

## Venture Capital (VC): Its Impact on Growth of Small and Medium Enterprises in Kenya

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### Abstract

Venture capital has had a significant impact on Small and Medium Enterprises (SME) in the developed countries. Small businesses have been and are the stepping stone of industrialization in these countries. Among the developing countries and especially Kenya venture capital has been present since independence yet industrialization is slow. The purpose of this study was to find out the impact of venture capital on growth of Small and Medium Enterprises (SME). The lack of finance has been cited as a major contributor to SME failure in Kenya. Venture capital which is the best source of business finance has been in Kenya for long but little used. The methodology adopted was collection of data before and after use of venture capital. The findings in this study revealed that venture capital has an impact on growth of SME they finance. The study has demonstrated that use of venture capital can be profitable in Kenya even in an inauspicious political and economic climate. The study concluded that SME that use venture capital experience improved growth and thus more SMEs should be encouraged to use this form of finance if the country has to achieve its vision 2030.

**Key words:** Venture capital, financial management, Small and Medium Enterprises

### 1.1 Introduction

Governments throughout the world are nowadays turning their attention to small-scale enterprises. This is because attempts to promote economic progress by establishing large industries have usually failed to improve the lives of the majority of the populations concerned (White Paper on International Development, 2000). Therefore, Small and Medium Enterprises (SMEs) are now viewed as important in even and equitable economic development. Kenya's policy on SMEs as outlined in the Sessional paper number 2 (RoK, 2005) clearly show that the sector is not only a provider of goods and services but also a driver in promoting competition, innovation and enhancing the enterprise culture which is necessary for private sector development and industrialization. The sector should effectively respond to challenges of creating productive and sustainable employment opportunities, promoting economic growth and poverty eradication in the country. The Sessional paper further provides a framework that will support research and development to boost SMEs's access to appropriate technologies; encourage innovation and promote product design, development and quality control. SMEs will play a significant role in contributing to the national goal of wealth creation and making Kenya an industrialized country.

Lack of access to credit is a major constraint inhibiting the growth of SMEs sector. The issues and problems limiting SMEs acquisition of financial services include lack of tangible security coupled with inappropriate legal and regulatory framework that does not recognize innovative strategies for lending to SMEs. Limited access to formal finance due to poor and insufficient capacity to deliver financial services to SMEs continues to be a constraint in the growth and expansion of the sector. Formal financial institutions perceive SMEs as high risk and commercially unviable As a result only a few SMEs access credit from formal financial institutions in the country. Various types of assistance have been provided to SMEs to boost their growth and development by making them more profitable (Institute of Economic Affairs & Society for Economic Development [IEA/SED] 2001). Several Organizations including business associations, voluntary organizations and other non-governmental organizations have set up programs to enhance the factors that influence development of SME especially as it relates to enterprise growth and development.

The types of assistance offered by these organizations, vary with some giving financial assistance, others training and extension services, pre-constructed commercial shades or assisting in marketing of products ( Admati, & Pfleiderer (1994). Despite the large number of assistance programs, the growth and development of SME has not been satisfactory. Ventures have collapsed as soon as assisting organizations pull out of the project, and remaining ones have remained small. What then contributes to this kind of scenario? According to the study undertaken by Hallberg (1998) and Mead and Liedholm (1998), access to finance is an important ingredient to development. Financial constraints are likely to affect business creation and improvement. SME in Kenya have difficulties of accessing both credit finance and equity.

Venture Capital is one source of non-bank financing, which is quite prevalent in developed financial markets for small or start up firms (Keuschnigg 1998). Venture Capitalists are organized providers of financing for winning but risky business proposals by small and medium firms that have a promising but as yet unproven idea. If the Venture Capitalists are convinced that a business idea is promising, they will take an ownership stake in the business and provide the needed fund while sharing the risk. It is expected that many of the country's small businesses whose growth has been constrained by shortage of capital or increased cost of borrowing will have another source of finance.

There is empirical evidence of the participation of venture capitalists in the industrialization of developed countries. In the United States of America, the role of Venture Capital has been instrumental throughout its industrialization; however it became institutionalized after the 2<sup>nd</sup> World War. Before World War II, venture investment was a monopoly led by wealthy individuals, investment banking syndicates and few family organizations with a professional manager (Hisrich and Peters, 2002). For example, over the years, the Rockefeller family has made the initial capital contribution to a number of successful businesses. The first step towards institutionalizing Venture Capital industry took place in 1946 with formation of American Research and Development Corporation (ARD). The next major development was the small business investment company act of 1958 which married private capital with government funds. It was led by professionally managed Small Business Investment Companies (SBIC) to provide capital to start-up and growing businesses with tax advantage and incentives. SBIC were the start of the now formal Venture Capital industry.

During the late 1960s, small private Venture Capital firms emerged which were formed to provide investment funds. The organizers behind the partnership could raise capital from institutional investors such as insurance companies, pension funds and Bank Trust departments. There are over 2000 Venture Capital of these types in the USA (Hisrich and Peters 2002) both formal and informal

The venture capital market in the USA has grown so rapidly that there exists another group referred to as *business angels*. According to Freear (2003) informal investors, include persons affectionately referred to as "*angels*". Along with family and friends, they are the largest providers of early stage financing, both from a dollar standpoint as well as their sheer numbers. They are a homogeneous group that is very difficult to identify and capture and surprisingly may be your next-door neighbor or a relative of your friends. They may be affiliated in that they have some contact with you or your business, or they could be non-affiliated in that they currently have no idea you even exist. However they are significant providers of equity risk capital at early stages of an entrepreneurial venture's life. Unlike the venture capital funds which are more visible, angels are less visible and difficult to find.

Due to perceived market opportunities and demonstrated success of the USA, Venture Capital industry had a capital base of USA. \$3.8 billion in 1995. Other developed countries like United Kingdom, Australia, Israel and Japan have joined a "bandwagon" mentality by establishing unlisted securities markets and developing tax shelters to encourage investors to create Venture Capital pools (Keuschnigg, 1998).

In Kenya private Venture Capital firms include: Kenya Equity and term financing which supports existing companies that wish to expand rather than start-up operations. Acacia Fund Limited provides risk capital to new or expanding enterprises, including the reorganization, rationalization and reconstruction. Aureos East Africa which provides private equity and loan facilities has replaced the activities of Acacia (The Finance Mail Vol 9 no. 6, 2003). Kenya Management Company Limited, which provides equity, related investments in private sector to companies with high growth potential to expand well-run businesses.

Donor backed public Debt Corporation that offer Venture Capital includes:

- i. Industrial credit and Development Corporation (ICDC) provide capital directed at profitable existing small and medium sized industrial or commercial projects seeking expansion, modernization, restructuring or diversification of existing activities. They also support business start-ups with firm prospects for financial and technical development. However its performance has been poor in the recent past and the World Bank which is the major source of its funds has called for liquidation
- ii. Industrial Development Bank (IDB), which is a subsidiary of ICDC, currently restructuring its operations to serve SMEs better.
- iii. Commonwealth Development Corporation

The presence of both private and government venture capital in Kenya is evidence that firms have a wide range of different sources of finance. But are the funds used? Are they known that they exist? This paper is concerned with enlightening the Kenyan investment community of the impact of Venture Capital on firms growth through SMEs and that the same finance is available in Kenya although little known. With the presence of Venture Capital firms in Kenya, entrepreneurs have an assured alternative source of finance.

### 1.2. Statement of the Problem

SME, in Kenya have difficulties in growth due to lack of finance. They hardly grow beyond start-up stage. Others go out of business at a very early stage (Bronwyn, 1995). The study undertaken by Hallberg (1998), and Mead & Liedholm (1998) reveals that access to finance is an important ingredient to development of SME. They have few alternatives of accessing finance other than relying on their retained earnings to finance their investments. Notwithstanding the financial difficulties faced by SME presently in Kenya, alternative sources of funds have to be sought to sustain this important sector.

Venture capital, which is quite prevalent in developed countries, has played a big role in enhancing growth of SMEs by providing equity capital. In countries where both forms of venture capital participate in financing SME, they are value-adding investors who bring significant benefits of their business know. The researcher feels that though venture capital firms have been present in Kenya as early as 1970s their impact on SME has not been significant.

### 1.3. Objective

To determine whether SMEs that use venture capital experience growth

### 1.4. Methodology

This study used 200 SME that have been financed by venture capitalists as the target population. The SME were drawn from various major urban centers in the country. On ascertaining the SME financed by venture capitalists the firms were stratified according to their locality and random sampling was carried out by assigning numbers to subjects of each stratum and a sample size was determined as shown in the table. A sample of 100 firms was picked at random from which data was collected.

Semi-structured questionnaire was the main instrument for data collection. Brien (1996) defines a systematic semi-structured questionnaire as a set of questions that logically follow each other and questions are both open ended and closed ended. The questionnaire was to interrogate respondents on various issues namely;

- a) The annual sales before and upon use of venture capital
- b) Profitability of the business before and after use of venture capital
- c) The value of the assets of the firm before and after use of venture capital.
- d) Number of workers employed by the business before and after the venture capital was introduced

Data was analyzed by using descriptive statistics with the help of SPSS computer software.

### 1.5. Results and Discussion

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

As Table 1 indicates, the minimum sales increased from Ksh 290,000 to Ksh 4,000,000. The maximum sales increased from Ksh 70, 800,000 to Ksh500, 000,000. The mean sales after use of venture capital are Ksh 139, 043, 076 up from Ksh10, 349,661. Generally there was improvement in sales volume after use of venture capital. This finding is in conformity with the studies by Steiner and Solem (1988), Cuba, et al (1983), Khan and Rocha (1982), and the United States Small Business Administration (1980) which has used sales growth as a key indicator of small business success and overall performance. Their study reported that there was substantial sales growth by firms that used venture capital. However availability of finance is no guarantee to increase in sales. Cook (2000) observed that proper marketing strategy, pricing policy, research and development, proper management among others contribute to sales growth. The presence of venture capitalists in a firm provides guidance to all the above hence sales growth.

A number of factual evidence on the economic impact of venture capital has been published especially for the USA economy which supports the finding of this study. According to a study carried out by Astrid & Bruno (2004) on venture capital funded firms for the period 1970-2000, the sales doubled, paid almost twice the federal taxes, generated almost twice the exports and invested almost three times as much in research and development as the average non-venture capital backed firms. The European Venture Capital Association (2001) has also established that venture capital backed firms report a high growth in sales as compared to other firms. The result reveals that venture capital leads to growth on sales of the firms that use these funds.

A descriptive statistic analysis was carried out on annual profit figures provided by respondents from the field to further prove that profit upon use of venture capital has shown any change. This analysis showed that the increase in profitability is significant in business growth (Table 2). The minimum profit before use of venture capital was Ksh 34, 866. Upon use of venture capital, the minimum profit increased to Ksh 600, 000. This shows an increase in minimum profit of 94%. The maximum profit respondents reported before use of venture capital was Ksh 38, 567,951 which increased to Ksh 62, 864,152 an increase of 63%. The average profit also increased by 69% (from Ksh 7,204,653 to Ksh 12, 202,775). This finding then implies that firms that use venture capital experience growth in profit. Similar trend was reported by Chaganti and Mahajan (1983) in Indian SME that used venture capital. The important aspect here is not just the finance the venture capitalists provide value creation in the venture. Empirical evidence (Brav and Gompers 1997) confirms that increase in profit by venture capital-backed firms is often attributed to better management teams and corporate governance structures that help these companies to perform better in the long run.

This study also sort to find out if the growth in profit had any bearing with types of business. Table 3 displays findings in relation to type of business and the profit margin growth rate. Merchandizing types of business reported an average growth in profit margin of 18.2%, followed by agriculture 14.4%, service 12.8% and manufacturing 9.3%. This implies that all the businesses from whatever sector they belong realized growth in profit as a result of use of venture capital. While merchandizing is considered a low technological sector that venture capitalists are careful in investing their money (Puri & Zarutskie, 2008), it seems to have a high (18.2%) average growth rate compared to manufacturing which is a preferred type of business with high chances of initial public offering (Gompers & Lerner, 2001). This finding relating to high profit margin for merchandising in relation to other types of business is interesting and could have been related to cost saving and increased efficiency in use of recourses and cross monitoring by venture capitalists. This result suggests that venture capitalists focus on scale or potential for scale rather than profitability. However each type of business has shown that profit margin grew upon use of venture capital indicating that venture capital has an influence on performance of SMEs.

Net assets were used as measure of growth. Liao, et al (2001) define enterprise growth as a unidimensional construct operationalized by a variety of growth measures which include sales, value of net assets, profit, number of workers, and market share among others. Barmes (1990) also observed that assets are particularly useful indicator of impact because their level does not fluctuate as greatly as others. Thus net assets are indicators of growth. Table 4 shows that assets of firms grew by a significant amount after use of venture capital. The maximum value of net assets reported increased from Ksh 600 million to Ksh 640 million. The average net assets also increased from Ksh 75.2million to over Ksh 102.5 million. This increase in value of net assets after use of venture capital is a worthy evidence to say that there is growth. Literature (Brigham and Houston, 2001) confirms that growth in assets can be directly linked with availability of funds as the business expands. Since venture capital is equity capital to the business then net assets also increase.

The study considered employees as a measure of economic growth of SMEs. This variable was also used by Gompers and Lerner (2001) in their study on the influence of venture capital on SMEs performance. Data collected on employees of the firms under study covered three categories namely; employees on permanent, contract and casuals terms (Table 5). It can be observed that the total number of employees before use of venture capital was 9,404 of which 3,922 were permanent, 4,304 were casuals and 1,178 were on contract. The average number of total workers was 145. The study reveals that the SMEs were only able to employ an average of 60 permanent workers and this may be due to lack of finance. Kauffmann (2005) and Saleemi (2009) confirms that SMEs in Africa have little access to finance, small local market and difficult business conditions which make expansion of both physical and human resource difficult. This is the environment that SMEs in Kenya face and hence the limited number of employment opportunities.

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

### 1.6. Conclusion

The impact of venture capital on growth of SME is real and practical as established by this study. Venture capital's investment in SME has facilitated wealth creation in ways that people's lives have been improved. This study reaffirms the correlation between SME development and poverty alleviation. A considerable contribution to economic growth has been logically witnessed and measured. The study has demonstrated that use of venture capital can be profitable in Kenya even in an inauspicious political and economic climate. The impact touched on both economic and social-economic factors.

The economic impact of venture capital has been realized by SME in sales growth, profit, asset and improvement in management of finance and other resources. The social impact from venture capital perspective include the employment opportunities created which has improved people's lives and alleviated poverty among the employees. It is common sense that the employees have joined cooperatives which help them to alleviate cash flow problems. The increased profits imply revenue collection for government expenditure though collection of tax. Also venture capitalists do not just provide funds but add value to SME, that is, they are not only involved in financing but also spur entrepreneurs who are responsible for economic growth. Venture capital involvement has demonstrated that the partnership implicit in equity capital is as important as the finance and that these two aspects of the relationship are mutually reinforcing. Venture capital not only assists SME in the provision of funds but also in the internal operations of the business especially in policy formulation. Therefore venture capital has demonstrated the business case for SME investment. Nurturing them at crucial junctures in their development and laying the foundation for an emerging generation of locally owned large enterprises. The fact that venture capitalists have exited from 50% of the SME, this has assured many managers the concern about losing control of their businesses. Venture capital is the fund to use to boost equity capital in the business.

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TABLES

Table 1: Sales Before and After use of Venture Capital

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

Table 2: Profit Before and After use of Venture Capital

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

Table 3: Growth in Profit Margin by Business Type.

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

Table 4: Net Assets Before and After use of Venture Capital

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

Table 5: Number of Employees before use of Venture Capital

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

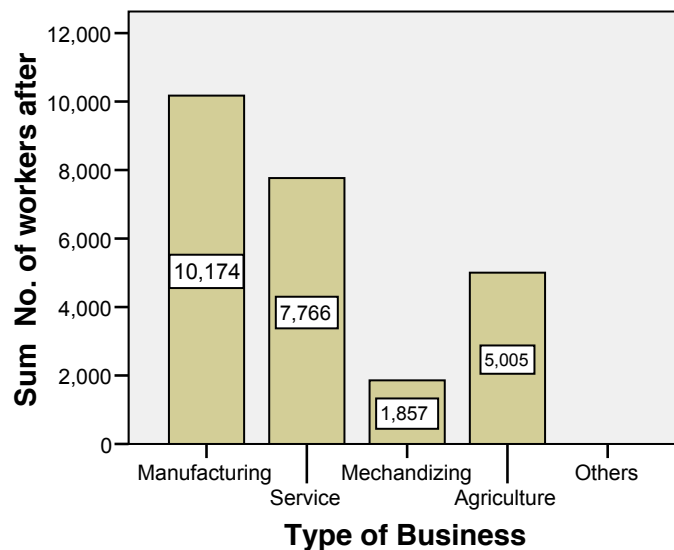


Figure 1: Number of workers after use of venture capital