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Influence of venture capital financing on corporate governance of Small and Medium Enterprises (SMEs) in Nairobi County.

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INFLUENCE OF VENTURE CAPITAL FINANCING ON CORPORATE GOVERNANCE OF SMALL AND MEDIUM ENTERPRISES (SMES) IN NAIROBI COUNTY

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DECLARATION

I, the undersigned declare that this is my original work and it has not been submitted to any college, institution or university other than Strathmore Business School, for academic credit. All material obtained from other sources is duly acknowledged.

Signature……………………………… Date………………………………………….

Maria Maali

This thesis has been submitted for examination with my approval as the appointed university supervisor.

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Prof.

DEDICATION

This study is dedicated to my mother who encouraged, pushed and supported me to commence and complete this journey. This would not have been possible without her continuous support and belief in all I do.

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God bless you all!

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LIST OF ABBREVIATIONS AND ACRONYMS

CBD	Central Business District
CEO	Chief Executive Officer
CMA	Capital Markets Authority
IPO	Initial Public Offering
MPT	Modern Portfolio Theory
NACOSTI	National Council of Science, Technology and Innovation
PE	Private Equity
POT	Pecking Order Theory
SMEs	Small and Medium Enterprises
SPSS	Statistical Package for Social Science
VC	Venture Capital

ABSTRACT

The role of small and medium sized companies cannot be understated in the global economy. Though appreciated for growing the economy both in developed and developing economies, SMEs are faced with challenges including lack of proper corporate governance and lack of access to finances, among others. With lack of proper financing from sources such as venture capital, SMEs face high risk of collapse which limits social and economic growth. However, while SMEs can be adequately funded the challenge of good corporate governance does not therefore guarantee sustainability of the SMEs. Therefore, there was need for good corporate governance structures to align with the expectations of venture capital financing. In this regard, how venture capital influences and ensures good corporate governance should be put into consideration as an assurance to venture capitalists. At this stage, there was need for empirical evidence to support understanding of the influence of venture capitalist on corporate governance particularly in venture capital-backed SMEs, yet the evidence is not adequate. It is against this backdrop in empirical evidence on the extent to which venture capital influences corporate governance that this study sought to investigate the influence of venture capital on corporate governance among SMEs in Nairobi. The study focused on three objectives: To determine the extent to which investment decision influence corporate governance in SMEs in Nairobi; To examine how management of the investment influence corporate governance in SMEs in Nairobi; and to determine the extent to which exit of venture capital influence corporate governance in SMEs in Nairobi. The study was anchored on two theories: pecking order theory and modern portfolio theory. In methodology, this study employed descriptive survey design which supported collection of quantitative data from a large population of SMEs in Nairobi. A total of 133 board members or owners and 133 managers were selected randomly from 133 SMEs. Questionnaire was used to collect data after reliability and validity test during piloting. Before data collection, ethical consideration involved acquisition of research permits as well as ensuring privacy and confidentiality of the respondents. The findings obtained were checked for completion, sorted and coded. The quantitative responses per objective were entered to Statistical Package for Social Sciences (SPSS) and analysed descriptively to yield frequencies, percentages and means before correlation and regression. Findings revealed that SMEs in Nairobi are ready to modify their governance structures as a means of allowing the capital venture to provide funds. Also, venture capitalists utilize most of the time in ensuring that management of investment is favorable to them. In addition, venture capitalists often build capacity by equipping human and technological resources. However, SMEs resist the takeover of the firms by the venture capitalists as a means of protecting their interests. Therefore, the study concluded that investment decision, management of the investment and exit of the venture capital jointly, separately and significantly influence corporate governance. The study therefore recommended that venture capitalists and SMEs owners interested in venture capital should develop clear frameworks that ensure interests of all parties are considered and respected. This will ensure that investment decisions are entrenched in a clear framework that will ensure collaboration and partnership.

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Many businesses across the world are facing challenges related to financial support and sustainability. The businesses have both short term and long-term goals that require adequate funding, yet the available funds do not support the implementation of strategic plans. As businesses have different modes of financing, venture capital is emerging as one of the modes financing business that have the potential of steady growth in future (Amissah, 2009; Bartlett, 2006). In many cases, venture capital has been focusing on promising business ideas that guarantee high returns and sustainability. However, venture capitalists consider corporate governance structures of financially constrained organisations in making investment decisions. According to Boateng (2010), the venture capitalists sometimes strive to become part of the ownership structure of the financially constrained organisation.

In most cases, the financially constrained are Small and Medium Enterprises (SMEs). Key among the challenges encountered by SMEs are access to finance and poor governance. According to Wanjohi and Mugure (2008), SMEs face financial constraints which limit the acquisition of relevant technologies, qualified employees and effective capital resources. Baraka and Anyieni (2015) also indicate that SMEs are financially constrained due to the failure in providing business information that guarantee financial support. The constraints are therefore related to corporate governance.

Corporate governance is an important aspect in SME growth and general improvement in the economy. Good corporate governance practices are regarded as important in attracting investors at low cost while reducing risks (OECD, 2014; Atacik & Jarvis, 2006; Njuguna, 2012); and attracting investment capital thereby improving the performance of companies (Todorovic, 2013). This implies that investment decisions are made depending on the level of corporate governance. However, corporate governance may not be well established in SMEs compared to large firms. Adri and Simango (2015) substantiate this fact by stating that corporate governance has often been associated with large and well-established firms and the distinctions among the major role players such as the management, board of directors, controlling and minor shareholders and other stakeholders is not apparent in SMEs. This therefore presents a challenge that is likely to affect firm value and general performance. The emerging question was whether venture capital affects corporate governance in case the SMEs are offered financial support by venture capitalists or not.

1.1.1 Venture Capital

Venture capital refers to professionally managed pool of money for making direct equity investments in rapidly growing private businesses (Rajan, 2010). According to Amissah (2009), venture capitalists assist business owners to access finance needed for the starting or expanding businesses. The venture capitalists also become part of the business ownership by acquiring stake in the business (Boateng, 2010). Venture capital is therefore a modern business financial innovation for start-up companies or expanding companies with convincing business ideas and high growth potential regardless of the risks involved.

Venture Capital is one of the sources of financing starting businesses. In many cases, venture capital has been focusing on promising business ideas that guarantee high returns and sustainability. According to Amissah (2009), venture capitalists assist business owners to access finance needed for the starting or expanding businesses. The Venture Capitals also become part of the business ownership by acquiring stake in the business (Boateng, 2010). Venture Capital is beneficial to firms with uncertainties including financial and management (Engel, 2002). In this case, risks in a given business or firm form critical aspects for consideration during decision making by venture capitalists. According to Bartlett (2006), venture capitalists are usually professional investor(s) investing in risk equity and whose goal is to realize their gains by exit. This is line with Modern Portfolio Theory (MPT) that that risk-averse investors can construct portfolios to optimize or maximize expected return based on a given level of market risk, emphasizing that risk is an inherent part of higher reward (Kaplan & Schoar, 2005).

Venture capitalists are individuals who provide the venture capital. Venture capitalists are believed to be extensively involved in the firms they finance, closely monitoring their activities and providing valuable support and governance (Hochberg, 2003). Venture capital occurs in three major phases: entry, management of investment and exit. According to Zider (1998), first phase is the investment decision when the venture capitalist evaluates which company to invest in. Second phase management of the investment when the capitalists drives the growth of the business to increase its market value. Third phase is the exit when the venture capitalist finally sales his or her own share of the company.

In each of the phases, venture capital has significant implications on the corporate governance structures, yet this is not clearly established in SME setting. For example, in the first phase, venture capitalists assess the corporate governance structures before making investment decision and sometimes negotiate for representation in the board of the start-ups (Broughman & Fried, 2013). This indicates that any investment decision is heavily dependent on corporate governance system in the company. In the second phase, venture capitalist use the board of directors also a method to advise the management team (Gombers et al., 2016). The venture capitalists seek representation in the board of management to secure their interests (Kaplan & Strömberg, 2003). Venture capitalists utilize most of the time in ensuring that management of investment is favorable to them. At the end of the venture capital contract which occurs in the third phase, venture capitalists can decide to buy shares and become part of the shareholders or not. According to Broughman and Fried (2013) and Roe (2004) venture capitalists destabilize corporate governance structures as well as limit fairness in safeguarding interests of shareholders after expiry of their term. It therefore follows that corporate governance of companies that accepted venture capital are potentially affected.

1.1.2 Corporate Governance

Corporate governance has been defined as a relationship between a company's management, board members, shareholders and other stakeholders. Shareholders represent company ownership which can either be limited or not and therefore when venture capitalists express interest, the ownership structure can be altered (Boateng, 2010). As for the Board members, some of the major roles include exercising corporate governance through formulation of policies and oversight of the enforcement of the policies (Broughman & Fried, 2013). The management also ensure corporate governance through promotion of the image of the company by running daily business in accordance with company policies and aspirations of the shareholders.

Corporate governance provides structures through which the company's objectives are set, means of attaining such objectives are provided and performance monitoring carried out (Okiro, Aduda & Omoro, 2015; Hochberg, 2003). Corporate governance therefore aids in protecting the rights and the interests of the shareholders and stakeholders, provides a framework for effective monitoring of management outcomes and performance and encouraging better results (Allen & Song, 2003). According to Abu-Tapanjeh (2008), corporate governance provides boosts for investment integrity in business.

Corporate governance comprises of both internal and external control frameworks. According to Hochberg (2003), the internal mechanisms of corporate governance include the board composition, managerial ownership, and non-managerial shareholding including the institutional shareholding while external mechanisms includes; the statutory audit, the market for corporate control and stock market evaluation of corporate performance. In this case, venture capitalists are considered grey directors who provide the firm with financial support (Monks and Minow, 2001).

In view of the roles of board directors in management of firms, it is expected that the roles of owners and managers to differ from the traditional corporate governance setting. This situation is determined at the first phase of venture capital process. According to Tuomaala, Välikangas, Lindström et al. (2018), venture capitalists are usually more active owners and they aim to exit the company after certain period instead of continuous ownership. In this regard, the venture capitalists may trigger changes in governance structures as a means of ensuring their interests are considered in the management of the firms especially during the second phase of venture capital process. However, the extent to which the venture capitalists make the changes in governance structures in SMEs in Kenya remained largely unexplored.

1.1.3 Small and Medium Enterprises

Small and Medium Enterprises (SMEs) are business entities in emerging markets that have continued to be choice of investment in the wake of increased need for economic growth in both developed and developing countries. In the developing world, SMEs are considered important business entities that create employment opportunities and promote business linkages at both local, regional and international levels (Rangamohan, Eunni, Candida, et. al., 2007). It is estimated that SMEs employ more than 80% of the workforce in developing countries (Memba, Gakure & Kabare 2013) and therefore this provides an opportunity for the governments to invest and promote growth of the SMEs.

Despite the contribution of SMEs in developing economies, SMEs are facing several challenges. Key among the challenges encountered by SMEs are access to finance and poor governance. According to Wanjohi and Mugure (2008), SMEs face financial constraints which limit the acquisition of relevant technologies, qualified employees and effective capital resources. Baraka and Anyieni (2015) also indicate that SMEs are financially constrained due to the failure in providing business information that guarantee financial support. The constraints contribute to collapse for the SMEs which are expected to create employment and promote trade linkages (Memba, et. al., 2013). In this regard, many people become unemployed as there are few SMEs that can absorb the skyrocketing numbers of the unemployed people especially in developing countries.

There is need for addressing the financial constraints of SMEs. One way of addressing the challenges is for the SMEs to pursue venture capital as personal savings or capital and other traditional financing sources are exhausted. This is supported by the Pecking Order Theory that firms attempt to reduce information asymmetries and maintain ownership by first using internal financing, followed by external debt and equity (Berger & Udell, 2003). However, while this form of financing was option to SMEs, there was need to examine the extent to which venture capital affected management of the SMEs especially corporate governance.

1.2 Problem Statement

The role of small and medium sized companies cannot be understated in the global economy. Though appreciated for growing the economy both in developed and developing economies, SMEs are faced with challenges including lack of proper corporate governance and lack of access to finances, among others. With lack of proper financing from sources such as venture capital, SMEs face high risk of collapse which limits social and economic growth. In such situations, high level of unemployment and slow economic growth sets in unless SMEs are adequately funded.

However, while SMEs can be adequately funded the challenge of good corporate governance does not therefore guarantee sustainability of the SMEs. There is need therefore for good corporate governance structures to align with the expectations of venture capital financing. In this regard, how venture capital influences and ensures good corporate governance should be put into consideration as an assurance to venture capitalists. Ordinarily, venture capital occurs in three phases (investment decision phase, management of the venture phase and exit phase). In this regard, there is need to get empirical evidence on how each of the phases influence corporate governance.

Although the impact of venture capital on SME has been widely researched, the influence of venture capitalist on corporate governance particularly in venture capital-backed SMEs has not been adequately established in Kenya. Little has been done to establish the significance of venture capital in boosting SMEs for a more inclusive economic growth and expansion through corporate governance. Several researchers have concentrated on the significance of venture capital funding methods on performance (Smolarski & Kut, 2011), Growth (Membe & Karanja, 2012), investment behaviour (Mbhele, 2011) of SMEs. Under such situations, it is academically difficult to make a conclusion on the extent to which venture capital influences corporate governance. It is against this backdrop in empirical evidence on the extent to which venture capital influences corporate governance that this study sought to investigate the influence of venture capital on corporate governance among SMEs in Nairobi.

1.3 Objectives of the Study

This study contains the following general and specific objectives:

1.3.1 General Objective

The general objective of this study is to investigate influence of venture capital on corporate governance among SMEs in Nairobi.

1.3.2 Specific Objectives

The specific objectives of this study are as follows:

1. To determine the influence of investment decision on corporate governance in SMEs in Nairobi.
2. To examine influence of management of the investment on corporate governance in SMEs in Nairobi.
3. To analyse influence of exit of venture capital on corporate governance in SMEs in Nairobi.

1.4 Research Questions

This study sought to answer the following questions?

1. To what extent does investment decision influence corporate governance in SMEs in Nairobi?
2. How does management of the investment influence corporate governance in SMEs in Nairobi?
3. To what extent does exit of venture capital influence corporate governance in SMEs in Nairobi?

1.5 Justification of the Study

Most advanced economies have solved the problem of corporate governance at least reasonably well by assuring the flow of finance to companies and actual financial return on investment back to the financiers. This however does not mean that they have solved the problem perfectly or that the mechanisms cannot be improved. The subject of corporate governance is of enormous practical importance (Shleifer & Vishny, 1997). The Capital Markets Authority (CMA) Corporate Governance blueprint for Kenya states that poor corporate governance hinders economic development by limiting access to, and raising the cost of capital to local enterprises as they struggle with weak internal control systems, poor board and risk management practices, and a culture of low transparency and disclosure.

In view of the requirements and expectations of corporate governance, the need for organizations that adhere to standards, regulations and policies is important for upcoming firms especially SMEs. As most SMEs are start-ups, provision of adequate information to support decision making on sources of financing is therefore significant in ensuring sustainability of the SMEs. Sustainable SMEs therefore important in promoting social and economic development given that SMEs account for the highest percentage of employment opportunities in most developing countries.

1.6 Scope of the Study

There are about 7.41 million SMEs in Kenya out of which 1.56 million are licensed while 5.85 million are unlicensed (Kenya National Bureau of Statistics, 2017). This study therefore focused on licensed SMEs in Nairobi since they are established entities in terms of fulfilling legal requirements such as Articles of Association that provides for finance structure. This study also focused on SMEs and their sources of equity financing more specifically venture capital and its influence on corporate governance. The study selectively examined SMEs financed by venture capitalists to ascertain whether there have been any significant changes in corporate governance and therefore firm value and performance. The study considered SME that use venture capital in Nairobi County.

1.7 Significance of the Study

This study provided empirical evidence of influence of venture capital financing on corporate governance of SMEs in Nairobi, Kenya. This information was used in informing various stakeholders on best corporate governance practices for survival and growth of SMEs especially policy makers, practitioners and SMEs.

The research findings of this study therefore, will be helpful to policy makers especially government in the sense that the recommendations of the study will be used to formulate policies that promote the enhancement of corporate governance by venture capitalists. The government of Kenya will benefit from this study as it contributes to the achievement of the Vision 2030 whose aim is to make Kenya an industrialized middle-income country providing high quality life for all Kenyans by the year 2030. This can only be achieved by developing a strong SME sector since SMEs have been found to be the building blocks of the global economy. In addition, this study will give insights on reducing collapse of SMEs due to financial constraints by developing framework on injecting capital to SMEs.

To practitioners, the findings of this study will enlighten them on the benefits of improving corporate governance through engaging in venture capital. In addition, the findings of the study will provide adequate information to support decision making on whether venture capital is useful in ensuring sustainability of SMEs.

Additionally, the findings of this study will be used by SMEs to gain external financial investments in order to boost their performance. The information generated here will be useful to the SMEs which have not embraced private equity or venture capital financing. Finally, the venture capitalists will use the findings of this study to enhance their role in influencing corporate governance in SMEs thereby improving their growth, firm value and performance. The improvement of corporate governance will include shareholders and managers attending corporate governance courses to acquire knowledge on best practices in corporate governance.

To scholars, this study will provide adequate information for closing the gaps on the influence of venture capital on corporate governance of SMEs. Scholars will benefit from this study by gaining more knowledge on the influence of venture capital on corporate governance among the venture capital financed SMEs. The information generated here will be highly beneficial to the government in the sense that in appreciating the significance of the SMEs in the economy, they will create policies that will enhance the role of venture capitalists in growth and performance of SMEs.

CHAPTER TWO
LITERATURE REVIEW

2.1 Introduction

This chapter describes analysed literature on venture capital and corporate governance. The chapter provides theoretical framework of the study. The chapter also provides empirical evidence on venture capital and corporate governance. It is from the theoretical and empirical analysis that the chapter describes research gaps in third section.

2.2 Theoretical Review

This section reviews the theories that guided the study. In particular, the study adopts the pecking order theory to support corporate governance and modern portfolio theory to support venture capital.

2.2.1 Pecking Order Theory

This study adopts the Pecking Order Theory (POT) by Gordon Donaldson in 1961 and modified by Myers and Majluf (1984). POT is a framework for examining firm financing that states that firms attempt to reduce information asymmetries and maintain ownership by first using internal financing, followed by external debt and equity (Berger & Udell, 2003). POT was originally devised by Donaldson (1961) to examine the financing of large corporations, but it was modified by Myers and Majluf (1984). to apply to small and medium-sized businesses. The "pecking order theory" of financing says that firms and individuals will use personal funds before acquiring external debt and equity.

Traditional finance theories are centred on agency conflicts between shareholders and debt holders. Up until the 1990s, the vast majority of finance studies focused on large corporations and publicly traded companies. Scholars began to realize that small firms, on the other hand, differ considerably from larger firms. Small and medium-sized businesses face different agency and information asymmetry challenges. For example, the firms are not likely to be publicly traded or incorporated, which limits the sources of financing available to them. The firms are not required to share as much information as public companies, hence, remain opaque (Ang, 1991). Financing decisions for small and new ventures may also be more complex because they are closely linked to the personal wealth or contacts of the owner/manager. Consequently, agency problems may be more intense as shareholders and partners are often made up of family and friends (Ang, 1992).

The "pecking order" model of firm financing is one method firms might use to address these agency problems. According to this theory, firms do not aim for a target debt ratio. Instead, firms select from funding sources that minimize the cost of capital (Myers, 1984; Myers and Majluf, 1984). In the case of the small firm or entrepreneur, personal sources are used first, external debt next, followed by outside equity. Equity is acquired last because the entrepreneur presumably has more information than the investor. The presence of significant information asymmetries causes the investor to charge a higher rate of return on equity than on debt (Frank and Goyal, 2003). Indeed, information asymmetry costs may be much higher for small firms than for large, and the pecking order framework may therefore explain a great deal of financing behaviour by entrepreneurs (Scherr, 1993; Hall et al., 2000).

Some researchers validate the view that SME owners/managers financing decisions are consistent with the "pecking order" theory (Sogorb and Lopez-Gracia, 2003; Watson and Wilson, 2002). For instance, Watson and Wilson (2002) suggest that under these circumstances an owner(s)/manager will choose first – a personal source of finance; second – short-term borrowing; third – longer-term debt; and – finally, the least preferred, equity finance which might affect his/her control upon the business.

Sogorb and Lopez-Gracia (2003) also suggest that owners/managers tend not to sufficiently organize their finances in order to obtain an optimal capital structure (i.e. debt versus equity ratio) but prefer financing options that both ensure and maintain their control of a business. Control of the business therefore includes the change of governance structures. This theory will therefore support analysis of the first objective on the extent to which investment decision influence corporate governance in SMEs in Nairobi. The theory supported the analysis of third theory on the extent to which exit of venture capital influence corporate governance in SMEs in Nairobi.

2.2.2 Modern Portfolio Theory

Modern Portfolio Theory (MPT) is a theory developed by Harry Markowitz (1952) is an investment theory based on the idea that risk-averse investors can construct portfolios to optimize or maximize expected return based on a given level of market risk, emphasizing that risk is an inherent part of higher reward. It is one of the most important and influential economic theories dealing with finance and investment (Kaplan and Schoar, 2005).

Also called "portfolio management theory," MPT suggests that it is possible to construct an "efficient frontier" of optimal portfolios, offering the maximum possible expected return for a given level of risk. It suggests that it is not enough to look at the expected risk and return of one particular stock. By investing in more than one stock, an investor can reap the benefits of diversification, particularly a reduction in the riskiness of the portfolio. Venture capitalists play a very important role as financial intermediary bridging the gap between demand and supply of capital by entrepreneurs and investors. MPT on the other hand quantifies the benefits of diversification (Kaplan and Schoar, 2005). The theoretical rationale for investing in an alternative asset class such as private equity is to improve the risk and reward characteristics of an investment portfolio, with the expectation that the asset will offer a higher absolute return whilst improving portfolio diversification (Bodie *et al*, 2005). In comparison with investing in more traditional securities such as public stocks or bonds, however, investing in Private Equity (PE) funds is considered a complex task due to their long-term and illiquid nature, as well as the noticeable lack of transparent and publicly available information pertaining to PE funds (Bygrave & Timmons, 1992). Moreover, there are material variations in performance across PE funds, implying that while PE investing may generate excellent returns, investors could also face large losses (Phalippou and Gottschalg, 2009). Hence, a PE fund investor needs to have the ability to select funds with the potential to deliver attractive returns.

Deeper insights about which investment strategies have proven successful, and, more specifically, about how these strategies may differ across various investor types, seem to be missing from the literature. This is somewhat surprising given the large amounts of capital that private as well as public institutions devote to this particular asset class each year, as a broader understanding about performance determinants could improve investor returns.

The activities of the venture capitalists in this theory point to the stage of decision making in venture capital phases. For example, risk assessment is one the first activities done before making decision on some form of investment. Decisions by the venture capitalists are done in the first stage where venture capitalists assess business risks including corporate governance structures before making investment decision and sometimes negotiate for representation in the board of the start-ups (Broughman & Fried, 2013). In this phase, contracts are designed with a view of achieving "efficient frontier" of optimal portfolios that offer the maximum possible expected return for a given level of risk. This theory therefore supports the analysis of the objective on the extent to which investment decision influence corporate governance in SMEs in Nairobi.

In addition, the activities of the venture capital in this theory are also related to management of the businesses under venture capital support. For example, venture capitalists are expected by this theory to manage the venture capital funds for high levels of return. This activity clearly relates to the second phase in venture capital where venture capitalists utilize most of the time in ensuring that management of investment is favorable to them (Kaplan & Strömberg, 2003). This is evident in continuous monitoring of the performance of the business as well as extent to which the policies and contracts defined in the first phase are enforced. In this regard, the theory supports analysis of the second objective on how management of the investment influence corporate governance in SMEs in Nairobi.

2.3 Empirical Review

This section presents empirical review on venture capital, corporate governance and SMEs. The section also reviews the relationship between venture capital and corporate governance.

2.3.1 Venture Capital Investment Decision and Corporate Governance

Venture capitalists are experts in reducing agency risks. This is demonstrated by the fact that venture capital has a high impact on the level of corporate governance in growth companies. In this regard, agency risk does not play a big role in sourcing possible investment possibilities and making the final investment decision. For example, according to a study conducted by Gompers et. al (2016) based-on survey of the answer of 889 institutional venture capitalists, the most important factor in investment decisions was the quality of the management team followed by business related factors.

In the investment decision phase, the venture capitalist influences the corporate governance of the portfolio company even before the investment is made. In the investment phase the major corporate governance institution is the contractual agreement that venture capitalist makes with the management of the company. The purpose of the contractual agreement is to reduce agency risk in the venture capitalist investment. For a venture capitalist the agency risk can be divided to management risk and competitive risk.

Management risk refers to the managers ability to adopt decisions that are detrimental to the venture capitalist investment. Management risk can be considered as the most important agency risk factor. In empirical studies managerial competence is seen by venture capitalist as the most important factor in the success of the investment (Gompers et al. 2016). Similarly, Kaplan and Strömberg (2003) found that venture capitalist see management as the most important internal risk factor for their investment.

In the contractual agreement venture capitalist limit management risk especially by provision enabling venture capitalist to remove the management team. According to study by Fiet et al. (1995) venture capitalist use extensive boilerplate contractual provision which enables them to replace the entrepreneur in the case of under-performance, incompetence and malfeasance. The contractual agreement also includes provision on the board representation and voting rights which enables the venture capitalist to reduce management risk by enabling the venture capitalist to better monitor the management and make corporate decisions (Kaplan & Strömberg 2003).

Usually new rounds of financing follow a new contractual agreement with the managers and venture capitalist. New rounds of financing typically lead to increase in venture capitalist control rights (Kaplan & Strömberg 2013). The staging of financing can also be considered to be a method of agency risk reduction, since new funding is locked behind the company achieving economic milestones aligning the interest of venture capitalist and the managers of the company. Competitive risk refers to the danger of the managers leaving the company and starting a competing business.

In venture capital competitive risk is important, because growth companies are usually based on innovation which represents a high information asymmetry between investors and managers. The managers ability might also be a vital part of the value of the firm which would decrease dramatically in the event of the managers departure. Venture capitalist can limit competitive risk by contractual provision which makes departure costlier for managers. According to Kaplan & Strömberg (2013) venture capitalist often use contractual provisions that limit the value of the managers share's in the event of early departure or non-compete clauses which prevent the management from starting a competing business within a certain timeframe of the departure. The above-mentioned provisions can also be seen as method of bonding the managers to the company, since the value of the managers shares increase the longer he stays in the company and the more valuable the company becomes while the non-compete clauses effectively narrow the management options in the case of departure.

The empirical evidence on the extent to which venture capital investment decision influences corporate governance reveals that venture capitalists assess the corporate governance structures before making investment decision. The assessment is made to determine the extent to which existing risks can be mitigated. The empirical evidence thus agrees with Modern Portfolio Theory (MPT) that risk-averse investors can construct portfolios to optimize or maximize expected return based on a given level of market risk, emphasizing that risk is an inherent part of higher reward (Kaplan and Schoar, 2005). This indicates that venture capitalists play a very important role as financial intermediary bridging the gap between demand and supply of capital by entrepreneurs and investors.

In this regard, findings of the assessment can compel the firms to review and modify the corporate governance structures before the venture capitalists become part of the firms. At this stage, it is clear that the SMEs also come to that decision as an ultimate source of financing the business. This also agrees with the Pecking Order Theory (POT) that firms attempt to reduce information asymmetries and maintain ownership by first using internal financing, followed by external debt and equity (Berger & Udell, 2003). It is therefore important to note that firms are ready to modify their governance structures as a means of allowing the capital venture to provide funds. However, it may not be possible for all firms to allow venture capitalists modify their governance structures. This implies that some firms may accept while others may not. Based on this argument, it is not clearly documented on how the influence occurs in SMEs is. This study therefore investigated the extent to which venture capital investment decision influences corporate governance before venture capitalists inject the finances into SMEs.

Venture capital is also considered an important force on corporate governance in terms of implementing governance policies. According to a study done in United States of America on how venture capital induces entrepreneurial teams to promote their start-up businesses, Broughman and Fried (2013) established that venture capital investors sometimes negotiate for representation in the board of the start-ups. Also, the venture capital investors negotiate voting agreements at Board level which sometimes override the statutory regulations in Board charter. Ordinarily, voting rights in Board charter stipulates voting rights for Board members, shareholders and other special members. In this regard, interests of venture capital investors therefore should be taken into consideration during decision making.

The study by Broughman and Fried (2013) indicates that venture capital has significant influence on corporate governance. Board composition and policies can therefore be changed to accommodate the interests of venture capital investors. In this regard, the involvement of venture capital investors in the decision making is therefore important in ensuring good corporate governance. However, while the study by Broughman and Fried (2013) focused on start-ups which include SMEs and large firms. The generalisation therefore does not clearly indicate how the SMEs are affected.and therefore the focus on SMEs is necessary. This study therefore focused on the extent to which venture capital influences corporate governance in SMEs in Nairobi.

2.3.2 Management of Investment and Corporate Governance

Management of investment is the second phase of venture capital process. Once the investment decision is made, the goal of the venture capitalist is to unlock the value potential in the firm in preparation for the future exit. A key method venture capitalist use to develop the company in the desired direction is through their representation in the board of directors. In academic studies venture capital has shown to have an effect in both the composition and the working of the board of directors. According to Broughman and Fried (2013) venture capitalist secure their representation in the board of directors by aggressive negotiation which typically leads to deviation from the default rule of “one share one vote”. According to a study by Gombers et al. (2016) the control of the board of directors is also one of the contractual provisions that venture capitalist are the least flexible about. Kaplan and Strömberg (2003) also found that the representation in the board of directors of venture capitalist typically increases with new funding rounds.

In academic research venture capital financing is generally associated with increased board independence. Broughman and Fried (2013) found that in the U.S the most typical composition of the board was such that neither the venture capitalist nor other owners held the majority, but that independent directors held the swing vote. According to Baker and Gombers (2003) venture capital involvement is associated with fewer inside and instrumental directors and more independent outside directors. Similarly, Gabrielsson and Huse (2002) found that venture capital funding was associated with decrease in the dual role of Chief Executive Officer (CEO) as both the CEO and board chairman. Although academic research has found a link between independence of the directors from the company, some authors have questioned whether this independence extends also to the venture capitalist.

Broughman and Fried (2013) suggested that the even though on paper neither venture capitalist or other owners have a majority in the board of directors, in U.S venture capitalist have de facto control of the board because the independent directors or the CEO are not independent from the venture capitalist. Similarly, Van den Berghe and Levrau (2002) found that venture capitalist often controls the board and do not actively try to attract directors that are also independent from the venture capitalist.

The control venture capitalists are able to exert is clearly shown in the tendency of venture capitalist to replace the founder CEO. It has been empirically shown that venture capital financing leads to a replacement of the founder CEO more often than in the case with no venture capital financing (Broughman & Fried, 2013 and Baker & Gompers, 2003). For example, in Broughman and Fried (2013) study of 50 venture capital backed start-ups in Silicon Valley found that after 6 years of operation 63 % of the firms had replaced their founder CEO.

The effect venture capitalists have on the working of the board of directors can mainly be seen by the increased role the board has in strategic decision making. According to Rosenstein et al.

(1993) compared to similar sized firms with no venture capital involvement, the board of directors in venture capital backed firms are more active in formulating the company's strategy. Gombers et al., (2016) also found that venture capitalists are active in strategic formulation.

Venture capitalists use the board of directors also a method to advise the management team. Gombers et al (2016) found that venture capitalists provide the portfolio companies help with customer introduction, operation guidance and hiring decisions. Although academic research has generally shown that venture capitalist participation in strategic decisions and the advisory function bring value to the portfolio companies, Rosentein et al (1993) also found that the ability of venture capitalist have an important impact on how company management perceives the value of venture capitalist involvement. According to the study by Rosenstein et al. (1993) management did not place higher value on the advice of the venture capitalist compared to other advisors unless the venture capital fund belongs in the "top-20" venture capital firms.

In view of the empirical evidence on influence of management of investment by venture capitalists on corporate governance, it is emerging that venture capitalists utilize most of the time in ensuring that management of investment is favorable to them. In this regard, the corporate governance structure and processes are significantly controlled by venture capitalists. However, while the studies provide more insight on the extent to which management investment influences corporate governance, how such influence is manifested in SMEs remains unclear. For example, there could be some SMEs which do not categorise venture capital firms but require the venture capital support including taking significance control of the governance structure. This study therefore investigated the influence of management of investment on corporate governance.

In the United States of America, a study on Venture Capital revealed significant effect of Venture Capital on innovation. According to the study, Dessi and Yin (2010) established that increase in Venture Capital provided adequate funds to support innovation. Similarly, Peneder (2010) found that venture capital improved innovation behaviour and firm growth. In the two studies, there is no clarity on how management of the firms including structures and systems promoted innovation when the funds are made available. As corporate governance involves the level of prudence in organization structures, systems and processes the study by Dessi and Yin (2010) does not elucidate the extent to which innovation was linked to corporate governance. This study will therefore investigate the extent to which Venture Capital influences corporate governance during the venture management phase.

In United States of America, Hochberg (2003) established that venture capital significantly affects governance and monitoring of firms. According to Hochberg (2003), firms with venture-capital financing have more independent boards and committees than do similar non-venture-backed firms, and are less likely to have a dual CEO/chairman. Also, venture capital firms promote adoption of shareholder rights agreements than by non-venture-backed firms (Hochberg, 2003). According to Hochberg (2003), shareholder rights agreements are securities issued to company shareholders entitling them to special rights and privileges if the company becomes the target of a takeover bid. Hochberg (2003) argues that while there are many types of SRAs, and while they vary in their potency, all SRAs increase the power of the board of directors by making non-negotiated takeovers more costly for the bidding firm.

This situation ensures good governance where interests of all stakeholders are considered in decision making and governance structures. The findings by Hochberg (2003) are supported by empirical studies which have explored facets of the beliefs that venture capital promotes good governance through active involvement in close monitoring of the firm activities. For example, Kaplan and Stromberg (2002) document that venture capitalists negotiate complex control rights at the time of their investment and put into place extensive monitoring and advisory systems. The empirical evidence by Kaplan and Stromberg (2002) indicate that venture capitalists help professionalize the firm and influence product market strategies.

However, the study by Kaplan and Stromberg (2002) only focused on newly created public firms. It is worth noting that while venture capitalists also support starting businesses, there is preference to firms that have been in operation and are innovative (Amissah, 2009). The emerging question is about venture capitalists being allowed by SME Board to continuously monitor implementation of venture capital funds for start-up business or businesses in operation. In this case, there is need to investigate the extent to which venture capitalists are engaged firms already established especially in Kenya's SMEs.

In another study on why venture capitalist quality affect corporate governance, Wongsunwai (2007) established that venture capital is a significant determinant of corporate governance. According to Wongsunwai (2007) firms with venture capital investments have larger boards of directors, a higher proportion of independent directors, and a higher likelihood of having a venture capital representative on their board. In addition, influence of venture capital on corporate governance extends to board characteristics and financial reporting quality of companies after they have gone public (Wongsunwai, 2007). In this regard, one important function of corporate governance is to ensure the quality of the financial reporting process hence the need for firms to engage in quality financial reporting. It therefore follows that firms supported by venture capital have expanded boards and provide quality financial reporting. However, this study does not specify whether the firms are SMEs or not. The present study therefore determined whether or not SMEs supported by venture capital have expanded boards that ensure quality financial reporting.

In Australia, decisions made by venture capital financiers required businesses seeking venture capital financing to reduce risks associated with governance risks. According to Siddiqui, Marina and Hossain (2016), one of the conditions for venture capital investment is assurance on the extent to which governance risks are addressed. Governance risks include lack of managerial and financial skills required in managing the venture capital investments. In this regard, findings by Siddiqui et. al. (2016) indicate that corporate governance is improved whenever venture capital considered an important source of financial source for businesses. However, while this study partly describes the influence of venture capital on lifecycles and success of enterprises, corporate governance is not fully explored in the context of SMEs. The emerging question is how venture capitalists are directly involved in management of the businesses they have invested in through seeking and maintaining skills that will be used in reducing financial risks. This study therefore investigated the extent to which venture capital influences corporate governance structures during the implementation of venture capital in SMEs.

In Kenya, a study on role of venture capital on growth of start-up business established that growth of startups was significantly influenced by venture capital. According to Kiprotich (2017), venture capital ensured appropriate management support, technical expertise and monitoring. By focusing on management support, Kiprotich (2017) found that good governance systems were put in place including frameworks to support implementation of strategic plans, communication and involvement of all key stakeholders in decision making or budgeting. The governance frameworks are considered internal controls that are expected to be in place before venture capital financing is in effect. In addition, the internal controls are also part of the requirements that ensure good utilization of the venture capital funds.

The findings by Kiprotich (2017) corroborate the findings by Sahlman (1990) who established that venture capitalists are expected to be involved in corporate governance activities such as monitoring of business operations, hiring and firing management. The involvement of venture capitalists in corporate governance matters ensures sound corporate governance. In addition, venture capitalists ensure that companies they have invested adopt modern corporate governance standards, such as nonexecutive directors, including a representative of the venture capitalist appropriate investment structure as well as the requirement of being an attractive business opportunity (Bygrave and Timmons, 1992). In this situation, the emerging question is about venture capitalists being allowed by owners or Board to develop of policies for implementation of the venture capital funds. This study therefore examined the extent to which management of the investment influences corporate governance through formulation and enforcement of policies aimed at promoting management of the venture capital funds.

In one study related to SMEs, venture capital affected performance of SMEs. According to Memba (2011), employees in firms before venture capital financing were not involved in decision making. However, after venture capital financing was done, majority of the employees were involved in decision making. In this regard, Memba (2011) explains that venture capitalists influence the management of the investees to appreciate and involve all employees on basic decision making. The findings by Memba (2011) concurs with Baker and Gompers (2003) who indicate that a successful management team will possess personality traits such as honesty, determination and capacity to get along with each other including lower level workers. In this study, the empirical evidence indicates that venture capital promotes good governance as employees are involved in management of the firm. This study therefore determined the extent to which management of venture capital ensures employee participation in SMEs in Nairobi.

In a study on analysis of effectiveness of venture capital on growth of SMEs, it was established that venture capitalists promote internal governance structures of firms. According to Wangari, (2013) venture capital not only assists SME in the provision of funds but also in the internal operations of the business especially in policy formulation of SMEs in Nanyuki. In this study, venture capitalists are known to identify risks and gaps that limit operations. In response, the venture capitalists mitigate the risks through installing governance structures and policies. This study therefore clearly indicates that venture capital significantly promotes corporate governance in SMEs.

However, the study was carried in Nanyuki which is a town different from Nairobi in terms of costs of business. The cost of business in Nairobi is relatively higher in Nairobi than in Nanyuki and therefore SMEs in Nairobi would require venture capital more than SMEs in

Nanyuki. This study therefore investigated the extent to which venture capital in terms of management of venture funds influences corporate governance structures among SMEs in Nairobi.

From the reviewed studies, there are indications that venture capital has significant effect on corporate governance. The influence on the Board and in management is an indicator of mitigating risks associated with their interests not represented in the management of the firms. From the perspective risks, the findings of the reviewed studies are in support of the Modern Portfolio Theory (MPT). According to Kaplan and Schoar, (2005), the venture capitalists are concerned more with securing the portfolio investment where they will be actively involved. This is unlike traditional securities such as public stocks or bonds, where role of investors in management is limited (Bygrave & Timmons, 1992). It is therefore important to note that venture capitalists are compelled to ensure that funds invested are utilised effectively so that rewards can be obtained. Phalippou and Gottschalg (2009) established that venture capitalists can face huge losses if they are not involved in management of their funds. This implies that the involvement can take place in form of altering corporate governance structure. How this was evident in Kenya's SMEs remained largely unexplored hence this study.

2.3.3 Exit of Venture Capital and Corporate Governance

At the end of the investment period, the goal of the venture capitalist is to sell the company at a profit. To sell the equity stake in the company, the venture capitalist can sell the shares back to the entrepreneurs (buy back), sell the company to another company interested in the assets (trade sale), selling the shares to financial investors (secondary purchase) and taking the company public through an Initial Public Offering (IPO). In the case the company cannot be sold the only option is liquidation which usually results in total loss of the invested capital (Cumming & MachIntosh, 2003). The research on venture capital is focused on IPO exit, because IPO requires information disclosure and is thus easier to research. Trade sale on the other hand does not require public disclosure of information, which makes it a harder research subject. Despite the emphasis of academic research on IPO exit, trade sales are a more common form of exit than an IPO and financially as important as IPO: s (Broughman & Fried, 2013). For example, in Gombers et al. (2016) study the venture capitalist interviewed reported that IPOs represented only 15 % of the exits while 53 % are through trade sales.

Cash flow rights of venture capitalist are especially important in the exit phase of the investment. In the United States venture capitalist are almost exclusively issued preferred shares for their investments in startups. Preferred shares are convertible to common shares and they carry a liquidation preference over common shareholders. The preferred shares give the venture capitalist an upside and downside protection meaning that as preferred shareholders they have priority over the common shareholders to the company's cash flows up to the liquidation preference while giving the venture capitalist the option to convert the preferred shares to common shares when their share of the company's cash flows as common shareholder would exceed the liquidation preference. In IPO exit the liquidation preference of preferred shares is not as important, since listing a company in the stock market typically requires that the preferred stocks are converted to common before the listing and the venture capitalist exits the investment as a common shareholder (Broughman & Fried, 2013).

In an IPO exit venture capitalist are often assumed to make changes to corporate governance to attract investor interest in the newly listed company. Kleinschmidt (2007) found that in exit preparations venture capitalists often add members to the board of directors who already have experience in board work from listed companies. He also found that venture capitalist backed companies preparing for an IPO follow corporate governance codes significantly more often than other portfolio companies. The author highlights that the possible reasons why venture capitalist initiate changes to corporate governance in IPO preparation might not be to strengthen the monitoring, bonding or advisory function of corporate governance, but to try to maximize the likelihood of a successful IPO. How this is evident in SMEs remained unclear hence the need to investigate the influence of venture capital on corporate governance at the time of venture capitalists exit.

Control rights are important in the exit phase, because the initiation of an IPO or a trade sale usually requires the approval of the board of directors and the approval of the common shareholders. As was stated before, venture capitalist typically has a high representation in the board of directors which enables them in the exit phase which enables them to initiate an IPO or a trade sale. Typically, corporate law always requires some level the approval of the common shareholders to initiate an IPO or a trade sale. The required level of common shareholder approval on the other hand can be different in different jurisdictions. In a trade sale the acquiring company can also require high level of common shareholder approval than the applicable corporate law requires (Broughman & Fried, 2013). In view of these findings, there was need to determine whether exit of venture capital leaves some venture capitalists on the boards of SMEs in Nairobi.

The venture capitalist has numerous ways to get the required approval from both the board of directors and common shareholders. Broughman & Fried 2013 classified these methods as either “carrots” or “sticks” in the context of trade sales. Carrots refer to methods such management bonuses and common shareholder carveouts, that motivate managers and common shareholder to support the exit transaction. Sticks refer to coercive methods that venture capitalist can use to pressure managers and common shareholders to participate in the exit transaction. They found that venture capitalist typically offer benefit to managers and common shareholders to get the required approval for the exit transaction. Coercive methods are less commonly used to convince managers and common shareholders to support the transaction. How this was evident among SMEs in Nairobi remained unclear hence this study.

Venture capital is also linked to corporate governance through expectations of venture capitalists and response of management team. The influence of venture capital on corporate governance is manifested through the need of venture capitalists to monitor the management of the investment. In this regard, there are tendencies of venture capitalists expecting the management team to professionally manage the venture. According to Broughman and Fred (2013), manager may want to retain the firm’s independence, stay in control and fear losing power in the company when the VC first enters the company, and later they may fear future changes such as dismissals resulting in a resistance towards VCs exit plans. How the relationship between venture capitalists and response of management team occurs in SMEs remained unclear. The present study therefore determined whether management team retain their independence or not before venture capitalists exit.

It has also emerged that venture capital does not only promote good corporate governance but can also negatively influence corporate governance. According to Roe (2004), venture capitalist usually demands and receives large stake in the company, becomes a dominant owner and consequently he or she may be able to shift value from smaller shareholders to themselves. This situation becomes a conflict between shareholders and venture capitalists. Regarding this unprecedented situation, Broughman and Fried (2013) assumes incentives for common shareholder resistance for similar reasons. Upon exit venture capitalists tend to have vantage over common shareholders in receiving pay-outs and consequently common shareholders may not receive significant benefits from a trade sale for example. In addition, venture capitalists try to exit their companies soon to realize the capital gains even if some “option value”, potential to increase firm’s value even further and get even a higher price by waiting, still remains in a case of which shareholders remaining in the company would prefer to delay going public.

The findings by Broughman and Fried (2013) and Roe (2004) indicate that venture capitalists destabilize corporate governance structures as well as limit fairness in safeguarding interests of shareholders. How this occurs in SMEs that require effective and sustainable governance structures remains unclear. This study therefore investigated the extent to which venture capital is not beneficial to corporate governance in SMEs in Nairobi, Kenya.

A study on effect of venture capital financing on growth of small and medium-sized enterprises in Kenya revealed that venture capital significantly affected growth of SMEs. According to Njama (2013), venture capital financing increased organizational capacity of SMEs in terms of credit rating of SMEs, marketing, technological advancement and human resource skills. The SMEs therefore recorded significant growth in human, technological and other capital resources. In his analysis, Njama (2013) established that there was significant relationship between growth of SMEs and management expertise. In this study, management expertise involved investment in managerial skills. Njama (2013) argues that as SMEs are resource constrained, increase in Venture Capital supports the SMEs in equipping human and technological resources.

In this regard, venture capital is a source of finance that enable SMEs expand operations, hire qualified staff, develop new products and invest in efficient production facilities. The study by Njama (2013) therefore brings into perspective the extent to which venture capital affects growth of SMEs. However, the study did not include governance in the human resource or management expertise. This study therefore investigated the extent to which venture capital improves capacity of the SMEs after exit of venture capital.

A study on determining the influence of venture capital financing on growth of SMEs in Nairobi revealed that venture capital financing improved corporate image of the SMEs. According to Baraka and Anyieni (2015), first venture capital financiers recorded turnaround, and this was a testimony that SMEs have the potential of growth. In this regard, the turnaround attracted more Venture Capital investors thereby improving corporate image of the SMES. Improvement of corporate image is one of the factors of corporate governance. According to Jeng and Wells (2000), venture capitalists successfully provide the type of corporate governance needed by new SMEs. Venture capitalists provide new business networks to suppliers and customers. In this regard, corporate image that gives assurance to other investors, suppliers and customers always improves due to governance structure changes resulting from involvement by venture capitalists. The role of venture capitalists therefore provides further justification for the SMEs to give priority to venture capital financing thus making it less attractive to consider other traditional sources of financing. To the SMEs, exit of venture capital leaves them with urgency need for more venture capital.

This supports the Pecking Order Theory (POT) that the SMEs after exhausting the initial forms of financing, the firms are left with option of long-term financing including venture capital that mostly affects control of the firms. According to Watson and Wilson (2002), firms which have exhausted personal sources of financing and short-term borrowing give priority to capital venture where the owners do not always have control over the business. How this evident in SMEs after exit of venture capital remained largely unexplored in Kenya hence this study.

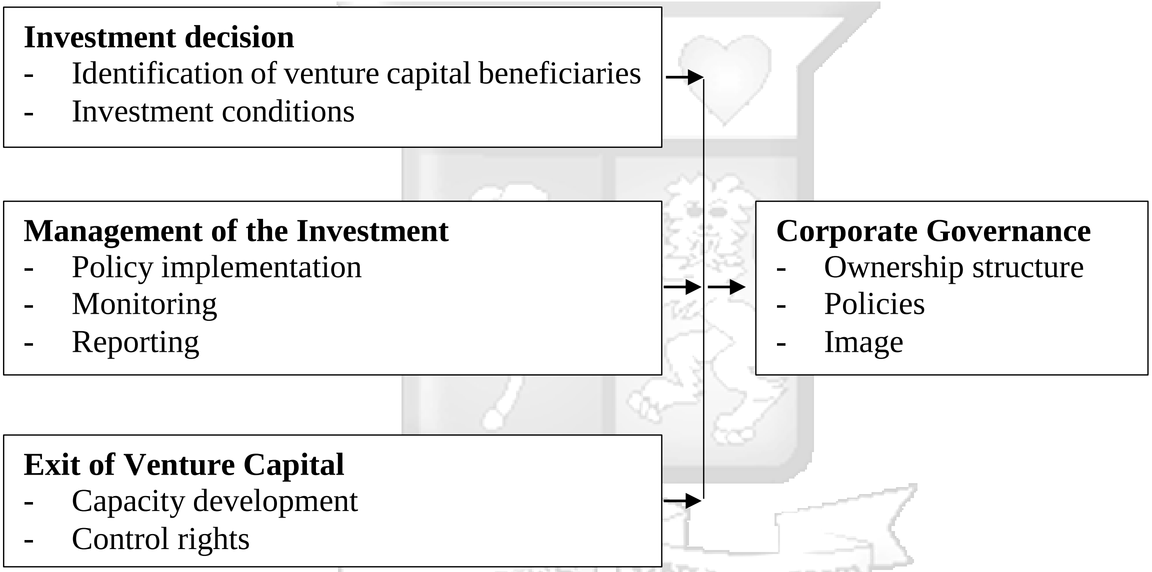
2.4. Research Gap

This study acknowledges that venture capital is significantly related to corporate governance. However, studies indicate that there is less empirical evidence on the extent to which venture capital can be used to promote corporate governance. Most studies have focused on the influence of venture capital on growth of SMEs (Memba, et. al., 2013; Njama, 2013; Kimaiyo, 2016; Dessi & Yin, 2010). Ordinarily, venture capital occurs in three phases (investment decision phase, management of the venture phase and exit phase) (Broughman & Fried, 2013; Gombers et al., 2016; Kaplan & Strömberg, 2003) yet this has not been established in a single study with regard to corporate governance. In this regard, there was need to get empirical evidence on how each of the phases influence corporate governance.

In addition, although the impact of venture capital on SME has been widely researched, the influence of venture capitalist on corporate governance particularly in venture capital-backed SMEs has not been adequately established in Kenya. Little has been done to establish the significance of venture capital in boosting SMEs for a more inclusive economic growth and expansion through corporate governance. Several researchers have concentrated on the significance of venture capital funding methods on performance (Smolarski & Kut, 2011), Growth (Membe & Karanja, 2012), investment behaviour (Mbhele, 2011) of SMEs. Under such situations, it is academically difficult to make a conclusion on the extent to which venture capital influences corporate governance. It is against this backdrop in empirical evidence on the extent to which venture capital influences corporate governance that this study sought to investigate the influence of venture capital on corporate governance among SMEs in Nairobi.

2.5 Conceptual Framework

The following conceptual framework illustrates the relationship between venture capital and corporate governance. The relationship indicates that favourable deal sourcing and investment decision promotes good corporate governance. Also, good management of the investment ensures good corporate governance. In addition, the exit of venture capital where capacity development and control rights were favourable, there is improved corporate governance. In general, the conceptual framework demonstrates the perspective of venture capital and its relation to corporate governance.



Independent variables **Dependent Variable**

Figure 2.2: Conceptual Framework

Source: Researcher, 20192.6 Operationalization of Summary of Variables

Table 2.1 below provides summary of the variables, measurement and operationalisation.

Table 2.1: Operationalization of Summary of Variables

Variable	Operational definition	How it is measured
Dependent Variable		
Corporate governance	- Ownership structure that defines the proportion of shares owned by different shareholders in the SME. - Policies that define the standard operating procedures in the SME. - Image of the SME which is the perception of the public, customers, suppliers and other stakeholders about the SME.	Ordinal 5-point Likert Scale
Independent Variables		
Investment decision	• Identification of venture capital beneficiaries i.e. the SMEs that require venture capital. • Investment conditions i.e. circumstances under which the investment will be done and includes amount, extent of control as well as period in SMEs.	Ordinal 5-point Likert Scale
Management of the investment	• Policy implementation i.e. enforcement of the guidelines and standard operating procedures supporting planning, directing and control of venture capital in SMEs. • Monitoring i.e. regular collection of data on performance of the SMEs supported by venture capital funds. • Reporting i.e. periodical provision of management reports of SME performance supported by venture capital.	Ordinal 5-point Likert Scale
Exit of venture capital	• Capacity development i.e. improvement of financial, human and technical resources of SMEs supported by venture capital funds. • Control rights of venture capitalists in SMEs supported by venture capital funds.	Ordinal 5-point Likert Scale

Source: Researcher, 2019

2.7 Chapter Summary

This chapter presented reviewed literature on theoretical and empirical frameworks. The chapter established that the two theories are relevant to the study by agreeing with empirical findings on extent to which investment decision, management of the investment, exit of venture capital influence corporate governance in SMEs. The chapter also demonstrated that venture capital is significantly related to corporate governance. The reviewed literature indicates that venture capital is one of the major sources of financing to business and firms. There are also indications that SMEs are economic and social units that promote employment and wellbeing of people in developing economies yet the entities are facing numerous challenges related to financial management and corporate governance. In this regard, several interventions including venture capital have been proposed to address the challenges thereby ensure sustainability of the SMEs. However, studies indicate that there is less empirical evidence on the extent to which venture capital can be used to promote corporate governance. The reviewed theoretical and empirical frameworks indicate that there was need to investigate the extent to which venture capital influences corporate governance in SMEs.

CHAPTER THREE
RESEARCH METHODOLOGY

3.1 Introduction

This chapter outlines the methodology and tools used to gather and analyse data. The chapter presents research design, target population, data collection procedure, research instrument and data analysis techniques.

3.2 Research Design

This study employed descriptive survey design. In descriptive survey design, information about characteristics of individuals, groups or situations from large populations is obtained (Kothari, 2004). The characteristics can either be qualitative or quantitative hence this type of research design supports quantitative and qualitative approaches of data collection and analysis. This research design was suitable to this study because it supported collection of quantitative data from a large population of SMEs in Nairobi.

3.3 Population and Sampling

The population of the study was SMEs located in Nairobi's Central Business District (CBD). According to Nairobi City County (2018), there are 96,800 registered SMEs in Nairobi out of which 21,100 are in the CBD. The study therefore targeted 21,100 SMEs who are grouped into 8 main groups. The groups are SMEs in retail trading, hospitality, transport, catering, entertainment, pharmaceuticals, technology and real estate.

A sample size was randomly selected from each category of target population using simple random sampling technique. From a large population, simple random sampling ensures that participants in the study have equal chance of selection. According to Smith and Albaum (2012), suitable sample is selected when there is adequate representation of the target population hence the need for simple random sampling that is scientifically derived. The scientific derivation ensures that selected sample is within the 5% margin of error and at 95% confidence level.

To obtain a suitable sample size, Fisher (2007) sample size formula was used. The formula provides sample size at 95% level of confidence and at 5% level of precision as illustrated below.

$$n = Z^2 pq/d^2$$

Where n=the desired sample size;

Z=standard normal deviation at required confidence level 95% or 1.96;

P= Business owners or directors and senior managers;

q=1-p (the proportion without characteristics);

d=level of statistical significance (degree of freedom=0.05);

Using the formula, the value of P will be calculated first as follows:

$$P = \frac{\text{SME in CBD}}{\text{SME in Nairobi County}}\ x\ 100\%$$

P=0.218

n was therefore calculated as follows:

$n = 1.96^2\ (0.218)\ (0.782)\ /\ (0.05)^2$

n =133 SMEs

From each SME, at least 1 board members or owner and 1 manager was selected. In total, 266 respondents comprising of 133 board members or owners and 133 managers were selected for the study.

3.4 Data Collection Method

Primary data was collected from Board members or owners and managers by use of questionnaires. Board members provided information on deal sourcing and investment decision as well as exit of venture capitalists with regard to corporate governance. Managers were also chosen to provide more information on management of the venture capital with regard to corporate governance. Questionnaires are advantageous because the respondents appropriated time to respond to the questions. The questionnaire contained questions on the extent to which venture capital influences corporate governance. The questions were constructed from the indicators or measures of the independent and dependent variables. In addition, opinion of experts was sought from lecturers and supervisors to ensure content validity.

The distribution of questionnaires first involved identification of the SMEs where official communication was done to the management for consent. Upon receiving the consent, random sampling of the Board members and managers was done to obtain 1 Board member and 1 Manager. The selected Board member and manager were given questionnaire and guided on instructions. This exercise took place in 15 working days with at least 8 SMEs visited per day and 16 respondents administered with questionnaires. The respondents were left with one week for filling.

3.5 Research Quality

The quality of the research was ensured through pilot study that was done to test reliability of the research instruments.

3.5.2 Reliability Test

A test is considered reliable when it measures what it is meant to measure consistently. Reliability refers to soundness dependability and authenticity of the research instrument. It is the measure of the extent to which an instrument of research yields homogenous result of data after repeated trials (Meyers, Gamst & Guarino, 2006). To ensure that the research instruments have high degree of consistency, the researcher used findings of the pilot study to determine the reliability of the instruments. Errors and ambiguities identified in the questionnaire during the pilot phase were corrected. Also, the concerns raised by the respondents were used to improve the administration of the questionnaires.

3.5.2.1 Pilot Study

Pilot study was carried out in 13 SMEs in Upper Hill. Upper Hill is one of the fastest growing business areas in Nairobi. The area has SMEs from which only 13 were randomly selected for the purpose of testing the instruments. The selected respondents were requested to participate in the pilot study as a means of testing the reliability of the questionnaires. Each respondent was administered a questionnaire and results collected after 2 days for analysis. The questionnaires administered to 13 Board members or owners and 13 managers which comprised of 10% of the sample size. The analysed data was used to correct errors and ambiguities identified. Also, the concerns raised by the respondents were used to improve the administration of the questionnaires.

3.5.2.2 Pilot Study Findings

In undertaking the pilot study, the researcher adopted the test-retest technique to test reliability of the questionnaires. After administration of the questionnaires, Cronbach’s test was used to check the reliability of the data collection tool. Cronbach's alpha ranges from r = 0 to 1, with r

= 0.7 or greater is considered as sufficiently reliable (Nunnally & Bernstein, 1994). Cronbach's alpha coefficient was 0.81 which was above the recommended coefficient of 0.7 considered reliable. The questionnaire was considered reliable for the study.

3.5.2.3 Validity Test

To ensure the questionnaires help the researcher to gather the data relevant to the objectives of the study, the researcher sought opinion of the experts in the field of venture capital and corporate governance. The research instrument was availed to the experts and peers, who established its content and constructed validity to ensure that the items were adequately representative of the subject area to be studied. The input from lecturers will be used to improve on the content and construction of the instruments. In addition, a pilot study was done in 2 SMEs that were not part of the main study. The pilot study ensured that the researcher identifies inconsistencies in the questions, incoherence, inadequate spaces for responses and improperly phrased questions. The researcher then corrected the inconsistencies identified and reconstructed the questionnaires for data collection.

3.6 Data Analysis

The questionnaires were checked for completion, sorted and coded. The quantitative responses per objective were entered to Statistical Package for Social Sciences (SPSS) and analysed descriptively to yield frequencies, percentages and means before correlation and regression was done. Responses on corporate governance in terms of ownership structure, policies and image were entered into Statistical Package for Social Science (SPSS), coded and analysed to yield means. Responses on deal sourcing in terms decision making on of venture capital beneficiaries and investment conditions were entered into SPSS, coded and analysed to yield means. Responses on management of the investment in terms of policy implementation, monitoring and reporting were entered into SPSS, coded and analysed to yield means.

Responses on exit of venture capital in terms of capacity development and control rights were entered into SPSS, coded and analysed to yield means. Means obtained in steps 1,2,3,4 were used in correlation between deal sourcing and corporate governance, management of the investment and corporate governance and venture capital and corporate governance. Means obtained in 1,2,3,4 were also used in multiple regression to obtain the influence of independent variables on corporate governance. The quantitative data was presented in frequency Tables.

Inferential statistics were also used to obtain the statistical influence of venture capital on corporate governance by use of ordinal regression analysis.

3.7 Ethical Consideration

Ethical consideration involved acquisition of research permits as well as ensuring privacy and confidentiality of the respondents. First, introduction letter was obtained from Strathmore University. The letter was used to obtain research permit from National Council of Science, Technology and Innovation (NACOSTI). The research permit included introduction letters to participants clearly stating the objectives of this research. The researcher was also transparent to and full disclosure of the findings to the SMEs. A consent letter was also offered to participants and clearly explained to them detailing their rights. The rights include; confidentiality, anonymity or both, right to skip some questions or not even take part at all. The respondents were requested to sign as an indicator of agreeing to participate in the study.

CHAPTER FOUR

DATA ANALYSIS AND INTERPRETATION OF FINDINGS

4.1 Introduction

This chapter presents analysed data on: the extent to which investment decision influence corporate governance in SMEs in Nairobi; how management of the investment influence corporate governance in SMEs in Nairobi; and the extent to which exit of venture capital influence corporate governance in SMEs in Nairobi. From the analysed data, interpretation is also presented as per the objectives of each study.

4.2 Response Rate

The response rate was determined by computing the percentage of successfully filled questionnaires. Out of the 266 administered questionnaires for 133 board members or owners and 133 managers, only 241 were successfully filled and returned. This represented 91% overall response rate which was considered adequate for data analysis. Summary of this information is presented in Table 4.1.

Table 4.1: Questionnaire Response Rate

Respondents	Administered questionnaires	Filled and returned questionnaires	Percentage
Board members/owners	133	114	86%
Managers	133	127	95%
Total	**266**	**241**	**91%**

Source: Researcher, 2019

4.3 Background Information

Background information on industry of the SMEs, type of ownership, number of employees and designation of the respondents was obtained and presented as follows:

4.3.1 Industry the SMEs

Respondents were requested to indicate the industry in which the SMEs belonged. The findings are illustrated in Table 4.2.

Table 4.2: Industry the SMEs

Industry of SMEs	Frequency of SMEs	Percentage of SMEs
Service industry	146	60.6
Manufacturing industry	95	39.4
Total	**241**	**100.0**

Source: Researcher, 2019

Findings in Table 4.2 indicate that majority (60.6%) of SMEs in Nairobi's CBD are in service industry while 39.4% are in manufacturing industry. The findings revealed that the service industry SMEs were providing retail trading in clothing, confectionaries, electronics, fast foods, money transfer and printing. Other SMEs engaged in provision of education and training, transport, banking and large retail chain stores. For manufacturing, the findings revealed that the SMEs had headquarters in the CBD with primary manufacturing services done outside the CBD especially in industrial area. The SMEs engaged in manufacturing of household and industrial equipment, food processing and drug processing. The findings in imply that majority of the SMEs in the CBD especially manufacturing require large capital investment hence the need for venture capital in case raising capital from other sources becomes a challenge.

4.3.2 Type of Ownership

Respondents were requested to provide information on the ownership of the SMEs. The Board members or owners of the SMEs as well as the managers provided their perceptions on the type of ownership of the SMEs. The findings are illustrated in Table 4.2.

Table 4.3: Type of Ownership

Ownership of SMEs	Frequency of SMEs	Percentage of SMEs
Public Limited Company	71	29.5
Partnership	64	26.6
Proprietorship	106	44.0
Total	**241**	**100.0**

Source: Researcher, 2019

Findings in Table 4.3 indicate that most of the SMEs (44%) are owned by sole proprietors followed by partnership (26.6%) and public limited company (29.5%). The findings revealed that most of the SMEs are individually owned and therefore governance structures are not robust compared to SMEs that are under partnership and public limited forms of ownership. The findings imply that venture capitalists will require more guarantees in individual owned SMEs than SMEs that are under partnership and public limited forms of ownership.

4.3.3 Number of Employees

Respondents were requested to provide information with regard to number of employees. The findings are presented in Table 4.4.

Table 4.4: Number of Employees

Number of employees	Frequency	Percentage
Less than 50 employees	129	53.5
50-99 employees	71	29.5
Above 100 employees	41	17.0
Total	**241**	**100.0**

Source: Researcher, 2019

Findings in Table 4.4 indicate that more than half of the SMEs (53.5%) hold less than 50 employees each compared to 29.5% of SMEs that hold between 50-99 employees. At least 17% of the SMEs employed above 100 employees. Number of employees is an indicator on the production processes as more employees implies that the processes are intense hence more employees. Thus, high costs are observed in SMEs with more employees of above 50 which require large capital investment hence the need for venture capital in case production should be maintained under financial constraint conditions.

4.3.4 Designation of the Respondents

Respondents were requested to indicate their designation. The findings are presented in Table 4.5.

Table 4.5: Designation of the Respondent

Designation of the respondent	Frequency	Percentage
Board member	33	13.7
Owner/co-owner	81	33.6
Manager	127	52.7
Total	**241**	**100.0**

Source: Researcher, 2019

Findings in Table 4.5 indicate that majority of the respondents (52.7%) were managers followed by owners (33.6%) and board members (13.7%). The findings revealed that SMEs have management structures comprising of managers, owners who also are part of the management as well as directors. The findings imply that SMEs are having some form of governance structures that support management.

4.4 Corporate Governance

This section presents findings on corporate governance. The respondents were requested to provide their opinion and description on management structure, relationship with stakeholders and governance systems. On the scale of 1-5, mean values of above 2.5 represented good corporate governance structure while mean values of below 2.5 represented weak corporate governance. The findings are illustrated in Table 4.6.

Table 4.6: Corporate Governance

Corporate Governance Indicators	SD	D	N	A	SA	Mean (n=241)
The organisation's ownership structure fulfils interests of all stakeholders or shareholders.	0.0%	0.0%	30.3%	35.3%	34.4%	4.04
The organisation's ownership structure supports the achievement of the strategic objectives.	0.0%	0.0%	34.9%	28.2%	36.9%	4.02
The organisation has never been involved in conflict with stakeholders.	0.0%	0.0%	41.5%	28.2%	30.3%	3.89
The organisation has adequate policies on sources of capital	0.0%	32.0%	36.1%	32.0%	0.0%	3.00
The organisation does not restrict sources of capital	0.0%	32.0%	36.5%	31.5%	0.0%	3.00
The organisation has never been involved in conflicts with regard to succession of Board members or management.	0.0%	32.8%	34.0%	33.2%	0.0%	3.00
The organisation has never been involved in legal cases with regard to failure to fulfil financial obligations.	34.4%	36.5%	29.0%	0.0%	0.0%	1.95
Overall mean	**4.91%**	**19.04%**	**34.61%**	**26.91%**	**14.51%**	**3.27**
Key: SD-Strongly Disagree; D-Disagree; N-Neutral; A-Agree; SA-Strongly Agree						

Source: Researcher, 2019

Findings in Table 4.6 indicate that corporate governance for the SMEs is good. With mean values of 3.27, corporate governance was good. The SMEs had organisation structures that fulfilled interests of all stakeholders and shareholders (mean of 4.04). Also, the SMEs organisation structure supported achievement of strategic objectives (mean of 4.02) as defined in their business and strategic plans. Most of the SMEs were never involved in conflict with stakeholders (mean of 3.89), had adequate policies on raising capital (mean of 3.00). However, with a mean of 1.95, most of the SMEs had legal cases with regard to fulfilling financial obligations such as tax returns and other statutory deductions.

The findings imply that while most of the SMEs have good governance structures, the SMEs are not fully ensuring good governance with regard to compliance with statutory requirements. This situation indicates that the SMEs are financially constrained and therefore require capital injections that will support production for more revenue. The increased revenue will therefore provide profits which can be used to off-set the pending statutory deductions. In this regard, the SMEs have relatively high marginal propensity to seek for venture capital as a strategy for injecting capital that will accelerate revenues.

4.5 Investment Decision and Corporate Governance

This section presents findings of first objective on the extent to which investment decision influences corporate governance in SMEs in Nairobi. The findings presented are on investment decision and influence of the investment decision on corporate governance.

4.5.1 Investment Decision

Respondents were requested to provide information on how venture capitalists make decision to invest in their businesses. On the scale of 1-5, mean values of above 2.5 represented highly informed decisions while mean value of below 2.5 were considered less informed decisions. The findings are illustrated in Table 4.7.

Table 4.7: Investment Decision

Investment decision indicators	**SD**	**D**	**N**	**A**	**SA**	**Mean (n=241)**
Highly innovative SMEs are highly targeted by venture capitalists.	0.0%	0.0%	29.5%	34.4%	36.1%	4.07
SMEs with no restriction on strategic business line (project) to be invested are highly preferred.	0.0%	0.0%	32.0%	36.5%	31.5%	4.00
SMEs with no restriction on amount of venture capital received are highly preferred by venture capitalists.	21.6%	27.8%	22.0%	28.6%	0.0%	2.58
High performing SMEs are highly targeted by venture capitalists.	32.8%	36.9%	30.3%	0.0%	0.0%	1.98
Total	**13.60%**	**16.18%**	**28.45%**	**24.88%**	**16.90%**	**3.16**

Key: SD-Strongly Disagree; D-Disagree; N-Neutral; A-Agree; SA-Strongly Agree

Source: Researcher, 2019

Findings in Table 4.7 indicate that with an overall mean of 3.16, most venture capitalists make highly informed decisions before investing in SMEs. The venture capitalists give priority to highly innovative SMEs (mean of 4.07) followed by SMEs without restriction on projects to be invested (mean of 4.00) and SMEs without restriction on amount of venture capital to be invested (mean of 2.58). However, highly performing SMEs were least considered due to high interests by other financial institutions. In this situation, venture capitalists preferred SMEs that are not highly performing so that decision can be made on projects where high performance can be achieved when venture capital is injected. The findings imply that venture capitalists make informed decisions that are favourable to their business interests.

4.5.2 Influence of Investment Decision on Corporate Governance

Comparison between findings on investment decision and corporate governance was done. Correlation coefficients were obtained to determine the strength of influence of investment decision on corporate governance. The findings are illustrated in the following Table 4.8.

Table 4.8: Influence of Investment Decision on Corporate Governance

		Investment Decision	**Corporate Governance**
Investment Decision	Pearson Correlation	1	.977**
	Sig. (2-tailed)		.000
	N	241	241
Corporate Governance	Pearson Correlation	.977**	1
	Sig. (2-tailed)	.000	
	N	241	241
**. Correlation is significant at the 0.01 level (2-tailed).			

Source: Researcher, 2019

Findings in Table 4.8 indicate that investment decision strongly and significantly influences corporate governance. With a Pearson Correlation Coefficient of .977 significant at the 0.00 level, corporate governance is strongly influenced by the investment decision made by venture capitalists. The findings imply that venture capitalists make final decision on investing in a given SME based on the corporate governance structures in place. In this regard, venture capitalists demand for strengthening of weak of governance structures where SMEs have weak governance structures.

4.6 Management of the Investment and Corporate Governance

This section presents findings of the second objective on how management of the investment influence corporate governance in SMEs in Nairobi. The findings presented are on management of the investment and influence of management of the investment on corporate governance.

4.6.1 Management of the Investment

Board members or owners and managers were requested to provide information on how venture capitalists engage in management of the investment. On the scale of 1-5, mean values of above 2.5 represented high level of participation in management while mean values of below 2.5 represented low level of participation in management. The findings are illustrated in Table 4.9.

Table 4.9: Management of the Investment

Management of investment indicators	SD	D	N	A	SA	Mean (n=241)
Venture capitalists continuously monitor implementation of venture capital funds.	0.0%	0.0%	0.0%	48.5%	51.5%	4.51
Venture capitalists are allowed by owners or Board to develop of policies for implementation of the venture capital funds.	0.0%	0.0%	27.0%	33.6%	39.4%	4.12
Venture capitalists continuously are allowed by owners or Board to monitor implementation of venture capital funds.	0.0%	0.0%	34.9%	33.2%	32.0%	3.97
Venture capitalists are always provided with periodical venture management reports by owners or Board.	0.0%	0.0%	36.1%	33.6%	30.3%	3.94
Venture capitalists require periodical venture management reports.	0.0%	0.0%	38.2%	30.7%	31.1%	3.93
Venture capitalists are involved in development of policies for implementation of the venture capital funds.	36.1%	27.4%	36.5%	0.0%	0.0%	2.00
Overall mean	**6.02%**	**4.57%**	**28.78%**	**29.93%**	**30.72%**	**3.75**

Key: SD-Strongly Disagree; D-Disagree; N-Neutral; A-Agree; SA-Strongly Agree

Source: Researcher, 2019

Findings in Table 4.9 indicate that venture capitalists are actively involved in management of the investment through different activities. With an overall mean of 3.75, the venture capitalists have high level of participation in management of the investment. The high level of participation is observed in monitoring (mean of 4.51), policy and implementation support (mean of 4.12) and reporting (mean of 3.93). However, venture capitalists are less involved in development of policies for implementation of the venture capital funds (mean of 2.00). The findings imply that the involvement of the venture capitalists follows an acceptance of the owners of the business for venture capitalists to highly participate in management of the venture investment. In addition, the involvement of the venture capitalists in management of the investment is purposive.

4.6.2 Influence of Management of the Investment on Corporate Governance

Comparison between findings on management of investment and corporate governance was done. Correlation coefficients were obtained to determine the strength of influence of management of investment on corporate governance. The findings are illustrated in the following Table 4.10.

Table 4.10: Influence of Management of the Investment on Corporate Governance

		Corporate Governance	**Management of Investment**
Corporate Governance	Pearson Correlation	1	.973**
	Sig. (2-tailed)		.000
	N	241	241
Management of Investment	Pearson Correlation	.973**	1
	Sig. (2-tailed)	.000	
	N	241	241
**. Correlation is significant at the 0.01 level (2-tailed).			

Source: Researcher, 2019

Findings in Table 4.10 indicate that management of investment strongly and significantly influences corporate governance. With a Pearson Correlation Coefficient of .973 significant at the 0.01 level, corporate governance is strongly influenced by the management of investment by venture capitalists. The findings imply that venture capitalists participate highly in management of the investments. In this regard, venture capitalists expect owners of the SMEs to allow them to get involved in monitoring, policy and implementation support and reporting. The involvement therefore has direct implication on the existing corporate governance structure. The involvement gives them special place in the SMEs therefore becoming quasi-management entities.

4.7 Exit of Venture Capital and Corporate Governance

This section presents findings of the third objective about the extent to which exit of venture capital influence corporate governance in SMEs in Nairobi. The findings are presented on exit of venture capital and influence of venture capital on corporate governance.

4.7.1 Exit of Venture Capital

Respondents were requested to their experiences on tendencies of venture capitalists when they exit businesses invested in. On the scale of 1-5, mean values of above 2.5 represented high tendencies of SMEs leaving impact after exit while mean values of below 2.5 represented low tendencies of SMEs leaving impact after exit. The findings are illustrated in Table 4.11.

Table 4.11: Exit of Venture Capital

Exit of venture indicators	SD	D	N	A	SA	Mean (n=241)
Venture capitalists aspired to develop capacity of the organisation at the exit of their investment.	0.0%	0.0%	31.5%	36.1%	32.4%	4.01
Organisations allowed and appreciated venture capitalists to develop capacity of the organisation as the contract comes to an end.	0.0%	31.1%	34.4%	34.4%	0.0%	3.03
Venture capitalists aspired to have control rights to be applied after venture capital contract comes to an end.	0.0%	32.8%	32.8%	34.4%	0.0%	3.02
Owners/Board allowed venture capitalists to have control rights of the organisation after venture capital contract comes to an end.	37.8%	33.6%	28.6%	0.0%	0.0%	1.91
Overall mean	**9.45%**	**24.38%**	**31.83%**	**26.23%**	**8.10%**	**2.99**

Key: SD-Strongly Disagree; D-Disagree; N-Neutral; A-Agree; SA-Strongly Agree

Source: Researcher, 2019

The findings in Table 4.11 indicate that exit of venture capitalists lenders is always impactful to the SMEs. With an overall mean of 2.99, the venture capitalists work towards creating impact on SMEs. This is most observed when capitalists always aspire to develop capacity of the organisation (mean of 4.01) and have control rights (mean of 3.02) at the exit of their investment. The aspirations of the venture capitalists are actualised when the owners of the SMEs allow and appreciate venture capitalists to develop capacity (mean of 3.03). However, owners of the SMEs do not fully allow (mean of 1.91) venture capitalists to have control rights of the organisation after venture capital contract comes to an end. The findings imply that after the exit of venture capitalists, SMEs are left with improved systems, operations and structures. However, there is limitation where SME owners do not fully allow venture capitalists to take control of the firms after their exit.

4.7.2 Influence of Exit of Venture Capital on Corporate Governance

Comparison between findings about exit of venture capitalists and corporate governance was done. Correlation coefficients were obtained to determine the strength of influence of exist of venture capitalists on corporate governance. The findings are illustrated in the following Table 4.12.

Table 4.12: Influence of Exit of Venture Capital on Corporate Governance

		Corporate Governance	Exit of Venture Capital
Corporate Governance	Pearson Correlation	1	.970**
	Sig. (2-tailed)		.000
	N	241	241
Exit of Venture Capital	Pearson Correlation	.970**	1
	Sig. (2-tailed)	.000	
	N	241	241
**. Correlation is significant at the 0.01 level (2-tailed).			

Source: Researcher, 2019

Findings in Table 4.12 indicate that exit of venture capital strongly and significantly influences corporate governance. With a Pearson Correlation Coefficient of .970 significant at the 0.01 level, corporate governance is strongly influenced by the exit of venture capitalists. The findings imply that interests of the venture capitalists after exit is to ensure that the SMEs remain sustainable.

4.8 Joint Influence of Venture Capital on Corporate Governance

In this section, inferential statistics were done to present joint influence of venture capital on corporate governance. Multiple regression analysis was done, and the findings are presented on form of model summary and distribution of coefficients.

4.8.1 Model Summary

Analysis of the model fit was done, and findings presented in Table 4.13.

Table 4.13: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.984[a]	.968	.968	.05539
a. Predictors: (Constant), Exit of Venture Capital, Investment Decision, Management of Investment				
				Source: Researcher, 2019

In Table 4.13, the findings indicate that with R-square value of .968, investment decisions, management of investment and exit of venture capital contribute 96.8% of the change in corporate governance. The findings imply that venture capital causes large change in the corporate governance structure, processes and system.

4.8.2 Distribution of Coefficients

Analysis of the distribution of coefficients was done to determine the relationship between the independent variables and their influence on corporate governance. The influence is represented by Beta coefficients/weights which show the relative importance of independent variable in both standardized and unstandardized terms.

Table 4.14: Distribution of coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.703	.093		7.527	.000
	Investment Decision	.281	.042	.405	6.672	.000
	Management of Investment	.238	.059	.244	4.008	.000
	Exit of Venture Capital	.264	.035	.346	7.595	.000
a. Dependent Variable: Corporate Governance						

Source: Researcher, 2019

Findings in Table 4.14 indicate positive relationship between all variables and corporate governance: Investment decision value (β = .281, t = 6.672); Management of investment value (β =.238, t = 4.008); Exit of venture capital value (β = .264, t =7.595). Furthermore, the significance levels were analysed and as shown in the table, all the variables had a significant relationship with corporate governance where $P<0.05$). Overall, the consistency of regression coefficients on the predictors in the model suggest that these variables are important factors influencing corporate governance but at varying degrees.

CHAPTER FIVE

DISCUSSION, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter presents summary of findings, conclusion and recommendations of the study.

5.2 Discussion of Findings

The summary of findings provides answers to the research questions. The first research question was to what extent does investment decision influence corporate governance in SMEs in Nairobi? The second research question was how does management of the investment influence corporate governance in SMEs in Nairobi? The third research question is to what extent does exit of venture capital influence corporate governance in SMEs in Nairobi?

5.2.1 Influence of Investment Decision on Corporate Governance

This study sought to answer the question on what extent does investment decision influence corporate governance in SMEs in Nairobi? The study established that investment decision strongly and significantly influences corporate governance. With a Pearson Correlation Coefficient of .977 significant at the 0.01 level, corporate governance is strongly influenced by the investment decision made by venture capitalists. The findings implied that venture capitalists make final decision on investing in a given SME based on the corporate governance structures in place. In this regard, venture capitalists demand for strengthening of weak of governance structures where SMEs have weak governance structures.

The findings are in agreement with other studies that established that venture capitalists assess the corporate governance structures before making investment decision. In particular, the findings of this study corroborate findings by Kaplan and Schoar (2005) who established that one of the preconditions for investment is the review and modification of the corporate governance structures before the venture capitalists become part of the firms. In addition, findings of this study are in concurrence with Broughman and Fried (2013) who established that venture capital investors sometimes negotiate for representation in the board of the start-ups.

At the decision-making stage for the venture capital investment, it is clear that the SMEs also come to that decision as an ultimate source of financing the business. This also agrees with the Pecking Order Theory (POT) as opined by Berger and Udell (2003) that firms attempt to reduce information asymmetries and maintain ownership by first using internal financing, followed by external debt and equity. In this regard, the involvement of venture capital investors in the decision making is therefore important in ensuring good corporate governance.

In addition, the findings agree with the Pecking Order Theory that firms attempt to reduce information asymmetries and maintain ownership by first using internal financing, followed by external debt and equity. In this regard, the involvement of venture capital investors in the decision making is therefore important in ensuring good corporate governance.

5.2.2 Influence of Management of Investment on Corporate Governance

This study sought to provide answers to the second research question about how management of the investment influence corporate governance in SMEs in Nairobi. The study established that management of investment strongly and significantly influences corporate governance. With a Pearson Correlation Coefficient of .973 significant at the 0.01 level, corporate governance is strongly influenced by the management of investment by venture capitalists. The findings implied that venture capitalists participate highly in management of the investments. In this regard, venture capitalists expect owners of the SMEs to allow them to get involved in monitoring, policy and implementation support and reporting. The involvement therefore has direct implication on the existing corporate governance structure. The involvement gives them special place in the SMEs therefore becoming quasi-management entities.

The findings of this study on influence of management of venture capital on corporate governance are supported by that venture capitalists have high level of participation in the management. The venture capitalists obtain special seats in the Board and lobby for the improvement of governance policies that ensure their interests are catered for. Gombers et al., (2016) also found that venture capitalists are active in strategic formulation which agrees with findings of this study that venture capitalists engage in policy formulation. Also, venture capitalists engage in monitoring of the projects they have invested (Hochberg, 2003) and this is in agreement with the findings of this study that venture capitalists monitor progress of the investment. Also, Kaplan and Stromberg (2002) document that venture capitalists negotiate complex control rights at the time of their investment and put into place extensive monitoring and advisory systems hence help professionalize the firm and influence product market strategies.

With regards to reporting, the findings of this study are in concurrence with Wongsunwai (2007) and Kiprotich (2017) who established that influence of venture capital on corporate governance extends to board characteristics and financial reporting quality of companies after they have gone public. In this regard, one important function of corporate governance is to ensure the quality of the financial reporting process hence the need for firms to engage in quality financial reporting.

The findings of this study as supported by other similar empirical studies fit the description of the Modern Portfolio Theory (MPT) that venture capitalists who are investors develop strategies that safeguard the investment. The safeguarding of the investment in this case involve engagement in managing investment. The theory is based on the idea that risk-averse investors can construct portfolios to optimize or maximize expected return based on a given level of market risk, emphasizing that risk is an inherent part of higher reward.

5.2.3 Influence of Exit of Venture Capital on Corporate Governance

This study sought to provide answers on the third research question about extent does exit of venture capital influence corporate governance in SMEs in Nairobi. The study established that exit of venture capital strongly and significantly influences corporate governance. With a Pearson Correlation Coefficient of .970 significant at the 0.01 level, corporate governance is strongly influenced by the exit of venture capitalists. The findings implied that interests of the venture capitalists after exit is to ensure that the SMEs remain sustainable.

The findings of this study agree with other empirical findings that exit of venture capitalists influence corporate governance. Kleinschmidt (2007) found that in exit preparations venture capitalists often add members to the board of directors who already have experience in board work from listed companies. The findings by Kleinschmidt (2007) are in agreement with this study findings that venture capitalists always aspire to have control rights to be applied after venture capital contract comes to an end. Also, with regard to capacity building of the SMEs as established in this study, Kleinschmidt (2007) established that venture capitalist backed companies preparing for an IPO follow corporate governance codes significantly more often than other portfolio companies. This is similar to Njama (2013) Venture Capital supports the SMEs in equipping human and technological resources.

This study also established that SME owners do not easily allow venture capitalists to have control rights of the organisation after venture capital contract comes to an end. This finding is similar to Roe (2004) who established that when venture capitalists demand shares in the SME at their exit, the situation brings conflict. Regarding this unprecedented situation, Broughman and Fried (2013) assumes incentives for common shareholder resistance for similar reasons.

The findings of this study on influence of exit of venture capitalists as supported by other similar studies fit in the Pecking Order Theory. The theory indicates that firms which have exhausted personal sources of financing and short-term borrowing give priority to capital venture where the owners do not always have control over the business. However, the study does not entirely agree with the theory that venture capitalists take control of the business after the venture capitalists exit since the SME owners do not give in easily into the demands of the venture capitalists.

5.2.4 Joint Influence of Venture Capital on Corporate Governance

The joint influence of the venture capital on corporate governance revealed that with R-square value of .968, investment decisions, management of investment and exit of venture capital contribute 96.8% of the change in corporate governance. The findings imply that venture capital causes large change in the corporate governance structure, processes and system.

The findings also indicate positive relationship between all variables and corporate governance: Investment decision value (β = .281, t = 6.672); Management of investment value (β =.238, t = 4.008); Exit of venture capital value (β = .264, t =7.595). Furthermore, the significance levels were analysed and as shown in the table, all the variables had a significant relationship with corporate governance where $P<0.05$). Overall, the consistency of regression coefficients on the predictors in the model suggest that these variables are important factors influencing corporate governance but at varying degrees

The findings on joint influence of the venture capital on corporate governance indicate that venture capital significantly influence corporate governance. This is well supported by empirical studies where venture capitalists assess the corporate governance structures before making investment decision (Kaplan & Schoar 2005; Broughman & Fried, 2013; Berger & Udell, 2003). Also, management of the investment is a predictor of corporate governance as indicated by Gombers et al., (2016); Hochberg, (2003); Kaplan and Stromberg (2002); Wongsunwai (2007) and Kiprotich (2017). In addition, exit of capital venture is also predictor of corporate governance in SMEs as indicated by Kleinschmidt (2007); Broughman and Fried (2013); Roe (2004). This study thus confirms that venture capital is significantly related to corporate governance.

5.3 Conclusion

This study concludes that SMEs in Nairobi are ready to modify their governance structures as a means of allowing the venture capital firms to provide funds. Also, venture capitalists utilize most of the time in ensuring that management of investment is favourable to them. In this regard, the corporate governance structure and processes are significantly controlled by venture capitalists. In addition, venture capitalists often build capacity by equipping human and technological resources. However, SMEs resist the takeover of the firms by the venture capitalists as a means of protecting their interests. Therefore, investment decision, management of the investment and exit of the venture capital jointly, separately and significantly influence corporate governance.

5.4 Recommendations

This study recommends:

1. Venture capitalists and SMEs owners interested in venture capital should develop clear frameworks that ensure interests of all parties are considered and respected. This will ensure that investment decisions are entrenched in a clear framework that will ensure collaboration and partnership.
2. SME owners should allow venture capitalists to participate in management of the of the firms after exit of the capital venture. There is need for Memorandum of Understanding on the extent to which venture capitalists can remain reserves and reliable alternatives of capital injection. This will address the issue of uncertainty around control of the SMEs after exit of venture capitalists.

5.4 Study Limitations and Recommendations for Further Studies

In this study, perceptions and experiences of venture capitalists were not obtained on the extent to which venture capital influences corporate governance. This study therefore proposes for another study that will include venture capitalists as part of the target and sample population.

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APPENDICES

Appendix 1: Letter of Introduction

I Maria Maali, a student at Strathmore University is undertaking Master of Business Administration is undertaking a study on influence of venture capital on corporate governance of SMEs in Nairobi. The study seeks to determine whether corporate governance of SMEs is significantly influenced by aspects of venture capital that include deal making, management of the venture and exit of venture capitalists. This study will support SMEs in making decisions related to finance sourcing and corporate governance.

You are therefore requested to participate in this study by proving your responses in this questionnaire. Note that participation is voluntary, and your identity will not be revealed. Also, the study is restricted for academic purposes. Your participation is highly appreciated.

Appendix 2: Questionnaire

QUESTIONNAIRE

Section A: Background Information

1. Name of organisation ____

2. Industry:

   Service [ ] Manufacturing [ ] Other (please specify) [ ]

3. Type:

   Public Limited Company [ ] Partnership [ ] Proprietorship [ ]

4. Number of employees:

   Less than 50 [ ] 50-99 [ ] Above 100 [ ]

5. Designation:

   Board Member [ ] Owner/co-owner [ ] Manager [ ]

Section B: Investment Decision

6. On the scale of 1-5 where 1=Strongly Disagree; 2=Disagree; 3=Neutral; 4=Agree; 5=Strongly Agree, please provide responses to the following statements

Statement	**1**	**2**	**3**	**4**	**5**
High performing SMEs are highly targeted by venture capitalists.	[ ]	[ ]	[ ]	[ ]	[ ]
Highly innovative SMEs are highly targeted by venture capitalists.	[ ]	[ ]	[ ]	[ ]	[ ]
SMEs with no restriction on amount of venture capital received are highly preferred by venture capitalists.	[ ]	[ ]	[ ]	[ ]	[ ]
SMEs with no restriction on strategic business line (project) to be invested are highly preferred.	[ ]	[ ]	[ ]	[ ]	[ ]

7. Give other information that supports the statements above

   ____

   ____

   ____

Section C: Management of the Investment

8. On the scale of 1-5 where 1=Strongly Disagree; 2=Disagree; 3=Neutral; 4=Agree; 5=Strongly Agree, please provide responses to the following statements

Statement	**1**	**2**	**3**	**4**	**5**
Venture capitalists are involved in development of policies for implementation of the venture capital funds.	[ ]	[ ]	[ ]	[ ]	[ ]
Venture capitalists are allowed by owners or Board to develop of policies for implementation of the venture capital funds.	[ ]	[ ]	[ ]	[ ]	[ ]
Venture capitalists continuously monitor implementation of venture capital funds.	[ ]	[ ]	[ ]	[ ]	[ ]
Venture capitalists continuously are allowed by owners or Board to monitor implementation of venture capital funds.	[ ]	[ ]	[ ]	[ ]	[ ]
Venture capitalists require periodical venture management reports.	[ ]	[ ]	[ ]	[ ]	[ ]
Venture capitalists are always provided with periodical venture management reports by owners or Board.	[ ]	[ ]	[ ]	[ ]	[ ]

9. Give other information that supports the statements above

____

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Section D: Exit of Venture Capital

10. On the scale of 1-5 where 1=Strongly Disagree; 2=Disagree; 3=Neutral; 4=Agree; 5=Strongly Agree, please provide responses to the following statements.

Statement	**1**	**2**	**3**	**4**	**5**
Venture capitalists always aspire to develop capacity of the organisation at the exit of their investment.	[ ]	[ ]	[ ]	[ ]	[ ]
Organisations allows and appreciate venture capitalists to develop capacity of the organisation as the contract comes to an end.	[ ]	[ ]	[ ]	[ ]	[ ]
Venture capitalists always aspire to have control rights to be applied after venture capital contract comes to an end.	[ ]	[ ]	[ ]	[ ]	[ ]
Owners/Board allow venture capitalists to have control rights of the organisation after venture capital contract comes to an end.	[ ]	[ ]	[ ]	[ ]	[ ]

11. Give other information that supports the statements above

____

____

____

Section E: Corporate Governance

12. On the scale of 1-5 where 1=Strongly Disagree; 2=Disagree; 3=Neutral; 4=Agree; 5=Strongly Agree, please provide responses to the following statements

Statement	**1**	**2**	**3**	**4**	**5**
The organisation's ownership structure fulfils interests of all stakeholders or shareholders.	[ ]	[ ]	[ ]	[ ]	[ ]
The organisation's ownership structure supports the achievement of the strategic objectives.	[ ]	[ ]	[ ]	[ ]	[ ]
The organisation has adequate policies on sources of capital	[ ]	[ ]	[ ]	[ ]	[ ]
The organisation does not restrict sources of capital	[ ]	[ ]	[ ]	[ ]	[ ]
The organisation has never been involved in legal cases with regard to failure to fulfil financial obligations.	[ ]	[ ]	[ ]	[ ]	[ ]
The organisation has never been involved in conflicts with regard to succession of Board members or management.	[ ]	[ ]	[ ]	[ ]	[ ]
The organisation has never been involved in conflict with stakeholders.	[ ]	[ ]	[ ]	[ ]	[ ]

13. Give other information that supports the statements above

____

____

____

END

THANK YOU