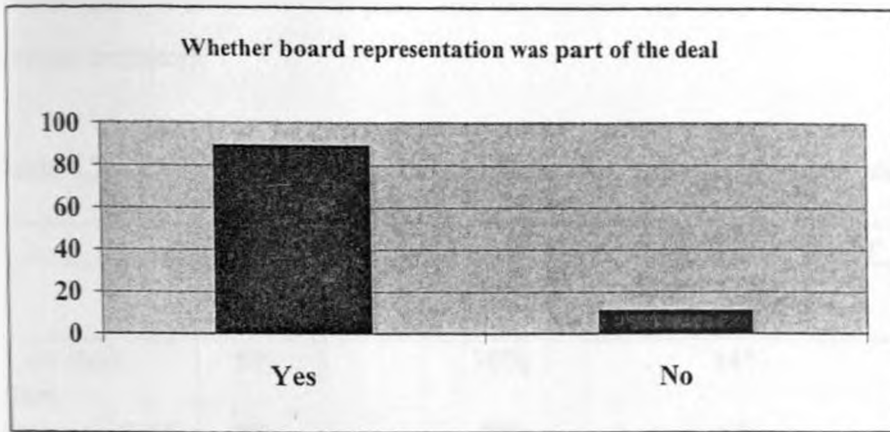
Board representation is one of the major requirements of venture capital financing contracts.

Chart 4.2.3 below shows that 89% of the venture capital deals had board representation as part of their funding requirements, while only 11% of the venture capital firms had no board representation in the part of the deal. It was further noted that all the 11% were in the acquisition stage. This is because acquisition stage does not require close monitoring.

The study further observed that significant number venture investors would require board representation and smaller ones would seek at least observer status on the board. In addition, venture investors will typically insist that, as a matter of good corporate governance, the majority of the board be composed of experienced directors independent of management

Venture capital contracts would therefore include clauses, which would give the venture capitalist the right to board representations and the right to retained important economic rights in addition ownership rights.

Chart 4.2.3 Board representation in the part of the deal



2.4 Venture capitalist involvement

Venture capitalist places contractual agreements that require the entrepreneur to provide detail management and financial reports and allow the venture capitalist get involve in the some aspects of management in the company.

Chart 4.2.4 shows that 48% of the venture capital firms spend less than 5 hours per week providing help to the investee company, 25% spend 5-10 hour,22% spend 10-15 hours, 4% spend 15-20 hours and only 1% spend over 20 hours

Chart 4.2.4(a) Average hours per week spend providing help to the investee company

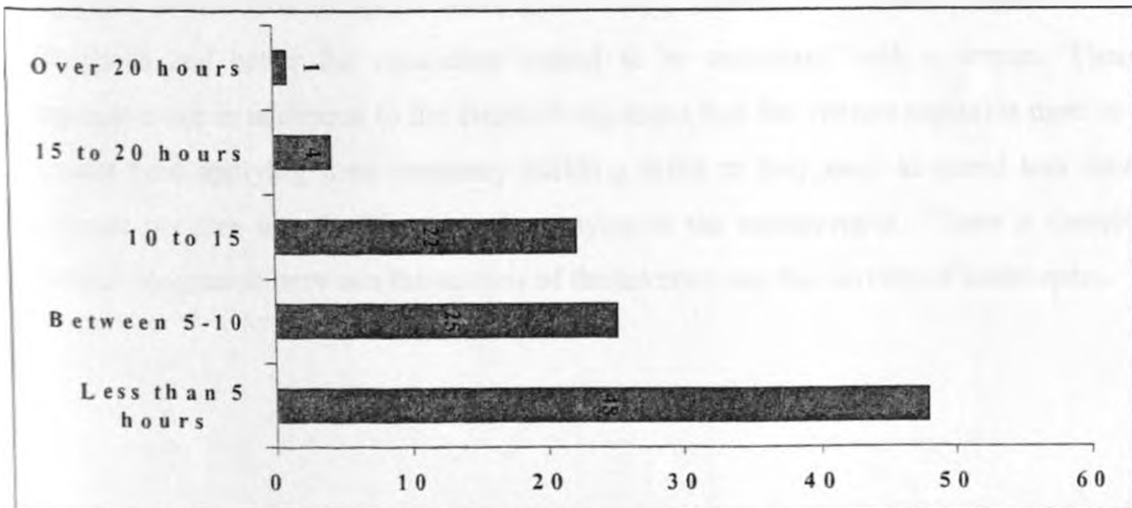


Table 4.2.4(b) below show how evenly spread the results were when correlating the amount of time spent in Investee Company and the venture capitalist view on the performance of that investee company

Table 4.2.4(b) Venture capital involvement and relative investee company performance

	Performance of investment			
	Poor	Fair/Good	Above Average	Outperform
Less than 5hrs	5%	10%	14%	14%
Between 5-10	9%	9%	5%	9%
Between 10-15	0%	0%	5%	0%
Between 15-20	5%	5%	5%	5%
Over 20 hrs	0%	0%	0%	0%
Total	19%	24%	29%	28%

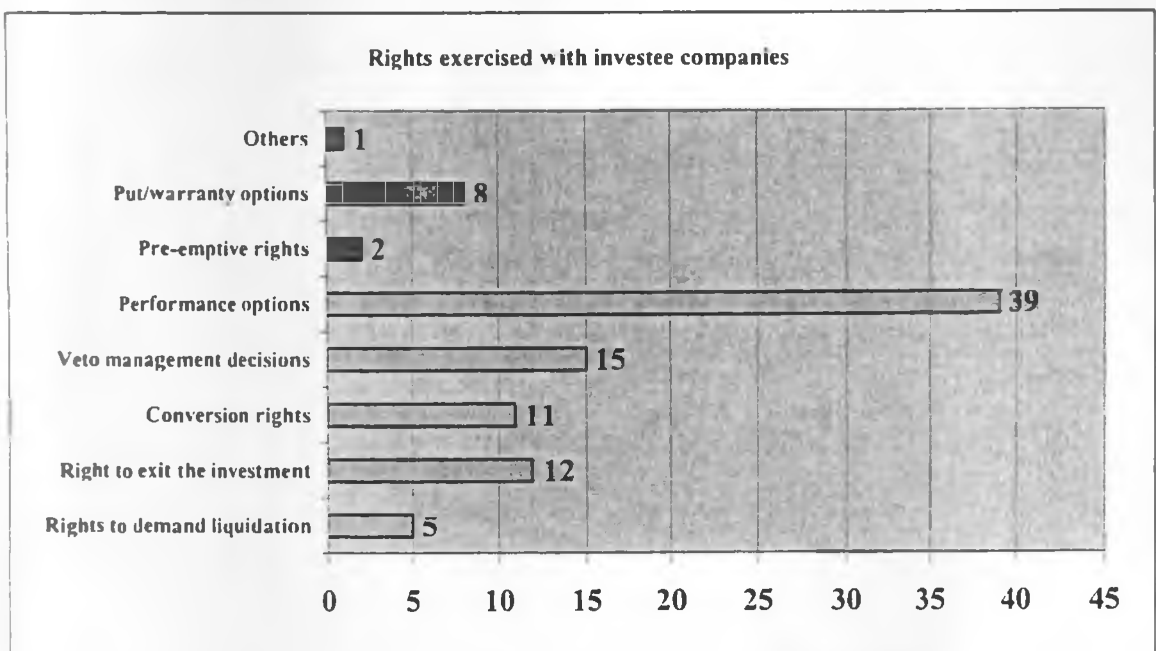
It can be therefore concluded that the success of a company cannot be solely reliant on how much effort the venture capitalist expends on the investee company. There are many variables why a venture capitalist spends varying levels of time on an investee. For example, there is an expectation that a greater number of hours spend helping is associated with greater success of an investee yet this might be simply because an investee is nearing a successful exit by the venture capitalist. In that case, a venture capitalist time would be spending with an investee arranging for initial public offer or other exit. Another argument is that Venture capitalist would like to spend more time with a successful investee because it is more illustrious and better for reputation capital to be associated with a winner. These two arguments are in additions to the standard argument that the venture capitalist need to spend greater time applying their company building skills or they need to spend less time with investee because it is inefficient and annoying to the entrepreneur. There is therefore no distinct correlation between the success of the investee and the number of hours spent.

4.2.5 Control rights in venture capital contracts

Venture capital contract contains explicit covenants permitting control to venture capitalist, following a poor performance by an entrepreneur. Control rights matter either because they allow one party to make a decision in the presence of conflict of interest, or because they affect the threat points in any renegotiation. Control is important since it affects the non-contractible behavior of the two contracting parties.

Chart 4.2.5 below shows that, 39% had exercised the right in venture capital contracts that gave the venture capitalist the rights to demand some level of performance from the investee company. 15% had exercised the right to veto management decisions while 12% had exercised the right to exit the investment when the investment failed to perform. 11% the venture capitalist had exercised the right to convert it shares to debt or any other form to secure its interest, 5% had exercised the right to demand liquidation while 8% had used put/warranty options rights. 2% had exercised pre-emptive rights and only 1% used other methods to exercise control.

Chart 4.2.5: Whether the venture capitalist has exercise of any control rights with the company



he right to demand some performance level by investee is therefore the control rights the venture apitalist would most of the time exercise. This is because the venture capitalist like any investors ias a minimum expected return on his investment and would even participate in search of a rofessional manager to manager the venture. Since venture capitalists are active investors, they emand contract provisions that would ensure their ongoing access to the firm's accounts and acilities and that she would not be held up by the entrepreneur. Control rights are not only mphasized while choosing the financial instruments but also in the bargaining between venture apitalists and entrepreneurs.

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CHAPTER FIVE

5.0 CONCLUSION AND RECOMMENDATION

5.1 Conclusion

Venture capital in Kenya is operated within the same concept as those overseas. Majority of the companies in which venture capitalist invest in are in seed/start-up stages of development. These are companies, which cannot get loans or even suppliers credit. Additionally information asymmetry associated with such start-up companies makes projects governance extremely importance.

The venture capitalist uses various financial instruments as vehicles of investment in a company. They include redeemable preference shares preferred equity, common equity, combination of debt and common equity and pure common equity. The study noted that like overseas venture capitalists, majority of Kenyan venture capitalists use preferred equity as an instrument of choice to invest with in an investee company.

The venture capitalist gave various reasons/combination of reasons for choosing particular instruments. Maximization of returns to funds invested was ranked the first in the level of importance while tax incentive reasons is not considered important in choosing an instrument to invest with. There is no particular instrument which provide tax incentives to venture capitalist.

The study observed that development finance institutions use combination of debt and common equity. In this context, one could argue that public-private partnership agencies are traditionally supporting the financing of startups and medium sized firms by publicly guaranteed loans in order to promote regional development. As they do not face the same extent of agency problems as private venture capitalists, they are more likely to use rather low powered incentive compatible financing instruments such as debt and silent partnerships.

Venture capital contracts are designed to give venture capital control rights in investee Company. Majority of the contracts gives the venture capital the right to demand some level from performance from the investee company. Some of the control mechanism being practise include staging of funding against predetermine milestones, board representation and being involved in the running of the investee company.

The venture capital industry in Kenya should be further developed to enhance economic development especially in technology-oriented industries. There is therefore a need for government support in regulating the industry and providing mechanisms and incentives that will support domestic resource mobilization into private equity.

5.2 Limitations of the Study

Due to the private nature of most venture capital companies, many were reluctant to divulge information about the size of venture capital deals entered into for fear of researcher being party to proprietary information.

Owing to the fact that the venture capitalist approached for information had an option of choosing the number of deals they wanted to report on, many chose to report on only one deal even though some of the venture capitalist engaged in a number of venture capital deals. The effect of this is that the venture capitalist could only have reported on only successful or simple ventures and thus data could be skewed to only successful and simple ventures.

5.3 Suggestion for Further Research.

Further areas of study may include legal and institutional barriers that hinder the growth of venture capital industry in Kenya, the average period the venture capitalist stay in the venture capital firm before exit and the most appropriate mode of exit and reasons for exit.

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ANNEX 1

QUESTIONNAIRE

Dear survey respondent,

Thank you for taking the time to complete this short survey. This study investigates the financial instruments and other control mechanism used by venture capitalist in Kenya when investing in an investee company. This is an academic research to be submitted in partial fulfillment for the award of Master of Business Administration, School Of Business. University of Nairobi.

Please fill this questionnaire by either ticking the correct answer in the boxes next to the question or indicating it in the spaces provided

A. General Information

1. Name..............................
2. Company............................
3. Your company started operation in Kenya in.......................
4. Your work title..................................
5. Years you have been in the firm.....................
6. Please select the most appropriate option for you as venture capital industry participant

   i) Investment bank Division/subsidiary [ ]
   ii) Development Finance institution [ ]
   iii) Venture capital fund [ ]
   iv) Specialized private Equity fund [ ]
   v) Other specify
   ....

7. How many Venture Capital deals would you like to respond to in this survey...

NB. The following questions would be deal specific and would be repeated for the number of deals you determined above. Provided you have details of the deal it is expected that each will take 3- 4 minutes to respond to.

B. Specific Venture capital deal information

1. Investee company name (optional)........................

2. Investment year...

3. Please chose the industry your investee company operates in?

i	Agricultural processing, dairy, food and beverages	[ ]
ii	Horticulture	[ ]
iii	Fisheries	[ ]
iv	Leather goods and Textiles	[ ]
v	Wood and wood products	[ ]
vi	Chemicals and Pharmaceuticals	[ ]
vii	Plastics, Metallic and Ceramic Industries	[ ]
viii	Mining quarrying and Drilling	[ ]
ix	Motor Vehicle accessories	[ ]
x	Electrical & Electronic products	[ ]
xi	Trade and services	[ ]
xii	Finance and Investments	[ ]
xiii	Information and communication Technology	[ ]
xiv	Insurance and medical providers	[ ]
xv	Property development.	[ ]

4. Stage of company development

i	Seed capital	[ ]
ii	Start up	[ ]
iii	Expansion	[ ]
iv	acquisition	[ ]
v	Turnaround	[ ]
vi	Working Capital	[ ]

5. Are you the first venture capitalist to invest in this company?

i	yes	[ ]
ii	No	[ ]

6. Is the company trading?

i	yes	[ ]
ii	No	[ ]

7. What was the total deal size? Kshs........................

8. What percentage did your firm contribute to the deal?......................

9. Was the deal jointly funded with other investors?

i yes [ ]
ii No [ ]

10. What percentage did other investors contribute to the deal?......................

11. How was the funding done?

i) All the required fund were paid at once [ ]
ii) Funds paid upon meeting certain predetermined conditions [ ]

12. Was board representation part of the deal?

i yes [ ]
ii No [ ]

13. Reflecting on the investment, how do you think it has performed?

iii) Outperformed expectation [ ]
iv) Above average [ ]
v) Good [ ]
vi) Fair [ ]
vii) Poor [ ]

14. On average how many hours per week do you spend providing help to the investee company?

i) Less that 5 hours [ ]
ii) Between 5 to 10 hours [ ]
iii) 10 to 15 hours [ ]
iv) 15 to 20 hours [ ]
v) Over 20 hours

15. Have you ever exercise any control rights with this investee company?
i) Right to demand liquidation of assets [ ]
ii) Right to exit the investment [ ]
iii) Conversion rights [ ]
iv) Veto management decision [ ]
v) Performance options [ ]
vi) Preemptive rights [ ]
vii) Put/warranty options [ ]
viii) Others specify........... [ ]

16. Select below the instrument use or combination of instruments used

i) Debt [ ]
ii) Convertible Debt [ ]
iii) Common equity [ ]
iv) Redeemable preferred shares [ ]
v) Preferred equity [ ]
vi) Convertible Preferred equity [ ]
vii) Other specify...

17. Please select and rank the possible reasons for choosing the above instrument/ combination of instruments. Please tick your level of importance

Reason	Ranking of importance				
	extremely	very	relatively	minor	not
i) To provide your firm the ability to call for liquidation					
ii) To maximise return in case of liquidation					
iii) To maximise return for your fund investors					
iv) Provide incentive to the investee company to perform optimally					
v) Provides avenue for monitoring the investee					
vi) Provides voting rights and control					
vii) Provides modalities for exit					
viii) Minimises risks					
ix) Provide a forum for providing advice					
x) Previous covenants with the investee are considered.					
xi) Tax incentives					
xii) Provides a deal that the management would accept					
xiii) Other specify.....................					

Sincere thanks for completing this questionnaire

Best regards

Remmy Koech

ANNEX 2

List of Venture Capital Companies

1. Loita Capital Partners
2. Bridges Capital
3. First Africa Capital
4. ICDCI
5. Kenya Capital Partners
6. Investment Promotion Services
7. Acacia Funs
8. Actis(Kenya)
9. Aureos Capital One
10. East Africa Capital Partners
11. East Africa Development Bank
12. International Finance Corporation
13. Oikocredit
14. CDC Group
15. ICDC
16. Department for International Development
17. Preferential Trade Area
18. Industrial Development Bank
19. Development Bank of Kenya

ANNEX 3

Terms, abbreviations & Definitions

AFC	- Agricultural Finance Corporations
ICDC	-Industrial and Commercial Development Corporation
IDB	**- Industrial Development Bank**
KIE	-Kenya Industrial Estates
KTDC	- Kenya Tourist Development Corporation
VC	-Venture Capital
EADB	-East Africa Development Bank
DBK	-Development Bank of Kenya
CDC	-Commercial Development Corporation
IFC	-International Financial Corporation

Investee Company – A company where a Venture Capitalist invested in.

ANNEX 4

Background information of some of the venture capital firms surveyed

Loita Capital Partners	Found in 1992 as an Investment Banking firm and funding of debt transactions. It gives advisory services and help in raising funds for equity transactions. It helps in management, correspondence banking, asset management including other corporate oriented services
ICDC	Incorporated in 1954 as Industrial Development Corporation and changed to ICDC after independence. Alongside providing other financial facilities , ICDC is a venture capital investor. The corporation has shares in many organisations in the manufacturing and other sectors.
CDC Group	It is a Property Limited company whose main engagements include refunding and investing in major retail development venture. Part of Aureous.
Acacia Fund Ltd	The venture capital investment corporation is engagement in Private Equity Funds in the business sector(s) and Financial sector(s), particularly financial services in the food products in Kenya.
Aureous	It was founded in July of 2001 as a joint venture between CDC Capital Partnters. They are international managers of Private Equity Funds and Risk Capital Investors in emerging market. It invests funds in all industries. typically making investments of between £ 100,000 and £ 2 million for 20-45 % of the equity invested in a company with less than 250 employees and a turnover of £ 25 million a year or less. Such companies must be linked to their local community by jobs market or supply chain. The fund seeks growth of companies at early and expansion stages. The fund also is get engagements in buy-out and buy-ins.
East Africa Development Bank	It was established in 1967 and was mandated with its own charter in 1980. Are lenders advisors and development partners. So far has committed up to US $ 1 million.
Department of International Development	See International Financial Corporation below
Preferential Trade Area Bank	Regional lenders advisors and development partners.
Kenya Capital Partners	Involved in the financial sector and particularly the venture capital, equity, financial grants and subsidies to small enterprises. It is also offers special Risk Capital Investment management services. Manages Preferred Fund projects and rehabilitation funds. It is wholly owned subsidiary of Aureos Capital
International Financial Corporation	It was established in 1956 to promote sustainable sector investment in developing countries so as to reduce poverty and improve people lives. It is a World Bank group of multilateral source of loans and equity financing private sector projects in the developing world. It is also engage in mobilizing financing and funds in international market, besides providing advice and technical assistance to businesses and governments.