

**FACTORS THAT INFLUENCE THE ESTABLISHMENT OF VENTURE CAPITAL
FIRMS IN KENYA**

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Abstract

The purpose of this study was to investigate factors that influence the establishment of venture capital firms in Kenya. The research design adopted was descriptive. Data was collected through semi-structured interviews from eight venture capitalists in 2012. Data obtained in the study was analysed through descriptive methods and content analysis. The objectives of the study were to identify the key factors that influence establishment of venture capital firms, challenges encountered as they set up and the sectors of the economy preferred. The results showed that macroeconomic variables specifically, Gross Domestic Product (GDP), interest rates and inflation, performance of the market, funds from investors, expected rate of return and networking among venture capitalists were the key factors considered in the set up of firms. Challenges encountered were scarce or no protection of investor's property, lack of proper documentation by the entrepreneurs who venture capitalist considered to invest in their firms or business, lack of proper valuation methods to determine the worth of a venture and lack of qualified venture capital personnel. The most preferred sectors invested by the venture capitalists were identified as manufacturing and health care. The study has contributed to the body of knowledge as this is an area where there is scarce literature especially in the emerging markets. Areas for further study include, establishing if there is an increase in the venture capital funds and the impact on the growth of the economy and to look further into the valuation methods used to determine a venture and determine the best practice for emerging markets.

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Abbreviations and Terms Defined

ARD- American Research and Development

CMA-Capital Markets Authority

EME-Emerging Market Economy

EU-European Union

GDP-Gross Domestic Product

ICDC-Industrial and Commercial Development Corporation

ICDCI-Industrial and Commercial Development Corporation Investment

IMF-International Monetary Fund

INSEAD-European Institute for Business Administration

IPO-Initial Public Offering

IPS-Industrial Promotion Services

IRR-Internal Rate of Return

KEM-Kenya Equity Management Limited

KNBS-Kenya National Bureau of Statistics

NSE-Nairobi Securities Exchange

OTC-Over the counter

PE-Private Equity

SME-Small Medium Enterprises

UK-United Kingdom

US-United States

USAID-United States Agency for International Development

VC-Venture Capital

VCF-Venture Capital firms

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CHAPTER 1: INTRODUCTION

1.1 Introduction

In the first half of the 20th century, private equity was a phenomenon among the wealthy individuals and families in the U.S. like the Vanderbilts, Whitneys, Rockefellers and Warburgs (Hirsch & Peters, 2002). It was only after the World War II that what is considered today to be true private equity investments began to emerge marked by the founding of the first two venture capital firms in 1946: American Research and Development Corporation (ARDC) and J.H. Whitney & Company (Gompers and Lerner, 2001)

The first modern venture capital firm was founded by Georges Doriot (former dean of Harvard Business School and founder of European Institute for Business Administration, INSEAD), who is known as the “father of venture capitalism” (Gompers and Lerner, 1999). George Doriot founded ARDC with Ralph Flanders and Karl Compton (former president of MIT), to encourage private sector investments in businesses run by soldiers who were returning from World War II. Venture capital financing was offered by individuals as institutional investors kept off until 1958 (Liles, 1977). Jeng and Wells (2000) argue that private equity investors are more concerned and actively involved in managing their portfolio companies unlike the other investors.

ARDC's was considered significant in that it was the first institutional private equity investment firm that raised capital from sources other than wealthy families. One of the successes of ARDC was its 1957 investment of US\$70,000 in Digital Equipment Corporation (DEC) would be valued at over \$355 million after the company's initial public offering in 1968 representing a return of over 1200 times on its investment and an annualized rate of return of 101% (Deventer and Mlambo, 2008).

Conversely, J.H. Whitney & Company was founded by John Hay Whitney and his partner Benno Schmidt. During the 1960s and 1970s, venture capital firms focussed their investment activity primarily on starting and expanding companies especially in information technology in the US initially developed for the Second World War.

It was also in the 1960s that the common form of private equity fund, still in use today emerged. This is where private equity firms organised limited partnerships to hold investments in which the investment professionals served as general partner and the investors who were passive limited partners put up capital.

Private equity is an asset class commonly used by institutional and private investors around the world. It involves the purchase of equity stakes in enterprises that are not listed on any stock exchange with the capital raised by the company being used to develop new products and technologies, to expand working capital, to make new acquisitions or to strengthen a company's balance sheet (Bloomfield, 2008).

Bloomfield (2008) further classifies private equity into three categories namely venture capital, development capital and buy-out funding. Venture capital is a subset of private equity therefore all venture capital is private equity, but not all private equity is venture capital. Salehizadeh (2005) defines venture capital as equity commitments consist of seed, start-up and expansion investments by private equities, government and international organisations like World Bank. On the other hand, Lerner (2001) views venture capital as long-term, hands-on equity investment in privately held, high-growth potential companies initiated and managed by professional investors.

According to Pandey (2010), venture capital finance is the early stage financing of new and young enterprises seeking to grow rapidly. This mostly involves financing of high and new technology based enterprises but this perception has changed over the years to include other industries. There are four stages in venture financing, namely: first, early stage financing which is also known as seed financing and it involves supporting an idea or concept, second, expansion financing which involves funds for working capital and expansion and finally, acquisition or buyout financing which is financing to acquire another firm (Pandey, 2010). The definition of venture capital in the US includes three types of investing; seed, start-up and expansion investment and excludes buyouts (Jeng and Wells, 2000).

Most institutions prefer to use fund structures which allow for a more efficient use of capital and a diversification of risk rather than invest directly into businesses. A number of institutions and private individuals invest into a fund run by a professional management company. The fund

manager is known as the general partner (GP), and deploys the pooled capital into a number of enterprises making investment decisions on behalf of its investors known as limited partners (LPs) within a set of restrictions set out in the initial agreement with the limited partners.

According to Zider (1998), there are four major participants in the venture capital industry, the entrepreneur who needs the funding, the investor who wants the high return, the investment bankers who need companies to sell and finally the venture capitalists who want to make money. Venture capital is a major source of funding for entrepreneurs and usually focuses on early stage, risk based, pre-initial businesses (Deventer and Mlambo, 2008).

After the venture capital industry grew in the US it expanded to Europe in the U.K. in the late 1970s where venture capital firms (VCFs) were set up as affiliates of the firms in the U.S. This then spread to Asia in the mid-to-late 1980s and by 1990; there were 300 venture capital firms in Asia. The growth in Africa is still in its infancy stage (Bruton, Fried and Manigart, 2005). High-growth potential businesses in emerging economies have typically relied on financing from other sources than traditional lenders like the banks during their early growth stages and this is by the more developed economies like United Kingdom, Canada and the United States (Wright and Robbie, 1998).

The US economy has benefited significantly from the growth of its venture capital funds and this was due to a combination of long-term factors, including first-rate educational institutions, supportive governmental policies, a sophisticated financial system and a culture of positive attitude towards investors. (Salehizadeh, 2005). The next group expected to benefit from the growth of venture capital industry are the emerging economies. According to the International Monetary Fund (IMF) and World Bank, an emerging or developing market economy is defined as an economy with low-to-middle per capita income (Banerjee, 2008). Emerging economies can also be defined as rapid-growth countries that are reforming their economies to increase the number of transactions governed by market forces (Ahlstrom and Bruton, 2006).

According to Banerjee (2008), the developing world has witnessed dramatic change in the private equity area and it is expected that apart from India and China, regions like Africa are the favoured destinations for opportunistic investments. In emerging markets like Kenya, which may

have less developed capital markets and less liquid stock exchanges which cannot accommodate large investments, private equity is increasingly being used as a proxy for the growth of the underlying economies. Venture capital has been widely researched in the U.S. however its study in other settings has been limited (Ahlstrom and Bruton, 2003). The study in Africa is almost nonexistent despite the fact that the industry is growing. This creates a major gap as it is not clear how venture capital was introduced in Africa.

1.1.1 Background of Venture Capital Industry in Kenya

According to Memba, Gakure and Karanja (2012), venture capital firms have been present in Kenya as early as the 1970s but their presence and impact have not been significant though not very certain. This is contrary to the fact that the first venture capital firm was formed by the government in 1954.

Venture capital industry started in Kenya before independence with the formation of the Industrial and Commercial Development Corporation (ICDC) through an Act of Parliament in 1954. The mission of ICDC is to effectively and efficiently offer quality service in provision of venture capital, commercial loans and management consultancy services. The rate of return that ICDC requires from its investments is 15% and for a period of ten years and the maximum shareholding that it can have is 40% of the total shares. ICDC has contributed in the creation of companies like East African Industries currently Unilever East Africa, Yana Tyres, Dawa Pharmaceuticals and Nairobi Airport Services (NAS) this was through equity investments. ICDC also give financing to those with good ideas and for growth.

In 1967, ICDC formed Industrial and Commercial Development Corporation Investment (ICDCI) which was listed on the stock exchange with the government being the major shareholder. This changed in 1997 when it sold off some of its shares and has since changed its name to Centum Investments with the government owing around 24% shares. ICDC is still the channel used by the government for investment in companies through provision of venture capital and currently it has invested in Centum Investments, Uchumi Supermarkets, Eveready East Africa, Funguo Investments, General Motors and Development Bank of Kenya just to name a few.

Furthermore, in the early 1990s donor funds like European Union (EU) and United States Agency for International Development (USAID) saw the need for long-term financing and hence gave funds to venture capital funds. Some of the venture capital funds that benefitted were Kenya Equity Management (KEM), Industrial Promotion Services (IPS) and Rehabilitation Advisory Services Limited (Kashangaki and Simba, 2008).

Industrial Promotion Services (IPS), a group of companies was formed in the 1960s to provide venture capital, technical assistance and management support to encourage and support private enterprises in sub-Saharan Africa and South Asia. Some of the companies in its portfolio are the Aga Khan institutions and Serena Hotel. IPS is also listed on the Nairobi Securities Exchange (NSE). IPS is seen more as a holding company which manages its portfolio of company in contrast with venture capital firms which are deemed to monitor the portfolio of their companies.

In Kenya, for most entrepreneurs the term venture capital is foreign and they still go to financial institutions like the banks to seek for financing of their businesses. ICDC is viewed as a development finance institution only but does provide venture capital financing. There has been a positive impact of the venture capital industry on the growth of SMEs in Kenya as it has facilitated wealth creation that has improved people's lives and alleviated poverty hence very crucial to the economic development of the country as a whole (Memba et al. 2012).

1.2 Problem Statement

It is not clear if the growth of private equity and especially the venture capital industry witnessed in the recent years is sustainable or will join a list of dying financial fads like the portfolio insurance and securitised sub-prime debt obligations (Lerner, 2011). This question became inevitable in the wake of 2008 financial crisis, and this has also become crucial to the emerging economies as well.

In the early 1990s, venture capital funds Kenya Equity Management and Rehabilitation Advisory Services collapsed without any significant impact and they were deregistered in 1997. The main reasons behind their collapse were poor management of the fund and lack of resources (Kashangaki and Simba, 2008). Since then, privately owned venture capital firms have emerged

and have been in operation since they started and the impact has been seen in the country (Appendix 3).

The Capital Market Authority (CMA) in 2007 formulated regulations for the venture capital firms in Kenya and to date, only one firm Acacia Capital Fund (sold to Aureos Fund in 2008) is listed yet there are around ten firms. The Act clearly stipulates what is to be considered as a VCF in Kenya, minimum fund of Kenya Shillings (Kshs) one million, preferred method of divestiture from an investment and methods of getting funds to name a few. With the legal framework clearly stated, it is not clear why only one venture capital firm is registered.

The government has played a vital role in attracting foreign investors into the country; in 2004 the Kenya Investment Authority was created with the primary aim of promoting investment opportunities both locally and internationally.

In Kenya, there is very limited academic literature on the establishment of venture capital firms but it is clear from the surveys conducted by various institutions and from the media that it is an industry that is growing. This creates a gap and the main aim of the study was to investigate the key factors that influence venture capital establishment in Kenya.

1.3 Research Objectives

The general objective of the study was to investigate the venture capital establishment in Kenya. In doing so, the following specific objectives guided the study:

1. To determine the key factors that influence establishment of venture capital firms in Kenya.
2. To determine the challenges faced by venture capital firms as they set up in Kenya.
3. To identify sectors of the economy preferred by venture capital firms and the factors that influences the choice.

1.4 Research Questions

The objectives were translated to the following research questions;

1. What key factors have influenced the establishment of venture capital firms in Kenya?

2. What factors have contributed to the sustainability of venture capital firms in Kenya?
3. What sectors of the economy are preferred by foreign venture capital firms and what influences the choice?

1.5 Justification of the Study

The contribution of this study will be of importance to the following groups:

1.5.1 Investors

The study will be able to provide an explanation as to the conditions that have contributed to the sustainability of venture capital firms in Kenya as compared to the early 1990s. This will also answer the question if venture capital is a fad or it is a concept that will last.

1.5.2 Government

The study will be able to identify the probable reasons why most venture capital firms have not registered with Capital Markets Authority (CMA) and what the government could do differently. It will also be clear if investors find organisations like Kenya Investment Authority useful when they are considering investment opportunities especially for the privately owned venture capital firms.

1.5.3 Future Researchers

Finally, for academic researchers the aim of the study was to contribute knowledge in the area of growth of venture capital industry especially in Kenya as there is limited academic research documented in this area.

1.6 Scope of Study

The scope of the study was limited to privately owned venture capital firms in operation in Kenya since 1999 to date. The period was chosen because the first privately owned venture capital firm still in existence was established in 1999.

CHAPTER 2: LITERATURE REVIEW

2.1 Introduction

This chapter provides literature on venture capital finance and is structured as follows: 2.2 theoretical framework of venture capital; 2.3 determinants of venture capital supply; 2.4 challenges faced by venture capitalists in emerging markets; 2.5 venture capital investment process; 2.6 benefits of venture capital to an emerging economy; 2.7 venture capital in emerging markets versus developed markets; 2.8 summary of the chapter.

2.2 Theoretical Framework of Venture Capital

In the past, the understanding of the venture capital process was built primarily on agency theory only. With time, other theories have been identified that explain the venture process better. The theoretical framework identified that provides a clear understanding of venture capital process and guided the current study include agency theory, control theory and the institutional theory..

2.2.1 Agency Theory

According to Kaplan and Stromberg (2004), agency theory is evident in venture capital ventures especially at the seed stage and this is because the agent (entrepreneur) and the principal (investor or the venture capitalist) have different views. They identify four generic (agency) problems at the investment stage.

First, the venture capitalist is concerned that the entrepreneur will not work very hard to maximise value after the investment has been made, to solve this venture capitalist will ensure that the compensation to the entrepreneur is based on performance.

Second, there is the information asymmetry where the venture capitalist thinks that the entrepreneur knows more about the venture or business but revealing less. This can also be solved by having contracts that are more on performance.

Third, in most cases after the investment is made by the venture capitalist, there arises conflicts between entrepreneur and the venture capitalist as the investor will want to make decisions for the business. This is solved through control theory where control is given to the venture capitalist in some stakes and to the entrepreneurs some percentage of control too.

Fourth, there is the “hold-up” problem which arises when the entrepreneur threatens to leave the business especially after they have become valuable to the firm in terms of human capital. To solve this, the venture capitalist could vest the shares of the entrepreneur.

Conflict arises between an entrepreneur and venture capitalist because in most cases the venture capitalist plays a large role in shaping and recruiting the senior management team of a firm after an investment. This can also involve replacing the founder of the firm. The venture capitalists therefore try to mitigate the agent-principal conflicts through sophisticated contracting, pre-investment screening and post-investment monitoring and advising. The venture capitalist identifies areas to monitor and add value during the screening of the venture. (Hart, 2000)

According to Cumming (2005) agency costs under venture capital finance are more pronounced depending on the structure of the firm, stage of investment that venture capitalists considers and the characteristics of the entrepreneurial firm. The agency costs include moral hazards, adverse selection, free riding, hold-up, trilateral bargaining and window-dressing especially when considering a venture.

2.2.2 Control Theory

Berglof (1994) states that since the venture capitalist invests for a period of time and the investor most likely wants to move on and set up another firm, therefore arises the need to structure the contracts so that it is clear what happens in the case either party exits and also how to solve conflicts arising from control of the firm. Sahlman (1990) states that the average holding period for a venture capital investment is less than five years. Exit from a venture takes place either through an initial public offering, which is commonly preferred by venture capitalists or through a trade sale of the company.

Problems can also arise when an entrepreneur derives sizeable private benefits from a project which had not been stated in the contract and the entrepreneur worries that another investor can take over without him being compensated. On the other hand, a venture capitalist worries that a new owner or a manager can take out assets from the business without paying for them at market value. These are issues that arise based on the structure of the contract.

According to Sahlman (1990), parties to venture capital arrangements should structure their contracts to combine use of debt and equity in the capital structure of the firm. This structure protects the initial parties against dilution of shares and extracts from a future buyer. Alchian and Demsetz (1972) support the idea by arguing that parties to a venture capital agreement should make good use of the right to sell control. An entrepreneur can normally face the private costs in liquidating his firm and he may lower this cost by outside finance by agreeing to give up control to the venture capitalist when the firm is doing badly (Aghion & Bolton, 1992).

2.2.3 Institutional Theory

Venture capital firms differ, some prefer early stage while others later stage, so while some VCFs are more experienced than others and when it comes to funding, some venture capitalists employ public funds while others non-public funds. According to Barney, Fiet and Moesel (1994) contracts used by venture capitalists are standardised because the industry is small. Chan, Siegel and Thakor (1990) argue that contracts are used to protect the investor against moral hazards.

Venture capital firms differ across countries in their organisational structure. It is evident that in the US and UK, firms are organised as limited partnerships while in countries like Germany and France, they have a different organisational structure with far more involvement of financial institutions (Lerner, 1994). The management style of venture capital firms differs across countries as well. In countries like Germany and Japan, venture capital firms are not actively involved in the day to day management of their investments unlike in the US (Hurry et al., 1991)

There is also the issue of opportunity cost in negotiating venture capital contracts which involves give and take on the part of the venture capitalist and the entrepreneur. The venture capitalist usually has an upper hand as they have experience in negotiating such contracts. There is also the issue of whether the contracts used by venture capital firms are standard. Isaksson A, Cornelius B, Landstrom H and Junghagen S (2004) concluded that the contracts used by venture capitalists and entrepreneurs tend to be similar hence a standard contract across the industry.

Isaksson et al. (2004) further argues that venture capitalists who are less experienced normally rely on the more experienced when it comes to identifying the best or appropriate contract to use

in investments. On the other hand, government controlled or public venture capital firms are limited in their choice of contract to use. Institutional theory therefore focuses on the choices made by venture capitalists in the selection of the covenants or contracts to use. Previous studies show that there is a trend that industry could be moving more towards using standardised contracts.

Institutional theory applies more to emerging economies in regards to the management of firms. This is because emerging economies are undergoing transition hence the major institutions are not that stable (Peng, 2002). From previous studies by Newman(2000) there is some similarity between the management of venture capital firms in developed markets and those in emerging economies. Bruton and Ahlstrom (2003) contradict in their findings. They found the differences to be substantial.

2.3 Factors that Influence Venture Capital

Previous studies have been done on the determinants of venture capital. Porteba (1989) argued that the many changes in venture capital financing arise due to the factors that affect the demand and supply of venture capital. Supply of venture capital refers to the desire of investors to provide funds to the venture capital firms. Demand of venture capital firms refers to the desire of entrepreneurs to attract investment of venture capital into their businesses.

Kitchen (1989) carried out a study on the venture capital industry in the developing markets and concluded that there are factors that need to be in place for the growth of the industry. First, the is need for a stable capital market, need for incentives to the investors from the government, a positive entrepreneurial culture, development banks to be involved in providing venture capital and the more exit channels are easily accessible to venture capital firms.

Gompers and Lerner (1999) carried out a study in the U.S to determine the drivers of venture capital between the periods from 1972 to 1994. It was during this period that the venture capital industry in the .U.S had grown dramatically but not consistent, that is, the growth was experienced in some parts of the country and there was an increase and decrease of venture capital funds during some periods. The factors considered in the study were macroeconomic, regulatory changes and performance factors. Regulatory changes referred to regulations changes

affecting pension funds, capital gains tax rates, research and development expenditure and overall economic growth while performance factors referred to the individual performance of the venture capital firms. Secondary data collected in the study was analysed through regression analysis.

Jeng and Wells (2000) carried out a study in twenty one countries in the developed market namely; Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, U.K and U.S. The findings of the study identified there are six key factors that determine venture capital funding. These are namely initial public offering, labour market rigidities in a country, financial reporting standards, private pension funds, macroeconomic variables and government programmes. Other factors not main include capital gains tax and efficient bankrupt procedures. The effects are determinants apply differently to government funded and non-government funded venture capital firms. Regression analysis and descriptive analysis methods were used in the study.

Sunil (2000) also carried out a study in the U.S and focussed more on the supply and demand factors. The factors that influence the venture capital industry that were considered in the study included industry and market performance, capital gains tax, interest rates and research and development. Data was secondary and it was analysed regression analysis.

Deventer and Mlambo (2008) carried out a study on the factors influencing venture capitalists project financing decisions in South Africa and the key results of the study were that entrepreneurs honesty, expected good market performance and high internal rate of return influences venture capital finance. Data was collected using a likert scale type of questionnaire. Descriptive methods were used to analyse the data.

Pandey (2010) carried out a similar study in India and the findings were that venture capital supply is determined by entrepreneurial tradition, unregulated economic environment, disinvestment avenues, fiscal incentives, education on business, venture capital managers, and promotion efforts by the government, institute-industry linkage and research and development(R & D) activities.

Cherif and Gazdar (2011) carried out a similar study on the drivers of venture capital investments in Europe. The study considered twenty one countries for a period of ten years. The study focussed on the macroeconomic variables as determinant of venture capital supply only. The dependent variables were early stage investments (sum of start-up and seed investments) and funds raised. Independent variables were macroeconomic determinants (GDP growth, interest rate, unemployment rate and stock market capitalization), technological opportunities (research and development positively associated with venture capital investments), variables directly related to the venture capital process (divestments methods) and institutional factors (index of economic freedom). Data was analysed through regression analysis.

2.3.1 Initial Public Offering

The life of the venture capital fund is limited hence the venture capitalist cannot keep the money forever as they have to account to the investors. This poses a risk to investors and venture capitalists as they are not sure of getting their money back. On the onset, since the duration of a new venture is limited, thus venture capitalists require a viable exit mechanism. An exit mechanism is important to investors for two reasons: first, it provides a financial incentive for equity compensated managers to expend effort and second, it gives managers an option of control of the firm (Black & Gilson, 1998). The best alternative to exit a venture is through IPOs (Laine and Torstila, 2003).

According to Jeng and Wells (2000) the most attractive exit mechanism for venture capitalist is through an IPO as this yields higher returns and gives investors an additional incentive to invest in start-ups that will grow to a level where they are able to sell shares to the public or other private investors. IPO is also important to an entrepreneur who wants to eventually regain control after venture capitalists. The study collected data on current and lagged IPOs and the increase IPOs was positively correlated to the demand and supply of venture capital funds. The data was provided by the respective countries capital market. The findings of the study were that IPOs were the strongest driver of venture capital investing in the 21 countries considered. This was contrary to the findings of Cherif and Gazdar (2011) that showed that exit mechanisms used by venture capital firms had no significant effect on early stage investments and neither on funds raised by venture capitalists.

Disinvestment avenues imply the existence of proper channels like over-the-counter stocks exchange catering to the needs of SMEs that can be used by venture capital firms to exit the company. Fiscal incentives are the other factor considered by Pandey (2010) and it refers to incentives offered by the government which render equity investment attractive unlike using debt so as to attract more venture capital firms. On the demand side of venture capital, an exit mechanism gives the entrepreneurs an additional incentive to start a company as the returns achieved are higher.

Venture capitalists generally aim at making medium- to long-term capital gains and this is normally between five to ten years after the initial investment. According to Pandey (2010), a venture capitalist may exit from a venture in four ways: through IPOs, acquisition by another company, purchase of the venture capitalists' share by the promoter or purchase of shares by an outsider.

Buyback by promoters is where the owners of the firm buyback the shares though this method is very expensive since the shares will have appreciated by the time the venture capitalists want to exit. IPOs are mostly used in developed countries and this is due to the fact that their capital markets are well advanced. The major exit modes by venture capitalists available in developed countries are promoter's buy back, public issue, sale to other venture capital firms, sale of shares over the counter(OTC) stock markets and management buyouts (Pandey,2010). Sunil (2000) from his findings identified that the overall performance of the capital markets affects the venture capital industry. This is as a result of the high returns or gains that venture capitalists get from an initial public offer. The success of any IPO is related to the performance of the capital markets. Capital markets are the favourable exit mechanism for venture capital firms (Kitchen, 1989).

2.3.2 Labour Market Rigidities

The other key factor identified was rigidity in the labour market of a country that a venture capital firm considers to set up. Labour market rigidities are a major threat to venture capital industry growth in a country. This has been witnessed in countries like Japan and Germany (Sahlman, 1990). This impacts on the industry negatively in that there will be less venture capital funding in a country. This is because strict labour laws in any country make hiring of employees

difficult especially expatriates. Jeng and Wells (2000) measured labour rigidity in the market in two ways; the first looked at rigidity for skilled labour in the market and the second considered rigidity in the overall labour market. The findings of the study were that venture capital firms that are involved in early stage financing are negatively impacted by labour rigidities but those in later stage financing are not affected.

2.3.3 Financial Reporting Standards

Financial reporting standards is a key factor since venture capitalist mostly invest in start-ups which are very risky and hence the need for a proper financials to enable due diligence to be carried out. If there is lack of information, investors in venture capital firms require high premiums hence will be expensive. Jeng and Wells (2000) measured this by using ratings on accounting standards issued or published by the International Accounting and Auditing Trends, Centre for International Financial Analysis and Research. The index is created by examining 1990 companies annual reports on their inclusion or omission of 90 accounting items. The study picked a minimum of three listed companies in the 21 countries considered in the study. Jeng and Wells (2000) argued that good accounting regulation positively influences but they fail to get a correct regression sign to explain this (Salehizadeh, 2005).

2.3.4 Private Pension Funds

Most venture capital firms raise funds from private pension funds as they are very eager to invest with venture capital funds due to high rates of returns. This is very common in the U.S as way of venture capitalists to raise funds. Gompers, Lerner, Blair and Hellman (1998) are of this school of thought in that they explain that supply of venture capital is based on the willingness of investors to provide funds to venture capital firms. The willingness of the investors depends on the internal rate of return. The regression analysis findings of Jeng and Wells (2000) found that there is a positive relationship between venture capital supply and private pension funds but it is believed that there is no impact on the demand of venture capital.

2.3.5 Macroeconomic Variables

The state of a country's economy will have an effect on the venture capital industry as growth in the economy of a country leads to an increase in start-ups or SMEs hence the demand for venture

capital funding. Market capitalization also leads to an increase in the supply of venture capital funding in an economy. Acs and Audretsch (1994) in their study suggest that macroeconomic fluctuations influence start-up finance in general. Macroeconomic expansions are therefore found to lead to an increase in the set up of start-ups in a country. Jeng and Wells (2000) predicted there would be a positive relationship but the results of the findings were that GDP as a factor did not influence supply of venture capital funds. Macroeconomic variables were measured by looking at the GDP of a country, interest rates, inflation and market capitalization.

Cherif and Gazdar(2011) in their study concluded that interest rates was not a significant determinant of venture capital supply in Europe though market capitalization, research and development expenditures, GDP growth and unemployment rate were significant confirming previous studies. Gompers and Lerner (1999) in the findings of their study concluded that macroeconomic factors that are GDP and research and development spending lead to a greater venture capital activity. GDP growth in an economy meant an increase of entrepreneurs who require capital hence increase in the demand of venture capital financing in the economy.

Sunil (2000) in the study looked at industry and market performance as the macroeconomic variables that influence venture capital activity. The findings of the study were that if an industry performs well, then it attracts more participants (demand and supply) and this has been proven historically. This is explained by the basic principle of profit maximization that dictates that individuals participate in economic activities with the aim of making profit hence an industry where there is profit attracts more players. The findings of the study indicated that interest rates affect venture capital, when the rates are high, funds to investors decrease as the returns would be less while if low, the investors supply funds to venture capitalists. Previous year's performance of the interest rate is used by investors as a gauge of where to best put their funds.

2.3.6 Government Programs

Government programs could have a positive or negative impact on the growth of venture capital funding of an economy. Lerner (1997) provides evidence that government funded programs encourage venture capital supply in a country. On the contrary, O'Shea (1996) points out that government spending on venture capital may hinder the development of the private venture capital sector. This could be the case because government funded venture capital firms would

have a better bargaining power in deals and also access to funds while private firms would be limited. The government's bureaucratic tendencies and control power have a positive impact on the development of venture capital industry in an economy (Dossani and Kenney, 2002).

The descriptive measures were used by Jeng and Wells (2000) to measure the implication of government programmes on venture capital. From the findings, government policies had a positively strong impact on the all stages of venture capital financing. It was found that in Portugal, venture capital firms were offered a number of tax benefits like exemption of new companies from corporation tax, exemptions from income tax for the first three years of establishment and deduction from tax of profits appropriated to reserves reinvested in other venture capital projects for the next three years. Cherif and Gazdar (2011) argued that policy makers especially the government must ensure coherent inclusive policies supportive of venture capital industry to enable the venture capital firms provide financing.

2.3.7 Networking among Venture Capitalists

Ahlstrom and Bruton (2006) carried out a study on networking among venture capitalists based on emerging economies around East Asia. Semi-structured interviews were used to collect data from sixty five firms. The research design applied in the study was exploratory. Data collected was analysed through content analysis as most of the data collected was qualitative in nature. The findings of the study found that networking among venture capitalists is crucial in growth of venture capital funding. This implies personal connections and relationships with entrepreneurs, government officials and customers. This is also likely to be very important in emerging economies. Networking among venture capitalists in emerging markets is important as the personal contacts assist in the necessary activities like selecting, monitoring and adding value to businesses as they get ideas. Informal institutions like associations in emerging economies are substitutes for the weak formal institutions.

According to the findings of Hochberg et al. (2007) networking among venture capitalists is a necessity as this is the channel used to become more visible to entrepreneurs and to access credibility. Association also improves the bargaining power with entrepreneurs. Contrary to the previous studies, the findings of the study showed that networking can be a barrier to new entrants in the venture capital industry. This is caused by the incumbent local venture capital

firms who have a better bargaining power with entrepreneurs and they want to maintain market share. Networking among venture capitalists can create a barrier to entry of new venture capital firms leading to a decrease in venture capital supply to entrepreneurs and harsh funding terms imposed by the incumbent venture capital firms. The study was carried out in the US. Secondary data was collected for all venture capital firms in the US between the periods 1975 to 2003 from the venture economics database. Incumbents were defined in the study as venture capital firms that had been in active operations that is 25 deals and above for the past one year while entrants were defined as firms which entered into their first deal during the year of study.

2.3.8 Other Determinants of Venture Capital

Though the above are the key factors except networking among venture capitalists identified by Jeng and Wells (2000) to influence the growth of venture capital industry, they also thought that capital gains tax and efficient bankruptcy procedures also had an impact but lacked enough empirical evidence during the research they conducted. These variables were not included in the main ones as the researcher faced the challenge of identifying a good measure for the variables. Individual capital was not a good measure as it had no relationship or impact on the venture capital supply.

On the contrary to the findings of Jeng and Wells (2000), Porteba (1989) argued that capital gains tax had no implication on the venture capital activity. Sunil (2000) differed in his findings as he identified that capital gains affect venture capital activity. He further clarified that capital gains tax had a two sided effect. An increase in capital gains tax reduces the profits of both the investor and entrepreneur while the decrease impacts positively in the industry by encouraging more venture capital firms to establish.

In South Africa, it was found that the three important determinants of venture capital funding are the entrepreneur's honesty and integrity, good expected market performance and acceptance and finally a high internal rate of return (Deventer and Mlambo, 2008). OECD (1986) also identifies government action, tax policy, divestment avenues by the investors and attitudes towards risk as the factors that determine venture capital funding in a country and especially in the emerging economies. The most important determinant of venture capital funding is rate of return depending on the stage of investment, holding period, ownership of firm (private or government

owned) and the country of operation (Manigart, Waele, Wright, Robbie, Desbrieres, Sapienza and Beekman, 2002).

After a detailed case study of the venture capital industry in India, Pandey (2010) identified nine factors that are needed for the success of venture capital in any country: entrepreneurial tradition, which involves government policies to encourage investment, unregulated economic or business environment, disinvestments avenues like a good capital market, fiscal incentives offered by the government, broad based education on business, experienced or professional venture capital managers, promotion efforts, institute e-industry linkage and research and development activities.

Furthermore, Pandey (2010) clarifies that, entrepreneurial tradition above refers to less of family based businesses model common in India and more of independent firms so as to encourage venture capital firms' investment. As for unregulated economic environment demands less of regulated and controlled businesses especially by the government. Broad-based education, on the other hand, refers to general business and entrepreneurship oriented education where all other professions like sciences and engineers have a basic understanding of accounting and book-keeping so as to be able to run a business. Pandey (2010) also identifies the education of venture capital managers to be a key factor for the success of venture capital establishment in any country and this is because well educated venture capital managers will be able to high-risk ventures competently. In addition to legal stability, venture capitalists look for environments with efficient markets for corporate control and capital where exit is easy as well as minimal corruption (Wright and Robbie, 1998).

2.4 Challenges faced by Venture Capitalists in Emerging Economies

Ahlstrom and Bruton (2006) indicated that recently, venture capital firms have become an important phenomenon in the emerging economies but faced with challenges as the emerging economies are in the process of transition. This uncertain environment adds to the already difficult task faced by venture capitalists in the selection of firms to fund and monitoring those investments effectively (Bruton and Ahlstrom, 2003).

2.4.1 Little Protection for Investors property

Peng (2001) carried out a study on investors in emerging economies undergoing transition. The study was carried out in Central and Eastern Europe. According to Peng (2001) many emerging economies are undergoing significant economic transition and they offer little protection for either investors or private property. Previous studies by Busenitz et al. (2005) had looked at how venture capital firms thrive in economies where there is protection of property and investors therefore it was not clear how to address the issue in emerging economies.

Investors deal with the challenge of lack of protection through networking with investors in the same industry. Smaller firms in the market can team up with the larger players to be protected. Investors could also make use of their human capital. This is by training them and ensuring they sustain them in the firm. It is also advisable for firms to make good use of technological advancement. As for foreign investors in emerging economies, Peng (2001) suggested they should form alliances with the local entrepreneurs so as to cushion themselves from challenges.

2.4.2 Institutional Instability

One of the challenges faced by venture capitalists in emerging economies is that there is institutional instability of major institutions like the legal system (Ahlstrom and Bruton, 2006). In addition; start-up firms in emerging economies have an added risk of being in environments that are unpredictable and volatile. From the results of the study, it was evident that institutional stability in emerging economies is unknown. This affects venture capital industry as the investors look for a regime that would protect their property, corporate governance and ease of exit from ventures.

Venture capitalists protect themselves by building strong networks as informal institutions are a substitute for the failure of formal institutions (Butler, Brown & Chamornmarn, 2003). Networking is important to venture capitalists in all markets but due to the weakness of the institutions in developing markets, networking is needed more (Chen, 2001).

2.4.3 Lack of Proper Documentation by Entrepreneurs

Meyer (2001) carried out a study on the entry mode choice by investors in Eastern Europe. Emerging markets are viewed to be imperfect markets therefore investors have to be strategic in

the entry. This is because the investors have to adapt to the host country. Foreign venture capitalists from developed markets investing in emerging markets are faced with the challenge of high transaction costs due to lack of information by the entrepreneurs. Klonowski(2007) identified that venture capitalists in emerging markets are faced with challenges at the initial contact that they have with entrepreneurs, the main one being lack of formal documentation describing their businesses like business plans and financial forecasts. They are also faced with unclear regulatory frameworks. The government is not the solution in those economies because the formal institutions are weak. To solve the problem of lack of information by investors in emerging economies, investors have to create awareness by investing in the education of the investors. Education could focus on marketing, accounting and leadership skills for the investors. This is the main reason why venture capital firms are involved in the management of their ventures (Child and Czegledy, 1996).

2.5 Venture Capital Investment Process

According to Tyebjee and Bruno (1984) there are six steps used by venture capital firms to evaluate an investment, deal origination, screening of the projects, evaluation or due diligence of the company, deal structuring, post-investment activity and formulation of an exit plan. The steps can be categorised as pre-investment and post-investment activities. The study was based on telephone surveys using a structured questionnaire.

The pre-investment phase involves deal origination, deal screening, deal evaluation and deal structuring. Deal origination involves venture capitalists and entrepreneurs being matched by various intermediaries in the industries. This is done through referrals. The venture capitalist could also be involved actively in pursuing companies at the start-up stage or those in need of expansion financing. The venture capitalist can use informal networks in this case. This is also the stage where a venture capitalist (lead) could seek the participation of other venture capitalists to increase the funds especially for large deals. This method is known as syndication.

Deal screening requires the venture capitalists and their qualified staff to go through a relatively large number of potential deals so as to identify those that meet their criteria of investment. This is usually a very tedious process since most venture capital firms operate a lean staff. Deal evaluation is the next step where venture capitalists use an assessment procedure based upon the

business plan presented by the entrepreneurs. This is where the firms weigh the risks and return of a prospective venture. Tyebjee and Bruno (1984) noted that very few venture capitalists determine the expected rate of return of an investment or its sensitivity to future uncertainties. In most cases, the deal evaluation is normally subjective as it depends on the characteristics that are set by the venture capitalist.

Deal structuring is the next stage in the model by Tyebjee and Bruno (1984) after evaluation of the deal. This involves an agreement between the venture capitalist and the entrepreneur. The main aim of the agreement or contract is that it establishes the price of the deal (Golden, 1981). The contract also states capital expenditures and management salaries, cases which can force the venture capitalists to take over the company, liquidation of the investment and the method to be used to exit.

Post-investment activities are after the agreement between the venture capitalist and the entrepreneur. This stage involves the venture capitalist being the collaborator by being involved in the management of the business or as a board member depending on what has been stipulated in the contract. This will go on until the venture capitalists exits after the set period mostly three years is the minimum time they invest. The model by Tyebjee and Bruno (1984) has been viewed as simple by the other researchers.

Klonowski (2007) recognised that the venture capital process in emerging markets involves nine stages. This involves stages from the point of deal origination to exit from a venture by the investor. The findings of the study were that structuring of deals is difficult in emerging markets because of institutional instability of the legal system which makes the process long. The stages involved deal origination, screening, evaluation, deal structuring and post-investment which are similar to the model developed by Tyebjee and Bruno (1984). The additional process is the exit stage which involves preparing an exit memorandum with the terms.

2.6 Benefits of Venture Capital to an Emerging Economy

The major role of venture capital in emerging economies is to provide capital to SMEs. Obtaining finance is a challenge to start-ups and newly established firms. The expansion of

venture capital financing to developed countries in the recent years has proved a new source of long-term investments (Mason & Harrison, 1995).

Memba et al. (2012) findings on the impact of venture capital on the SMEs in Kenya found that venture capital financing is beneficial to the entrepreneurs. The main objective of the study was to identify the impact of venture capital financing on the SMEs who were financed by venture capitalists. The sample of the study was 200 SMEs who had been financed by venture capital firms. Venture capital firms provide capital to entrepreneurs who would not have been considered for lending facilities offered by financial institutions. Data collected was analysed by using descriptive statistics. The results of the study were the SMEs financed had increased their sales, profit, value of net sales, employment of more skilled personnel and the market share of the firms. Therefore the findings concluded that the benefits of venture capital financing on the economy's growth are tangible.

Besides, when venture capitalists from developed countries set up in emerging markets, they bring in expertise in the form of management who train the others. They manage the ongoing ventures (Busenitz, Fiet & Moesel, 2004). Chan et al. (1990) are of the view that venture capitalists play a very unique role in the economy because they act as financial intermediaries between the fund providers and young high growth firms in need of risk capital.

Despite the fact that venture capital industry is growing, it has received much less academic scrutiny than other parts of the financial sector. At the theoretical level, the most fundamental question to ask is why venture capital industry exists at all (Amit, Brander & Zott, 1998).

Seed capital which is the initial type of financing under venture capital as this is offered to newly founded companies. These funds are mostly used for research and development of a product. The other type of financing, start-up is targeted for those companies that have moved past the idea stage and are now ready to produce or manufacture the product. Seed capital and start-up financing are referred to as early stage investments. Expansion stage financing is for already established companies which need capital for expansion.

According to Gompers and Lerner (2000), the role of a venture capitalist is to provide funds to entrepreneurs with ideas but lack funding. Venture capital has also been behind the growth of

some of the major companies in the U.S like Microsoft; Oracle and Sun systems. Venture capital is different from investment trusts in that the venture capitalist is involved in the management of the client enterprises. Venture capitalists also look for companies that will grow and not remain small.

U.S is regarded as the economy that has benefited enormously from the growth of its venture capital funds (Jeng and Wells, 2000). The growth is due to a combination of long-term factors including supportive governmental policies, an attractive environment inducing immigration of entrepreneurs and professionals, protective patent laws, a sophisticated financial system, and a culture with a positive attitude towards monetary rewards for investors and innovators (Mueller and Thomas, 2000).

An economy is more likely to have substantial growth in venture capital and entrepreneurship if it features high educational establishments, an independent and fully functional legal system, well-diversified and highly liquid capital and financial markets, supportive government policies and an environment that attracts educated and wealthy investors (Salehizadeh, 2005).

2. 7 Venture Capital Industry in Emerging Markets versus In Developed Markets

Only a few emerged economies have any progress in establishing venture capital companies. Most of the venture capital funds in developed countries have been set up through development banks. Also very few emerging economies provide incentives to venture capital firms unlike in developed countries where incentives are frequently encountered (Kitchen, 1989). The government in emerging economies does not implement policies that support or encourage investors. OECD (1986) suggested there is need by the government in emerging markets to improve tax policy, attitudes towards risk and exit mechanism to make them more favourable to the investors.

According to Black and Gilson (1998) the entry of foreign based venture capital firms in emerging economies help in the growth of the industry in those countries by shortening and reducing costs of the learning process. South Africa has witnessed the merging of venture capital firms hence expansion of private equity activity in the country.

According to Ahlstrom and Bruton (2006) venture capital firms in emerging economies in East Asia do not consider exit mechanism and this is because the capital markets are severely constrained hence the listing process of companies is expensive and tedious. This is contrary to developed markets where exit mechanism and especially use of Initial Public Offer is commonly used by venture capitalists due to the high returns. The capital markets are more efficient in the developed markets (Sahlman, 1990).

Networking among venture capitalists in emerging economies is more beneficial than in developed markets and this is because of the weak formal institutions in emerging markets resulting in investors to rely on the informal institutions (Salehizadeh, 2005). Lack of proper documentation by entrepreneurs has also contributed to networking. Weak formal institutions especially the legal system in emerging economies has resulted in deal structuring process to be too slow and tedious unlike in the developed markets.

Information on the venture capital firms activities and listing is readily available unlike in the emerging markets where is hard to get information. This also applies to information on entrepreneurs which is scarce in emerging markets resulting in the deal process taking long or having uncompleted deals (Wright et al., 2002). Venture capitalists often face difficulties in decision making because entrepreneurs are at an advantage as they possess information about the business that potential investors do not have (Chan et al., 1990).

Kitchen (1989) argues that very few venture capital firms have been successful in establishment in developing markets recommending development banks to set up funds to bridge the gap. There has been no boom experienced in the industry in emerging markets as we have seen in the developed markets like in the US and UK. Venture capital firms in emerging markets are involved in the later stages of finance like acquisition and buyouts and not start-ups because the risk is too high. This results in entrepreneurs at the stage requiring seed or start-up capital to raised funds from family or from their savings. On the contrary, in the developed markets, venture capital is for entrepreneurs at the seed and start-up stages.

There are similarities in the markets in the investment model used by venture capitalists to determine a venture is the same in both the emerging markets and the developed markets. The

model differs depending on the firm, entrepreneurship and type of deal. In both markets, the aim of the venture capitalist is to engage in value adding activities in the management advisory, customers and supplier's advice (Ahlstrom and Bruton, 2003). Though it is clear foreign (from the West) venture capitalists bring in more than funds to a venture as their advisory impacts the business.

2.8 Summary of the Chapter

The main factors that determine venture capital establishment in emerging markets are: state of the country's economy, how viable it is for the privately venture capital firms to exit a venture or investment, support from the government, expected good performance of the market, networking among venture capital firms or professionals and also the expected rate of return for the investors. Kitchen (1989) attributes the growth of venture capital industry in the developed market especially in the U.S which experienced boom to a very dynamic and efficient capital market, favourable attitude towards the industry by entrepreneurs and government support including tax reduction for investors. In the UK, the venture capital industry had experienced growth due to an efficient capital market, increase in management buyouts hence demand for venture capital funding, and banks (merchant) providing venture capital.

There is a gap in literature as it is not clear if the factors considered are inter-correlated, for instance, if the rate of return expected from an entrepreneur in the country is high but the labour laws are rigid, it is not clear if the venture capitalist will still consider that market. It is not clear which determinants of venture capital have more impact than the others.

There is also a lack of adequate academic research done on the venture capital industry in emerging markets and especially in Kenya and the main aim of this study was to bridge that gap by identifying the factors that owners of venture capital firms consider before establishment.

Table 2.1 Summary on Findings of Previous Studies

Table 2.1 shows a summary of the previous findings indicating the location of the study, key factors that influence venture capital establishment and other factors.

Study	Location	Key Factors	Other Factors
1) Jeng and Wells (2000)	Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, UK & US	-Initial public offerings -Labour market rigidities -Financial reporting standards -Private pension funds -Macroeconomic variables -Government programs	-Capital gains tax -Efficient bankruptcy procedures
2) Cherif and Gazdar (2011)	Australia, Belgium, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Netherlands, Norway, Poland, Portugal, Romania, Slovakia, Spain, Sweden, Switzerland & UK.	-Macroeconomic variables(GDP, market capitalization, research and development and unemployment)	
3) Sahlman(1990)	Japan & Germany	-Labour rigidity	
4) Black and Gilson (1998)		-Exit mechanism -Private pension funds	

5) Manigart et.al (2002)		-Rate of return	
6) Gompers and Lerner(1999)	U.S	-Macroeconomic -Regulatory changes -Performance factors	
7) Pandey(2010)	India	-Entrepreneurial tradition -Unregulated economic environment -Disinvestment avenues -Fiscal incentives -Education on business -Venture capital managers -Promotion efforts -Institute-industry linkage -Research and development activities	
8) Ahlstrom and Bruton (2006)	Hong Kong, Taiwan, China, Singapore & South Korea	-Networking among venture capitalists	
9) Hochberg, Ljungqvist and Lu(2007)		-Networking among venture capitalists	
10) Deventer and Mlambo (2008)	South Africa	-Entrepreneur's honesty - Expected good	

		market performance -High internal rate of return	
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CHAPTER 3: RESEARCH METHODOLOGY

3.1 Introduction

The purpose of this study was to examine the key factors that influence venture capital firms as they set up. The study extended previous works done from other countries to the Kenyan context. The chapter is structured as follows: 3.2 research design; 3.3 target population; 3.4 data collection; 3.5 data analysis; 3.6 quality of research.

3.2 Research Design

Descriptive research design was adopted in the study. This is a method whose major purpose is to describe the state of affairs and to give meaning. This was selected based on the objectives of the study. Objective one sought to examine the key conditions that have influenced the establishment of venture capital firms. This also applied to identifying challenges faced as they set up and the sectors preferred referring to objective two and three respectively.

3.3 Target Population

The population of the study are the registered privately owned venture capital firms in Kenya. As at December 2011, there were 10 identified from African Venture Capital Association. There was no sampling of the population because of the small size of the target population.

3.4 Data Collection

Data collected was primary in nature by use of semi-structured interviews and all interviews were recorded. The method was appropriate for this study because the firms identified were few and also to increase the response rate from the respondents.

The respondents of the study were mostly senior officials initially targeting the founders and in case not available; the senior investment analysts were interviewed. The respondents were contacted through personal visits to the firms and phone calls.

During the interviews, the respondents were asked to explain in detail the conditions that have led to the sustainability of their firms, role played by government in setting up, challenges faced and the future of their firms in Kenya.

3.5 Data Analysis

Primary data that was obtained from the interviews was analysed by initially coding the information. The respondents were also coded from VCF 1 to VCF 8 to maintain confidentiality and to aid the analysis process. For the closed ended questions, likert scale was used to analyse the data while information obtained through open ended questions was analysed using content analysis to identify the themes, categories and common things as to link the specific responses obtained to the analytical concepts and categories obtained from the literature review.

The presentation of data incorporates the use of descriptive methods. Descriptions were developed from the responses received through interviews and were presented according to the research objectives. The data has been presented in tables.

3.6 Quality of Research

The four aspects of research quality namely validity, objectivity, subjectivity and reliability were considered during the process of the study.

3.6.1 Validity

Validity refers to the degree to which results obtained from the analysis of the data actually represent the phenomenon under study. In the study, validity was guaranteed through data collection methods that is the use of both interviews and secondary data. Comparisons of the data were compared with previous studies to validate the findings.

3.6.2 Objectivity

Objectivity requires that the findings are free of bias and especially by the researcher. Objectivity in this study has been achieved through choosing appropriate data collection methods and the researcher maintaining professionalism in analysing data.

3.6.3 Reliability

Reliability refers to the measure of the degree to which a research instrument yields consistent results or data after repeated trials. This was maintained in the study by using a standard semi-structured interview guide to collect data, all semi-structured interview guides were coded VCF1

to VCF 8 to avoid repetition in data analysis and the interviews were conducted by one researcher to ensure consistency in how questions were asked.

CHAPTER 4: PRESENTATION OF RESEARCH FINDINGS

4.1 Introduction

This chapter presents the results of the study. They have been presented using descriptive methods as discussed in the data collection section in Chapter three. The results from the interviews and secondary data have been presented. The data was analysed and presented based on the specific research objectives that guided the study. The specific objectives were: i) to examine the key conditions that have contributed to the increase in the number of private owned venture capital firms; ii) to determine the challenges faced by venture capital firms as they set up in Kenya and iii) to identify the sectors of the economy that venture capitalists prefer to invest in.

The chapter is structured as follows: 4.2 response rate; 4.3 factors that influence venture capital establishment; 4.4 challenges encountered by venture capital firms; 4.5 sectors of the economy.

4.2 Response Rate

The study identified 10 venture capital firms operating in Kenya and was able to get interviews from eight, which have been presented as VCF 1 to VCF 8. The categories used in the interview guide (section A to E) have been used to outline the results. The findings are presented as per the research objectives of the study.

Data were collected from 8 operational venture capital firms. It was found to be consistent and the investment analyst or founders interviewed mentioned the other firms as peers. The response rate achieved was 80% and this was due to personal visits to the firms and making phone calls to book appointments.

4.2.1 Preliminary Information on Venture Capital Firms in Kenya

The researcher identified 8 venture capital firms operating in Kenya which are managed and owned by foreign investors whose focus was on SMEs in the East Africa region. All firms were established in Kenya between the years 2002 to 2009.

Presented below in table 4.1 is a summary of the preliminary information from the venture capital firms. This table shows a brief summary of the venture capital firms, year of

establishment, type of business , current fund size, portfolio of companies invested in and type of financing engaged in.

Table 4.1 Venture capital firms General Information

Company information	Year of establishment	Type of business	Fund size	Portfolio	Type of financing
VCF 1	2005	Foreign owned	\$100m	Parent company with 8 subsidiaries	Acquisition/expansion
VCF 2	2006	Foreign owned	\$40m	More than 10 companies	Acquisition/expansion
VCF 3	2007	Foreign owned	\$14.1m	5 companies	Acquisition/expansion
VCF 4	2007	Foreign owned	\$20m	8 companies	Acquisition/expansion
VCF 5	2009	Foreign owned	\$50m	2 companies	Acquisition/expansion
VCF 6	2008	Foreign owned	\$50m	12 companies	Acquisition/expansion
VCF 7	2004	Foreign owned	\$14.1m	3 companies	Expansion/acquisition
VCF 8	2006	Foreign owned	\$320m	More than 5 companies	Start-up/expansion

From table 4.1, the respondents interviewed set up in Kenya between the years 2004 to 2009. It was noted that they engaged in acquisition or buyout type of venture capital and only VCF 8 was involved in start ups. The venture capitalists interviewed steered away from offering seed capital and preferred companies that have been in existence for more than three and have a proven track record of growth. This is consistent with the findings of Salehizadeh (2005) that foreign venture capital firms in emerging economies invest in businesses which require financing at the expansion stage and not early stages as the economies are risky and they do not want to invest in riskier ventures as well. This is consistent with the findings of Kitchen(1989) that venture capital in emerging markets is cooingly used to finance mature companies and not seed or start-ups. From the findings, 30% of the respondents were in the process of investing funds from the first fund while 70% were in the process of setting up the second fund.

4.3 Factors that Influence Establishment of Venture Capital Firms in Kenya

The first objective of the study was to establish the factors that influence the establishment of venture capital firms in Kenya. The factors identified in literature review that were used as a guiding factor include macroeconomic variables for instance Gross Domestic Product (GDP) and interest rates, disinvestment avenues, fiscal incentives, government support, labour market rigidity, expected rate of return from the investments, funds from investors and networking among venture capitalists. Descriptive statistics was used to analyse the data and the percentage of positive responses determined.

The respondents of the study were asked to rank the factors using a likert scale from a range of 1 to 5 where, 1 was strongly disagree, 2 disagree, 3 neutral, 4 agree and 5 strongly agree. The positive responses were taken to be above 4 and the negative response to be below 3. The sum of positive responses was then determined. The responses from the study are below.

4.3.1 Macroeconomic Variables

During the interviews, respondents of the study were asked in their opinion to rank macroeconomic variables as a factor influencing their decision to set up. In this study macroeconomic variables included interest rates, inflation and Gross Domestic Product (GDP).

The likert scale was used where, 1 was for strongly disagree, 2 disagree, 3 neutral, 4 agree and 5 strongly agree. The results of the study were 12.5% of the respondents (1 out of 8) agreed that macroeconomic variables influenced their decision while 87.5% of the respondents (7 out of 8) strongly agreed.

The results of the study were contrary to the findings of Jeng and Wells (2000) who argued that macroeconomic variables were not significant determinants of venture capital supply. They were backed by the findings of Cherif and Gazdar (2011) that identified that interest rates and inflation were not a significant determinant of venture capital in Europe. The results of this study could be different because the study has been carried out in emerging markets where interest rates and inflation are significant determinants as they determine returns to the firm as it affects the entrepreneurs. An investment analyst in VCF 4 further explained that due to the volatility of interest rates in Kenya, most of their ventures were struggling financial due to incurring high charges paid to financial institutions. This in turn affected the venture capitalists returns from the venture.

4.3.2 Disinvestment Avenues

The respondents were asked to rank from a scale of 1 to 5, 1 being strongly disagree and 5 being strongly agree to identify if an exit mechanism and especially the use of Initial Public Offer (IPO) from a venture was a factor that influenced their decision to set up. 100% (8 out of 8) of the respondents stated that an exit mechanism was not a factor considered. They further explained that this was because most if not all companies in their portfolios were not listed hence could use IPOs. The only available channel was through buyback of shares.

The results of the study were contrary to the findings of Jeng and Wells (2000) that identified exit mechanisms and specifically initial public offers (IPO) was the strongest driver of venture capital supply in the 21 countries where the study was conducted. IPOs were considered due to the high returns and were a motivating factor for the entrepreneurs to grow their businesses. They also identified that disinvestment avenues were significant to those venture capital firms involved in later stage financing (acquisition and buyouts) but not for those involved in early stage financing. This was echoed by Cherif and Gazdar (2011) in their findings that disinvestment avenues have no significant effects on the early stage venture capital finance.

4.3.3 Flexibility of the Labour Market

The respondents were asked to rank the role played by the labour market to influence their decision to set up. All 8 respondents (100%) stated that they did not consider the labour market. This was because they termed the labour market not to be friendly. According to Jeng and Wells (2000) labour market rigidities applied or were a significant determinant to those who engaged in the early stage of venture financing.

4.3.4 Fiscal Incentives from the Government

Respondents were asked to rank the impact of fiscal incentives from the government on their decision to set up. 12.5% of the respondents (1 out of 8) did not consider fiscal incentives while 87.5% (7 out of 8) stated they considered fiscal incentives as a factor but did not influence their decision. This was due to the fact that the government did not offer any incentives in form of tax to the venture capital firms. The respondents felt that they paid the same rate irrespective of their positive impact to the growth of the economy. The findings of the study were contrary to the expectation that fiscal incentives offered by the government were a significant determinant of venture capital supply.

4.3.5 Government Policies to Encourage Investments

The respondents were asked to rank government policies that are in place to encourage investments. The responses were 87.5% of the respondents (7 out of 8) stated that government policies did not encourage investments while 12.5% (1 out of 8) did not consider government policies. This was because the respondents felt that there were no policies that have been put in place by the government to encourage investments especially by the venture capitalists. The findings of this study were different to those of Cherif and Gazdar (2011) that identified inclusive policies from the government as a significant determinant of continuous financing cycle especially for start-ups. Jeng and Wells (2000) in their study found that venture capital supply was thriving in countries like Portugal where venture capital firms were exempted from paying corporation tax in the first three years of operation and deduction from paying tax if revenue reserves of the firms were reinvested in venture capital projects for three years after being achieved.

4.3.6 Networking among Venture Capitalists

The respondents of the study were asked to rank networking among venture capitalists as a factor using the likert scale. Of the responses, 37.5% (3 out of 8) of the respondents were neutral while 62.5% (5 out of 8) agreed that networking among venture capitalists was a significant factor. The main reason for networking by setting up an association was to make the individual venture capital firms more visible so that entrepreneurs can term them worth to approach and also for venture capitalists to identify ventures. Entrepreneurs are also able to access credibility of venture capital firms. Networking also enables venture capitalists to gather relevant information and it can be a channel to lobby for tax relief and more favourable policies by the government. Additional information gathered during the study was that the East African Venture Capital Association is being established.

The responses of the study are echoed by the findings of Hochberg, Ljungqvist and Lu (2007) that networking among venture capitalists as a determinant of venture capital supply was significant because networked venture capital firms are good performers unlike those not networked. This argument is demonstrated by Ahlstrom and Bruton (2006) in their study. They recommended venture capitalists in emerging economies to put greater emphasis on networking in the selection, monitoring and exiting of deals for efficiency. Networking is also important to venture capital firms in emerging economies as it is a channel that can be used to navigate challenges encountered in the industry.

4.3.7 Funds from Investors

The respondents were asked to rank using the likert scale the importance of funds received from investors as a factor influencing their decision to set up. From the responses, 100% of the respondents (8 out of 8) strongly agreed that funds from investors were a significant determinant of venture capital. This was because funds from investors in the venture capital fund determined the portfolio of the firm and size of a deal to source and close. Venture capitalists earned a certain percentage of management fees hence the higher the fund size, the more profitable the firm. The results of this study were similar to the findings described by Black and Gilson (1998) that venture capital firms are managers of the funds they receive from investors and the size of a fund determines the portfolio of companies to invest. The venture capital firm performance

influences the ability of the firms to raise additional funds from investors (Gompers and Lerner, 1999).

4.3.8 Expected Rate of Return

The respondents were to rank the significance of the expected rate of return from an investment as a factor influencing set of venture capital firms by use of the likert scale. 100% of the respondents interviewed (8 out of 8) strongly stated that was a significant determinant. The findings of the study were similar to Deventer and Mlambo (2008) findings that South African venture capitalists considered a high rate of return as an important factor in their set up.

In conclusion to the responses achieved for objective one, according to Jeng and Wells (2000) there are six key factors that determine venture capital funding across 21 countries namely initial public offering, labour market rigidities in that country, financial reporting standards, private pension funds, macroeconomic variables and government programmes. The results of this study are similar for specific factors like labour market rigidities which negatively influence supply of venture capital but contradict the findings in regards to macroeconomic variables. The difference could be because of the market in consideration. The willingness of investors to commit their funds in venture capital firms depends on the expected rate of return from investments in ventures (Gompers and Lerner, 1999). Sunil(2000)emphasized that better returns in the venture capital industry will attract supply and hence demand while poor performance in terms of returns discourages investors.

On the other hand, Denver and Mlambo (2008) who carried out their study in South Africa argued that entrepreneur's honesty, expected good market performance and high internal rate of return as the factors that affect venture capital funding in a country. This is similar to this study in that expected rate of return was identified by 100% of the respondents.

4.4 Challenges Faced by Venture Capital Firms as they set up

The second objective of the study was to determine the challenges venture capital firms encountered when they set up in Kenya. The challenges identified in literature review and applied in the study were lack of protection of investors' property by the government, lack of proper documentation by entrepreneurs and institutional instability. Lack of proper valuation

methods and lack of qualified staff were additional challenges identified by respondents. The likert scale was used to rank the challenges during data collection and information gathered was analysed by use of descriptive methods.

4.4.1 Lack of Protection for Investors Property from the Government

The respondents of the study were asked to rank little or no protection for investor's property from the government using the likert scale. Of the responses, 100% (8 out of 8) stated that there was no protection of investor's property by the government. This was linked with the insecurity rates in the country. This led them to look for office space in areas which were not prone to insecurity hence very expensive and difficult to get due to competition. The research findings are according to Peng (2001) who argued that little protection of investors' property is one of the challenges faced by venture capital firms as they set up.

4.4.2 Lack of Proper Documentation by Entrepreneurs

During the interviews by use of the likert scale, the respondents of the study were asked to rank if lack of proper documentation by entrepreneurs was a challenge encountered. From the literature review, it was expected that most of the respondents would identify the challenge and rank nothing below 4 (agree). 100% of the respondents (8 out of 8) stated that lack of proper documentation was a challenge faced. The respondents further explained that most of the entrepreneurs especially those in the early stage do not have proper accounting information as it does not conform to the International Financial Reporting Standards (IFRS). Lack of proper documentation also applies to family based enterprises that are now seeking investors. The lack of proper documentation delays the investment process. The findings of this study were strongly advocated by Meyer (2001) who argued that entrepreneurs in emerging economies do not conform to accounting standards and this is because the laws to enforce are few.

4.4.3 Institutional Instability

The respondents of the study were asked to rank the institutional instability as a challenge encountered. Of the responses, 75% (6 out of 8) of the respondents did not identify with institutional instability while 25% (2 out of 8) of the respondents identified. The legal system was deemed to be unstable. One of the respondents (VCF 3) elaborated further that they had

faced challenges when they were merging with an international venture capital firm and the legal process was too tedious and affected their operations. The findings of this study were similar to the previous study of Ahlstrom and Bruton (2006). The findings of the study were that institutional stability is not common in emerging economies. Institutional instability is a challenge faced mostly by venture capital firms that engage in early stage financing. The formal institutions in emerging economies were termed to be weak.

4.4.4 Lack of Proper Valuation Methods

The respondents identified lack of proper valuation models for their ventures to be a challenge encountered. The respondents further clarified that the models adopted in the deal evaluation are tedious and hence it takes too long to close a deal. The methods are quantitative that is financial and accounting which can be manipulated and hence not a true reflection of the business being considered in the deal. The quantitative models are also impersonal and the interaction between the venture capitalists and the entrepreneur is limited. Klonowski (2007) identified that structuring of venture capital deals in emerging markets is difficult and this is because the legal system is not well structured. This leads to creatively structuring the deals which make the process long tedious for the investor and entrepreneur to the extent there are many deals left pending.

4.4.5 Lack of qualified Venture Capital Personnel

The respondents additionally identified lack of qualified venture capital personnel as a major challenge encountered. The respondents explained that there is lack of experienced personnel who understand venture capital and they have to bring in those experienced and this is very expensive as they are paid more and also labour laws in Kenya are stringent hence the process of getting work permits takes long affecting operations of the firms.

In conclusion, from the research findings, little or no protection for investors' property from the government, lack of proper documentation by entrepreneurs, lack of proper valuation methods of the SMEs and lack of qualified VC staff attracted 100% of the responses while institutional instability especially the legal framework attracted 25% of the responses.

4.5 Sectors of the Economy Invested by Venture Capital Firms

The third objective of the study was to determine the sector of the economy preferred by venture capitalists and the reasons behind it. The main sectors initially determined were manufacturing, agriculture, financial services, infrastructure, communication and technology and consulting. In addition, health care, education, oil and gas and mining services were identified by the respondents in the study. Respondents were asked to state the sectors of the company invested in as per their portfolio and to give reasons for the preference. Data collected was analysed by use of descriptive methods and results presented in a table. The summary of responses is presented in table 4.2 below. This is a summary of the sectors of the economy preferred.

Table 4.2 Sectors of the Economy Invested by Venture Capital Firms

Sector	VCF 1	VCF 2	VCF 3	VCF 4	VCF 5	VCF 6	VCF 7	VCF 8
Manufacturing			✓	✓	✓		✓	✓
Agriculture					✓	✓		✓
Financial services					✓		✓	
Infrastructure				✓				
ICT	✓			✓				
Consulting				✓				
Health care			✓	✓	✓	✓	✓	✓
Media	✓							
Telecommunication	✓							
Oil & gas					✓			
Mining services					✓			

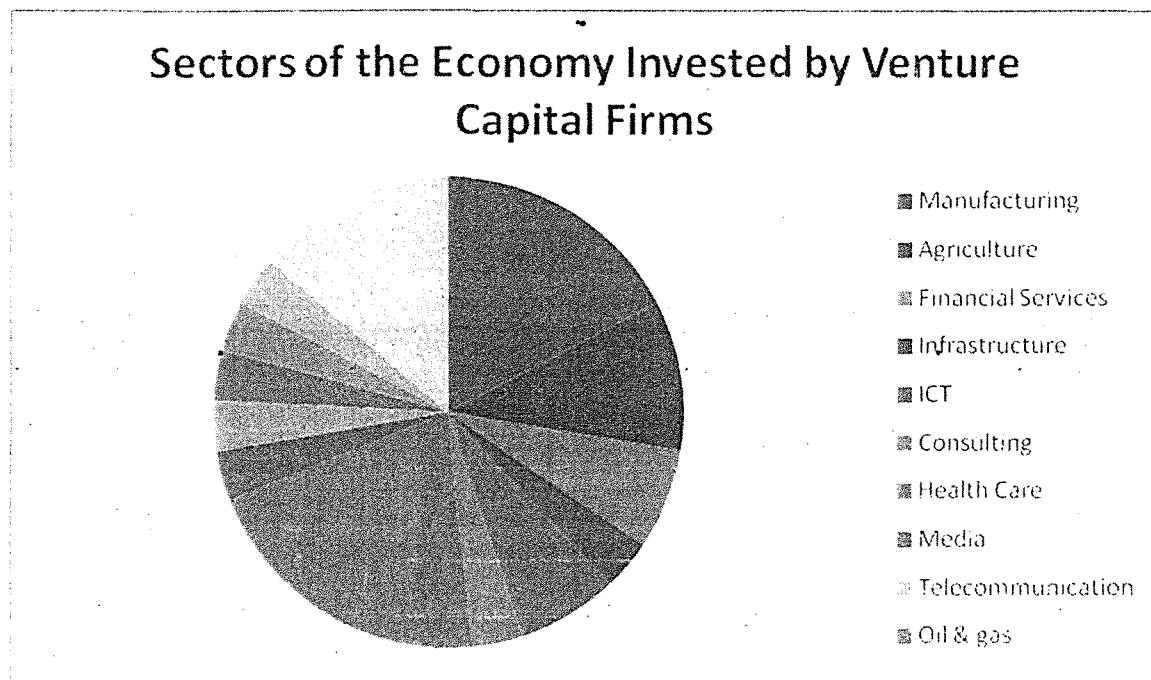
Logistics			✓					
Education					✓	✓		✓
Essential services(water & housing)						✓		

Healthcare and manufacturing sectors were identified as the sectors where most venture capital firms had invested with 75% (6 out of 8) and 62.5% (5 out of 8) of the respondents respectively. Sectors like logistics, media, telecommunication and provision of essential services were the least invested sectors by venture capital firms in Kenya. The reasons given by the respondents of the preference of particular sectors to invest in were growth, less volatile, value adding and where venture capital firms could bring in their expertise or skills. For value adding, the venture capitalists were looking for companies where they could add value to the entrepreneurs by providing help in identifying managerial talent, suppliers and customers.

Figure 4.1 below clearly represents the sectors most preferred and shows that most venture capital firms invest in health care, manufacturing and then agriculture. This is due to the fact that they are not volatile.

Figure 4.1 Sectors of the Economy Invested by Venture Capital Firms

Figure 4.1 is a summary of the sectors of the economy that venture capital firms invest in. Manufacturing and ICT are the most preferred sectors while consulting and media are the least preferred sectors.



CHAPTER 5: DISCUSSION ON FINDINGS

5.1 Introduction

This chapter presents a summary of the study giving the implications of the findings based on the research objectives. It is structured as follows: 5.2 summary of the study; 5.3 summary of findings and conclusion; 5.4 implications for policy and practise; 5.5 recommendations for further study; 5.6 limitations of the study.

5.2 Summary of the Study

This study was an attempt to respond to Jeng and Wells (2000) previous study which looked at the determinants of venture capital supply in 21 countries in the developed market. The findings are now applied to an emerging market to confirm or disapprove the same. The first objective of the study was to determine the key factors that influenced venture capital establishment. Data was collected based on the previous studies identified in the literature review and analysed using the likert scale.

The second objective sought to identify the challenges encountered by venture capitalists as they set up. The guiding factors were identified from previous studies in the literature review and analysed by use of likert scale and presented using descriptive methods.

The third objective was to identify the sectors of the economy to invest in preferred by the venture capitalists and the reason behind their choice. The closed ended questions were analysed through content analysis to identify the themes and categories and to link this to the literature review.

5.3 Summary of Findings and Conclusion

The first objective of the study was to determine the key factors that influence the establishment of VCFs in a country. The study aimed at establishing whether the findings of Jeng and Wells (2000) are the similar or different in the emerging markets. Data collected was analysed by use of descriptive methods. The results indicated that macroeconomic variables like GDP, interest rates and inflation were key to investors and this is because they determined the performance

of the market and hence the returns. This was contrary to the findings of Jeng and Wells (2000) that argued macroeconomic variables not to be a significant factor of venture capital supply.

From the findings, disinvestment avenues were negatively viewed and this is because the only exit mechanism that can be used is buyback of shares because the venture capitalists consider the listing of IPOs in the capital market to be a rigorous process. According to Jeng and Wells (2000) the most attractive exit mechanism for venture capital firms is through an IPO as this yields higher returns and gives investors an additional incentive to invest in companies that will grow. Black and Gilson (1998) argued that a well developed stock market that permits venture capitalists to exit through an IPO is crucial for the existence of a vibrant VC market.

The respondents termed the labour market not to be flexible and this was because of the stringent regulations faced as they tried to get work permits. Venture capitalists bring in skilled personnel to work in their firms but mostly to boost the management of their ventures. The respondents pointed out that there were no fiscal incentives for investors from the government. The tax rate had been the same for years. The same applies to policies by the government to encourage investment as there are none in place.

Networking among venture capitalists is a key factor in the set of firms and this is because through the associations, they update each other on the changes in the industry. It was clearly pointed out that an East African association of venture capitalist is being set up as currently most are members of the Africa Venture Capitalists Association (AVCA) which is based in London and they felt it does not address their issues.

The results of the study clearly indicated that funds from investors and expected rate of return were strongly considered by the respondents when they were considering setting up. Venture capitalists manage venture capital funds and charge a management fee. They can have several funds. If there are no funds raised, then they cannot invest in ventures. The same applies to the expected rate of return from the investments which is around 15% for most of the venture capital firms.

The second objective of the study was to establish the challenges that were faced by venture capital firms as they set up. The respondents of the study were presented with the challenges and

they were asked to rate them. The likert scale was also used for analysis. Lack of government support, lack proper documentation by entrepreneurs, lack of proper valuation methods and lack of qualified VC personnel were all identified as challenges encountered. According to La Porta, Lopez-de-Silanes and Vishny (2002) legal structures and the protection of property rights by the government influence the attractiveness of a venture capital market.

In response to objective two, the findings of the study were that the government had failed to protect investors and their property. Entrepreneurs and especially SMEs seeking venture capital funding did not have proper documentation in place aligned to the international financial standards. In the due diligence process carried out by venture capitalists as they considered a venture, they were faced with the challenge that the financial records were not compliant with the International Financial Reporting Standards(IFRS) and hence to understand them or to make comparisons was hard. Though it was clear that this mostly affected those who dealt with start-ups as most established companies had complied. Jeng and Wells (2000) argues that if a company has proper documentation in place, less time is spent on gathering information about a firm.

Instability of major institutions like the legal system was deemed to pose a major challenge as the process of registration of a firm was a long and tedious exercise. One of respondents who was in the process of merging with an international venture capital firm further explained that it had taken close to one year for them to merge and to change their name which affected their business as operating under the new name was crucial for their branding.

There were two key challenges that were identified by the respondents but had not been derived from the literature review. These were lack of proper valuation methods and the lack of qualified venture capital personnel. It was clear that the valuation method used was more quantitative and tedious. According to Deventer and Mlambo (2008) venture capitalists make use of both quantitative and qualitative methods. The quantitative methods used are revenue and financial data. If not available, then the methods are not effective. Qualitative methods which are used to gauge strengths and weaknesses are from the strategy school of thought. There was scarcity of qualified VC personnel hence the need to bring in expatriates which was costly to the firm. Most venture capital firms operated by lean staffs which makes the investment decision criteria tedious

(Larsson and Roosvall, 2000). Deal structuring is a challenge in emerging markets due to a weak legal system. This leads to the deal process being slow and tedious for both the venture capitalist and entrepreneur resulting in many uncompleted projects or transactions (Klonowski, 2007).

The third objective was to determine the sectors of the economy that were preferred by venture capital firms to invest in. The respondents of the study were presented with a list of sectors and they were to indicate which sectors they had invested in and the reasons behind it. Healthcare and manufacturing were identified as the sectors most preferred and the reasons given were growth, they were less volatile, value adding and where they could contribute through bring in their expertise. On the other hand, education, provision of essential services and telecommunication were least preferred. This implies there was more growth opportunity in manufacturing and health care sectors and thus higher returns for venture capitalists. Most venture capital firms did not invest in real estate because they considered the market to be volatile.

In conclusion, the findings of the study were to some extent similar to those of Jeng and Wells (2000). Similar factors were seen to be macroeconomic variables, funds from investors, networking among venture capitalists and the expected rate of return. There were differences in that in Kenya, fiscal incentives, labour market and exit avenues were not key factors due to the weaknesses of government. On the part of challenges faced, the findings of study confirmed previous studies.

5.4 Implications for Policy and Practise

5.4.1 Government

From the findings, it was clear that fiscal incentives from the government, flexibility of the labour market and government policies that encourage investors were not factors considered by the venture capital firms. The implication of this finding was that the government had not implemented policies that encourage venture capital funding in the country. The labour market was also not flexible as there were many regulations. One of the conditions that venture capital firms put across to the SMEs when investing is that they would bring in skilled personnel. It was clear that there were stringent labour laws in place that made it harder to bring in skilled

personnel from other countries to work in the SMEs where venture capital firms have invested in.

From the current study, it is clear the government needs to educate or raise awareness among the entrepreneurs on venture capital financing concept which is still new in Kenya, this will further increase the entrepreneurs' confidence in their input. The government also needs to provide incentives for instance to reduce taxes for venture capital firms to encourage more to set up. According to Jeng and Wells (2000) venture capital firms are important in an economy as they serve as financial intermediaries in a market where lenders and borrowers find it costly to get together.

The government also needs to place stringent regulations on the financial reporting standards in the country especially for SMEs. This will ensure they have proper documentation that will facilitate the process of deal sourcing and sign off for the venture capital firms as it has been slow in the past mainly due to lack of proper documentation by entrepreneurs.

5.4.2 Capital Market Regulators

From previous studies, one of the key factors considered by venture capitalists before establishment is the exit mechanisms from a venture. The most commonly used method is through an IPO. Findings from this study indicate that the exit mechanism from a venture is not considered and this is because most SMEs are not listed due to the rigorous process. The Capital Market Authority (CMA) together with Nairobi Securities Exchange (NSE) in Kenya need to encourage more companies especially SMEs to be listed and they need to create awareness on the same. From the interviews conducted, it was clear that the venture capitalists felt the requirement by CMA to have all venture capitalist registered was not clear hence the reason why they were not registered. Venture capital industry in the US and UK have experienced a boom due to an efficient and favourable capital market (Kitchen, 1989).

5.4.3 Venture Capitalists

From the research findings, venture capital industry is growing in Kenya and hence the need for smaller firms to merge so as to attain their potential. This implied that it was time for more venture capitalist to set up and especially for local investors. The study expounds on the key

factors that venture capitalists consider when they establish firms and hence this encourages more to set up.

For the prospective investors, it is clear that venture capital industry is still at its infancy hence there is room for more to set up. The current venture capitalists also need to engage in creating awareness on their role to entrepreneurs so that more businesses can gain from venture capital financing which is cheaper than financing from financial institutions. Venture capitalists go an extra mile by involving themselves in the management of the business. Awareness will also reduce hostility faced by venture capitalists from the entrepreneurs.

5.4.4 Academic Researchers

Venture capital is increasingly regarded as an important aspect to the growth of emerging economies. This study has tried to answer questions in regards to the factors that influence establishment of venture capital firms. Academic researchers need to conduct more studies on venture capital especially focussing on emerging markets because there is scarce work done and there is need for more information on this important area. Foreign investors look for information way before they decide to invest and it would be helpful if they can readily access information.

5.5 Recommendations for Further Study

Further study can be conducted to focus more on the venture capital funds to establish if there has been an increase and the impact on the economy. The study could extend this to the benefits that entrepreneurs accrue from having a venture capitalist to establish if this is the case as has been indicated in previous studies.

Further study can be conducted on the methods of valuation of SMEs that are used by venture capital firms and to determine the best suitable method that applies to emerging market. This is because the venture capital firms are using the same valuation method in the developed market and it makes the deal process too long.

Further study can be carried out on the role of CMA in regulating the venture capital industry and the specific factors that hindered the venture capitalist from being registered with regulator. The CMA Act established in 2007 and its impact could also be considered in the study.

Further study can be conducted on the supply and demand of venture capital finance in Kenya. This could be by use of an econometric model of macroeconomic variables within a period of time. This is would expound more on the macroeconomic variables individually as they react differently. Some variables are significant while others as shown by findings from previous studies.

5.6 Limitations of the Study

The limitations encountered in the course of this study were: first, that Capital Markets Authority (CMA) did not have the official list of registered venture capital firms yet they had indicated that this would be out by October 2012. This affected the sample of the study as the list used was from an association whose membership is optional hence not sure if all venture capital firms were considered in the study. Secondly, the method of data collection was through the use of semi-structured interviews which was time consuming and also some information not relevant to the study was gathered.

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APPENDICES

Appendix 1: Sample Invitation Letter of Study to Venture Capitalist

(Date)

(Addressee)

(Company Name)

(Company Address)

Dear Sir/Madam,

RE: ACADEMIC RESEARCH THESIS

I am a Masters of Commerce second year student at Strathmore University undertaking academic research. The subject of my research thesis is on the Venture capital industry in Kenya and focuses mainly on the venture capital funding. The purpose of the study examines the conditions that influence the increase and sustainability of venture capital firms in Kenya. This will provide a better understanding of whether the industry is sustainable.

Your firm has been identified to participate in the study owing to your involvement in the venture capital industry in Kenya. I would like to request for an interview with a senior officer especially the founder/Chief Executive Officer/Chief Financial Officer from your firm. The information gathered from your firm will be treated with utmost confidentiality and your firm will remain anonymous. No specific reference will be made to the firm or the respondent in the research report. I will provide a generic overview of the research findings with your firm upon completion of my research.

Let me thank you in advance for your collaboration. My contact details are Jane Ngaruiya, cell phone number +254721358240, email: ngaruiyaj@yahoo.com

You may also contact my university supervisor Dr. Freshia Mugo-Waweru at fwaweru@strathmore.edu for any clarification or queries.

Yours Sincerely,

Jane Ngaruiya

Masters of Commerce Student

Strathmore University

Appendix 2: Semi-Structured Interview Guide

Structured Interview Guide Used With Senior Officers in the Venture Capital Firms

Section A: General Information

1. Company Name.....
2. Year the company was founded.....
3. Is the firm locally owned to foreign subsidiary?
4. Which of the four stages of venture financing do you engage in?

Seed financing ☐
Start-up financing ☐
Expansion financing ☐
Acquisition/buy-out ☐
5. Total funding of the firm in Kenya (Kshs) p.a.....

Section B: Establishment in Kenya

How would you consider the following venture capital development factors in Kenya as hindering or supporting your investment operations? (1-strongly disagree, 2-disagree, 3-neutral, 4-agree, 5-strongly agree)

	1	2	3	4	5
	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
Macroeconomic variables	☐	☐	☐	☐	☐
Disinvestment	☐	☐	☐	☐	☐

avenues					
Flexibility of the labour market	☐	☐	☐	☐	☐
Fiscal incentives from the government	☐	☐	☐	☐	☐
Government policies to encourage investments	☐	☐	☐	☐	☐
Networking among VCFs	☐	☐	☐	☐	☐
Funds from investors	☐	☐	☐	☐	☐
Expected rate of return from an investment	☐	☐	☐	☐	☐

Any other factor in addition to the above? If so please specify.....

.....

Section C: Challenges faced when setting up in Kenya

1. Which of the following challenges did you face/still facing when you were setting up in Kenya?

	1	2	3	4	5
	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
Little or no protection for investor's property from the government	☐	☐	☐	☐	☐
Lack of proper documentation by entrepreneurs	☐	☐	☐	☐	☐
Institutional instability	☐	☐	☐	☐	☐

Apart from the above, is there any other challenge encountered? Please specify.....

.....

In general terms what are the effects of these challenges in the operations of your firm?

2. What are the frequently reported challenges from your clients?

Section D: Portfolio

1. How many companies are currently in your portfolio?
2. Which of the following sector(s) of the economy have you invested in?

Sector	
Manufacturing	
Agriculture	
Financial services	
Infrastructure	
ICT	
Consulting	

Any other sector in addition to the above? Please specify.....

.....

.....

Reasons for preference of sector(s) of the economy

.....

.....

.....

.....

.....

Section E

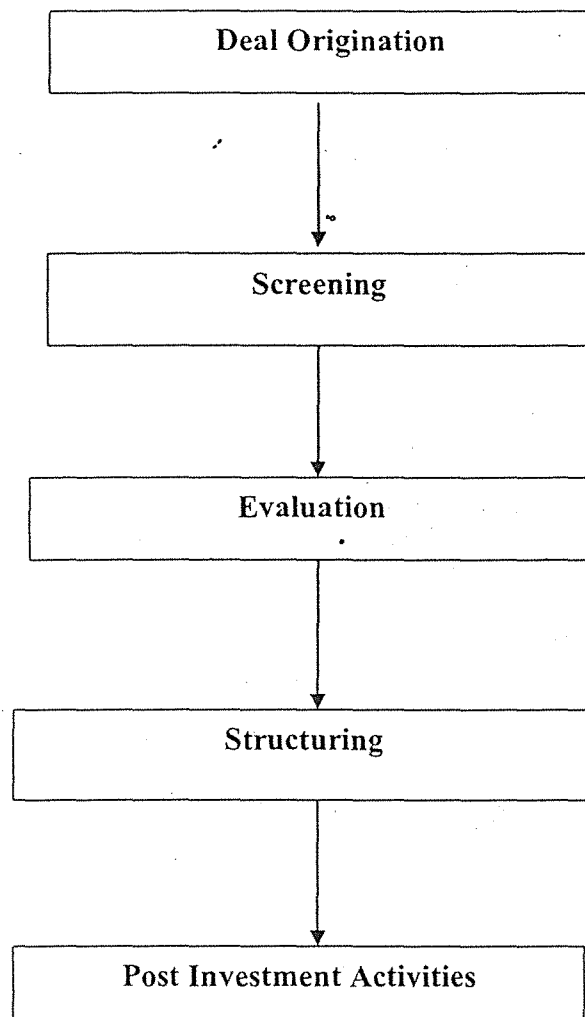
1. Where do you suggest that government should be more focused in developing the venture capital industry bearing in mind that it is still an infant industry in Kenya?
2. How do you foresee the future of venture capital industry in Kenya?

Appendix 3: List of Venture Capital Firms in Kenya

Name	Location	Year of Establishment
InvestQ Capital Fund	Ambassador Court, Suite no. A4 Milimani Rd, opposite. Heron,Hotel +254 20 2730980/1	2002
Aureos Capital Fund	Norfolk Towers,1 st floor Kijabe Street +254 20 2228870	2004
Grofin	CIC Plaza, Ground floor Upper Hill +254-20-2730280	2004
East Africa Capital Partners	Wilson Business Park, off Langata Road Block C,1 st floor +254 20 6006521/0714-606823	2005
Business Partners International Kenya	Africa Re Centre,1 st Floor Hospital Road, Upper Hill +254-20-2805000	2006
Fusion Capital	ACK Garden House, Block A 1 st Ngong Avenue. +254 20 2710149/53/55	2006
Inreturn Capital Kenya (Now Jacana Partners)	Statehouse road, opposite Philippines Embassy +254-20-2504775	2007
TBL Mirror Fund BV	Nairobi Business Park Block A, Ground floor Ngong Road	2007

	+254-20-2019374	
Acumen Fund	1 st Floor, Cape office park, opposite Yaya +254-20-3861559/60/61 +254 716252802	2008
Fanisi Capital Limited	4 th floor Arlington block/14 Riverside drive +254-20-4207000	2009

Appendix 4: Decision Process Model of Venture Capitalist Investment Activity



Tyebee and Bruno (1984)