TYPE OF VENTURE CAPITAL INVESTMENT, VENTURE CAPITAL CONTROL AND FINANCIAL GROWTH OF FUNDED SMALL AND MEDIUM ENTERPRISES IN NAIROBI CITY COUNTY, KENYA

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ABSTRACT

Global venture capital industry expansion has boosted entrepreneurship and innovation, leading to the generation of wealth and jobs in a number of countries. SMEs play a crucial role in socioeconomic development by promoting wealth generation, economic growth, and job creation in their individual economies. These SMEs nevertheless have uneven and restricted access to sustainable finance, which is essential to their survival and expansion, despite their prominence and importance in developing countries such as Kenya. This study aimed to examine how type of venture capital investment and venture capital control affect the financial growth of selected SMEs in Nairobi County, Kenya. Both a descriptive research design and quantitative research methods were applied. The target population for the analysis consisted of 139 SMEs that have received venture capital funding. Data was analyzed using descriptive and inferential statistics. Results indicated that type of venture capital investment had a positive and significant effect on SMEs' financial growth. SMEs' financial growth was positively, but not significantly, impacted by venture capital control. The study concluded that venture capital control had a positive but insignificant effect on SMEs' financial growth. The study recommended that entrepreneurs should consider a diverse syndicate of venture capitalists. This is key for improved risk management, survival rate, access to more strategic collaboration and attraction to resources and expertise. In addition, the study recommended that entrepreneurs should review the venture capitalists' level of control in the business. This would help to mitigate negative impact resulting from venture capital-imposed restrictions on managerial autonomy.

Keywords: Type of Venture Capital Investment, Venture Capital Control, Financial Growth, Funded Small and Medium Enterprises.

INTRODUCTION

Venture capital investment can be a useful instrument for fostering the expansion and development of small and medium-sized enterprises (SMEs), especially in low-income nations (Brixiova & Kangoye, 2019). The authors went on to say that venture capital financing can give SMEs access to management know-how and strategic direction in addition to financial resources, which can assist them overcome the difficulties of doing business in a setting that is changing quickly. According to Biney (2018), venture capitalists provide access to professional managerial expertise and strategic support for entrepreneurs looking to finance the development of fresh concepts. Because venture capital financing greatly benefits entrepreneurs, its presence in emerging nations greatly enhances their economic growth (Kato, 2021). SMEs have a major impact on employment opportunities, innovation, and a nation's GDP (Gross Domestic Product) (Colombo & Murtinu, 2017). In developing countries, SMEs act as catalysts for economic enhancement (Gbandi & Amissah, 2014). Moreover, SMEs also contribute to the development of local communities, particularly in rural areas, by creating opportunities for income generation, improving the standard of living, and reducing poverty (Fiseha & Oyelana, 2015).

Syndicated and non-syndicated investments may have varying impacts on SMEs' financial growth (Tykvová & Walz, 2020). Syndicated investments involve multiple VC firms collaborating to fund a venture, while non-syndicated investments involve a single VC firm providing the funding (Gompers & Lerner, 2004). A syndicate with a large number of members can actually accelerate growth by contributing more diverse resources to support the success of the backed businesses in the portfolio. However, coordination costs increase as well and may lead to inefficiency in directing the funded enterprises (Kim & Park, 2021).

Venture capital control, which refers to the level of control and decision-making power exercised by the VC firm, can influence the strategic direction and operational decisions of the invested SME, thereby affecting its financial growth (Kato & Tsoka, 2020). Entrepreneurs and venture capitalists are set up such that the entrepreneurs can keep control rights if the business is operating well and give them up to the VCs if it is underperforming (Mwendwa, Gatauwa & Mungai, 2024). Various elements, including board representation, contractual terms, and governance frameworks, might influence the level of VC control (Njagi, 2017). The presence of venture capitalists or their representatives on the boards of funded businesses can be quite advantageous and help to minimize agency issues (Amornsiripanitch et.al., 2019). The rivalry and tension between business owners and financiers, however, could eclipse any potential advantages (Spenzia et al., 2002). Therefore, to achieve favorable returns and growth for the venture, it is imperative to obtain the proper mix of ownership and board representation that addresses the agency problem and supports the endeavor without causing conflict (Biney, 2018). Venture capital finance has a positive contribution compared to other sources of finance since the venture capitalist has substantial experience and knowledge that can be provided to the young and growing companies (Kato & Tsoka, 2020).

Statement of the problem

Due to their ability to generate income, economic expansion, and jobs within their individual economies, SMEs are essential to socioeconomic development (OECD, 2017). Even though these SMEs are prevalent and significant in developing nations like Kenya, they nevertheless have limited and uneven access to sustainable finance for their survival and expansion (Kato, 2021). Due in large part to their small size, scarce resources, perceived risk, and opaque operations, SMEs have difficulty obtaining financing (Harvie et al., 2013). This has led to a failure rate for SMEs in the country within three years of establishment to be around 70% (Douglas et.al, 2017). If this problem is not solved, many SMEs would close down, there would be increase in job loss and the GDP of Kenya would decrease (Wambui, 2023).

Venture capital is necessary to bridge the funding mismatch and encourage the growth of SMEs in Kenya and other African countries (Sofia, 2022). This significant contribution of venture capital financing on SMEs has attracted intensive interest from researchers around the world (Apuoyo, 2020). Though, several past studies carried out have shown mixed results. According to certain studies (Gompers & Lerner, 2001; Kanniainen & Keuschnigg, 2003; Kato & Tsoka, 2020; Lerner & Nanda, 2020), venture capital financing promotes the expansion and survival of SMEs. Nevertheless, other research has uncovered that the impact of venture capital financing on the expansion of SMEs is contingent upon the specifics of the venture funding (Biney, 2018).

Moreover, some scholars contend that because venture capital investors are opportunistic, the existence of venture capital in businesses eventually reduces the value of those businesses (Katti & Raithatha, 2020). A limited number of investigations have been conducted in Kenya. Memba et al. (2012) conducted an investigation into the influence of venture capital on the growth of small and medium-sized enterprises (SMEs) in Kenya and discovered that the funding was beneficial. Peter and Anyieni (2015) investigated the impact of venture capital financing on the growth of micro, small, and medium-sized enterprises (MSMEs) in Kenya. They discovered that enterprises with venture backing had rapid growth as a result of enhanced brand recognition. A study by Muchira et al. (2019) examined the association between venture capital availability and firm features and entrepreneurs, and they discovered a strong correlation. However, there still lack research that has focused of venture capital specifics. In particular, the study examined how type of venture capital investment and venture capital control affect the financial growth of selected SMEs in Nairobi County, Kenya.

Objectives of the Study

i. To investigate how type of venture capital investment affects the financial growth of SMEs in Kenya
ii. To determine the effect of venture capital control on the financial growth of SMEs in Kenya

Research Hypotheses

$H0_1$: Type of venture capital investment does not significantly affect the SMEs' financial growth.
$H0_2$: Venture capital control does not significantly affect the SMEs' financial growth.

Significance of the Study

The study has substantial implications for multiple stakeholders; including policymakers, venture capitalists, entrepreneurs, and researchers. For policymakers, it may provide them with a better understanding of the role of venture capital financing in promoting the growth and success of SMEs in Kenya. Policymakers can then use the findings to create policies that promote venture capital investment in the country and to design regulations that ensure proper governance and accountability of venture capital funds. The study may be beneficial to venture capitalists by providing insights into the factors that contribute to successful outcomes in VC financing. The outcomes can help VC to make informed investment decisions and adopt best practices in their investment processes, thereby increasing the likelihood of success. For entrepreneurs and SMEs who are seeking venture capital financing for their businesses, the study may provide insights into the factors that attract venture capitalists when making investment decisions, allowing entrepreneurs to better position their businesses for venture capital investment. For researchers, the study might offer empirical data on the connection between SME financial growth and venture capital financing strategies in the Kenyan environment. This would contribute to the limited body of literature in this field and function as a framework for future research.

LITERATURE REVIEW

Theoretical Review

Agency Theory

Jensen and Meckling (1976) proposed this theory. According to the notion, when one party, the agent, represents the other, the principal, in a specific area of contractual negotiations or decision-making, there is an agency connection between two or more parties. According to the hypothesis, when the principal possesses the knowledge necessary to confirm the agent's conduct, the agent is more likely to behave in best interests of the principals. According to Memba et al. (2012), the theory aims to explain the interaction that exists between venture capitalists and SMEs, which in turn explains the relationships between investors and entrepreneurs. The funded SME entrepreneur is the agency and the venture capitalist is the principal in venture capital financing (Biney, 2018). The entrepreneurs and the venture capitalists operating rationally may not have sufficient common goal incentives therefore inducing an opportunistic dysfunctional behavior that creates an agency problem. According to Apuoyo (2020), agency conflict can arise from a variety of factors, including ownership arrangements, venture capital exit timing, ownership structure returns, and corporate governance structures. Due to the venture capitalist's inability to directly oversee the extent or level of the supported entrepreneur's activities, asymmetrical information naturally influences the partnership (Kwame, 2017).

Due to the venture capitalists' percentage influence over ownership and board participation in SMEs, the theory supports the independent variable of venture capital control. Venture capitalists are less informed about the subject matter of the business proposal than supported SME entrepreneurs (Bitta, 2022). Moral hazard and adverse selection are the two issues that result from this. Asymmetric information often leads to adverse selection, and without a legally binding contract with SME entrepreneurs, venture investors are unable to access the same information

(Kato & Tsoka, 2020). Due to the sponsored SME entrepreneur's lack of discernible effort, a related problem known as moral hazard develops. The interests of venture capitalists are not always aligned when an entrepreneur acts rationally and engages in non-value-adding activities (Panda, 2018). Therefore, the agency theory offers a beneficial lens for the current study by giving a framework to comprehend how venture capitalists choose syndication with other VCs and control rights through Board involvement in the quest to align incentives (Njagi, 2017). However, the critique that can be leveled against the theory is that it over emphasizes the principal-agent problem as the root of all interpersonal conflict in an organization. Hence it fails to demonstrate how the principal and the agent can utilize the financial resources to achieve financial growth of the SMEs.

Empirical Review

Type of Venture Capital Investment and Financial Growth

Kim and Park's (2021) study examined the connection between venture growth and the size of venture capital syndicates. The study's objective was to ascertain how the size of the venture capital syndicate, or the number of venture capital firms participating in a particular investment, affects the projects that the firms back as they expand. The study's findings indicate that the growth of the sponsored businesses is inversely correlated with the syndicate's size. The study also discovered that the Inverse-U curve is flattened by geographical distance between syndicate partners and is shifted to the right by the lead VC firms' stellar reputations. The current study concentrated on SMEs in Nairobi County, Kenya, that are supported by venture capital between 2018 and 2022.
Awounou and Boufaden (2020) examined how syndication strategy, in particular, affected the ways in which venture capital (VC) financing impacted the growth of high-tech enterprises' innovation. The research employed panel data analysis, encompassing 1122 venture capital transactions involving French biotechnology companies between 1998 and 2008. The findings showed that compared to other forms of funding, venture capital firms had a bigger and more beneficial influence on enterprises. Crucially, when investors participate in syndication, venture capital investment is favorably correlated with increased patenting and innovation activity on the supported firms (Gatauwa, 2014; Gatauwa, 2022). The study also found that when VC syndication engages industry experts with complementary skill sets, innovation development is probably going to be stronger. The current study used financial growth as the dependent variable.

Siddiqui et al. (2016) examined how venture capital investment and investment syndication affected the firm life cycle and profitability of Australian venture capital-backed businesses. The 2009 Thomson Reuters Venture Expert dataset report provided secondary data for the study. From 1984 to 2008, Australian venture capital-backed enterprises were the study's primary focus. The study examined exit growth and the venture capital life cycle using a probit regression model based on syndication. According to the study, companies that receive syndicated venture capital investment typically outperform other venture capital-backed companies, but companies that do not typically outperform those that do. Using primary data, this study employed a descriptive research approach.

Research conducted by Muhuhu et al. (2023) examined the relationship between venture capital financing and the expansion of small and medium-sized enterprises (SMEs) in Kiambu County, Kenya. The multiple regression model was employed as the inferential statistic, and the questionnaire and secondary data collection sheet served as the study instruments. According to the study, venture capital monitoring, management support, technical support, and financial support all significantly and favorably impacted the growth of SMEs in Kiambu County. Nevertheless, the study was conducted in a different geographic location than the current research project, therefore the results of the two studies might not be identical. This study was based in Nairobi County, Kenya Apuoyo (2020) studied how venture capital financing affected the expansion of SMEs in Kenya's Nairobi County. The study's target population consisted of 97 SMEs that had received venture financing between 2013 and 2017. Multiple regression analysis was employed as an inferential statistical method. The expansion of SMEs, the financing options used, and venture capital financing were found to be significantly and favorably correlated by the study. Using a census survey, the current study concentrated on the years 2018–2022.

Venture Capital Control and Financial Growth

Katti and Raithatha (2020) assessed how venture capital affected Indian enterprises' ability to grow as a firm. The focus of their study involved validating the monitoring role through board representation or majority stake ownership by the venture capitalists. Using a panel data analysis of 565 observations on companies registered on the Bombay stock market between 2005 and 2014, the study discovered no proof that venture capital investors' engagement had any appreciable impact on the growth of the company. The study also found that venture capitalists are not sufficiently driven to engage in oversight activities, such as serving on boards, in order to enhance company growth. The current study will focus on non-listed firms and will also be based in a different geographical location.

Kirimi et al. (2022) focused on the connection between Kenyan commercial banks' ownership structure and financial growth between 2009 and 2020. Financial statements that have been audited provided the data. For the study, a sample size of 39 banks was used. Regression analysis was used in the study to find compelling evidence that ownership structure control contributed to the banks' varying financial growth. The study limited itself to financial institutions while the current study looked at SMEs across different industries.

Velamuri and Liu (2017) investigated the ownership and control structures of 783 SMEs in China between 2009 and 2012 that were listed on the SME. The study used data from the Wind financial system, which offered details on businesses listed on the Shenzhen Stock Exchange. It's interesting that the study discovered that companies with venture capital investment didn't do any better than companies without it. Additionally, the study observed that firms in which there was a high VC control rights had a negative long-term growth compared to firms where VC control was low. Hochberg (2012) examined how venture capitalists influenced the corporate governance of recently listed companies. In order to reduce agency issues and promote company growth, the study underlined the significance of board control and venture capitalist shareholding. When comparing venture backed firms to non -venture backed firms, the study observed that due to the control rights and governance role provided by the venture capitalists, venture backed firms showed superior growth. Through a probit analysis of the variables, the study was able to show that involvement of venture capitalist in boards of the firms increased independence of the boards resulting in increased long term financial growth.

Conceptual Framework

The independent variables in this research included the type of venture capital investment, and venture capital control. The outcome construct of the study was financial growth.

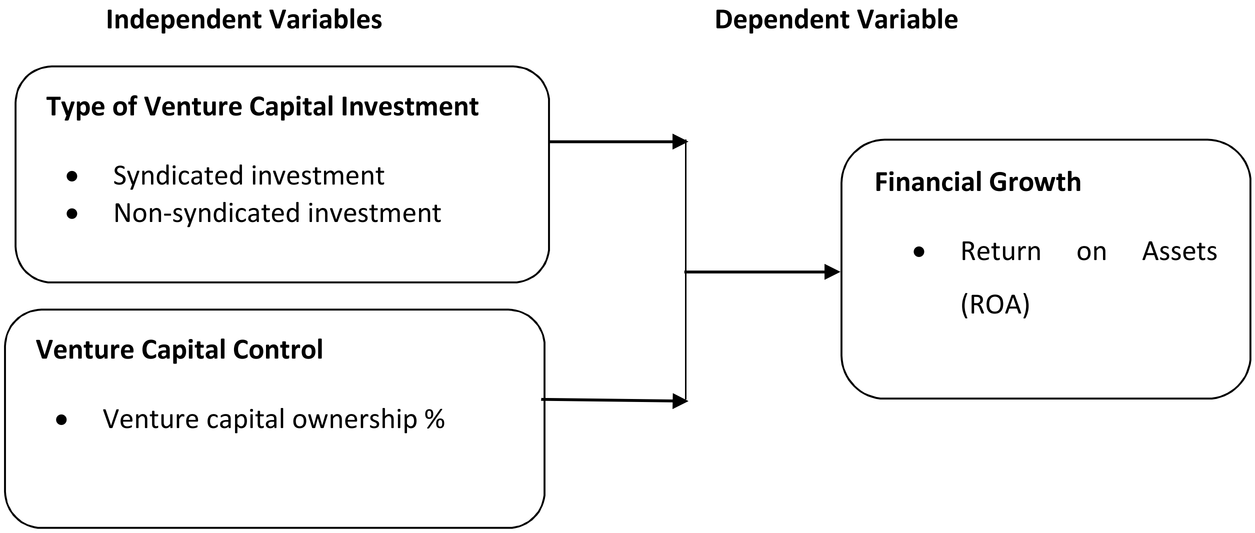

Figure 1: Conceptual Framework

RESEARCH METHODOLOGY

Research Design

The research methodology for the study was descriptive in nature. Descriptive research, according to Calderon (2006), is an intentional endeavor that involves the methodical gathering, analysis, classification, and arrangement of data about current circumstances, practices, procedures, trends, and cause-and-effect linkages.

Target Population

Target population serves as the primary focus of the research inquiry and is the group from which the researchers intend to draw conclusions (Creswell, 2014). All SMEs in that receive funding from venture capital in Nairobi County made up the study's target population. The study's target group consisted of the 139 SMEs in Nairobi, Kenya that had obtained funding from venture capital. This figure was arrived from data provided by the East Africa Venture Capital Association (EAVCA) as of 2023. Data is collected using a census survey approach from all target demographic segments (Creswell, 2014; Gatauwa, Aluoch & Adhing'a, 2024). Therefore, the current study used a census and all the 139-venture capital funded SMEs in Nairobi County were studied.

Data Collection Instrument

The study made use of both primary and secondary data. Primary data was gathered using questionnaires. A proficient tool for gathering data in descriptive research is a questionnaire (Akpan & Onyia, 2022).

Statistical Analysis

The science of statistical analysis includes large-scale data collection, exploration, and presentation to find underlying patterns and trends (Mazzarol et al., 2020). The SPSS was used as the statistical analysis application for this investigation. The standard deviation and mean were utilized to collect descriptive data. Further, multiple regression model was computed to determine the relationship between the study variables.

RESULTS AND DISCUSSION

Descriptive Statistics

Type of Venture Capital Investment

The study aimed to find out how the type of venture capital investment affects the financial growth of SMEs in Kenya. The respondents were asked to express their level of agreement with statements measuring type of venture capital investment.

Table 1: Descriptive Statistics for Type of Venture Capital Investment

Statement	Mean	Std. Deviation
Firms with a diverse syndicate of venture capitalists tend to outperform those with single VC funding	3.7	1.2
Venture capital syndication leads to better risk management strategies for funded SMEs.	3.6	1.3
SMEs that are that are funded by Venture capital syndicates have higher survival rate than those that are not	3.8	1.2
SMEs funded by Venture capital syndicates have access to more strategic collaboration and networks than those that are not	3.9	1.3
Syndicated venture Capital SMEs are more likely to attract additional resources and expertise	3.8	1.3
Overall score	**3.8**	**1.3**

Results indicate that most respondents agreed that firms with a diverse syndicate of venture capitalists tend to outperform those with single VC funding (Mean=3.7, SD=1.2), venture capital syndication leads to better risk management strategies for funded SMEs (Mean=3.6, SD=1.3), and SMEs that are funded by venture capital syndicates have greater rate of survival than those that are not (Mean=3.8, SD=1.2). Further, the respondents were in agreement that SMEs funded by Venture capital syndicates have access to more strategic collaboration and networks than those that are not (Mean=3.9, SD=1.3), and syndicated venture Capital SMEs are more likely to attract additional resources and expertise (Mean=3.8, SD=1.3). Generally, most entrepreneurs supported the importance of syndicated venture capital in enhancing SME’s financial growth. The results

corroborate a study by Siddiqui et al. (2016) that concluded that that venture capital-backed companies that obtain syndicated funding generally do better than those that do not.
The respondents were asked whether their venture capital finance syndicated or non-syndicated. Based on the findings majority of respondents revealed that their venture capital financing was syndicated. This provides firms with access to more deals and better deal flow by leveraging the network and reputation of co-investors. Most of the syndicated firms had two venture firms on board.

Venture Capitalist Control

The study sought to establish the effect of venture capitalist control on the financial growth of SMEs in Kenya. The respondents were asked to express their level of agreement with statements measuring venture capital control and results are shown in Table 2.

Table 2: Descriptive Statistics for Venture Capitalist Control

Statement	Mean	Std. Deviation
Venture capitalists influence the strategic decisions taken by the firms	3.6	1.2
Venture capitalists have a high level of control in funded SMEs	3.7	1.3
Venture Capitalists have representation in the board of directors of SMEs	3.8	1.3
Having representatives in the board of funded firms by venture capitalists creates bureaucracy	2.4	1.4
Venture capital-imposed restrictions on managerial autonomy negatively impact SME growth	3.7	1.4
Overall score	**3.4**	**1.3**

Findings indicate that most respondents were in agreement that venture Capitalists have representation in the board of directors of SMEs (Mean=3.8, SD=1.3), venture capitalists have a high level of control in funded SMEs (Mean=3.7, SD=1.3), and venture capitalists influence the strategic decisions taken by the firms (Mean=3.6, SD=1.2). Further, the respondents agreed that venture capital-imposed restrictions on managerial autonomy negatively impact SME growth (Mean=3.7, SD=1.3). In addition, majority of respondents disagreed that having representatives in the board of funded firms by venture capitalists creates bureaucracy (Mean=2.4, SD=1.4). In general, the respondents supported the critical role of venture capitalist control in promoting SME's financial growth. According to Hochberg (2012) companies with venture capital control didn't do any better than companies without it.

The respondents were further asked to state the percentage of ownership and board representation their firm has ceded to the venture capitalist. Majority of the entrepreneurs stated that the venture capitalists get 15% to 30% of both ownership and board representation, while the business retains the rest.

Financial Growth

The respondents were asked to indicate their net profit and total assets for the period from 2018-2022.

Table 3: Descriptive Statistics for Financial Growth

	Mean	Std. Deviation	Minimum	Maximum
Net profit	773.80	215.89	248.91	1395.46
Total assets	13507.43	3604.88	4366.80	23831.20
Return on Assets	5.71	0.32	4.84	6.80

Results indicate that the average annual net profit for SMEs throughout the data period was 7,738,000. Further, the average annual total assets for SMEs throughout the data period was 13 5,074,30 million. In addition, the average annual ROA for SMEs throughout the data period was 5.71%.

Regression Analysis

Regression analysis was conducted to determine the effect of venture capital syndication and venture capital control on financial growth. Results are shown in Table 4.

Table 4: Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	3.789	0.154		24.654	0.000
	Venture capital syndication	0.167	0.078	0.289	2.152	0.034
	Venture capital control	0.101	0.061	0.204	1.666	0.099

a Dependent Variable: Financial growth

Results indicate that type of venture capital investment has a positive and substantial effect on SMEs' financial growth (β=0.167, P=0.034<.05). This suggests that SMEs' financial growth would improve by 0.167 units for every unit increase in venture capital investment. The findings corroborate research by Siddiqui et al. (2016) that found venture capital-backed companies using syndicated funding generally do better than those that do not.

Venture capital control has no significant influence on SMEs' financial growth (β=0.101, P=0.099>.05). This implies that venture capital control does not significantly affect SMEs financial growth. The finding is consistent with that of Velamuri and Liu (2017) who observed that firms in which there was a high VC control rights had a negative long-term growth compared to firms where VC control was low. Similarly, Hochberg (2012) discovered that companies with venture capital control didn't do any better than companies without it.

Hypothesis Testing

This section summarizes the results of the test hypothesis showing whether the null hypothesis of is rejected or accepted.

Table 5: Summary of Hypothesis Testing

Hypothesis	Test (P value)	Conclusion
HO$_1$: Type of venture capital investment does not significantly affect the SMEs' financial growth.	0.034<0.05	Rejected
HO$_2$: Venture capital control does not significantly affect the SMEs' financial growth.	0.099>0.05	Not rejected

CONCLUSION AND RECOMMENDATIONS

Conclusion

The study concluded that venture capital control had a positive but insignificant effect on SMEs' financial growth. Venture financiers have a high level of control in funded SMEs, venture capital-imposed restrictions on managerial autonomy negatively impact SME growth and venture capitalists influence the strategic decisions taken by the firms. The study found that the type of venture capital investment significantly and favorably impacted the financial growth of SMEs. The implication is that type of venture capital investment contributes significantly to improvement in SMEs' financial growth. In particular, a diverse syndicate of venture capitalists leads to better risk management strategies, increases survival rate of SMEs, businesses have access to more strategic collaboration and attract additional resources and expertise.

Recommendations

The study recommended that entrepreneurs should consider a diverse syndicate of venture capitalists. This is key for improved risk management, survival rate, access to more strategic collaboration and attraction to resources and expertise.

In addition, the study recommended that entrepreneurs should review the venture capitalists' level of control in the business. This would help to mitigate negative impact resulting from venture capital-imposed restrictions on managerial autonomy.

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