

**FACTORS THAT INFLUENCE VENTURE CAPITALIST'S DECISION IN  
FUNDING SMALL MEDIUM ENTERPRISES IN KENYA**

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## ABSTRACT

Small and medium Enterprises are a key economic growth driver in Kenya. Although many start-ups rely on founder's savings, friends and family to raise funds, these sources are normally not sufficient to scale the business to a profitable level. The entrepreneurs are therefore forced to look for alternative sources of funding. Banks have always been a popular source of capital for business but due to the high risk levels and uncertainty associated with SMEs, the banks always put conditions which are way above the SME's reach hence making it difficult for them to access the much required capital. Venture capital has become popular in Kenya in the past 10 years as an alternative source of funding since they are willing to take up the risks associated with SMEs. The aim of the study was to determine the factors considered by venture capitalists in evaluating SMEs in Kenya. The specific objectives were; to determine the influence of management characteristics on VCs' consideration for funding of SMEs in Kenya, to find out the influence of entrepreneur's characteristics on VCs consideration for funding of SMEs in Kenya, and to establish the influence of business characteristics on VCs consideration for funding of SMEs in Kenya. This study was a descriptive survey design. The target population in this study comprised of venture capital firms registered with East Africa Venture Capital Association, Capital Markets Authority or . Primary data was collected through Self-completed Questionnaires. Self-completed Questionnaires to executives and managers of Venture capital or private equity firms in Kenya was used as the sole data collection tool. The researcher analysed data on the three objectives using factor analysis. The study findings were that three key variable viz; market factors, product factors and financial factors were the key factors considered by VCs in their consideration to fund SMEs. The study also established that each of the key variables had specific items of interest to the VCs in their evaluation of SMEs for funding. On entrepreneurship characteristics, education background of the entrepreneur and entrepreneurs past experience were the critical items of consideration by VCs, on management factors, a team with a good education background and a team with a wide industry experience would be considered. On product factors, ability to stimulate a new market and the product with a global potential are key considerations. Market factors that are critical according to the study are huge market for a product and a huge market growth potential. Key financial aspects of consideration were ability of the venture to generate sufficient operating cash flows and potentially profitable exit options. The study concluded that SMEs

seeking venture funding from VCs should pay attention to enhancing their capacities on the three key variables stated in the study as important; market factors, product factors and financial factors. The study recommended the need for venture capital firms to be encouraged to create conducive environment that will encourage business persons to share their business ideas, venture capital firms be encouraged to do thorough marketing to create awareness of their key areas of interest when evaluating SMEs for funding and the government's involvement in venture capital is important to the venture capital market.

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## DEFINITIONS OF TERMS

**Venture Capital:** is money provided by investors to startup firms and small businesses with perceived long-term growth potential (Hellman, 2010).

**Small & Medium-Sized Enterprises:** An enterprise is an entity engaged in an economic activity. Small and medium enterprises are thus defined as firms with 10 to 250 employees, and more than 10 million euro turnover or annual balance sheet total (World Bank, 2010).

**Entrepreneurial Experience:** is the dynamic process of acquiring the vision, change, and creation that enhances enterprise performance by engagement (Casey, 2012).

**Growth:** An increase in the capacity of an entity to produce goods and services, compared from one period of time to another or increase in size, number, value, or strength; extension or expansion (Kruger, 2014).

**Access:** The proximity of acquiring a requirement or resources towards achieving a particular outcome. It can also be seen as the ability or right to approach, enter, exit, communicate with, or make use of (Gorman and Sahlam, 2009).

## LIST OF ABBREVIATIONS

CMA	Capital Markets Authority
DFCK	Development Finance Company of Kenya
EAVCA	East Africa Venture Capital Association
GOK	Government of Kenya
ICDC	Industrial and Commercial Development Corporation
IPS	Industrial Promotion Services
IRR	Internal Rate of Return
SME	Small and Medium Enterprises
VC	Venture Capital
VCF	Venture Capital Fund

## **DEDICATION**

This paper is dedicated to Engineer Stephen Muthua , you ignited the dream in me and have always been an inspiration that I look up to. I will always be grateful for your support.

To my brothers and sisters- you can do it.

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## **CHAPTER ONE:INTRODUCTION TO THE STUDY**

### **1.1 Introduction**

This study explored and identified the factors considered by Kenyan venture capitalists in their venture screening and evaluation processes. Various factors were considered for investigation guided by three objectives which formed the key variables of the study being, management characteristics, entrepreneurship characteristics and business characteristics.

Management characteristics are considered by venture capitalists since people behind an idea or company and, more importantly, their character is extremely important. A team could have the best idea in the world, but it might never get off the ground with the wrong team in place.

Entrepreneurship characteristics become crucial in business performance since they are the drivers of growth. They help in creating innovative enterprises which provide foundation for building competitiveness. Enterprise creation needs risk capital. Venture capitalists provide risk capital and facilitate the development of entrepreneurship. There are several factors relating to entrepreneurship and venture capital that form the basis for furtherance as regards this study.

Business characteristics relate to factors that generally reflect the business environment in general which in this study included financial, product and market factors. These factors are important for any business to consider since not every opportunity is going to produce overnight returns, and the risk versus the reward is always taken into consideration. While every deal is different, profit potential and the probability of a return on the initial investment is always analyzed heavily.

Venture capitalist Investors in venture capital funds are typically individual and very large institutions such as pension funds, financial firms, insurance companies, and university endowments all of which put a small percentage of their total funds into high-risk investments (Hellmann, 2010). Because these investments represent such a tiny part of the institutional investors' portfolios, venture capitalists have a lot of latitude. What lead these institutions to invest in a fund is not the specific investments but the firm's overall track record, the fund's "story," and their confidence in the partners themselves. This study seeks to assess the factors that influence VCs into selecting SMEs for funding.

### **1.1.1 Background of the Study**

From a global perspective, Venture Capital industry in the US economy, account for 68% of global VC activity according to Global VC Investment Report (2013). Europe accounts for only 15% of global VC activity. China, the third largest hotbed in the global VC rankings accounts for 11% of the global VC activity. India, fourth in the global VC rankings, has in the recent years seen an increase of venture funding in consumer services sector. Israel has also seen a sizable share of global VC activity accounting for about 5% of the global activity. Canada, which accounts for 2% of global VC activity, also had an extremely strong improvement, with volumes up 23% and value up 14% (OECD, 2013). In the U.S. and Western Europe, most venture capital funds are organized as private limited partnership where the venture capitalists serve as general partners and outside investors serve as limited partners (Barry, 2010). Venture capitalists are actively involved in monitoring, strategic management; marketing and planning of the companies they fund also called investee companies (Murray, 2011).

Much of the interest in venture capital investing in The People's Republic of China is closely related to its rapid economic growth in recent years (Lerner, 2010). China has attracted renewed business attention since its official return to a market orientation. China's dynamic growth can be attributed largely to its policy of economic reform and opening its markets to the outside world, which began in 1978 under the leadership of Deng Xiaoping (Stuart, 2013). According to Kelly (2010) rapid economic growth, bold reform measures, and massive infrastructure plans point to enormous market potential in China.

Hong Kong accounted for more than 40% of the foreign direct investment in mainland China because it has a stronger legal framework and a more mature venture capital industry; many foreign venture capital funds targeting Greater China are now based in Hong Kong (Wang, 2011). As a key capital Centre in Asia and a gateway to mainland China, Hong Kong's venture capital industry has grown dramatically over the past ten

years. In 2009, 77% of the funds raised in HK came from non-Asian countries (mostly from US), 7% from Hong Kong locally, and 16% from other areas in Asia (Kovner, 2010).

In South Africa, eight out of 10 jobs that are created occur in the SME sector (Karungu et al, 2009). Nevertheless, in such emerging economies VC funds face additional challenges, such as fewer qualified entrepreneurs, limited management competencies, and inadequate regulation and legal infrastructure (Hassan, 2010). As a consequence, VC managers must formulate innovative success strategies within those contexts.

In Ghana venture capital industry started with an informal style of operations in the early 2000 by private firms (Chatman, 2010). Pieces of information about the industry also revealed that Private Equity (PE) style of operations had taken place in the early 1990s through the collaborating efforts between the United States Agency for Development (USAID) and the Commonwealth Development Cooperation (CDC) of the European Union (VCTF, 2010). Vettivetpillai (2009) cites that focus was to support Ghana's economic reform Program called Financial Sector Adjustment Program (FINSAP). However, formalization of the industry came about in 2004 when the government set up a Venture Capital Trust Fund (VCTF) after the enactment of Act 680 through the parliament of Ghana. The essence of Act 680 was to provide the legal and the regulatory framework for the establishment of VCTF. The scheme was set up to perform two main tasks: to ensure effective partnership with private firms for the provision of investment capital to Small and Medium Term Enterprises (SMEs) (Frimpong and Opoku 2009) and also to provide the enabling environment to develop and promote a viable venture capital industry in Ghana (VCTF report, 2010).

In Nigeria, venture capital gained recognition from late 1990s, when the then government, requested for the support of the banking industry to ensure development in the country (Uba, 2009). This plea, led to the 10% profit after tax deductions from banks profits which rose to N43Billion as at 2009. This fund was expected to be used as equity investment fund for SMEs with the aim that the experiences of the United States, India, Canada, Indonesia, Malaysia etc will be replicated in Nigeria (Beecroft, 2012). In the mid-2006,

the Central Bank of Nigeria (CBN) reported that only N14.7Billion out of the N43Billion has been accessed over the years; and calls were made to SMEs to access the fund ([www.bidnetwork.org](http://www.bidnetwork.org), 2009).

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. According to Zavatta (2008), the Venture Capital firms operating in the country are mainly foreign owned. Private equity funds and fund managers registered with the Capital Markets Authority (CMA) as of year 2015 included Acacia Fund Limited, Aureos Kenya Managers Limited, and InvesteQ Capital Limited (Capital Markets Authority [CMA], 2015). Other players in the industry include Business Partners International Limited (BPI), Grofin East Africa, Acumen Fund, African Agricultural Capital, Miliki Ventures, Africa Invest Capital Partners and Fanisi Fund. There are also notable efforts by upcoming groups of local investors putting money into some of these funds. Some of the initial local venture capital firms, including the Industrial and Commercial Development Corporation (ICDC), contributed to the creation of firms such as NAS services, Yana Tyres among others. Some other notable local investors include Transcentury Kenya and Centum Investments which are currently vibrant as per Capital Markets Authority (2017) data.

Memba (2011) established that in Kenya, a Venture Capital Fund is licensed and regulated by the CMA. The CMA defines a venture capital firm as a company which has been duly incorporated under the Companies Act as a company limited by shares, with its principal objective being the provision of risk capital to small and medium size businesses in Kenya through equity, quasi-equity investments or other instruments whether convertible into equity or not, as well as managerial or technical expertise to such business entities (CMA, 2010).

Some of the VCs operating in Kenya are Aureos East Africa which provides private equity and loan facilities and has replaced the activities of Acacia Fund Limited, which provided risk capital to new or expanding enterprises, including reorganization, rationalization and reconstruction. Some venture capital firms like Acacia Fund Limited exited the Kenyan

market due to their interest in funding firms that had been over a decade in the market but lacked expansion capital (CMA, 2010). The challenge for such firms is that most high growth potential companies in Kenya are new and do not have the operational history which many foreign venture capital firms seek. Another venture capital firm operating in the country is the Kenya Management Company Limited which provides equity and related investments to companies with high growth potential, and has seen tremendous success in some companies it has financed especially in the agri-business sector (Memba, 2011).

### **1.1.2. Overview of Small and Medium Enterprises (SMEs)**

The Kenya Micro-Small Enterprise Act (2012) defines a micro-enterprise as any business entity with less than 10 employees, with annual turnover not exceeding Ksh. 500,000 and whose registered capital is below Ksh. 10M. The World Bank (2010) stated that, a firm with up to 10 employees are referred to as Micro firms. SMEs are engines of growth, vital to most economies. Research suggests that micro businesses and SMEs account for 95 percent of firms in most countries, create jobs, contribute to GDP, aid industrial development, satisfy local demand for services, innovate and support large firms with inputs and services (adminkaaa, 2017). Small and medium-sized enterprises contribute significantly to European job creation and economic growth.

In 2016, nearly 24 million SMEs in the European Union made up 99.8% of all non-financial enterprises, employed around 93 million people (66.6% of total employment) and generated 56.8% of total added value (EUR 4,030bn) (EIF,2017). In 2017, there were 5.7 million businesses in the UK of which 99% were SMEs. In Sub Saharan Africa, 95 percent of all firms are SMEs. Generally, the crucial role played by SMEs in economic development arising from innovation, industrialization and hence jobs and wealth creation is recognized by all major economies of the world as well as the developing and emerging markets (Intellectap, 2015).

Despite their significance contribution to economic growth and prosperity, many small and medium-sized enterprises in difficulty securing the financial backing they need to



grow. This group of businesses is often referred as 'the missing middle', where they have outgrown micro financing but do not yet have access to regular financial services (Business Consulting team, Intellectap, 2015). Kaplan (2012) states that the initial capital raised by the founders (mostly from families and friends) of SMEs is not sufficient for growth and expansion after take-off. Additional capital is required to run and scale up the business. Even though banks have always been the first choice for many entrepreneurs, the SMEs which are much smaller and unquoted face difficulties in raising capital and some even fail within the first two years of operation due to lack of finances.

This is because the banks are risk averse and to protect themselves, they impose requirements which are way above SMEs reach including requirement for collateral or guarantees. These SMEs are also not ready for listing or Alternative market investments. In Europe the numbers of SMEs that rank finance access as one of the highly important issue remain high with 1 out of 4 SMEs reporting access to finance as a significant problem. In the US, a survey done by Trade up Capital Fund (2015), showed that out of 670 surveyed SMEs, 49 percent listed accessing capital as their leading challenge.

In their Economic Survey, KNBS (2017) defines SMEs as enterprises employing between 10 and to 99 employees, while enterprises employing less than 10 employees are regarded as Micro enterprises. The survey states that, the Micro Small Medium Enterprises (MSME) sector in Kenya has over the years been recognized for its role in provision of goods and services, enhancing competition, fostering innovation, generating employment and in effect, alleviation of poverty. The crucial role of MSMEs is underscored in Kenya's Vision 2030, which is the development blueprint which seeks to transform Kenya into an industrialized middle-income country, providing a high quality life to all its citizens by the year 2030. The MSME sector has been identified and prioritized as a key growth driver for achievement of the development blue print.

Intellectap (2015) further states that SMES account for 20% of GDP and 80% of employment in Kenya. Kenyan SMEs are hindered by a number of factors including inadequate capital, limited market access, poor infrastructure, lack of adequate knowledge

and rapid changes in technology which are hard and expensive to keep up with (Deloitte Kenya Economic Outlook, 2016). Kenyan SMEs in comparison to other Sub-Saharan African Countries continue to face challenges related to finance despite the Kenyan's bank improved involvement. (Adeyeye.2016). On their research in Kenya, Economic Survey (KNBS, 2017) found that out of the MSMEs that shut down in 2016, 29.6% sighted lack of sufficient funds to run their operations.

## **1.2. Problem Statement**

In their growth cycle, SMEs are likely to encounter a shortage of funds or a dire need for capital to undertake a major project like rolling out a new product to the market or scaling their operations (Kaplan, 2012). However, accessing venture equity funding is not as automatic and although many apply for funding to this firms, only few are selected. This is despite the fact that Venture capital funds are still holding uninvested cash (dry powder). It is also common to find some entrepreneurs who are not keen on utilizing the Venture capital channel to source for funding.

Szabo, Mallory & Hughes (2004) observe that, although Venture capitalist invest in relatively young, high risk business with a potential to post high returns, they reduce their risk by carefully evaluating the technical and business merit of the proposed business plans Sohl (2013). The most viable candidate according to their different criteria is then selected for funding. This makes up a fraction of the many SMEs in need of financing and hence the financing gap noted in many SMEs sectors in many economies is still wide.

Various studies have been conducted on venture capital impact on SMES; International, Mansa, (2011) did a study on the impact of venture capital financing on small and medium enterprises in the Tema Metropolis, Ghana; Mbhele, 2011 also did a study on the effects of venture capital finance and investment behaviour in the small medium-sized enterprises. Locally; Koech, (2008) also did a study on the use of venture capital instruments and other control mechanisms on venture capitalist in Kenya while Njoroge (2011) did a study on the effect of venture capital on financial performance of small and medium enterprises in Nairobi Kenya.

Despite the myriad of studies in this field, the researcher noted that there was a gap in literature as none of researchers looked at factors that are considered by the venture capitalists in their decision to fund SMEs in Kenya. Notably, the studies reviewed have ignored these factors that continue to limit small and medium enterprises from accessing venture capital thus creating a knowledge gap. It is for this reason that the current study will specifically seek to fill this gap by investigating the factors considered by VCs when evaluating SMEs for funding in Kenya.

### **1.3. Objectives of the Study**

#### **1.3.1. General Objective**

The general objective of the study was to determine the factors that influence venture capitalist's decision in funding small medium enterprises in Kenya.

#### **1.3.2. Specific Objectives**

The specific objectives of this study were:

- i. To determine the influence of management characteristics on VCs' consideration for funding of SMEs in Kenya.
- ii. To find out the influence of entrepreneur's characteristics on VCs consideration for funding of SMEs in Kenya.
- iii. To establish the influence of business characteristics on VCs consideration for funding of SMEs in Kenya.

### **1.4. Research Questions**

- i. What is the influence of management characteristics on VCs' consideration for funding of SMEs in Kenya?
- ii. What is the influence of entrepreneur's characteristics on VCs consideration for funding of SMEs in Kenya?
- iii. What is the influence of business characteristics on VCs consideration for funding of SMEs in Kenya?

### **1.5. Scope of the Study**

The Study focused on providers of venture/private capital to SMEs in Kenya who are registered with East Africa Venture Capital Association. EAVCA is a body of all registered venture capital firms operating within the east African market. All of them are also registered with the Capital Markets Authority.

### **1.6. Significance of the Study**

**To Entrepreneurs:** The study is aimed at educating the entrepreneur further on the criteria that Venture Capitalists use when evaluating a potential venture. The research will help the entrepreneurs understand what factors make a business attractive to Venture equity fund and hence model and structure their business accordingly and also what factors hinder them from accessing venture equity funds and hence improve on the same. This will make it easier for the SMEs to access capital which is hard to obtain from the mainstream financiers or other forms of funding like personal savings or micro-finance institutions which is mostly never adequate. In general the study will give the entrepreneurs more insights and understanding on how Venture Capitalists operate and hence demystify the alternative source of funding.

**Policy:** The research will help the Policy makers and regulatory bodies in the country's financial markets and commercial sector to create an enabling environment for both the SMEs and the Venture equity providers to operate on.

**Practice:** The study will bring into the light the reasons why some viable SMEs are not willing to take up Venture capital and possibly come up with training strategies or even improve on the way the Venture Capitalists sells themselves and operate to ensure an increase in interested investees.

**Academia:** This research builds into the already existing research work and provides a basis on which further research can be conducted.

### **1.7. Organization of the Study**

This study was divided into five chapters, introductory and background, literature review, research methodology, data analysis with presentation and finally the study conclusion and recommendations. Chapter one being the introduction and background gives an entry behavior on factors influencing access to venture capital on growth of SMEs, where the problem statement is explained leading to the study specific research objectives and questions. The chapter also gives the scope of the study, justification of the study, and the significance of the study.

Chapter two of the study reports on the findings from other scholars by reviewing gaps of the study by giving suggestions to the factors influencing access to venture capital on growth of SME, based on the study variables. The chapter will be concluded by a conceptual framework that will guide the study.

Chapter three gives the study road map towards investigating the objectives where the research design, study area, the target population, the sample size and data collection instrument will be explained in detail. Chapter four gives the analysis done on the data, which will be collected by the researcher. It also gives presentation of findings and qualitative analysis. Finally chapter five provides summary of key finding, conclusion and recommendations based on both literature review and data analysis

## **CHAPTER TWO: LITERATURE REVIEW**

### **2.1. Introduction**

This chapter presents the theoretical perspective of the study, the concept of SMEs growth, the factors influences access to venture capital by the SMEs, and the empirical studies done on venture capital. The chapter also presents the conceptual framework of the study, critique of existing literature, research gap, and chapter summary.

### **2.2. Theoretical Review**

This section gives the theoretical backing for the study as informed by the information Asymmetry theory.

#### **2.2.1 Information Asymmetry**

Information asymmetry reigns in the early stage market and has since venture capital came into being, with each group holding an informational edge over the people in the layer beneath. Investors have a negotiating advantage over founders since they have better insight into deal terms and trends in the broader market (Preuss, 2015). There is a significant positive relationship between information asymmetry and equity financing (Selahi *et al.* 2014). Bharath et al,(2006) in a research to find out whether Asymmetric Information Drive Capital structure decision found that between year 1973 to 2002, Asymmetric information affected the capital structure of US firms and hence the reason why pecking order theory is only partial in explaining the capital structure of firms.

Information asymmetry is evident where two parties making decisions are in a situation where one party has more or better information than the other causing an imbalance of power between them (Osano & Languitone, 2016). VCs are financial intermediaries focused on funding very high risks projects with characteristics like nascent technologies, domains and business models and intangibility of assets. This results to extreme high levels of information asymmetry and thus funding this project requires specialized skills of risk assessment. Information asymmetry results into two kinds of risks: adverse selection and Moral hazard. When entrepreneurs possess information not known to the VCs there is a risk of adverse selection and when the entrepreneurs take actions not known

to the VCs it results into the risk of Moral Hazards. Intensive proposal screening and due diligence is one of the main tactics employed by the VCS to tackle the risk of Adverse selection (Joshi *et al.*2015).

Asymmetrical information is a central feature of Venture Capital investment. Moral Hazards and adverse selection create market failures in entrepreneurship financing which could results into un-qualifying firms to be funded while the qualified ones are left out. Venture capitalists cannot eliminate these risks but they exist because they are more skilled in reducing this risk than unspecialized investors (Amit, Brander, & Zott, 2016). Due to the fact that transnational VCs lack local networks in India, they use investment strategies that enable them to compensate for the same as far as assessing the risks of a potential investee are concerned. Strategies like investing in firms whose entrepreneurs have erstwhile founding experience and syndicating with the Local VCs are used. They also keep away from investing in early stage deals as they are associated with high magnitude of information asymmetry (Joshi & Subrahmanya, 2015).

The theory will be applicable in this study in that it will inform the researcher how information about a particular business is significant in informing the capital venture firms to offer funding to these firms. The information about an organization is what matters in relation to venture capital firms offering funding to the SMEs.

### **2.3. Empirical Literature Review**

A study by Gompers et al. (2016), states that the ability to generate a pipeline of high quality investment opportunities is an important determinant of success in the VC industry. The study finding also shows that for every 100 potential opportunities assessed, only one firm is selected for funding by the VC firm. A VC must assess the probability of success and potential returns before making an investment. Therefore a potential investment goes through four stages before a VC puts their money in the business. This stage include: initial screening, the term sheet, due diligence and closing (Yasuda& Metric, 2011). Once VCs make an initial screening of an investment, they proceed to a more detailed level of due diligence. The most important parts of both screening and due

diligence are the assessments of the potential market and the quality of management. These major questions are supplemented by analyses in 10 major areas: customers, product, technology, competition, projections, channels, partners, money, transaction terms, and terrible things” (Yasuda& Metric, 2011).

### **2.3.1 Entrepreneur Factors**

Frank *et al* (2008) in their study assessing the influence of entrepreneur characteristics on access to VC funding found that industry experience, education background and leadership experience are the three most important team characteristics considered by VCs in their venture evaluation process. Frank *et al* (2008) further went ahead and indicated the importance of the different parameter values and providing insights on utility trade-offs between team characteristics. They found out that industry experience and leadership experience may suffice only when one member of the team possess it. Heterogenous teams are often preferred over teams where all members have the same education background.

In this regard, Axelson and Martinovic (2013) supported the finding by Frank et al (2008) stating that “diverse entrepreneurial knowledge is key for long term growth, though financing start-up firms is wrought with challenges’. The potential entrepreneur needs to have the skills, the idea and the courage to start the venture and in addition to these, he is required to be able to convince outside investors to fund the venture which is a more critical requirement. Axelson and Martinovic (2013) further noted that, because of information problems and inherent risks of new ventures, successfully financing new start-ups requires highly and actively involved and knowledgeable investors. Capital markets that are well developed are required to allow a successful exit that will give the investors a decent return.

Teraman, Teker and Teker (2016) researched and found that VCs will conduct a due diligence on a potential investee where they focus on evaluating the founders, the management team, the concept, the market place, the revenue model, the value added potential of the firm, the amount of capital needed to heal the business and whether all these fits into the funds objectives. Some studies like Pandula (2011) have indicated that



the entrepreneur personality determined SMEs' access to finance. Pandula (2011) added that the evaluation of entrepreneur characteristics lowered risk of default thus insisted by private equity firms because it mitigates both the adverse selection and moral hazard problems which results in credit market failures (McKenzie, 2009).

Well networked entrepreneurs were found by Andula, (2011) to easily attract capital from private equity firms because affiliation to social ties or professional associations allows SME operators to establish relations with bankers. Group lending increases a firm's access to credit because group members have the incentive to screen and monitor their group members to ensure that they invest their funds wisely (McKenzie, 2009).

Another entrepreneur characteristic of interest by various researchers like Kozan (2016) is educational qualifications of entrepreneurs. In this regard, Kozan (2016) found that there is a positive relationship between higher educational qualifications and business growth. Education affects entrepreneurs' motivation (Smallbone and Wyr, 2010). In addition, education helps to enhance the exploratory skills, improves communication skills and foresight. These enhanced skills are positively related to presenting a plausible case for a loan to a banker at the time of preparing a loan proposal and hence convincing the banker during the client interview.

According to Kumar and Francisco (2015), education has a strong effect when it comes to explaining to financial services. They also added that graduates had the least difficulties in accessing venture capital. Educated entrepreneurs have the ability to present positive financial information and strong business plans and they have the ability to maintain a better relationship in venture capital industry (Kumar and Francisco, 2015). Educated entrepreneurs have the skills to manage the other functions of the business such as human resources, finance, marketing, and these skills results to high performance of the business which helps those firms to access venture capital without any challenges.

The entrepreneurs' level of education also increases the probability of SMEs' access to venture capital. The highly qualified entrepreneurs are more efficient in their work and moreover, providers of funds have more confidence in those with higher academic

qualifications than those with lower levels of qualification (Berger and Udell, 2016). From the funds supply perspective banks and financial institutions perceive small business owners with higher educational qualification as being more creditworthy. Therefore, in such a case well educated entrepreneurs have a higher likelihood of accessing venture capital than those without. These educated entrepreneurs possess the necessary confidence to overcome any barriers they might come across when seeking access to venture capital and are well informed in regard to venture capital services and requirements. Thus, it is more likely that such individuals tend to apply for loan more than those with lower educational qualification.

Turning to experience, as measured by the number of years in an industry, Cole (2008) found that experience also enhances the availability of credit. In fact, Nofsinger and Wang (2011) hypothesized that the experience of the entrepreneur is one factor that explains the difference in external financing levels available to SMEs. The findings of the study proved this hypothesis. They further explained that prior experience in the industry positively correlates with the share of external financing in the firm and added that the cumulative experience of the owner–manager plays a crucial role in overcoming some of the problems that hinder SME access to external finance, including information asymmetry and moral hazard. From the lender’s perspective, as experienced entrepreneurs are believed to be better performers than less experienced entrepreneurs, it is then rational to factor experience into the process of evaluating entrepreneurs with leadership capabilities influence relationship in venture capital industry.

Regarding entrepreneur’s leadership abilities and past record, researchers; Nofsinger and Wang (2011) established that ability to drive the organizational vision and mission as a key factor considered by VCs when assessing a potential investee. The VCs are attracted to a business associated with an entrepreneur with good track record in leading successful programmes from previous organizations or projects (Nofsinger and Wang, 2011). Leadership capabilities helps the entrepreneur to deploy work unit, a combination of task behaviour, relations behaviour, change behaviour and external behaviours that are relevant to their situations, including environments, strategies, threats and opportunities in order to

enhance the performance of a team (Yukl, 2012). Frederick, Kuratko and Hodgetts (2007) asserted that entrepreneurial leadership is the most important factor in managing high growth ventures successfully, and concur that strategic leadership is the most effective for small businesses that are growing, or have the entrepreneurial potential to grow, in sales, revenue, and employment. Visser, de Coning and Smit (2005) found that transformational leadership, as found in large firms, can be applied to entrepreneurial leaders in SMEs, where organisations experience disruptive changes in technology, heightened global competition, and their workforces.

### **2.3.2 Management Team Factors**

The personality of the entrepreneur and of the management team are the most valued groups of criteria employed by VCs when evaluating capital investments according to a study done in Portugal by (Jose *et al.* 2013). They found that VCs with a majority of private share capital value more the personality of the entrepreneur and management team than companies with a majority of public share capital. For the VCs who are yet to internationalize, the personality of the entrepreneur and management team and the financial aspects are more important criteria than for the VCs who have expanded abroad. The summary of the findings showed the important aspects in each of criteria. Honesty and Integrity were the most important aspects under the personality of the entrepreneur, while being focused and familiar with the market objectives of the company and knowledge of the sector were the most crucial characteristics considered as far as the experience of the entrepreneur and his management team criteria is concerned (Yukl, 2012). Under the Market Criteria, the growth rate of the market and ease of access to distribution channels and suppliers were the most important characteristics considered by the investors.

Firm age in years is frequently used to control for the fact that older firm may have more experiences of applying for loans and have deeply long relationship with ventures and therefore more probability to access venture capital. It seems that financial life-cycle pattern is homogenous for different industry and consistent over time (La Rocca, 2011). An SME in start-up life cycle stage faces many challenges in

mobilizing money because they need overestimated money for formation of fixed asset and working capital. Whereas, in the growth life stage, businesses faces challenges based on time and money. A number of studies have found that there is a correlation between firm age and access to credit. Being in the business for many years suggests that the firms are at least competitive on average. It can be argued that being an older firm means there is lower informational opacity (Mason and Harrison, 2014).

Further, studies by Zinecker and Rajchlová (2010) in Czech Republic identified that the most significant criteria employed by Private and venture Capitalists in investment decision making. Zinecker and Rajchlová (2010) found that characterization of management i.e. their competencies and experience in all stages of a business lifecycle is the most critical factor considered by Venture capitalist when evaluating a potential investee's proposal. Their findings further concluded that investors emphasized on market and product criteria while making their decisions. The Managers' personality -high level of performance and perseverance was emphasized upon by the investors together with the ability of the senior management to identify problems, allocate tasks and set objectives, identify and evaluate risks and their ability to represent an idea.

According to Gompers *et al.* (2016), VCs focus on the quality of the Management team of the potential investee, the market, the competition, the product and the business model in their investment decision. In their survey the respondents ranked management team of the prospect investee as the most important factor considered by the VCs while making their investment decision. The most important management characteristics perceived by the VCs included ability, industry experience, passion, entrepreneurial experience and team work (Bygrave and Timmons, 2010).

### **2.3.3 Business Characteristics**

These factors relate to factors that generally reflect the business environment in general which in this study included financial, product and market factors. These factors are important for any business to consider since not every opportunity is going to produce overnight returns, and the risk versus the reward is always taken into consideration.

### **2.3.3.1 Product Factors**

VCs carefully evaluate the quality of a venture's product using the following criteria: is the product unique or sufficiently differentiated compared to competitors' offerings (Muzyka et al., 2017)? Is the product proprietary (MacMillan et al., 2015)? Does a functioning prototype of a product exist (MacMillan et al., 2015)? Will a product allow a venture to obtain a competitive advantage due to its apparent superiority over the competitors' products or services (Fried and Hisrich, 2014; Zacharakis and Meyer, 2011)?

A study by Pintado (2010) in South Africa established that three of the product characteristics, that is, proven product success, product stage of life cycle and marketing strategy were ranked as important. On the other hand, a study by Bruton (2010) found that market related issues rated higher than the requirement that the product be high tech, indicating that market issues relating to the product are more important than whether the product is orientated toward high technology. However, market related issues are generally ranked as being less important than owner and product characteristics.

Authors such as Van Osnabrugge (2010), Stedler and Peters (2013) and Clark (2014) found product related reasons in their top three investment criteria. According to these academics, business angels predominantly evaluate product potential (Van Osnabrugge 2010; Clark 2014) and product uniqueness (Stedler and Peters, 2013) in their investment criteria. Product related attributes tend to go hand in hand with the market related reasons, as there must be a desire for these products in the markets, in order to derive the business potential.

### **2.3.4 Market Factors**

Under the Market factor, a fast enough growing market and weak competition was highly regarded criterion by investors at the early stage financing (Bottazzi, 2011). At this stage sufficient access to the relevant market was also an important factor considered by investors. Under the Financial factor they found out that the most crucial criteria was potential for maximizing the value of co-ownership share (Silvola, 2011). The research went further to identify the most frequent reasons for rejecting business proposals and

obtained the following reasons;-unsuitable management, character of business proposals which earn 'insufficient expected returns' and are 'unrealistic, uncompetitive, innovative, too much risk is involved in them, there is insufficient opportunity for growth of the proposal and they do not promise to generate sufficient cash flow'. Some proposals are unacceptable due to too early a stage of proposal or unsuitable branch of business.

According to Abor (2010), while the venture capitalists are definitely more qualified to talk about lending to SMEs, it is a widely held view that venture capital investors have difficulties in financing start-ups and SMEs in spite of the significant number of SMEs. In addition, SMEs dominate economic activities and make a very significant contribution to GDP. Aryeetey, (2014) outline the following reasons as to why venture capital investors are reluctant to lend to SMEs: limited branch network, limited range of financial instruments and lending conditions, investors' risk-averse behaviour; preference for investing in Treasury bills, non-performing assets, which make the venture capital investors too cautious to undertake further lending, lack of established information network such as a credit reference bureau for tracking defaulters, VC investors' inadequate capacity to appraise the credit worthiness of SMEs (Silvola, 2011).

Venture capital funds generally seek out investments that are intermediate term, equity-related investments, target technology-based private firms, and invest in those rare firms that have the potential of going public or being acquired at a premium within a few years (Gompers & Lerner, 2011). This involves helping firms develop compensation and human resources policies; hiring key executives, such as the marketing president; and intervening to replace poorly-performing managers early enough to promote effective change. Although informal venture capital provides a different perspective in terms of sector coverage and degree of risks absorption, Sheffrin (2009) stress that the trend towards concentration of venture capital under the control of a few firms is increasing. Thus, it is possible to find a situation where a venture capital firm has a controlling stake in some SMEs. Furthermore, most lending institutions are more inclined to lending to the large scale businesses that

have higher success rate and repayment rate, the small scale businesses are relegated to the micro finance institutions (MFI's) and shylocks whose lending requirements may further discourage them.

SMEs contribute to output and to the creation of “decent” jobs, on the dynamic front they are a nursery for the larger firms of the future. The size and credit demand of SMEs also have outgrown the capacity of venture capital institutions, which offer small, short loans via group-lending methodologies. However, the capacity of the SME risk profile combined with the lender's lack of sophisticated risk assessment techniques makes many of them appear undesirable as credit customers among banks and other financial institutions. In Kenya, most SMEs are undercapitalized and over-leveraged (Kinyanjui, 2014). Moreover, many entrepreneurs lack collateral acceptable to the banks. This means that capital venture finance would be more suitable than debt finance and is one of the only options for entrepreneurs without collateral.

### **2.3.5 Financial Factors**

According to Dean (2008), and Dean and Baksi (2010) VCs need to compare first-time/early round opportunities and multiple-investment/later round opportunities and choose those that promise the highest return. It may be difficult for a start-up SMEs that has obtained initial financing in the first round to raise more money for further rounds because their initial investors may be tapped out, and since a great number of VC firms' manage uncertainty by spreading funds across ventures and not funding subsequent rounds (Dean and Giglierano (2010) and Steier and Greenwood (2015)).

VC investments are usually into highly risky business ventures due to their preference for small cap and unquoted firms. It is a general conception that investments into such ventures have the possibility of recording 100% investment loss (Fuerst and Geiger, 2013). Understandably, targeted firms for VC investment are usually ventures without significant operational history. For that reason, VC investors unlike other traditional investors have higher expectant investment returns in capital gains

as compensation for the risk assumed. The average VC investment has the potential of reaping investment returns of between 25 to 35 percent (Randjelovic, 2011).

Several studies conducted by Poindexter, (2005) have demonstrated that VCs are extremely concerned whether the projected returns from investment in a venture will be sufficient to justify a venture's funding. The studies have also indicated that VCs do not quite trust entrepreneurs' 'overoptimistic' projections regarding their future returns, and pay more attention to the market growth rate and whether a product satisfies a market need (Poindexter, 2005). According to Tyebjee and Bruno, (2014) VCs look into their potentially profit exit choices before they invest. Since VCs' funds have a limited life span (typically, up to ten years), VCs are concerned whether they will be able to liquidate their investment on time (MacMillan, 2015). Therefore, VCs may or may not fund a venture depending on their estimates of the likelihood and timing of certain anticipated exit alternatives (Kaplan and Stromberg, 2010).

Venture Capital investors are interested in companies with high growth prospects, enjoy barriers to entry from competitors, are managed by experienced and ambitious teams and have an exit opportunity for investors which will provide returns commensurate with the risk taken (Intertrade, 2015). Ongera (2015) in his study to establish the factors that affect access to equity/venture capital by SMEs in the Information and Technology Industry in Kenya concluded that, the most notable organizational factors that hinder access to venture capital are high risk, information asymmetry, and high cost of operation, management experience and networking. He also noted that external factors affecting access to equity /venture capital are limited access, firm size, legal framework and stringent conditions.

#### **2.4. Research Gap**

Most of the literature review on the factors and criteria employed by venture capitalist when making investment decisions is from study done elsewhere but Africa and especially Kenya. There are very few studies on Kenyan context. Literature on venture capital in Kenya had been fronted by (Okongo, 2001) but only focused on formal venture capital



firms and their requirement in financing SMEs especially institutionalized venture capital firms. A study by Ngigi (1996) focused on the role of venture capital in financing technology based SMEs covering formal venture capital firms that are Government owned. The findings indicated that many technology based firms do not qualify for venture capital finance due to lack of basic requirements. Another study by Sigara (2004) focused on factors hindering SMEs from using venture capital finance and unawareness was found to be the major contributing factor among others. Despite the myriad of studies in this field, the researcher noted that there was a gap in literature as none of researchers looked at factors that are considered by the venture capitalists in their decision to fund SMEs in Kenya. Hence as much as the research has been conducted in other countries, it is important to conduct similar study in Kenya for local consumption. This will validate or add to the few studies done in Kenya.

## **2.5. Summary of the Chapter**

This chapter has reviewed theories related to venture capital financing. The theories that has been specifically reviewed is information asymmetry theory. According to information asymmetry theory, VCs are financial intermediaries focused on funding very high risks projects with characteristics like nascent technologies, domains and business models and intangibility of assets. This results to extreme high levels of information asymmetry and thus funding this project requires specialized skills of risk assessment. The entrepreneurship theory contends that entrepreneurs are important for economic growth of any country and therefore financing is necessary to help SMEs set up and expand their operations, develop new products, and invest in new staff or production facilities.

A review of empirical studies on venture capital financing has also been done. The review is predominantly based on studies done outside Kenya and this confirms the lack of attention by scholars in Kenya on venture financing as a source of funding. From the review, it can be noted that there are inconsistencies in how various factors affect access of venture capital financing. Further, some of the methodologies used are not clear in providing useful information on how venture capital financing affects performance of the SMEs. The present study therefore seeks to bridge the inconsistencies in literature.

## **2.6. Conceptual Framework**

Svinicki (2010), defines a conceptual framework as an interconnected set of ideas about how a particular phenomenon or functions is related to its parts hence serving as the basis for understanding the causal or correlational patterns of interconnections across events, ideas, observations, concepts, knowledge, interpretations and other components of experience. The conceptual framework shows the relationship between the dependent and independent variables. The independent variables in this study included management characteristic, entrepreneur characteristic, and business characteristics which include Product Factors, Market Factors and Financial Factors while the dependent characteristic will be access to venture capital by SMEs.

The conceptual framework of this study was based on three independent variables and one dependent variable as represented diagrammatically in the figure below. The study used a conceptual framework in order to answer the research questions. According to the study, the SMEs access to VC is conceptualized as being dependent on management characteristic, entrepreneur characteristic, and business characteristics which include Product Factors, Market Factors and Financial Factors while the dependent characteristic will be access to venture capital by SMEs.

On the access to venture capital, the study used amount of capital disbursed to SMEs by the VCs as measuring parameters.

In entrepreneur factors, the study assessed the personality of the entrepreneur, education background, past experience and leadership capabilities and the extent to which such factors influence the VCs decision to fund SMEs.

Under management factors, the study assessed the board of directorship composition to ascertain how management is composed of a team with a wide industry experience, good education background and shareholding structure.

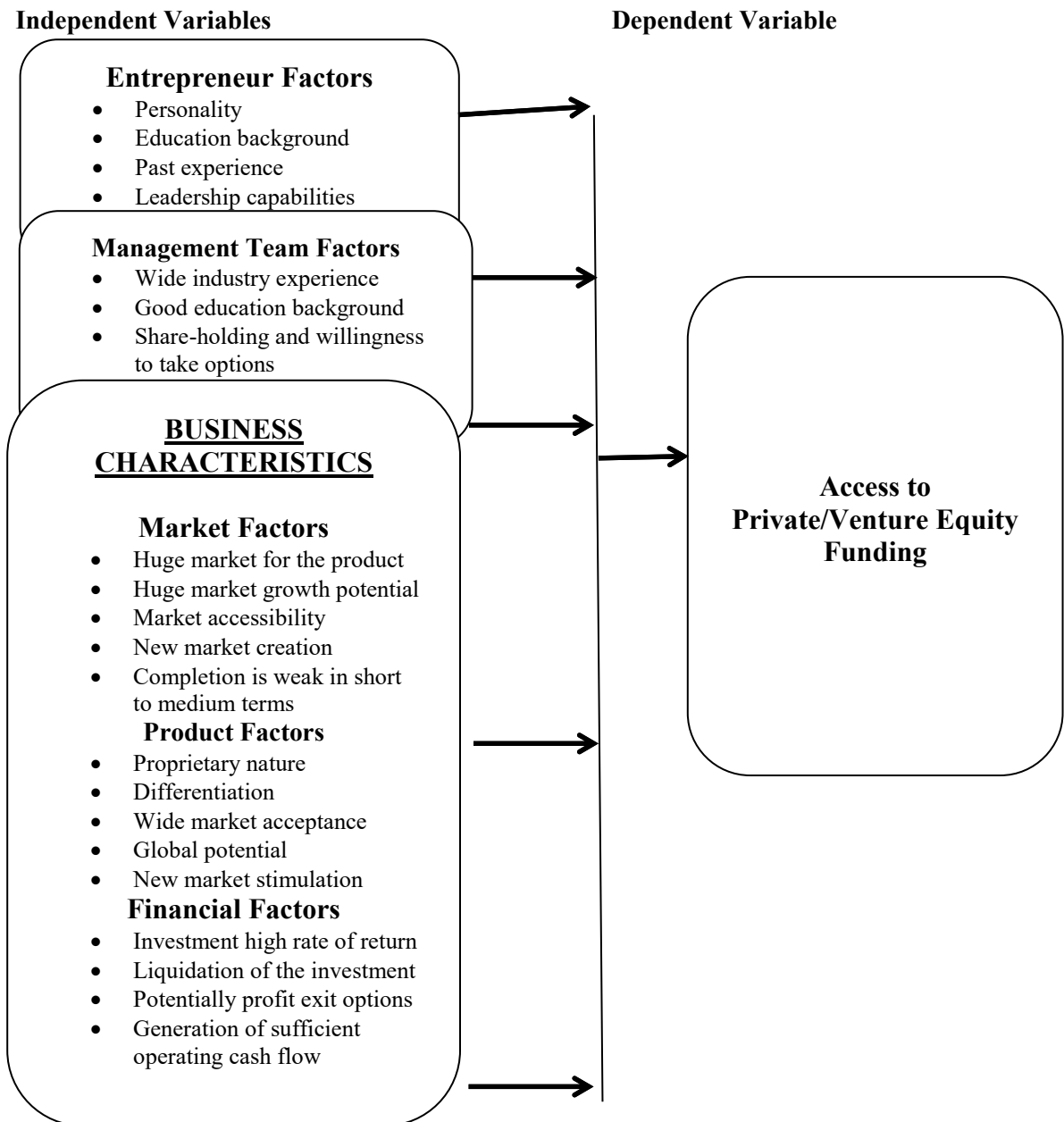
Business characteristics are business environment factors in general which in this study included financial, product and market factors.

On product factors, the study went further to look at the influence of proprietary issues regarding the SMEs products, differentiation, wide market acceptance of the products, global potential and new market stimulation in VCs decision to fund SMEs.

Under market factors, the study used the influence of huge market for the product on VCs decision to fund SMEs, influence of huge market growth potential, market accessibility and ability to acquire new market creation.

On financial factors, the study sought to ascertain the influence of investment high rate of return, liquidation of the investment, potentially profit exit options and generation of sufficient operating cash flow.

**Figure 2.1 Conceptual Framework**



## **CHAPTER THREE: RESEARCH METHODOLOGY**

### **3.1. Introduction**

Research methods refer to the methods the researchers use during the course of studying their research (Kothari, 2004.) This chapter contains research designed that was adopted by the researcher to conduct the study, the target population, sampling methods, data collection method, data analysis, research quality and ethical considerations during the study.

### **3.2. Research Design**

This was an exploratory research that shall enable the study to examine open and broad questions in order to explore and gain insight on the pre-investment considerations of Venture Capital Funds (Hopp & Lukas, 2014; Saunders, et al., 2009). Bryman and Bell (2007) asserted that exploratory studies set the foundation for future more analytical studies, and examine if an emerging phenomenon might be explained by a currently existing theory. Within the exploratory research methodology, the study used quantitative research designs to examine the factors that influence access to venture capital by SMEs in Kenya.

### **3.3. Population and Sampling**

A population is defined as the total collection of elements about which we wish to make some inferences (Cooper and Schindler, 2006). It was not possible to accurately establish the number of venture capital firms in the country despite much effort to do so. Not even the list provided by the East African Venture Capital Association seemed comprehensive and all-inclusive. Neither has the Capital Markets Authority been able to compel all venture capital firms to register. Nonetheless, the author established a list from Kenya Treasury report on number of private equity firms in Kenya. From the list, a total of 50 venture capital firms were identified.

The study adopted a census approach in which all the existing venture capital firms in Nairobi were targeted and at least one respondent approached. However, due to logistical challenges and unavailability of some respondents, the researcher sets a response rate of 60% as adequate as suggested by (Cooper and Schindler, 2006).

### **3.4. Data Collection**

Primary data was collected in this study. Primary data was collected through Self-completed Questionnaires. Self-completed Questionnaires to executives and managers of Venture capital or private equity firms in Kenya was used as the sole data collection tool. The questionnaires were emailed to the respondents of the companies . The respondents were asked to rank the five criteria of evaluation: the entrepreneur characteristics, the management's characteristics, the product characteristics, the market characteristics and the financial characteristics in order of their importance from 1 to 5. The rest of the survey contained Likert scale questions under the above specific criteria as identified in the literature review. The respondent rated each sub-criteria in order of importance 1 being "least important" through 5 as "very important".

### **3.5. Data Analysis**

The data from the questionnaire was first checked for incompleteness, inconsistencies and mistakes. Factor analysis was used to outline the most critical factors that are used for evaluating SMEs for the purposes of informing VCs decisions to fund SMEs. Factor analysis was the most relevant approach since the researcher focused to extract the study items into fewer numbers of factors. This technique extracts maximum common variance from all variables and puts them into a common score.

The process of factor analysis involved various procedures. The first step involved generating factor loadings to obtain correlation coefficient for the variables and factors. Factor loading showed the variance explained by the variable on each particular factor. Eigenvalues: showed variance explained by that particular factor out of the total variance. From the commonality column, the analysis explained how much variance is explained by the first factor out of the total variance.

Scree plots: showed the number of variables that were critical in explaining the highest variance among several factors. The number of factors are determined by the point of leveling off.

According to Tabachnick and Fidell, (2007) for any data to be subjected to for factor analysis, its variables must have factor loadings of above 0.40. The researcher therefore ran the data to test the factor loadings of the variables in which items were confirmed to have factor loading above 0.40 and hence were appropriate for further analysis.

Kaiser-Meyer-Olkin (K.M.O) measure was used in testing the adequacy of the data collected to be run for principal component analysis using the factor analysis technique. From the study results which were determined using the Kaiser-Meyer-Olkin measure the data was found to have sampling adequacy .601, which was adequate. The Bartlett's test of sphericity was found to be significant at ( $\chi^2 (190) = 434.512, p <.05$ ).

### **Factor Analysis for Key Variables**

**Table 3.1 KMO and Bartlett's Test**

Kaiser-Meyer-Olkin Measure of Sampling Adequacy.		0.601
	Approx. Chi-Square	434.512
Bartlett's Test of Sphericity	df	0.190
	Sig.	0.000

The correlation matrix on the diagonals were all over .5, which led to the researcher's decision to include all the items in the factor analysis. On generating communalities, all items had communalities of above .3 which confirmed that all items shared some common variance. Based on these measurements, all items measuring variables were included in the factor analysis.

### 3.6. Research Quality

Saunders *et al.* (2016) explains that internal validity is the extent to which a scholar can conclude that there is a causal relationship between two or more variables while external validity is defined as the degree to which the results of a study can be generalized to other people, situations and times. Likert scale questionnaire will ensure the means of obtaining data is consistent and will ensure that there is no bias that comes with interviews and open ended questions in the data collected. Research quality was enhanced by employment of data collection personnel with adequate capacity to administer qualitative tools. Predetermined structured questions to the respondents were set to ensure the responses are standard. The researcher conducted a pilot survey for testing questionnaires. The data collected from Pilot test was tested using Cronbach Alpha to measure consistency and reliability.

#### 3.6.1 Reliability Tests

From the data collected, the researcher subjected the entire data collected using questionnaire to reliability test. In this study, the instrument reliability was determined using the Cronbach's alpha coefficient which measured the internal consistency of the questionnaire. The higher this coefficient, the more reliable is the test. According to Zinbarg (2005) for a data to have acceptable consistencies, it must attain an alpha value of 0.70 and above. Such a data is assumed to have good internal consistency which makes it reliable in research generalization as it is representative of the target population. The test results are as presented in the table 3.2 below.

**Table 3.2 Reliability and Validity**

Variable/Construct description	Item Means	Item Standard deviations	Coefficient Alpha Reliability
Management characteristics	6.9	6.1	0.789
Business characteristics	5.2	2.4	0.796
Entrepreneur's characteristics	5.9	2.9	0.774

Source: Field Data (2017)



As shown in the table 3.2 the Cronbach's alpha for management characteristics was 0.789, for business characteristics was 0.796, for entrepreneur's characteristics was 0.774. The Cronbach's reliability test for all the variables was above 0.7 and therefore surpassed the recommended levels of reliability.

### **3.7. Ethical Considerations**

The researcher took the measures to ensure that the following ethical considerations are considered. The researcher explained the study benefits to all the participants and assure them of privacy where required. The participants were given contact details of the research owner and Strathmore university's business school in case they wish to seek further clarification or complain about the research. The participants were guaranteed privacy in case confidentiality or anonymity was required. Permission to interview the participant was sought from relevant authorities. Informed consent was sought where necessary especially in the companies. This involved describing the study topic and purpose of the research, giving good faith, letting the participant know their participation is voluntary and non-response was acceptable and in case they wished so they could withdraw from the study without negative consequences.

## CHAPTER FOUR

### DATA ANALYSIS AND PRESENTATION OF RESULTS

#### 4.1 Introduction

This chapter presents the study findings and discusses the inferential and empirical findings in relation to the study overall objective which was to evaluate factors that influence venture capitalist's decision in funding small medium enterprises in Kenya. The analysis is also done as per the study objectives which were; to determine the influence of management characteristics on VCs' consideration for funding of SMEs in Kenya, to find out the influence of entrepreneur's characteristics on VCs consideration for funding of SMEs in Kenya, to establish the influence of business characteristics on VCs consideration for funding of SMEs in Kenya.. The analysis followed the approaches and techniques as outlined in chapter three.

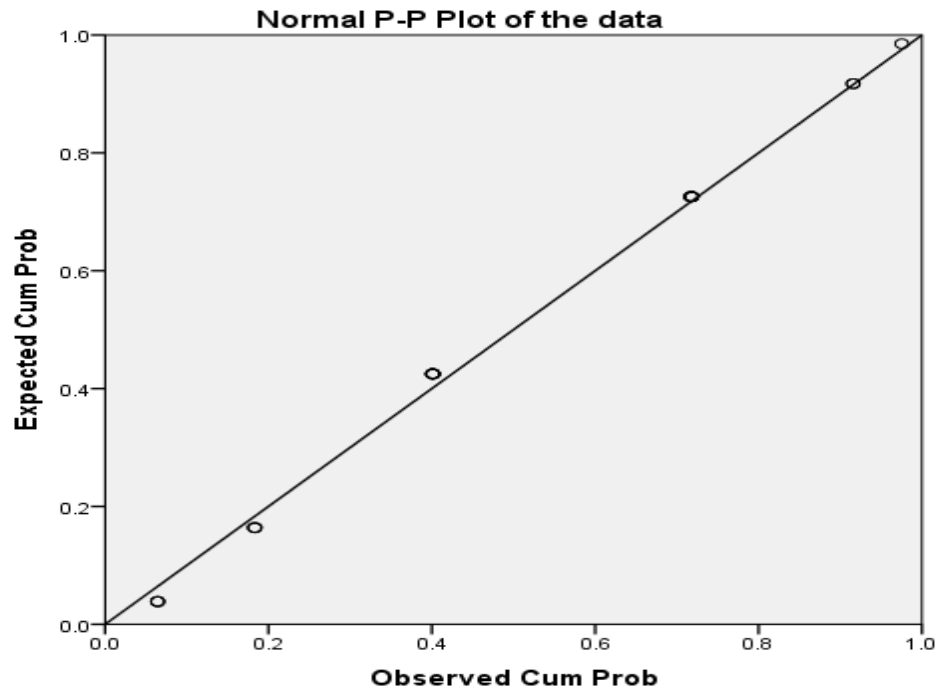
#### 4.2 Response Rate

The study covered 50 VCs that were operating in Nairobi. Of the 50 VCs, questionnaires were distributed to 43 VCs (See appendix V). However, not all the respondents chosen successfully returned filled questionnaire. The researcher was however able to collect 26 questionnaires which were returned by respondents. This represented a 52.2% response rate. As recommended by Mugenda and Mugenda (2003) the response rate was above 50% response which was an adequate response rate for any survey. Using these arguments by the stated researchers, the response rate was rated as enough. This meant that the data was good to make proper generalization and conclusions.

**Table 4.1: Response rate**

population	Sample targeted	Successfully covered	percent
50 managers for VCs	50 respondents	26 respondents	52%

**Figure 4.1: Data distribution**



As can be seen from the P-P plot, the circles all lie quite close to the line; this shows that since the circles are close enough the study data can therefore be termed to come from a normal distribution.

### **4.3 Analysis by objectives**

Various factors were assessed in regard to how they influence venture capitalist's decision in funding small medium enterprises. Various items were used to measure the extent to which they influence venture capitalist's decision in funding small medium enterprises. The main study variables under study were; management characteristics, business characteristics, entrepreneur's characteristics. These three variables had various items for assessment designed in a Likert scale format. Factor analysis was used to determine how each of the variables influenced funding decisions as per the opinion of the respondents.

From the factor analysis the study identified the most prominent influencing factors. The initial communality indicated that the highest factor measured 43.94% of the variance, the second item 28.39% in variance while the third one had 15.71%. From the factor analysis, only three factors of the five original constructs were significant in the analysis as critical influencing factors that affect VCs funding decisions. This was further supported by a break after the third item as illustrated by the scree plot.

**Table 4.2: Total Variance for Key Variables**

**Total Variance Explained**

Component	Initial Eigenvalues			Extraction Sums of Squared Loadings		
	Total	% of Variance	Cumulative %	Total	% of Variance	Cumulative %
1	2.197	43.949	43.949	2.197	43.949	43.949
2	1.420	28.398	72.346	1.420	28.398	72.346
3	.786	15.717	88.063			
4	.555	11.093	99.156			
5	.042	.844	100.000			

Extraction Method: Principal Component Analysis.

A component matrix showed that the most prominent factors considered by VCs in their decision to fund SMEs as; market factors, product factors and financial factors with coefficients of .968, 0.934 and 0.599 respectively. The higher the coefficient, the more the factor is significant in determining funding decisions. The total variance for the items was also computed to determine the percentages at which the three most prominent factors. It can therefore be concluded that the three prominent factors which were; market factors, product factors and financial factors whose coefficients had variances of 43.94%, 28.39% and 15.71% respectively. This meant that VCs consider market factors at a rate of 43.39%, product factors at a rate of 28.39% while financial factors are considered at a rate of 15.71%.

### 4.3.1 Objective one: Entrepreneurship Factors

The study sought to determine the specific entrepreneurship factors that influence VCs in their decision to fund SMEs. These included items such as; personality of the entrepreneur, education background of the entrepreneur, entrepreneurs past experience, leadership capabilities and willingness to relinquish control.

On generating communalities, all items had communalities of above .3 which confirmed that all items shared some common variance. Based on these measurements, all items measuring entrepreneurship factors were included in the factor analysis.

**Table 4.3: Total Variance for entrepreneurship factors**

Component	Initial Eigenvalues			Extraction Sums of Squared Loadings		
	Total	% of Variance	Cumulative %	Total	% of Variance	Cumulative %
1	2.120	42.407	42.407	2.120	42.407	42.407
2	1.115	22.294	64.701	1.115	22.294	64.701
3	.932	18.636	83.337			
4	.496	9.920	93.257			
5	.337	6.743	100.000			

Extraction Method: Principal Component Analysis.

#### **Total Variance Explained**

From the factor analysis the study identified the most prominent entrepreneurship factors. The initial communality indicated that the highest factor measured 42.407% of the variance, the second item 22.294% in variance. From the factor analysis, only two factors of the six original entrepreneurship constructs were significant in the analysis as critical entrepreneurship factors that affect VCs funding decisions. This was further supported by a break after the second item as illustrated by the scree plot.

A component matrix showed that the most prominent entrepreneurship factors considered by VCs in their decision to fund SMEs as; education background of the entrepreneur and entrepreneurs past experience with coefficients of 0.849 and 0.815 respectively. The

higher the coefficient, the more the factor is significant in determining funding decisions. The total variance for the items was also computed to determine the percentages at which the two most prominent entrepreneurship factors. The table 4.3 shows the findings in this regard.

It can therefore be concluded that the two prominent factors which were; education background of the entrepreneur and entrepreneurs past experience whose coefficients had variances of 42.407% and 22.294% respectively. This meant that VCs consider education background of the entrepreneur at a rate of 42.407% while entrepreneurs past experience are considered at a rate of 22.294%.

### 4.3.2 Objective two: Management Factors

The study sought to determine the specific management factors that influence VCs in their decision to fund SMEs. These included items such as; the management team has a wide industry experience, the management team has a good education background and the management team has shareholding or is willing to take share options.

On generating communalities, all items had communalities of above .3, which confirmed that all items shared some common variance. Based on these measurements, all items measuring management factors were included in the factor analysis.

**Table 4.4: Total Variance for management factors**

#### Total Variance Explained

Component	Initial Eigenvalues			Extraction Sums of Squared Loadings		
	Total	% of Variance	Cumulative %	Total	% of Variance	Cumulative %
1	1.813	60.444	60.444	1.813	60.444	60.444
2	0.749	24.962	85.405			
3	0.438	14.595	100			

From the factor analysis the study identified the most prominent management factors. The initial communality indicated that the highest factor measured 60.444% of the variance, the second item 24.962% in variance. From the factor analysis, only two factors of the

three original management constructs were significant in the analysis as critical management factors that affect VCs funding decisions. This was further supported by a break after the second item as from the scree plot.

A component matrix showed that the most prominent management factors considered by VCs in their decision to fund SMEs as; a team with a good education background and the team has a wide industry experience with coefficients of 0.86 and 0.758 respectively. The higher the coefficient, the more the factor is significant in determining funding decisions. The total variance for the items was also computed to determine the percentages at which the two most prominent management factors.

From the analysis, three prominent factors were determined which were; a team with a good education background and a team with a wide industry experience whose coefficients had variances of 60.444% and 24.962% respectively. This meant that VCs consider good education background at a rate of 60.444% while a wide industry experience is considered at a rate of 24.962%.

### **4.3.3 Objective three: Business Characteristics**

The business characteristics according to the study were categorized into three aspects of; product factors, market factors and financial factors.

#### **4.3.3.1 Product Factors**

The study sought to determine the specific product factors that influence VCs in their decision to fund SMEs. These included items such as; the product is proprietary or can be patented, the product is well differentiated in the market, the product has a wide market acceptance, the product has a global potential and the venture will stimulate a new market. On generating communalities, all items had communalities of above .3 which confirmed that all items shared some common variance. Based on these measurements, all items measuring product factors were included in the factor analysis.

Table 4.5: Total Variance for Product Factors

**Total Variance Explained**

Component	Initial Eigenvalues			Extraction Sums of Squared Loadings		
	Total	% of Variance	Cumulative %	Total	% of Variance	Cumulative %
1	2.277	45.545	45.545	2.277	45.545	45.545
2	1.416	28.327	73.871	1.416	28.327	73.871
3	.927	18.543	92.414			
4	.206	4.116	96.530			
5	.173	3.470	100.000			

Extraction Method: Principal Component Analysis.

From the factor analysis the study identified the most prominent product factors. The initial communality indicated that the highest factor measured 45.545% of the variance and the second item 28.327% in variance. From the factor analysis, only two factors of the three original product constructs were significant in the analysis as critical product factors that affect VCs funding decisions. This was further supported by a break after the second item as illustrated by the scree plot.

A component matrix showed that the most prominent product factors considered by VCs in their decision to fund SMEs as; the venture will stimulate a new market and the product has a global potential with coefficients of 0.934 and 0.836 respectively. The higher the coefficient, the more the factor is significant in determining funding decisions. The total variance for the items was also computed to determine the percentages at which the two most prominent product factors. The table 4.5 shows the findings in this regard.

Two prominent factors were found to be critical which were; the venture will stimulate a new market and the product has a global potential whose coefficients had variances of 45.545% and 28.327% respectively. This meant that VCs consider the venture will stimulate a new market at a rate of 45.545% while the product has a global potential are considered at a rate of 28.327%.



#### 4.3.3.2 Market Factors

The study sought to determine the specific market factors that influence VCs in their decision to fund SMEs. These included items such as; there is a huge market for the product, there is a huge market growth potential, the competition is weak in the short to medium term (0-3 years), the market is easily accessible and the venture will create a new market.

On generating communalities, all items had communalities of above .3, which confirmed that all items shared some common variance. Based on these measurements, all items measuring market factors were included in the factor analysis.

**Table 4.6 Total Variance for Market Factors**

Component	Initial Eigenvalues			Extraction Sums of Squared Loadings		
	Total	% of Variance	Cumulative %	Total	% of Variance	Cumulative %
1	1.989	39.779	39.779	1.989	39.779	39.779
2	1.102	22.038	61.816	1.102	22.038	61.816
3	0.865	17.299	79.116			
4	0.568	11.37	90.485			
5	0.476	9.515	100			

From the factor analysis the study identified the most prominent market factors. The initial communality indicated that the highest factor measured 39.779% of the variance and the second item 22.038% in variance. From the factor analysis, only two factors of the three original market constructs were significant in the analysis as critical market factors that affect VCs funding decisions. This was further supported by a break after the second item as illustrated by the scree plot.

A component matrix showed that the most prominent market factors considered by VCs in their decision to fund SMEs as; huge market for a product and a huge market growth potential with coefficients of 0.787 and 0.749 respectively. The higher the coefficient, the more the factor is significant in determining funding decisions. The total variance for the items was also computed to determine the percentages at which the two most prominent product factors. The table 4.6 shows the findings in this regard.

The study therefore determined two prominent factors which were; huge market for a product and a huge market growth potential had variances of 39.779% and 22.038% respectively. This meant that VCs consider that a huge market for a product at a rate of 39.779% while a huge market growth potential are considered at a rate of 22.038%.

#### **4.3.3.3 Financial Factors**

The study sought to determine the specific financial factors that influence VCs in their decision to fund SMEs. These included items such as; the investment has a potential high rate of return, the investment can be easily made liquid, there are potentially profitable exit options and the investment will generate sufficient operating cash flows.

On generating communalities, all items had communalities of above .3, which confirmed that all items shared some common variance. Based on these measurements, all items measuring market factors were included in the factor analysis.

**Table 4.7 Total Variance for Financial Factors**

<b>Total Variance Explained</b>						
Component	Initial Eigenvalues			Extraction Sums of Squared Loadings		
	Total	% of Variance	Cumulative %	Total	% of Variance	Cumulative %
1	2.171	54.282	54.282	2.171	54.282	54.282
2	0.896	22.394	76.676			
3	0.5	12.512	89.188			
4	0.432	10.812	100			

From the factor analysis the study identified the most prominent financial factors. The initial communality indicated that the highest factor measured 54.282% of the variance and the second item 22.394% in variance. From the factor analysis, only two factors of the three original financial constructs were significant in the analysis as critical financial factors that affect VCs funding decisions. This was further supported by a break after the second item as illustrated by the scree plot.

A component matrix showed that the most prominent market factors considered by VCs in their decision to fund SMEs as; the investment will generate sufficient operating cash flows and there are potentially profitable exit options with coefficients of 0.813 and 0.808 respectively. The higher the coefficient, the more the factor is significant in determining funding decisions. The total variance for the items was also computed to determine the percentages at which the two most prominent financial factors. The table 4.7 shows the findings in this regard.

It can therefore be concluded that the two prominent financial factors which were; the investment will generate sufficient operating cash flows and there are potentially profitable exit options whose coefficients had variances of 54.282% and 22.394% respectively. This meant that VCs consider that the investment will generate sufficient operating cash flows at a rate of 54.282% while there are potentially profitable exit options considered at a rate of 22.394%.

#### **4.4 Summary of Findings**

##### **4.4.1 Key factors for funding decisions**

The study through factor analysis outlined that in the Kenyan VC market, three key variables are considered by VCs in their decision to fund SMEs. These were; market factors, product factors and financial factors whose coefficients had variances of 43.94% , 28.39% and 15.71% respectively.

#### **4.4.2 Entrepreneurship Factors**

From the study findings, it was established that only two factors of the six original entrepreneurship constructs were significant in the analysis as critical entrepreneurship factors that affect VCs funding decisions. These were; education background of the entrepreneur and entrepreneurs past experience whose coefficients had variances of 42.407% and 22.294% respectively.

#### **4.4.3 Management Factors**

From the factor analysis, only two factors of the three original management constructs were significant in the analysis as critical management factors that affect VCs funding decisions. Which were; a team with a good education background and a team with a wide industry experience whose coefficients had variances of 60.444% and 24.962% respectively.

#### **4.4.4 Product Factors**

From the factor analysis, only two factors of the three original product constructs were significant in the analysis as critical product factors that affect VCs funding decisions. Which were; the product will stimulate a new market and the product has a global potential whose coefficients had variances of 45.545% and 28.327% respectively.

#### **4.4.5 Market Factors**

The study determined two prominent market factors which were; a huge market for a product and a huge market growth potential whose coefficients had variances of 39.779% and 22.038% respectively. This meant that VCs consider that a huge market for a product at a rate of 39.779% while a huge market growth potential are considered at a rate of 22.038%.

#### **4.4.6 Financial Factors**

Two prominent financial factors were determined which were; the ability of the venture to generate sufficient operating cash flows and profitable exit options whose coefficients had variances of 54.282% and 22.394% respectively. This meant that VCs consider that the investment will generate sufficient operating cash flows at a rate of 54.282% while potentially profitable exit options considered at a rate of 22.394%.

## **CHAPTER FIVE: DISCUSSION, CONCLUSION AND RECOMMENDATIONS**

### **5.1 Introduction**

This chapter summarizes the main findings, conclusion and recommendations emanating from the results of this study. Research findings were aligned to the objectives of the study which were: to determine the influence of management characteristics on VCs' consideration for funding of SMEs in Kenya, to find out the influence of entrepreneur's characteristics on VCs consideration for funding of SMEs in Kenya, to establish the influence of business characteristics on VCs consideration for funding of SMEs in Kenya.

### **5.2 Discussion of Findings**

The study was guided by three objectives which were; to determine the influence of management characteristics on VCs' consideration for funding of SMEs in Kenya, to find out the influence of entrepreneur's characteristics on VCs consideration for funding of SMEs in Kenya, to establish the influence of business characteristics on VCs consideration for funding of SMEs in Kenya. Literature review on each of the variables informed the study. As informed by information asymmetry theory the study found that VCs while making decisions are in a situation where they more or less information than the SMEs causing an imbalance of power between them. The study in this regard had findings some in agreement with findings by other scholars and some with some unique insights.

#### **5.2.1 Entrepreneurship Factors**

Out of five items that were assessed, the study highlighted two items as important to the VCs in their consideration for funding of SMEs in Kenya. Three of the entrepreneurship factors were considered to be unimportant, with only education background and past experience rated as important factors of consideration by VCs. This confirming the results reported by Frank et al (2008) who established that industry experience and education background are important factors considered by VCs in their venture evaluation process. The study further confirms arguments raised by Axelson and Martinovic (2013) that "diverse entrepreneurial knowledge is key for long term growth. This is important for any potential project funded by VCs as any potential entrepreneur needs to have the skills, the

idea and the courage to start the venture and in addition to these, he/she is required to be able to convince outside investors to fund the venture which is a more critical requirement aspect in the fund seeking process. The study however finds that although the existing results cannot reveal utility trade-offs to education background and industry experience, if a team lacks industry experience, proper technical knowledge can cover for the gap and vice versa. However, a more detailed understanding of team evaluation criteria is required.

### **5.2.2 Management Factors**

The rating of the entrepreneur's management capabilities as most important by the VCs is in agreement with what Pintado (2007) who found that all characteristics about the management team to be of high importance, with knowledge and experience being the most important, followed by sector knowledge, work experience, management team, leadership skills and, finally, understanding of company objectives. This study confirms similar findings by Jose et al. (2013) that VCs with a majority of private share capital value more the personality of the entrepreneur and management team than companies with a majority of public share capital.

### **5.2.3 Product Factors**

The study determined two factors of product constructs as significant product factors that affect VCs funding decisions. These were; the ability to stimulate a new market and the product's global potential. The study findings were in consonance with similar studies by Fried and Hisrich (2014) and Zacharakis and Meyer (2011) who established that VCs will consider a product that allows a venture to obtain a competitive advantage due to its apparent superiority over the competitors' products or services. The findings are also in agreement with findings by Bruton (2010) who found that ability to compete in a global market rated higher than the requirement that the product be high tech, indicating that market issues relating to the product are more important. From this perspective the study recommends SMEs to develop their products around the two aspects of uniqueness and far reaching market acceptability potential.

#### **5.2.4 Market Factors**

The study established that important market factors were a huge market for the products and a huge market growth potential. In this realm, a good market acceptance for the product or service was the most important market factor. The importance of this criterion is confirmed by Abor (2010) who found market acceptance of the product and insulation against competitive attacks to be the most important criteria and an indication for success. Mishra (2004) found that, as a rule, VCs will not invest in a business without a clear indication of market acceptance for the product no matter how technically advanced the product may be.

#### **5.2.5 Financial Factors**

The study highlighted two important finance factors that are important to VCs while evaluating SMEs for funding. The first factor was ability to generate positive cash flows and the second was ability to ensure profitable exit options. In this regard, the return on investment as observed by Wright and Robbie (1998) is important as it is a process that is likely to be made up of a series of iterations using differing possible future trends in the performance of the venture and that this is the most common performance measure in the industry. The rating of this criterion as jointly most important by VCs concurs with Wright and Robbie (1998) but seems to be in disagreement with Dixon (1991) who states that there is little scrutiny of information to adjust target required returns.

### **5.3 Conclusion**

The real factors that influence VCs decisions on funding SMEs were determined in this study. The factor analysis showed that three key variables are majorly considered by VCs in their decision making process to fund SMEs. These were; market factors, product factors and financial factors. As per the study findings, the market factors forms a key area of focus in evaluating SMEs followed by product factors while financial factors were ranked third. The study therefore concludes that SMEs should focus on building their potential around these three key variables in order to raise their potential for funding from the VCs.

The study also concludes that focusing on a holistic perspective the key variables will be achieved by focusing on some specific factors. In this regard, entrepreneurship factors of key concern are education background and past experience of the entre. Management factors of concern for any entrepreneur interested in accessing venture capital would be good education background and wide industry experience. Market factors that should be considered in order to qualify for funding from VCs are a huge market for the product and a huge market growth potential . When it comes to product aspects, the study established that the product should be able to stimulate a new market and the product should have a global potential. On financial aspect, the study established that SMEs should ensure that their ventures have the ability to generate sufficient operating cash flows and have profitable exit options.

#### **5.4 Recommendations**

Based on the findings of this research, the researcher proposes the following recommendations that can take venture capital market in Kenya to the next level:

Entrepreneurs should be encouraged to seek help from venture capital firms to finance their business ideas and this will help stop over relying on formal financing. Venture capital firms should also be encouraged to create conducive environment that will encourage business persons to share their business ideas. This will help the venture capital market to grow at a much faster rate than it has done in the recent past.

Information is power and for the SMEs to access venture capital, adequate information about parameters considered by VCs is paramount. Venture capital firms should be encouraged to do thorough marketing to create awareness of their key areas of interest when evaluating SMEs for funding. Learning institutions should emphasis the importance of this type of financing to their students and expose the students early enough; this will help them change their perception on venture capital financing.

Government's involvement in venture capital is important to the venture capital market. However, the government has not fully utilized its potential in carrying out awareness about this type of financing. This study therefore recommends a closely-knit relationship between the government and venture capital firms for better results.



### **5.5 Limitations**

**Access:** the study depends on having access to people, organizations, or documents and, for whatever reason, if access is denied or otherwise limited, this may limit the research in general.

### **5.6 Suggestions for Further Research**

The access to venture capital financing by SMEs in Kenya can be termed as being low. In line with this finding, an important direction for future research that emerges regards the how SMEs can position themselves for qualification for venture funding through VCs.

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## APPENDIX 1: INTRODUCTION LETTER



Strathmore Business School

To whom It may concern.

Dear Sir/ Madam,

RE: FACILITATION OF RESEARCH -TABITHA WAITHIRA

This is to introduce Tabitha Waithira who is a Master of Business Administration student at Strathmore Business School, admission number MBA/ 92966/16. As part of our MBA Program, Tabitha is expected to do applied research and to undertake a project. This is in partial fulfilment of the requirements of the MBA course. To this effect, she would like to request for appropriate data from your organization.

Tabitha is undertaking a research paper on **“Factors That Influence Venture Capitalist’s Decision On Funding Small and Medium Enterprises In Kenya.”** The information obtained from your organization shall be treated confidentially and shall be used for academic purposes only.

Our MBA seeks to establish links with industry, and one of these ways is by directing our research to areas that would be of direct use to industry. We would be glad to share our findings with you after the research, and we trust that you will find them of great interest and of practical value to your organization.

We appreciate your support and we shall be willing to provide any further information if required.

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'Muriithi Njogu', is written over a horizontal line.

Muriithi Njogu.

**Director- MBA Programs**

**APPENDIX II: QUESTIONNAIRE**

Kindly fill in the following questionnaire. Information obtained will be used for academic purposes only and will therefore be handled with the highest level of confidentiality. Your corporation will be highly appreciated

**SECTION A: GENERAL INFORMATION**

1. Indicate the position that you hold in the organization?

- Manager  Team Leader
- Departmental Head  Supervisor
- Technical Personnel

Any other (specify).....

2. How long have you worked in this organization?

- 1- 5 years  6 – 10Years
- 10 – 15Years  Above 16Years

**Section b**

3. Using a scale of 1-5, where 1- least important, 2-slightly important, 3-Moderately important, 4-Important, 5-Very important. Please rate the factors below as considered by VCs/PE to evaluate the viability of a potential investee pre-investment.

		1	2	3	4	5
1	Entrepreneur Factors					
2	Management Team Factors					
3	Product Factors					
4	Market Factors					
5	Financial Factors					
<b>1</b>	<b>Entrepreneur Factors</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
	Personality of the entrepreneur					
	Education Background of the entrepreneur					
	Entrepreneurs past experience					
	Leadership capabilities					
	Willingness to relinquish control					

<b>2</b>	<b>Management Team Factors</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
	The team has a wide Industry Experience					
	The team has a good education background					
	The team has shareholding or is willing to take share options					
<b>3</b>	<b>Product Factors</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
	The Product is proprietary or can be patented					
	The product is well differentiated in the market					
	The product has a wide market acceptance					
	The product has a global potential					
	The venture will stimulate a new market					
<b>4</b>	<b>Market Factors</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
	There is a huge market for the product					
	The is a huge market growth potential					
	The completion is week in the short to medium term(0-3 yrs)					
	The market is easily accessible					
	The venture will create a new market					
<b>5</b>	<b>Financial Factors</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
	The investment has an potential high rate of return					
	The investment can be easily made liquid					
	There are potentially profitable exit options					
	The investment will generate sufficient operating cash flows(subsequent cash injections from the investor not required)					
	<b>Please indicate any other relevant factor other Factor not included above</b>					

### **APPENDIX III: LIST OF VENTURE CAPITAL FIRMS**

1. Abraaj
2. Action Rich Investment
3. Actis
4. Acumen
5. AECF
6. Africinvest
7. Agrivie
8. AHL venture partners
9. Alios finance
10. Alpha Africa asset managers
11. Amethis finance
12. AOG invest
13. Ascent capital
14. Bamboo capital partners
15. Burbridge capital
16. Business partners international
17. Catalyst Principal Partners
18. Centum Investment
19. Cross boundary
20. Cytom
21. DOB Equity
22. East Africa Capital Partners
23. ECP
24. Energy Access Ventures
25. Fanisi
26. Frontier energy
27. Fusion Capital
28. GenAfrica
29. Grassroots Business Fund

30. Grofin East Africa
31. Helios Investment Partners
32. Inreturn Capital / Jacana Partners
33. Intercontinental Trust
34. Kenya Climate Ventures
35. Kestrel Capital
36. Kibo
37. Kuramo Capital
38. Metier
39. Milost Global Inc
40. Novastar Ventures
41. Pearl Capital
42. Phatisa
43. Progression Capital
44. Quantum Global
45. SANLAM
46. Pinebridge East Africa
47. Silk Invest
48. TBL Mirror
49. Terrafirma Africa
50. Voxtra

**THE END**