EXPLORING VIABILITY OF PRE-ESTABLISHMENT OF DESIGN STRUCTURES OF VENTURE CAPITAL FUNDS IN KENYA

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DECLARATION AND APPROVAL

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I declare that this work has not been previously submitted and approved by any university. To the best of my knowledge and belief, the dissertation contains no material previously published or written by another person except where it is by reference in the dissertation itself

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Signature____

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APPROVAL

This dissertation was reviewed and submitted with my approval as University Supervisor.

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ABSTRACT

The purpose of this study was to explore the viability of pre-establishment design structures of venture capital funds in Kenya. It was guided by the following objectives: to identify the most effective fund design of a Venture Capital Fund (VCF) in Kenya; to identify the key variables that need to be considered at pre-establishment of a VCF, to identify the risks and opportunities considered by the venture capital funds in relation to their establishment in Kenya and to propose viable pre-establishment VCF designs and structures that can be replicated in Kenya. The study adopted a qualitative research design. A purposive sample of seven VCFs were surveyed. The main data collection instrument was an interview guide. Face to face in-depth interviews were conducted with the owners of the VCFs and their business partners. The data collected was content analyzed using NVIVO software to generate patterns and themes. The findings revealed that there are three types of fund structures that the VCFs used. One was the family fund where an individual or a family put their money for investment in a particular region. This means that the VCF does not spend a lot of time and energy in fundraising. There is a lot of flexibility with this type of fund structure and the decision making on investment is easy and fast. A board of governors heads this type of fund and the members of the board include a representative of the family that has put in the fund. An investment committee headed by a CEO manages the VCF. The second type of structure is the debt funded structure which is headed by a board of governors who are experts in various fields such as banking and financial markets, and managed by a CEO. The third type of structure is one funded by Limited Partners (LP) and this is the most complex and rigid type of structure. It has various investors with competing interests such as return on investment on the one hand and high social impact on the other. This means that for any investment decisions to be made they have to wait until the structured calendar meeting. The study proposes a structure based on preferred convertible equity structure for the VCFs as an optimal VCF design at the pre-establishment. The study recommends for the establishment of a proper legislation defined through partnership between the VCF and the government regulatory authorities.

Key words: venture capital, venture capital fund, venture capitalist, VCF establishment.

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LIST OF ABBREVIATIONS

CMA	Capital Markets Authority
DFCK–	Development Finance Company of Kenya
EVCA	European Venture capital Association
GOK	Government of Kenya
GP	General Partner
ICDC	Industrial and Commercial Development Corporation
IDB	Industrial Development Bank
IPS	Industrial Promotion Services
IRR	Internal Rate of Return
ISP	Informal Sector Programme
KES	Kenya Shilling
KIE	Kenya Industrial Estates
LP	Limited Partner
LS VCC	Labour Sponsored Venture Capital Companies
PCP	Participating Convertible Preferred Stock
RBA	Retirement Benefit Authority
SME	Small and Medium Enterprises
TS	Trade Sale
VC	Venture Capital
VCF	Venture Capital Fund

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To God be all the glory.

DEDICATION

I dedicate this entire MBA journey to my father who has taught me and showed me the ways of the God.

CHAPTER ONE: INTRODUCTION TO THE STUDY

1.1 Introduction

Venture Capital Fund (VCF) is generally considered to be a mainstay of economic growth as it supports a wide range of enterprises. Gompers and Lerner (2000) argue that venture capital has materialized as a critical go-between in financial markets, providing cash resources to firms that might otherwise have difficulty in attracting funding from outside. Jeng and Wells (2000) say that venture capital covers three types of investments: seed, start-up and expansion but excluding buyouts. Unlike Jeng and Wells, Pandey (2010) suggests that VC funding does include acquisition or buyout financing in addition to seed, start-up and expansion stages.

Rubin (2010) defined VCF as a subclass of private equity (PE). He defines PE as an asset category that is made up of equity investments in privately owned companies, as opposed to those publicly listed and traded on the stock exchange. VCF investments are generally made in young companies, i.e. between early stage and expansion. He acknowledges that most venture capitalist firms are made up of professional fund managers who source financing from pension funds, financial institutions, endowments, wealthy individuals, and corporations and invest them in such a way as to generate maximum returns for their investors.

Therefore, VCFs constitute early bankrolling of small and medium-sized enterprises (SMEs) that need finances in order to spur their growth (Pandey, 2010). Boateng (2010) asserts that VCFs provide financing to allow a business to carry out a project in exchange for a stake in the business. VCFs have often been associated with the expansion of small firms into big corporations. For example, in Europe and the United States, VCF funds have been used to fund SMEs in their early stages with a number of these becoming some of the world's biggest organizations (Mason & Harrison, 1995).

Over years since the late 1990's there has been a change in the business model of Venture Capital Funds from investing locally toward investing globally and across borders (Aizenman & Kendall 2011). When it comes to venture capitalists investing abroad, there are many factors that venture capitalists consider. However, little is known about what factors influence venture capital firms' cross-border investment decisions (Mäkelä & Maula 2008). Today venture capitalists from one country invest abroad while at the same time portfolio companies placed in the same country receive funding from other venture capitalists abroad (Schertler &Tykvová

2012). The decision to invest (especially abroad) in risky ventures is difficult, because once the investment is made, it is not liquid and its success is reliant on the entrepreneurs and managers of the venture (Tyebjee & Bruno 1984). Thus, it is relevant to carefully evaluate the potential decision before it is made paying respect to several factors (Fried &Hisrich, 1994). Schertler and Tykvová (2012) argue that there are at least two reasons for venture capital firms to invest across borders. First, by crossing borders, venture capitalists take advantage of differences in risk-adjusted expected returns between their home country and the portfolio companies' countries (Mäkelä & Maula 2008). Second, venture capitalist firms invest abroad in the hope of further deal flows and because of value-adding activities (Schertler & Tykvová, 2012).

Sorenson and Stuart (2001) argue that a venture capitalist's age and experience are important drivers for a venture capital firm to invest in geographically distant places. Sorenson and Stuart (2001) continue by presenting that as venture capital firm's age and gain experience, their networks broaden between industries and across borders. Wright and Lockett (2003) and Schertler and Tykvová (2010) on their part add that their reputation grows leading other venture firms to bring good investment deals to them. Wright and Lockett (2003) posit that as venture capital firms gain experience, they earn more confidence in evaluating ventures and entrepreneurs which helps them to reduce the costs of monitoring and become less dependent on their networks to gain information to evaluate potential ventures. Therefore, as venture capital firms grow older and gain experience, they become more likely to invest in distant geographic locations, such as across national borders (Sorenson & Stuart 2001). A venture capitalist invests abroad when a higher expected return compared to domestic investment outweighs the cost of investment (Schertler & Tykvová, 2012). This study seeks to assess the factors that influence the pre-establishment design of VCFs in Kenya. It is important to note that this study looks into the phase before VCF are established, this includes what informs the setting of VCF, how they identify the investors, how long it takes them to raise funds, how they determined a country to invest in, what are the governing structure used etc. This study does not look into the investment done by VCFs in an enterprise, as this research has already been done.

1.2 Background to the Study

VCFs have been present in Kenya for more than half a century with some of them being formed by the Kenyan Government as early as 1954. The Kenyan VCF industry picked some vibrancy in the 1990s. However, operation volumes are still small in scale. Venture Capital Funds

account for a tiny share of the financial market (Zavatta, 2008). Although, some private equity firms have shown interest in the Kenyan market, the Kenyan equity financing is not very developed. It is important to note that exact data on the Kenyan VCF industry is not available.

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

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

The history of venture capital in Kenya dates back to the establishment of the publicly-backed Industrial Development Bank Limited (IDB) established in 1954. IDB began operations on 15th February 1955 and was the sole investment vehicle in the country for a decade. The government then established the Development Finance Company of Kenya (DFCK) in the 1963/64 financial year; another publicly backed venture capital company, but with interest in large scale business start-ups. In June 1967, the government established the Industrial and Commercial Development Corporation (ICDC) as a venture investment company to provide risk capital to indigenous private businesses. In the first four decades of independence, the venture capital industry in the country was largely publicly-backed, mostly through state-owned Development Finance Institutions. Due to the massive structural economic problems that arose in Kenya, as

in nearly every African country, further development of venture capital as an alternative source of financial capital stagnated throughout most of the 1980s and 1990s (Leys, 2008).

Zavatta (2008) observes that in terms of fundraising, capital is sourced by the VCFs from international investors; mainly development finance institutions and multilateral donors. Most of Kenya's Venture capital funds come from international investors and especially the International Finance Corporation (IFC). These investors include the European Investment Bank, Field Marketing Organization (FMO), and Commonwealth Development Corporation (CDC) among others. These investors also provide equity financing through the Industrial and Commercial Development Bank, a development institution whose shareholders include the regional governments and some private commercial banks.

In Kenya, private Venture Capital firms include: Kenya Equity and Term Financing which supports existing companies that wish to expand rather than start-up operations. Aureos East Africa which provides private equity and loan facilities and has replaced the activities of Acacia Fund Limited, which provided risk capital to new or expanding enterprises, including reorganization, rationalization and reconstruction. Some venture capital firms like Acacia Fund Limited exited the Kenyan market due to their interest in funding firms that had been over a decade in the market but lacked expansion capital (CMA, 2010). The challenge for such firms is that most high growth potential companies in Kenya are new and do not have the operational history which many foreign venture capital firms seek. Another venture capital firm operating in the country is the Kenya Management Company Limited which provides equity and related investments to companies with high growth potential, and has seen tremendous success in some companies it has financed especially in the agri-business sector (Memba, 2011).

In general, Kenya accounts for 46% of the total number of venture capital deals in Eastern Africa and sixty-nine percent of total reported values in 2013. This reflected the views of stakeholders that Kenya remains a top destination country in Eastern Africa as well as Africa wide for venture capital investment (Deloitte, 2014). The main focus of investors in SSA (Sub-Saharan Africa) continues to be the key economies of South Africa, Nigeria and Kenya where venture capital players seek to ride on established systems and more certainty, i.e. lower risk. On the retail end, medium enterprises venture capital funds have invested in pharmacy chains, e.g. Fanisi Venture Capital Management in Halton's, a Kenyan pharmacy chain that aims to use the funding to expand their branch network across the country (Deloitte, 2014).

Many foreign venture capital firms that operate in Kenya face challenges in operating in the local market due to poor social ties and information flow between venture capitalists' networks that do not create value for investments to geographically distant locations (Aizenman &Kendall, 2011). The study therefore sought to explore viability of pre-establishment design structures of venture capital funds in Kenya.

1.3 Statement of the Problem

The review of literature indicates that venture capital financing has become a global concept because of its enormous contribution to small businesses with high growth potential globally. Through venture capital financing, businesses such as Apple, Facebook and Yahoo received the necessary funds to grow. Larsson and Roosvall (2000) noted that venture capital firms utilize investment decision criteria as they are mainly operated by a lean staff and are inundated with proposals that become a significant bottleneck in their operations.

VCF often target companies that are characterized by long development and capital-intensive processes, which includes certain risks throughout the development chain. When making investments decisions VC funds, apply specific portfolio strategies and evaluation criteria and can face significant challenges in knowing how to get going at pre-investment stages. Also, due to the global attributes of the financial sector, pre-investment in foreign countries commonly leads to additional challenges. Therefore, VCF can face difficulties to fully understand what evaluation criteria they can use, as well as how they can successfully meet the demands in a foreign market (Guler & Guillen 2010).

Ngaruiya (2013) conducted a study to investigate factors that influence the establishment of VCFs in Kenya. The study found out that GDP, interest rates, inflation, performance of the market, funds from investors, expected rate of return and networking among venture capitalists were the key factors considered in establishing the funds. The study did not look at the structural foundation of the VCF and its effects on the sustainability of the VCFs. The study limited itself to the key factors that influence the establishment of venture capital firms, challenges encountered as they set up and the sectors of the economy preferred. The study did not factor in the pre-establishment design that is likely to affect the success of the VC firms.

Mathenge (2012) conducted an exploratory study on venture capital growth and regulation in Kenya. The study revealed that the VC industry in Kenya was young and, in this light, that facilitative regulation needed to be considered that would allow the industry to grow. He stated that the VC Industry was also affected to a great extent by government policies, especially taxation and legislation. The study highlighted gaps in tax regime, legal framework, and risk taking amongst the VC starters.

Recently it was reported that Kenya's pioneer venture capital fund, Acacia was set to wind up after falling into dormancy (Deloitte, 2013). Acacia was formed in 1996, the Sh1.9 billion fund was invested in Kenya's private firms including fashion retailer Deacons and Hoggers. The local daily further indicated that this was a voluntary liquidation, after its backers formed new investment vehicles, including private equity funds, to invest in the increasingly competitive local and regional markets.

Analysts, business leaders, and policy makers have widely pointed to venture capital (VC) as an important catalyst for economic growth (Bottazzi & Rin 2002). These commentators have also attributed slow growth to the relative shortage of venture capital firms. Previous studies (Mathenge 2012; Ngaruiya 2013) have studied how external factors such as regulation, GDP, inflation, interest rates and performance of the market, influence the establishment of funds in Kenya. However, given the relatively small number of funds that have been set up in Kenya (CMA 2017), and exit of funds such as Acacia (Deloitte 2013), this study contends that other factors affecting the pre-establishment phase, such as the structural design of the funds also require investigation. Some pre-establishment structural factors scantily mentioned in the literature include fund size, investment period, risks and opportunities, investment process, local experience and territorial coverage (Memba, 2012). There is therefore, a need to conduct the current study to explore viability of pre-establishment design structures of venture capital funds in Kenya.

1.4 Objectives

1.4.1 General Objective

The general objective of this study was to explore viability of pre-establishment design structures of venture capital funds in Kenya.

1.4.2 Specific Objectives

The specific objectives of the study were to:

i. Examine designs used by VCFs in the pre-establishment phase of a Venture Capital fund in Kenya.
ii. Identify the key variables that need to be considered at pre-establishment of a VCF.
iii. Identify the risks and opportunities considered by the venture capital funds at the pre-establishment phase in Kenya.
iv. Propose viable VCF pre-establishment designs and structures that can be replicated in Kenya.

1.5 Research Questions

The study was guided by the following research questions:

i. What designs do VCFs use at pre-establishment of a Venture fund in Kenya?
ii. What are the key variables that need to be considered at pre-establishment of VCFs?
iii. What are the risks and opportunities considered by the venture capital funds at the pre-establishment phase in Kenya?
iv. What viable VCF pre-establishment designs and structures can be replicated in Kenya?

1.6 Scope of the study

The primary interest of this study was to explore viability of pre-establishment design structures of venture capital funds in Kenya. The study covered the pre- establishment designs of seven VCFs purposively sampled regardless of their location within the country or targeted sector. The study was conducted qualitatively.

1.7 Significance of the Study

To the government, the insights generated by this study will give policy makers a better understanding of how to design venture capital companies and how to formulate better regulation and policy to encourage and promote more venture capital funds in the country. The insights from the study can also be applied by the government to review and improve the designs and structures of existing state-owned or backed venture capital firms such as the Industrial Promotion Services (IPS) Limited. In this regard, the study is to inform existing and

interested VCF in Kenya on the best designs for establishing VCF in the market aligned to the specific dynamics in the country.

To the Capital Markets Authority (CMA), the results of this study will provide important effective regulation and license of venture capital market, and seek to deepen the capital markets by promoting diverse structures and design of VCFs. To the venture capital companies and investors, in particular, the study will provide valuable insights on appropriate pre-establishment designs and structures in the context of Kenya's macro-economic environment, national needs, and opportunities.

For aspiring home-grown venture capitalists and investors, the study will generate valuable insight in the design of better-aligned funds and thus more effective venture capital funds for the economy.

To the body of knowledge and to academicians, the study will add value to the body of knowledge in the area of venture capital financing and also form a basis for further research in the same field. In this regard, the study will further be a review especially to the Knowledge Base View theory in that, the study has established that the relationship between the investees and management should go beyond just provision of capital but also to knowledge sharing.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter discusses the literature on venture capital guided by the research objectives and questions outlined in chapter one. The chapter starts with the theoretical framework and empirical literature. Thereafter research gaps and conceptual framework are outlined.

2.2 Theoretical Literature Review

This study is based on two theories: knowledge based view theory, and the financial intermediation theory. These are discussed below.

2.2.1 Knowledge based view theory

The Knowledge Based View theory was propounded by Penrose in 1959 with its main tenet being to ensure sustainable value creation, in particular, through the creation of growth opportunities (Foss, 2009). The Knowledge Based View Theory is one of a number of strategy theories based on resources and capabilities (the Resource Based View – RBV) that results mainly from the growth theory of the firm proposed by Penrose (1959). The firm appears to be a set of resources and an entity for accumulation of knowledge guided by the vision of the managers and depending on the experience they have acquired. The origin of sustainable growth is found in the ability to learn and in the specificity of the stock of accumulated knowledge. This theory is at the origin of an extensive current of research (Foss, 2009) that considers the knowledge-based theory of the firm in a strict sense (KBV) as one of its components (Kaplan, 2011).

The knowledge-based approach is significant to this study since it involves a reconsideration of the traditional financial approach to management, in which the relationship between the firm and the financial investors (VCF) is limited to the contribution of capital and where the only objective is to secure the financial investment by disciplining the managers as best as possible. Such a relationship exists between investees and venture capital investors. Therefore, as suggested by Ritter, (2003) and Thaler, (1999) finance also includes a cognitive aspect. Accordingly, Aoki (2011) believes that, in the model associated with venture capital, it is not the ability of the venture capital investor to contribute funds that is the most important factor, but his ability, based on his knowledge and experience, to select the most promising VCF and refuse the financing (or refinancing) of the less interesting VCFs.

2.2.2 Financial Intermediation Theory

The financial intermediation theory was propounded by Fama (1980) and states that firms and households interact through markets and financial intermediaries play no role. When markets are perfect and complete, the allocation of resources is efficient and there is no scope for intermediaries to improve welfare. Moreover, often financial structure does not matter: households can construct portfolios which offset any position taken by an intermediary and intermediation cannot create value (Fama, 1980).

The application of intermediation theory to investment is supported by decades of practice, in which financial intermediaries, such as banks and insurance companies, and more recently, venture capitalists have acted as intermediaries between individual investors and the market. Ideally, there would be no need for such intermediation (Fama, 1980) but since ideal, perfect markets do not tally with reality, the role of intermediary becomes necessary.

This theory is relevant to this study since it states that intermediaries, including venture capitalists, play a unique role in the economy, as they source funds from disparate investors, and create value by investing them in firms with promising growth prospects. Thus, they are the link between those who have excess funds and those who need excess funds. Due to the vast amount of funds at their disposal, financial intermediaries are diverse by nature in their choice of investments, from a multiplicity of stocks and bonds to alternative investments such as real estate. Thus, the growth of intermediaries is commensurate with the growth of financial and capital markets, including the venture capital market (McKinnon, 1973).

2.3 Empirical Literature

2.3.1 Designs used by VCFs in the pre-establishment phase

A venture capital fund is a professionally managed pool of capital that is raised from public and private pension funds, endowments, foundations, banks, insurance companies, corporations, and wealthy families and individuals. Venture capitalists (VCs) generally invest in companies with high growth potential that have a realistic exit scenario within five to seven years. A typical VCF investment structure will include rights and protections that are designed to allow the VCs to gain liquidity and maximize the return for their investors. According to Fried and Ganor (2006) any venture capital fund structure can be defined in three main aspects

of a venture capital structure commonly known as the term sheet: (a) liquidation rights, (b) management participation and control, and (c) exit rights.

Liquidation Rights

Wilson (2009) observed that most venture capital investments are structured as convertible preferred stock with dividend and liquidation preferences. The preferred stock often will bear a fixed-rate dividend that, due to the cash constraints of early-stage companies, is not payable currently but is cumulative and becomes part of the liquidation preference upon a sale or liquidation of the company. The payment of dividends on the preferred stock will have priority over common stock dividends. These cumulative dividend rights provide a priority minimum rate of return to the VCFs (Wilson, 2009).

On his part Ganor (2009) argued that the preferred stock will have a liquidation preference that generally is equal to the purchase price (or a multiple thereof), plus accrued and unpaid dividends, to ensure that the VCFs get their money back before the holders of the common stock (e.g., founders, management, and employees) if the company is sold or liquidated. Most VCFs also insist on participation rights so that they share on an equal basis with the holders of the common stock in any proceeds that remain after the payment of their liquidation preference (Block & Sandner, 2009). These liquidation rights and the right to convert the preferred stock into common stock allow the VCFs to share in the upside if the company is successfully sold (Block & Sandner, 2009).

According to Roberts (2011) an important consideration to VCFs is the percentage of the company that they own on a fully diluted basis. Roberts (2011) terms "Fully diluted" as the total number of issued shares of common stock, plus all shares of common stock that would be issued if all outstanding options, warrants, convertible preferred stock, and convertible debt were exercised or converted. This percentage is a function of the pre-money valuation of the company on which the VCFs and the company agree.

Management Participation and Control

Mendoza (2011) established that many VCFs invest in management, not technology, and VCFs expect the management team to operate the business without undue interference. In this regard Mendoza (2011) observed that most investment structures provide, however, that the VCFs participate in management through representation on the board of directors, affirmative and

negative covenants or protective provisions, and stock transfer restrictions. On the role of management control in venture capital funds McCahery (2013) opined that typical protective provisions give the VCFs the right to approve amendments to the company's certificate of incorporation and bylaws, future issuances of stock, the declaration and payment of dividends, increases in the company's stock option pool, expenditures in excess of approved budgets, the incurrence of debt, and the sale of the company. McCahery (2013) adds that VCFs generally require that management's stock be subject to vesting and buy-back rights. However, Mendoza (2011) argued that as long as the company is achieving its business goals and not violating any of the protective provisions, most VCFs permit management to operate the business without substantial investor participation except at the board level. However, VCFs may negotiate the right to take control of the board of directors if the company materially fails to achieve its business plan or to meet certain milestones, or if the company violates any of the protective provisions.

Exit Rights

According to Vermeulen, (2012) VCFs must achieve liquidity in order to provide the requisite rate of return to their investors. Most VC funds have a limited life of 10 years, and most investments from a fund are made in the first four years. It is for this reason investments are structured to provide liquidity within five to seven years so that investments that are made in a fund's third and fourth years are liquidated as the fund winds up and its assets are distributed to the fund's investors (Vermeulen, 2012). The primary liquidity events for VCFs are the sale of the company, the initial public offering of the company's stock, or the redemption or repurchase of their stock by the company. Wong (2002) observed that generally, VCFs do not have a contractual right to force the company to be sold. However, the sale of the company will be subject to the approval of the VCFs, and depending on the composition of the board of directors, the VCFs may be able to direct the sale efforts (Wong, 2002). In his part Wiltbank (2012) established that VCFs typically also have demand registration rights that theoretically give them the right to force the company to go public and register their shares. Wiltbank (2012) added that VCFs generally will have piggyback registration rights that give them the right to include their stock in future company registrations.

Another characteristic structure of VCFs according to Fried (2006) is the redemption rights to achieve liquidity if it is not available through a sale or public offering. This according to Fried (2006) gives the investors the right to require the company to repurchase their stock after a

period of generally four to seven years. Consequently, McCahery (2013) argued that an early-stage company (particularly one that is struggling) may not be able to finance the buyout of an investor, and the redemption right may not be a practical way to gain liquidity. However, this right gives the VCFs tremendous leverage to force management to deal with their need for an exit and can result in a forced sale of the company. Also, if the VCFs trigger their redemption right and the company breaches its payment obligations, the VCFs may be able to take over control of the board of directors of the company. Zwilling, (2012) gave other exit rights that VCFs typical require as tag-along and drag-along rights. Tag-along rights give the investors the right to include their stock in any sale of stock by management. Drag-along rights give the investors the right to force management to sell their stock in any sale of stock by the investors (Zwilling, 2012).

2.3.2 Key Variables Considered at Pre-establishment of VC fund

The venture capital fund establishment can be informed by factors categorized into two (Soderblom, 2012). The first category includes factors having a more direct effect on VCF return. These factors often relate to the VCF investors, the VCF itself, and the companies the VCF invests in. The second category consists of institutional and environmental factors that generally have more indirect effects on VCF performance. They are, however, of high importance in order to create and keep a vital VCF industry alive. The factors in each country tend to be different and reflect among other things varying economic and market conditions, the involvement of government and entrepreneurial potential (Klonowski, 2013). According to Wright (2005) the variation in the development of VCF industries across countries raises important questions concerning the factors driving these developments and the behaviour of VCF in different markets. According to Wright (2005) some of the factors behind the growth and success of VCF include; appropriate VCF structure, appropriate VCF processes i.e. (deal generation, due diligence, portfolio management and exit management) and appropriate remuneration for VCF management as well as and availability of skilled HR capital.

At the pre-establishment stages VCFs also need to develop appropriate investment strategy with main focus to their Limited Partners (LPs) (King, 2008). This becomes a part of their investment agreement and is called a covenant. While LPs often do not directly force VCFs to keep to the initial strategy, it is in the interest of the VCFs to do so. This according to King (2008) serves to protect the LPs in case of a failure in strategy. This effect introduces a significant constraint to VCFs, especially for the less established firms. Because of the nature

of their relationship with their LPs they will not be able to change direction quickly, since doing so may limit their raising of funds from those LPs in the future. This limited manoeuvrability may lead to limited returns on their funds, keeping them very dependent on their relationships with their LPs. Established firms, however, have a lot more manoeuvrability, because they will have a longer history of successful funds, they know they will be able to raise funds again even if their current fund does not perform well. This flexibility allows them to improve the returns of their fund because they can more easily adapt to changes in the environment (King 2008).

Research has shown that the choice of advisors by VCFs affects the investment focus that VCFs develop (Sheperd, 2007) and experience affects the fund performance (Zarutskie, 2010). Having experienced advisors which is an integral part of the human capital of a VCF, is a firm resource and creates a competitive advantage (Hitt and Bierman, 2001). This motivates VCs to specialize because it allows them to increase their knowledge of a particular focus which will improve their added value and allow them to discern valuable investment opportunities more effectively (King 2008).

Fundraising is another key variable that determines the success of a VCF. According to Granovetter (2005) VCFs can enhance fund raising strategies through their networks. Granovetter (2005) proposed three main ways through which social networks influence economic outcomes. Firstly, by improving the quality and flow of information, secondly, through introducing a source of reward and punishment for negative opportunism. And thirdly, by establishing trust among parties (Granovetter 2005). For VCFs their social network with other VCFs is source of competitive advantage and through various processes affects how a VCFs strategy develops.

One important way through which peers' influence fundraising is through co-investing (Dimov, 2008). Through co-investing a firm can more safely invest funds in a company which may not currently fit inside its investment focus by co-investing with a VCF that does have experience in that specific investment focus. Through this process VCFs can invest in more diverse opportunities through co-investing and gain expertise and reputation in new portfolios that they may wish to specialize in (Dimov, 2008). A peer network also influences which deals a VCF has access to. A lot of VCFs acquire new deals from fellow VCFs who cannot invest in them for various reasons. And because of the socially embedded nature of VCFs among peers the referred deals are usually of a higher quality than deals acquired through entrepreneur's

approaches, this is especially important for later stage investment opportunities (Granovetter, 2005).

A vibrant stock market is one factor facilitating the establishment of a Venture capital fund. Szerb and Varga (2012) note that stock markets play a very important role as they provide a perfect place for initial public offers as this enables the venture capital investors to sell their ownership in the investee company. Gompers and Lerner (2011) underline the importance of robust stock market for IPOs hence offering VCFs a viable exit option. Jeng and Wells (as cited in Gompers &Lerner, 2011), examined factors that influence VCF fundraising in 21 countries and found that the strength of the IPO market to be an important factor in determining VCF commitments. Exit strategy is a very important and critical part of making investments not only for venture capital players but also for strategic business partners (Nishith Desai Associates, 2009).

A study by Lima (2011) emphasizes that a stock market is an important exit mechanism, showing that in Brazil 50% of IPOs in 2014-2015 were by private equity backed companies. Hellman (2010) observed that the relatively well-developed IPO market in UK supports the largest venture capital industry in Europe. However, Jeng and Wells (2011) observe that the IPO market does not influence commitments to early stage funds as much as to later stage ones. Further, Botazzi and Rin (2009) showed that high VCF activity does not necessarily correspond with more IPOs.

Favourable government policy is also very fundamental if private equity activity has to thrive. The choices of the government can affect both the size and structure of the industry. Government policy can be in terms of measures taken to promote the venture capital industry like in Singapore (Hellman, 2010), or specific programs with the aim of facilitating the industry's growth like the Small Business Investment Corporations (SBICs) in the US, the Yozma program in Israel (Pfeil, 2002) and the Canadian Labour-Sponsored Venture Capital Corporation (LSVCC) program (Cummingi, 2007). Besides direct promotional efforts, government policy can also enhance growth of private equity through favourable tax policies that minimize taxes capital gains realized by investors exiting from private equity investments (Heilman, 2000; Dossani and Kenney 2002). Further, Jeng and Wells (as cited in Gompers & Lerner, 2011) find that government can have dramatic effect on the current and long-term viability of the VC sector. However, Armour and Gumming (2005), in their 2004 study of 15

countries covering a 13-year period found that government involvement can hinder the growth of private equity.

Closely related to government policy is regulatory framework. An adequate regulatory framework does not only ensure a clear and favourable tax policy (Gompers & Lerner, 2001) but has also provisions that allow institutional investors like pension funds to invest in private equity funds. In Brazil, for example one of the factors that facilitated the industry was the allowance for pension funds to invest in the private equity asset class (De Lima Ribeiro et al. 2006). Adequate regulation is very important. In fact, in India there are clear-cut regulations for both local and foreign private equity firms and specific conditions governing the investment by particular categories of investors (Dossani & Kenney, 2002; Nishith Desai Associates, 2009).

Another important factor is legal infrastructure and enforcement as it ensures that all the players in the industry are well catered for from a legal perspective. Leeds and Sunderland (2003), comment that a major reason for problems faced by PE funds that entered emerging markets in the 1990s was that the legal framework did not provide adequate investor protection and dramatic differences in accounting standards, corporate governance and exit potential created problems. Leeds and Sunderland (2013) underscore that a proper legal system offers a reliable outlet for resolving disputes among the parties in a private equity transaction.

2.3.3 Opportunities for venture capital funds

Opportunities or entrepreneurial activities are obviously very crucial and in fact, are preconditions for the development of private equity and specifically for venture capital. Dossani and Kenney (2012) examining differential development of VCF markets in Asia, note the importance of investments opportunities, development of a technological industrial base supporting entrepreneurship. Venture capital occurs and thrives only where there is a constant flow of opportunities with great upside potential (Dossani & Kenney, 2012). Hellman (2010) supports this view underlining that venture capital can only thrive with an adequate supply of entrepreneurs.

Availability of competent human resources is another important factor. There is need to have highly skilled people both in the VCFs and in the potential investee companies. Pfeil (2010) and Hellman (2010) agree that the venture capital industry needs skilled venture capitalists.

Citing an example of Silicon Valley where most successful companies are run not by their original founders but by experienced professional managers Hellman (2010), says that availability of human capital is critical for the growth of new firms. Other factors that play a role in the success of private equity are institutional factors like a stable business environment, political climate and adequate infrastructure (Wright, 2005).

Good management is important to the success of all VCFs, for fast-growing in pursuing risky investment strategies. Managerial resources often are particularly scarce in young, growing companies; the most innovative VCFs are not necessarily endowed with talents as managers. And, as the newly organized VCFs grow, its human resource needs become greater and more complex. Thus, it is often the case that realizing the potential of a VCF depends on its capacity to recruit high-level managers (Hellman and Puri, 2002). On their part, Kortum and Lerner (2000) argued that venture capitalists may have a comparative advantage in recruiting management for portfolio companies by virtue of their "networking" capabilities and access to private information about managerial talent based on their previous experiences with managers. The extent of that comparative advantage may depend on various attributes of the venture capitalist and the portfolio companies. Different financiers may have different skills and resources for solving the human resource problems of portfolio companies. And portfolio companies may differ according to the difficulties they face in identifying and attracting the right managers to the firm. VCFs which are very risky firms may find it harder to attract managers who are risk-averse (and who, therefore, may prefer a safe job in an established firm to a risky job in the portfolio company) (Hsu, 2004).

The ability of the venture capitalist to use his or her network of industry connections to "recycle" good managers whose firms fail (for exogenous reasons) may permit the venture capitalist to attract skilled managers more successfully. High-risk activities also make the process of screening managers more difficult. In this study, we hypothesize that human resource due diligence gives venture capital funds non-financial benefits because it allows venture capitalists to use their human resource networking capabilities to transfer valuable information acquired in previous investments. Thus, venture capitalists' access to private information about managerial talent gives them an advantage in recruiting that is increasing in importance with the riskiness of the industry.

2.3.4 Risks Involved in VC Fund Establishment

In the investment decision making process, VCF are often faced with uncertainty about the future performance of the venture and the adverse selection problem. The reason for this is that VCF have to rely on information about the venture supplied by the entrepreneur (Tourani-Rad and England, 2013). A comparative study by Zacharakis and Meyer (2010) showed that VCF investments fail at a rate of 35 to 55 per cent. Innovation and technological adaptability by VCF is an essential part for VCF in order to stay competitive on a global basis. Hence, research on comprehensive risk management for the VCF industry is of great practical importance to improve the practices of how German VCFs pursue risk management which might reduce the risk of failure.

By investing in ventures, venture capitalists bear high risk due to information asymmetries (LiPuma and Park, 2014). Hence, Venture Capital Funds apply different types of risk management measures to reduce the risk of the investment. *Agency risk* is one of the major risk for VCF due to potential problems of adverse selection of potential ventures (Bengtsson and Sensoy, 2011). This depicts the conflict of interest between the principal and the agent, in the case of VC founders or managers of the venture and the VCF (Fama and Jensen, 1983; Jensen and Meckling, 1976). Mechanisms like financial contracting, milestones, gradual provision of capital and active involvement in the board are applied by venture capitalist funds to overcome the information asymmetry involved in the dealings that the VCFs are engaged in (Bengtsson and Sensoy, 2011).

Venture Capitalist Funds also face liquidity or financial risks. Kut (2007) classified financial risk in their analysis on the level of the portfolio and macro economy. Contrary, liquidity risk was analyzed by Cumming (2005) indicating that VCF adjust their investment decisions according to liquidity risk. Liquidity risk refers to the exit risk for the VCF in IPO markets describing the risk of not being able to reach an exit in a proper way. The study showed that VCF prefer to invest in high-tech and early stage ventures to defer the exit and increases the syndication size (Cumming, 2005).

Human resources risks are risks associated with the quality and capabilities of the management of VCF. This was analyzed by the studies of Kut (2006) and Smolarski (2005). In these studies, human resources risk was measured by the lack of management performance and the lack of management focus. To mitigate the risk related to the management, VCF can verify the track

record of the management team and can invest in management teams which are previously known (Kut, 2007). Kaplan and Strömberg (2012) showed that risks associated with the management accounted for 61% of the risks that VCFs in the USA have to mitigate (Kaplan and Strömberg, 2012). In addition, a further risky issue for VCF is an incomplete management team (Kaplan and Strömberg, 2012). Overall, the results indicate that risks associated with human capital are of high relevance for VCF.

2.5 Research Gap

Cumming, Fleming and Schwienbacher (2003) concur that there is a financing gap by Venture Capital funds in Africa. However, very few studies, if any, have focused on VCF pre-establishment designs and challenges for the VCF establishment in Africa. While explaining the scarcity of studies in this theme, Barry (1994) argued that empirical evidence on VCF is not easy to develop due to the private nature of VC firms and their investments.

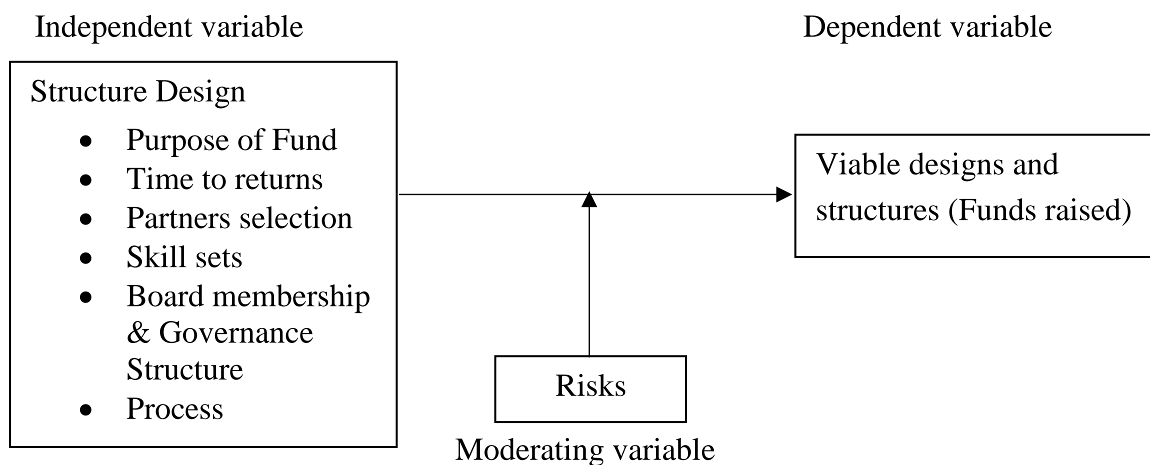
Various designs have been put forward as major designs used by VCFs in their pre-establishment stages. However, no consensus amongst the various research propositions has been highlighted as the preferred model for structuring VCF before establishment. Jeng and Wells (as cited in Gompers and Lerner, 2011) investigated the variables that VC consider during the pre-establishment and identified factors such as entry strategies, VCF structures and VCF management processes. Gompers and Lerner (2001) underline the importance of robust stock market for IPOs hence offering VCs a viable exit option. Jeng and Wells (as cited in Compers and Lerner, 2004), posit that the IPO market does not influence commitments in stage funds much as do later stage ones. Since the VCF concept was tailored to perform in the American institutional environment, the extent to which it can be successfully adapted to other countries with diverse challenges especially the developing ones like Kenya remains a pertinent question. This study sought to explore the viability of pre-establishment designs for the VCFs in Kenya, by assessing existing VCFs to identify best practice.

2.6 Conceptual Framework

The success of a venture capital firm is measured by its ability to attract investment from Limited Partners (Walske & Zacharakis, 2009; Bezza, 2012; Gompers & Lerner, 1999; Barnes & Menzies, 2007). And this happens long before the firm can make any investment in a venture, hence the focus of this present study on the pre-establishment phase of venture capital.

The dependent variable in this study is the viable design as determined by the funds raised. Whether or not a venture capital firm succeeds in fundraising is influenced by several independent variables at the design level, among these being purpose of fund, time to returns, partners' selection, skill sets, board and membership governance and process. Risks is the moderating variables .

Figure 2.1 Conceptual Framework



Source: *Researcher, (2017*)

Explaining the variables

Structure design: This refers to identifying who the partners are, the purpose of establishing the VC fund, how the VC fund identifies the board and what governance structure is being used, and the type of skill set required, and agreements made with investors. Time is of the essence in VCFs as relates to investment period at the pre-establishment stage. What time does it takes before investors get back their returns?

Risks: The study sought to establish the risks and risk mitigation mechanisms at pre-establishment.

Viable VCF designs and structures (Funds raised): The outcome of a viably designed pre-establishment phase is defined by the VCF's ability to raise funds from investors. In other words, if potential investors are convinced that the VCF has thought through the investment

design and process, identified risks, and possible mitigation strategies, then they are likely to invest in such a fund.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This chapter outlines the study methodology adopted for the study. This includes the study design, population and sampling techniques, and data collection approaches and data analysis methods. Issues of research quality and ethical considerations are also addressed.

3.2 Research Design

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

3.3 Target Population and Sampling Techniques

A population is defined as the total collection of elements about which we wish to make some inferences (Cooper & Schindler, 2006). It was not possible to accurately establish the number of venture capital firms in the country despite much effort to do so. Not even the list provided by the East African Venture Capital Association seemed comprehensive and all-inclusive. Neither has the Capital Markets Authority been able to compel all venture capital firms to register. Nonetheless, the author established a list from various studies and reports on venture capital activity in Kenya and the East African region. From the list, a total of 67 VCFs were identified.

The study adopted non-probability sampling; in this case, purposive sampling was used to select seven VCFs to be surveyed. The study respondents comprised of owners of the VCFs and their business partners. The criteria used for selecting those to include in the study was those that had existed for over three years, and had at least concluded one cycle of fundraising.

3.4 Data Collection

Qualitative research was conducted using interviews, document survey and focus group discussions (Elmendorf & Luloff, 2001). An interview guide that captured the study objectives was utilized. The interview guide is as outlined in Appendix II. The interview guide focused on pre-establishment activities and was within the subject matter of the study as proposed by (Cornford & Smithson, 2006). The interview guide was designed in simple questions which enabled consistency throughout the interview process. To enhance consistency, a pilot study was conducted to test reliability and validity of the interview guide and to determine areas of the interview guide that needed improvement before the field data collection was done. During the pilot study, the time taken to cover one interview was found to be close to one hour and half. However, after the redesign and improvement of the interview guide, the time taken per interview during the field work was one hour per respondent. The interview guide consisted of an introduction, the main body which had sections on Designs used by VCFs in the pre-establishment phase, Key variables at pre-establishment of a VCF, Risks and opportunities for VCFs, and the viable VCF pre-establishment designs and structures. Data was collected through face to face in-depth interviews. Permission was sought from the respondents to audio record the interviews.

3.5 Research Quality

3.5.1 Reliability

Reliability in relation to qualitative research is not necessarily about repeatability, since in-depth interviews reflect reality at a point in time, which may change in each setting. The value of qualitative data collection is that is it dynamic, flexible and complex. The flexibility allows for exploration. Therefore, any attempt for standardisation cannot be achieved without risking undermining the strength of the research (Saunders et al., 2016). However, in using this approach, the researcher sought to explain the methods of data collection in detail, keep interview duration to about the same length of time (one-hour), use the same interviewer (to reduce researcher bias), and analyse the data in detail (to ensure rigour). These measures ensure reliability of the research findings (Saunders et al., 2016).

Proper design of data collection instruments was essential for reaching reliable conclusions. Information was obtained on a comparable basis across individuals to allow for comparisons and general statements to be made based on the data obtained.

3.5.2 Instrument validity

Joppe (2009) provides the following explanation of what validity is in qualitative research. Validity determines whether the research truly measures that which it is intended to measure or how truthful the research results are. In other words, does the research instrument allow you to reach the core of your research objective?

Wainer and Braun (2008) describe the validity in qualitative research as "construct validity". The construct is the initial concept, notion, or question that determines which data is to be gathered and how it is to be gathered. They also assert that qualitative researchers actively cause or affect the interplay between construct and data in order to validate their investigation.

Data quality was incorporated in the entire study process especially at the data collection point to include completeness of interview process, legibility of records and validity of responses. At the data processing point quality control included; data cleaning, validation and confidentiality. The use of expert opinions, literature searches, and pretesting of open-ended questions helped to establish content validity.

3.6 Data Analysis

Once the data was collected, the transcripts were coded to themes. NVIVO was used to analysis the data, all the variables in the questionnaire was input into the NVIVO software and the emerging themes were grouped to the various research together to assist in deducing and understanding of the data. McMillan and Schumacher (2001) argued that qualitative data analysis tends to be primarily an inductive process of organizing data into categories and identifying patterns among categories. In this study, the analysis process followed the six phases described by Braun and Clarke (2006) which are: familiarization with the data, generation of initial codes, searching for themes, reviewing themes, definition of themes, and report production. Cross-cases matrices were used to capture these emerging themes as per the study objectives.

3.7 Ethical Considerations

One very important consideration a researcher must not overlook is the issue of ethics in research (Malhotra & Birks 2007). The researcher in accordance with this took steps to make sure that no respondent or participant in this research work was harmed in any way. The

researcher ensured that permission was sought and the aims and objectives of the study were made known to the VCFs through introductory letters.

Respondents were also assured that the study was only for academic purposes. Participants were not forced but rather encouraged to voluntarily participate. The researcher made sure that personal or demographic information was kept confidential. The interview was scheduled and location identified at the convenience of the participants. At the start of each interview, participants were reassured that all information was to remain confidential and that their anonymity was respected. During the interview and focus group discussion process, notes were taken in addition to the audio recording. At the end of the interview, the participants were thanked for taking part and reassured again that confidentiality was respected at all stages of the research process.

3.8 Limitations of the study

The limitations encountered in this study were an inconclusive list of the number of VCFs probably owing to membership being voluntary. Opportunities to conduct interviews with locally registered Funds were also limited as the VCFs tend to be quite closed and private about their operations. The study had intended to collect data from ten VCFs out of 67 but only seven agreed to participate in the study. Despite these challenges, sufficient data was gathered that enabled the research objectives to be achieved.

CHAPTER 4: PRESENTATION OF RESEARCH FINDINGS

4.1 Introduction

This chapter presents the findings of the study exploring factors that influence the pre-establishment design of Venture Capital Fund (VCF) in Kenya. The objectives of the study as outlined in chapter one were, first, to examine the design used by VCFs in the pre-establishment phase, second, identify key variables that need to be considered at pre-establishment of a VCF, third identify the risks and opportunities to be considered by the VC Funds in relation to their investment in Kenya, and fourth, propose viable VCF pre-establishment designs/structures that can be replicated in Kenya. The respondents in the study were the owners of the VCFs and their business partners.

4.2 Characteristics of the Venture Capital Funds

A total of seven VCFs participated in the study. As shown in Table 4.1 below, all the VCFs have offices in Kenya's capital city.

Table 4.1: Location of the offices and region of operation

Fund	Number of employees	Number of Offices	Location of Offices	Region of operation
VCF 1	100 (15-20 Kenya)	12	Colombia, Kenya (Nairobi), Ghana, USA (New York), India and Pakistan	South America, East and West `Africa, India, Pakistan and America
VCF 2	12	12	Canada (Vancouver), Ghana (Accra), Kenya (Nairobi), Zambia (Lusaka)	Canada, East Africa, West Africa, Southern Africa
VCF 3	9	3	Netherlands, Kenya, Tanzania	Kenya Tanzania, and Rwanda
VCF 4	10	1	Kenya (Nairobi)	Kenya, Uganda, Tanzania, and Rwanda (East Africa)
VCF 5	6	3	USA (New York), Kenya (Nairobi), Nigeria (Lagos),	Sub-Saharan Africa
VCF 6	12	2	Ethiopia (Addis), Kenya (Nairobi)	Ethiopia and Kenya
VCF 7	7	7	Kenya (Nairobi), Tanzania, Nigeria and Ghana, Netherlands	Kenya and Tanzania

Source: Field data, 2017

All the Funds use Nairobi as their base of operation and conduct investments in the East African region. Only one of the VC Funds is Kenyan owned, all the others have roots in Europe or the USA. Most of the Funds interviewed had between 8-12 employees except VC1 which had 100 employees worldwide, as shown in Table 4.1.

The Funds interviewed were established in Kenya between 2008 and 2014. And their investment portfolios range from 50 million USD to 250 million USD as shown in Table 4.2 below. Of the Funds interviewed, three were closing their first fund cycle and were already investing their second fund cycle, while four were in the process of fundraising for their second fund cycle.

Table 4.2: Year of establishment and fund size

Fund	Year established in Kenya	Fund Size (Million USD)	Period of Fund
VCF 1	2008	121	In 2nd fund
VCF 2	2008 - 2009	100	In the 2 fund
VCF 3	2013 Kenya, 2015 Tanzania	100	Closing 1st fundraising
VCF 4	2010	50	2nd fund
VCF 5	2011-2012	195-250	Closing 1st fundraising
VCF 6	2014	80	Closing 1st fundraising
VCF 7	2009	10	With a first loss provision of 5 million and 6 million for TA

Source: Field data, 2017

The funds raised their investment capital in four ways as shown in Table 4.3 below.

The funds raised their investment capital in four ways as shown in Tables 4.3(a) and 4.3(b) below.

Table 4.3(a): VCF, Sectors Funded and type of funding

Fund	Sectors operate in	Specific sector approach at pre-establishment	Target Investee	Type of funding
VCF 1	Operate in 6 sectors. In East Africa, sector focus is energy and agriculture, health, water and sanitation.	Energy to catalyze off-grid energy access to low-income households. Agriculture- invest in integrated agricultural value chains.	Early stage business at least 1 year in operation	Charitable donation
VCF 2	Agriculture, financial inclusion, energy access, and human capital and fund investors with frontier	Had no sector approach it developed over time	Businesses in all sectors but mainly growth stage businesses, most companies are small businesses pre- or post-revenue	Family funded
VCF 3	Health, education, retail, transport, renewable energy	Health, education, retail, transport, renewable energy	The deal must be between USD 1-4 million, however, there is flexibility below and above that number	Raised fund
VCF 4	Agribusiness, retail consumer, healthcare, and education.	Initially (first 2 years) was not focused on any sector. Currently food, medicine, and education. Deals of between USD 1-9 million	Consumer driven businesses in 4 main sectors, agribusiness, retail consumer which is FMCG, healthcare, and education	
VCF 5	Generalist	A Swiss port. Deal between USD 5-20 million.	Mid-market businesses largely those that are driven by the consumer growth stories	Raised funds
VCF 6	Across All Sectors	Invest in anything from USD100,000 dollars to 2 million in a more mature business	Growth stage business	Raised funds
VCF 7	Health Sector	Invest from USD 5000 to 2.5 million	Established to growing businesses	Debt

Source: Field Data 2017

Table 4.3(b): VCF, Sectors Funded and type of funding (contd.)

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The Funds operate in different sectors of the economies in Sub-Saharan Africa; while some are sector-specific, others are generalists and operate across all sectors as shown in Tables 4.3(a) and 4.3(b). Their target investees included early stage investments or growth stage investments.

4.3 Design of VCs at pre-establishment of a Venture Fund in Kenya

4.3.1 Registration of the Funds

Registration of Funds is informed by the region of operation and the country where the Fund is managed from. Five out of the seven VCFs interviewed had their funds domiciled in Mauritius for tax reasons depending on the Limited Partners (LPs) and the target markets. The findings revealed that five out of the seven Funds studied were private entities registered in Mauritius and were subject to their regulations.

VCF 3 and VCF 6 were contracted as local advisors of the Fund and were locally registered as limited companies under the Companies Act and were therefore subject to tax regulations in Kenya. One of the respondents for VCF 4 commented that,

> *"I think it is very difficult to register VCFs in Kenya compared to Mauritius on these off-shore funds. I know Kenya tries."*

A respondent at VCF2 said that;

> *"VCs, are private entities, and the regulation should be like it is done for other private entities."*

Another respondent from VCF6 noted that:

> *"It all comes down to tax; it is always about tax, about the capital gains, income, withholding or corporate tax, whatever it is. Things like that influence your domicile. You wouldn't easily directly invest in companies here in Kenya because even capital gains tax is 5% and income is taxed here and we always pay the tax that is due but we don't pay twice. Kenya should therefore learn from practices in successful countries like Mauritius and enhance their regulatory framework."*

The respondent at VCF1 argued that the government of Kenya has a role to play, it depends on how the government behaves, and right now it is a good market for investors. However, Kenya does not have many double taxation treaties so it is not a good market in which to start a Fund. The respondent claimed that:

> *"If the government aims to increase capital gains tax in VCFs here then people will be interested in investing in companies that are domiciled in Mauritius."*

4.3.2 Designs of Funds

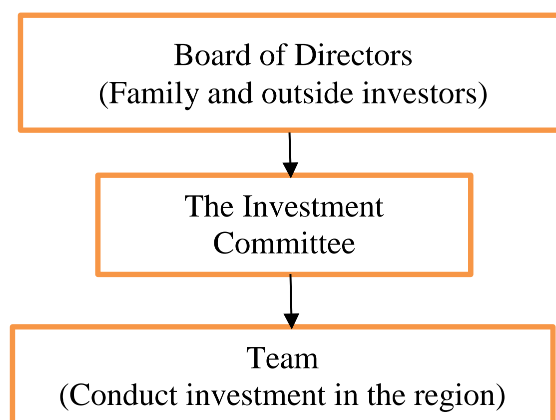
The study identified three major structures of Funds operating in Kenya, they are: the family funded structure, debt financing, and limited partners funding. The findings revealed that the structures for limited partners funding are the same across the board. From the study findings, 3 VCFs were family funded, while 2 were debt financing and another 2 were limited partners funding.

4.3.2.1 Family Funded

Family funded structure is comprised of a board of governors, the investment committee, and the investment team. This type of Fund structure is more flexible, it is an evergreen Fund. It can carry on investments of up to ten years as it is patient capital, it also invests in start-ups. Family Funds differ from the others in that the Funds are availed in an instance or after a short negotiation. With the availability of Funds, the Board of Directors' only mandate is to create a team to figure out the best approach to use in investing and the team to conduct the actual investment. A respondent from such a Fund said that,

> *"The team came before the money and then they figured out what investment opportunities can be made and based their fundraising strategies around those."*

Figure 4.1 Structure: Family-based Fund

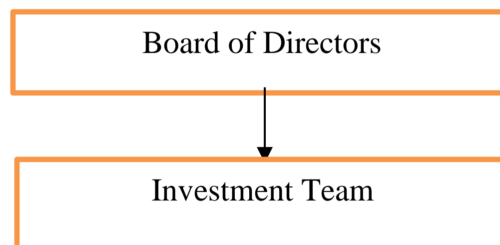


(Source: Field data, 2017)

4.3.2.2 Debt Funded

Debt funded structure comprises of a board of directors and the investment teams. It raises funding from various institutions like development banks, individuals and organizations to on-loan to private health clinics. They syndicate loans with the banks at a 50/50 rate to fund health business enterprises and in addition provide technical support in the form of business training and quality assessment to identify the gaps. A business plan is then developed to finance the enterprise. They are non-profit making funds that provide debt to only the health sector. Below is the structure that was formed at pre-establishment.

Figure 4.2 Debt Fund Structure



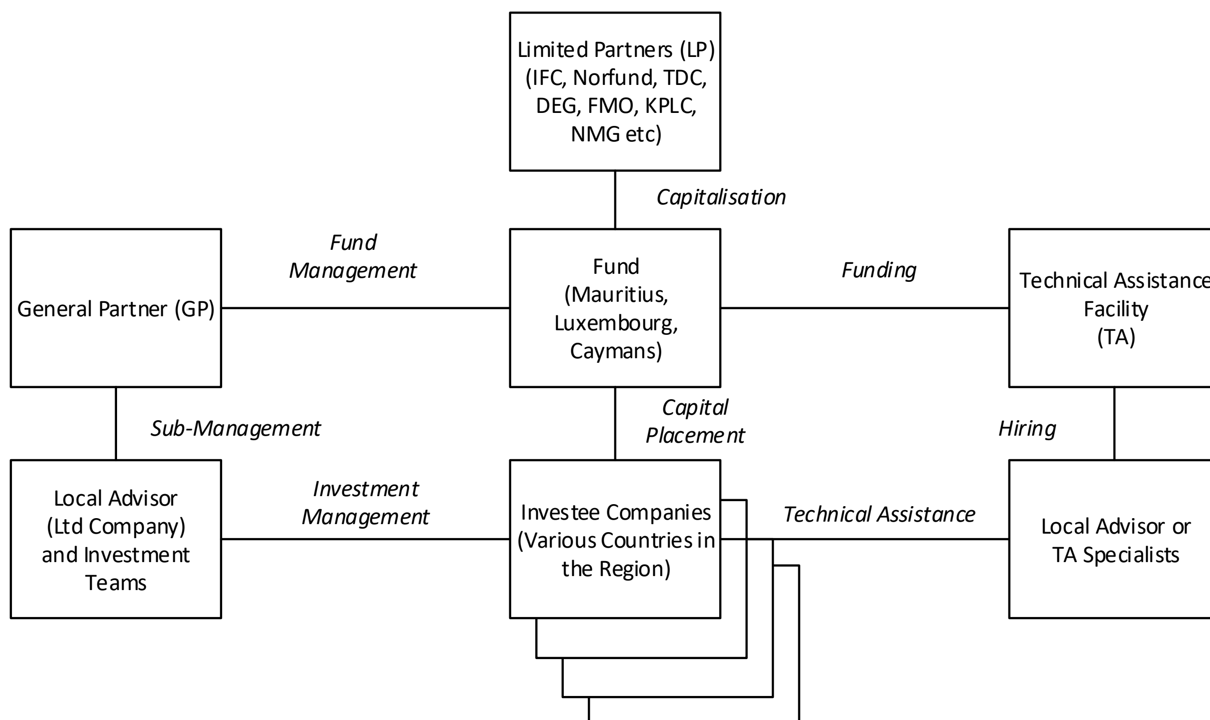
(Source: Field data, 2017)

4.3.2.3 Limited Partners Based Fund

In this structure, Funds raise money from various sources to invest back in businesses. They can be non-profit evergreen Funds or for-profit where investors expect returns on their investments. Their structure is much more complex and they have several limited partners. In most cases the structure is rigid and there are many players, however, some have flexible investment committee structures that make decisions on investments. One respondent said that:

> *"When it comes to investment, what we have done differently is that our investment committee is flexible and we meet when we need to meet and we can call a meeting whenever we need a decision to be made on our investment. This is unlike other funds which have an investment committee meeting which has a fixed meeting calendar, which means that one has to wait until the next meeting and this an inconvenience for an entrepreneur."*

Figure 4.3 Structure: Limited Partners Funded Sources



(Source: Field data, 2017)

4.3.3 Financial Contracts

The structure of financial contracts with LP investors is rather standard and is based on the critical value. A respondent went further to explain that the standard for private equity fees is 2% management fees and 20% carried interest or 'carrier'. He added that:

> *"For us, given we are a Private Fund we are also given 1% management fees and 10% carrier. But that is going to change as we move forward to the second phase Funds."*

The other structures of the contracts include a contractual obligation, which is reporting semi-annually, sometimes quarterly and for the bigger players annually. The rest are captured in investment mandates, where Funds explain areas they are investing in and the amount of money they are investing.

The respondents also said that the structure of financial contracts depended on the targeted internal rate of return (IRR) for the Fund which varies from Fund to Fund, the basis for this depending on the type of investments. Funds for evergreen investments either get loans in which there is an expected return to the investment or receive charitable donations with no

expectations of any return on investment and what they get from the investment is used for reinvestment in other businesses.

Funds raised from limited partners, however, attract an IRR and according to respondents some of the Funds attract a target of 15-20 % IRR, whereas others attract a target of 25% IRR, three times in money multiples. These targets they said are largely driven by risks and since they raise Funds, the rates are arrived at to incentivize the investors, with a number that can be realized.

One of the respondents explained that:

> *"You also want to sell to them the African story, the investors are mostly US and European private entities and if you sell to them that you want to give a Fund for 10 years in order to double their money, they can easily do that in the US. So they don't see the value of the added risk, hence it is a question of how much time is required for returns to be realized from investing in developing markets than in developed markets."*

4.3.4 Legislation

In Kenya, the biggest issue is regulation, as the regulators are not in tune with the investment market in the region, despite making various attempts to the government to change regulations in order to attract more investors to come and set up in the country. Kenya is still hostile to investors because it does not have double taxation treaties with other countries. Most Funds will set up management in Mauritius and operate in Kenya. The other aspects of regulation that bring challenges are that regulations are not in tune with private equity, for example, in the East African space, Kenya is more advanced when it comes to capturing the whole essence of private equity. The way VCF structures are designed become more difficult to establish. One respondent explained that:

> *"When you are looking at some of the approval into some of the structures you wish to adopt it is really not easy. For example, looking at a listed company that you want to invest in and you want to take preference shares that becomes difficult for the regulator to approve yet preferential shares are a common way of investing."*

The other aspect of regulation is on the infrastructure of the companies. Investments in private companies are easier and that is where most of the Funds set their sights to invest. They

confessed that not much investment goes into capital markets because they must get approval from the CMA.

All the respondents explained that they were not really regulated by the Capital Markets Authority. The Fund manager advises the LPs so they are not regulated by the Capital Markets Authority in Kenya. One of the respondents said that,

> *"But I am not even sure if the CMA knows how to regulate a Fund."*

The respondents also affirmed that there is no regulator in Kenya and that the CMA has no role to play, and that their regulation does not affect any Fund.

4.4 Key variables considered at pre-establishment of VCs

Key variables considered at pre-establishment of VCs related to the business landscape, political landscape, skill set, fund size, fund management, pipeline and motivation to start the VCF in the region. These are discussed in turn below.

4.4.1 Business Landscape

During their pre-establishment in Kenya, all the respondents interviewed acknowledged the business landscape was different, that there were very few Funds in existence and those that were coming in had low investment capital and there were few investment opportunities and pipelines that were bankable. One respondent also explained that:

> *"There were also fewer entrepreneurs that had innovative ideas or promising businesses in the market."*

They said that it is not only about strategy or copying an existing business but a game changer business which is innovative uses technology and has a network that is unique, different and scalable. During the interview, it became apparent that there were specific sectors in this region that had become a lot more interesting to investors, one of the more popular ones being the energy sector as stated by VCF1, VCF2 and VCF3. In particular, there were a lot of investments that had been made in the renewable energy sector. One respondent (VCF2) said that:

> *"The solar sector has become the most lucrative space and there is a lot of money that has gone into that space."*

Another one also added:

"I have seen a lot of Funds come focused purely on energy, agriculture, financial technology and you get a lot of niche Funds which are coming and we are yet to see how those go."

The other one explained that:

"Seen a lot of energy saving cook stoves available in the market. M-Kopa is obviously an impact investment vehicle which has changed the way solar is sold in Kenya and as they expand they influence the use of mobile money in other regions."

4.4.2 Political landscape

One of the notable responses given by the respondents was about investing in areas with political stability. As much as they operate in sub-Saharan Africa, there are some areas in the African space which they avoid. For investors it is important to invest in stable markets, that is why all of them agreed that investing in countries like South Sudan and Somali is a no go zone. One respondent said that:

"You want to avoid these areas. In the case of investing in an LP funded in South Sudan is a no-go because it is more vulnerable to political instability and it will affect us raising a Fund."

4.4.3 Skill Set

Funds need credible managing partners in all the areas: skill set, experience, and credibility. One respondent said that the process of investment is about teamwork:

"Investment is very much a team thing and you need to demonstrate that you have a team in place and that you have the right people on the ground."

The respondents believe a Fund needs a GP whose managers have a background in investment or finance or financial consulting. They also agreed that the GPs should have an understanding of the economies that they are investing in. Nearly a third of the Funds interviewed added that the GPs should be flexible and hands on and should provide technical assistance where needed.

There was also a lack of training on talent required to carry out investment in Africa, or the region, this was compounded by the absence of locally trained investment personnel. Most Funds preferred to have a person of European descent to run their investments, as they felt safer with them. One respondent said that,

"Europeans (whites) just love their own and if you have a European, then you feel that your money will be taken care of."

Also, all the respondents believe that Africa is attractive for investment right now, as we have witnessed a number of Funds set up in Johannesburg, Lagos and Nairobi, and they are able to invest in those regions. South Africa is a mature market, while Kenya has a stable and good labor force, they speak good English and are educated in good business schools.

4.4.4 Fund Size

According to five of the respondents, determining the Fund size depends on the type of Fund and phase for management of the Fund. Some explained that typically, most Venture Capital Funding Kenya do not reach 80 million dollars. They are much smaller than Private Equity Funds, their mode of operation also differs as private equities do much more and invest more money than venture capitals.

Five of the respondents also agreed that it was difficult for a first-time Fund manager to be given 200 million dollars to manage. That is the nature of the market, people don't generally give first-time Funds. Funds do not give much money, particularly in a very risky space as sub-Saharan Africa. One respondent said that:

"We actually wanted more than an 80-million-dollar Fund we wanted a 100-million-dollar Fund but because it was a first time Fund, operating in this region as their strategy the LPs were comfortable at 80 million."

The other factor that determined the Fund size was the type of funding received, whether for an evergreen Fund or a returnable investment. One of the respondents (VCF 2) said that:

"We were given 100 million dollars that were deemed as a charitable donation, (a charitable non-profit with insights in investments). Internally we do have our own targets it is an evergreen fund so every dollar we make gets reinvested. The company will not take any money back."

The other determinant of the Fund size was the pipeline (guideline for the Fund disbursement) which the proposed Fund has managed to build up. This is basically before investors can accept to put their money with a particular General Partner. One respondent reiterated that:

"We usually have the pipeline, this provides the estimate between 4th quarter and laid down investments, which sort of guides you with regard to a number of funds you need."

4.4.5 Fund Management

The study found that there were different types of partners. The first were those not expecting to get returns for their investment as stated by VCF 2 which is a non-profit and their contributions were philanthropic. They include family, highly networked individuals, companies doing CSR, and different people who wanted a better footprint in the world.

A responded in VCF 6 needed their General Partners to have access to local Funds and to build capacity to run VCF, for the investors (LP) they needed those who would consider local partnerships, be open to equity, pay for advice and have patience. Another responded in VCF 7 needed a sponsor to act as an anchor to the Fund and help them recruit, develop and maintain a team while they fundraise. Once this is done, then it becomes easier to raise Funds. The LPs actually make a choice of who to invest in, and it always helps to have relationships with them. The GPs are not selected; they come from the founders of the managing firm.

Four of the respondents also talked about having to meet certain due diligence markers, these come in the form of questionnaires which have to be addressed in terms of the sector they are looking to invest in, ticket sizes, what content is required to be invested and in their governance structures. Investors either find the information provided attractive or make a determination to invest in the Fund or that it is not a match for them; that is the nature of the selection process.

4.4.6 Pipeline

Before investing in a Fund, investors require these Funds to have the following according to four of the respondents. First, one has to have a business case outlining how they are going to raise Funds, second, they have to have a pipeline, and third they need a team and strategy on how they are building their team. Investors also need to know the Fund's minimum return (Huddle) which is always between 6-8 % of the Funds. The respondents also mentioned ticket size, governance, and impact on investment, the nature of investment and the region the firm is focused on as key factors influencing these investors' decision making processes.

According to all respondents, another requirement for the investors is the Fund's sector of investment. Initially, when some of the VCFs began their operations in the region, their

investments were not sector specific, along the way they learned to specialize in sectors they were investing in, they realised that it is easier to make money in some sectors like food, medicine, education, energy and agriculture.

Other Funds were generally sibyl aspect as they invested in multiple sectors as long as their investment philosophy was met by the investee, potential investment company or Fund manager. One respondent agreed that:

> *"We don't look at any specific sectors, we look at companies that can become big and return the kind of venture returns that we seek in the market."*

4.4.7 Motivation for starting a VCF in the region

Despite the fact that six of the VCFs interviewed were foreign based, all the founders had some experience in Africa. Three VCFs interviewed stated that they had done business in Africa, one was born in Africa, and two were Africans. Three of the respondents confirmed that their founders' motivation for starting a VCF and setting up an office in the region was the need to provide investment opportunities for businesses in the region in a sustainable way. Although one of the founder's initial motivation was charitable (seed capital), then grants, he quickly realized that he could help other businesses in a sustainable way while making money.

The other four of the respondents said that their founder's motivation in starting their Funds was to make money since there was a lot of opportunity in the African space where the large economy drivers are SMEs but not many Funds were taking advantage of it. They acknowledged that countries like South Africa, Kenya, Nigeria, Ghana and maybe Tanzania were hubs which had connections and leverage, which business people operated from and moved into other markets. And there was also a possibility of working with a lot of Funds which they could co-invest with.

The founders of investment companies (GPs) knew what they expected in terms of the impact in the mid-market as they understood the whole concept of dealing with investment in Africa. Coming into this market they knew that most of the attractive investments were run by families and that corporate governance would be an issue for those who would come to invest. One of the respondents said that,

> *"For SMEs, sharing their businesses with somebody is their last resort, the idea of giving away a share of the business they founded was not easy."*

Most of the Funds were motivated by mid-market businesses, largely those that were driven by consumer growth stories, particularly consumer goods, financial empowerment and inclusion, infrastructure space, a great level of urbanization and manufacturing factors. They also targeted the consumer market, which was fuelled by the emerging middle class which was expanding rapidly across Africa and presented an interesting investment opportunity.

4.5 Opportunities and Risks Considered by the Funds

Risks and opportunities were considered by the Funds in relation to their investment in Kenya. Opportunities and risks at pre-establishment of every Fund differed with the creation of the Fund and the market the Fund was investing in.

4.5.1 Risks

Every respondent accepted that the risks of investing differed with the Fund. So the teams on the ground worked hard daily to make sure that they minimized the risks. All risks were based on the investments and having investments across all sectors mitigated these risks, as a Fund was not tied down to one sector. There were also risks that were liabilities but that were taken up in the structuring with the GP and LP so that there was understanding of the risks. The risks highlighted by the respondents included pipeline, legislation, skill-set, investments, and lifeline of the Fund. These are discussed below.

4.5.1.1 Pipeline

All the respondents mentioned that a Fund needed to have a deal flow, which is the reason why Funds have to be invested/ or have deals made with companies before they can raise money. Most of all they needed to have a commitment from the general partners as well as from the team.

They said that there were more investors and there was a lot more money available in the region and that many Funds had significant capital. However, there was a risk in identifying the most potential ventures since most high potential ventures were new and lacked enough financial history for assessment. They also agreed that there were more deals in the market with high bankable deal pipeline projects and good companies in the region were getting funded. Because of the upsurge in the number of investors, deal evaluations were fairly high, and this led to

changes in the approach of some Funds which were now looking for markets for their investments alongside making new investments in Kenya and elsewhere in the region.

There were many more foreign entrepreneurs with fundable businesses than Kenyan entrepreneurs hence the money put into those Funds would be for foreigners to give money to foreign countries depending on the nature of the investment. Local investors get very protective when a Fund wants to take equity stakes in their businesses. Thus, many VCFs faced the risk of getting low returns from their investment due to the entrepreneur protective behaviour which forced them to place high value for their businesses. Most entrepreneurs did not understand the benefits of such arrangements, hence there was need to educate the entrepreneurs. And because of the nature of the investment businesses build in this region, one respondent explained that,

> *"We are not looking for some business that will give us small modest returns, we are looking into building a business across the region and across the continent which is global and local entrepreneurs don't have that vision yet, we will get there in time but that is only imagined."*

4.5.1.2 Legislation

There are bodies like the East Africa Private Equity and Venture Capital Association (EAVCA) working with the larger African Private Equity and Venture Capital Association (AVCA), to respond to venture capital needs and to make it easier for private equities to work with players. However, no one is subjected to regulation and membership is voluntary.

Six out of the seven VCFs that were covered in the study were private entities registered in Mauritius and were subject to their regulation. Most of the respondents interviewed (four VCFs) explained that the Funds were regulated by a body established in Mauritius called Financial Security Council. They were not, therefore, subject to regulations in Kenya. The companies that were contracted as local advisors of the Fund were, however, locally registered limited companies registered under the *Companies Act* and therefore subject to tax regulations in Kenya. One of the respondents commented that,

> *"I think it is very difficult for a country like Kenya to compete with a country like Mauritius on these off-shore funds. I know Kenya tries to strengthen the market and its structures."*

Another respondent said that,

"VC and PE is private entity, regulating it is like coming to regulate a family business and thus minimal regulation in line with the regulation done for other funds is appropriate."

Four VCFs that were interviewed also commented that the Kenyan government had tried to change its regulations in order to make it more attractive for investment firms and said that this move had not yet yielded fruit. Investors were choosing not to establish big Funds in Kenya from a regulatory perspective because of double taxation and unpredictability of the government when it comes to capital gains. One respondent made the following comment,

"So you try to avoid such strict regulations and you go to a more stable mature economy with a more mature financial fund market and a financial base such as Mauritius, Seychelles or the Cayman Islands. We have a long way to go in enabling funds to be registered. Basing operations in Kenya like we are based here is just because of the strict regulations."

However, one of the respondents believed that the Kenyan government is re-evaluating the tax set up for Funds registered in Kenya. This is because of the initial registration of some of the VCs in Kenya. The respondent explained that:

"Because we are a non-profit and registered as a branch of non-profit, there is a certain tax breaks for certain things but with continued evaluation of operations, like if you are investing in businesses that are making money and they are paying back and sometimes with interest, how is the government gaining in that? And they have begun to ask questions and are making demands that if even as a non-profit you invest in something commercial and you are not set up in a commercial way the government is able to collect what belongs to them."

4.5.1.3 Skill-set

The skills set of the Fund Manager and the local team are very important for raising and running the Fund. The process of negotiation is normally based on proposals made to investors by the local advisors. The respondents agreed that this process differs for VC depending on their funding structure as well as the understanding between the Local Advisor and the LPs. This depends on the profile and the ability of the local advisor to make financial decisions concerning investment. Second, one of the ways PEs make money is leverage, especially when companies can access cheaper debt which can allow them to accomplish more.

A respondent from VCF5 argued that,

> "*there is general knowledge in the market that there are many local businesses which are co-owned by foreigners and that investments are naturally biased towards them because they know the language of operation and presentation of their businesses. Only 20 percent of indigenous businesses attract investment in the Kenyan market. Some GPs in the country have started investing in internship programs to train new people on investment."*

The respondent at VCF5 also added that *"we have an internship program where we are bringing people in."*

On their part, VCF1 reported that,

> *"some of the Funds are investing in financial literacy and conducting business training with the entrepreneurs that they are investing in. This is being done in conjunction with the identification of quality gaps and mending of these to ensure sustainability before exiting. Lack of proper skills in management of VCFs raises the risk of failing to run the partnerships between local entrepreneurs and the foreign funders of the VCFs. This may lead to loss of funds invested in various projects."*

4.5.1.4 Investments

For the VC not funded by families, selection of partners is not easy especially when fundraising without an anchor investor. The seven respondents agreed that having an anchor investor makes it easier to access financing. However, they believed that it was also very crucial to know venture strategies in Africa (through research) and to put together a qualified team to manage the fund.

However, according to a respondent at VCF3, philanthropic Funds had no challenges in the selection of their partners as many people, companies, and institutions were looking for ways to give. There were those looking for a return on their investments and there were those who supported the Fund with money. The only difference was that some of the investors came with funds and specified the sectors and regions they wanted their investment in. Educating people on philanthropic investment has helped funds of this nature to continuously attract partners who are willing to give their money. Lack of knowledge in the local dynamics and lack of proper information on how local dynamics could affect the investments poses a great risk of failing to realize forecast return from the investments.

During investments, the respondents from VCF2, VCF5 and VCF7 agreed that there are always currency risks, especially where they invest in different countries with different currencies. However, they agreed that currency risk can only limit a Fund to a certain degree and that to mitigate that, VCFs should make their investments in USD and expect such returns in US Dollars.

4.5.1.5 Lifeline of the Fund (Flexibility of the Fund)

The process of negotiation also depends on the flexibility and the structure of the funding. If one is funded by a single LP (family outfit), that is a lot more flexible than typical capital funds where one has multiple LPs. Also, some multiple LPs can be flexible, especially government funded LPs which have restrictions on how you use their funds. One of the respondents said that,

> "*Our money is from the UK government and the Dutch government. Each of them has restrictions on how we use their funds, so we have to choose standardized things so that we can accommodate everyone but not to bend ourselves out of shape. This is a more rigid kind of structure than a family outfit which you can do what you want.*"

4.5.2 Opportunities

On the opportunities, some of the risks also presented opportunities that could support the growth of the VCF sector. These included legislation, investments and fund management. Other opportunities were exits, investee confidence and round two fundraising. These are discussed below.

4.5.2.1 Legislation

In 2001, the CMA was mandated under the *Capital Markets Authority (CMA) Act of 2001* to approve investment so that pension funds could invest in VCFs that were registered in CMA. The only requirement for pension fund investment is the registration with the CMA, which is what the new law requires. Changes in legislation that have allowed Kenyan pension schemes to invest in private equity funds without any special approval from the RBA has also opened up the local investment market. National Social Security Fund (NSSF) contributions are growing; the average age of commencement for a contributor is 19, so as people continue to contribute the impact of VCFs will be greater. According to three of the respondents, other sectors of the economy, like the stock market and property market are not doing well and this is a positive thing to the investors since investors would get good deals at cheaper rates.

> "*The stock market is not doing well, property has stalled/plateaued, and so the VCFs need options to deploy the capital. So in 10 – 20 years from now equity shall have its own money to sustain them."*

The other part of legislation that has changed is the recent interest rate capping. All the respondents believed that this legislation would make entrepreneurs look for other sources of funding. This is because the banks were not lending to them as in the past due to interest rate capping, because it has maxed the borrowing ability of the entrepreneurs.

All the respondents believed that this recent revolutionary change in Kenya's banking sector is very significant because it could be a good thing for the funds, however, they are yet to see the implication if it can be sustained long term. Most of the respondents interviewed believe that it is a positive development for them to play in Kenya. Most SMEs are family owned businesses that are not keen to take in additional equity investors. But with the introduction of the interest rate cap by the government at 14% there is a new shift. One of the respondents at VCF 7 noted that,

> *"The SMEs are coming to check us out because when the banks don't lend to them they come to us. So if it is something that is sustainable for long periods then it is something that would be great for us."*

However, three of the respondents believe that the interest rate cap had affected some of the companies they work with, but they did not think that the legislation had resulted in any impact on how they make their investments.

4.2.2.2 Kenyan Fund Managers

Kenyan Fund Managers have a responsibility of advising entrepreneurs, to help them understand that the investor is a partner, not a banker. The investor will come on board to help with strategy, recruitment, and technical assistance. Their priority is a partnership because the business is complex and they need somebody to think through it and to bring in networks that can help them work through various challenges, not just the capital.

According to comment by VCF 3;

> "*Fund managers form the centre from which VCFs operate and are crucial in implementing the agreements between VCFs and entrepreneurs*."

4.2.2.3 Kenyan Investors

All the respondents agreed that there are Kenyans or East Africans engaging in Venture Capital as well which was not part of Kenyan entrepreneurial culture a few years ago, meaning that the general long term view on investment in this region is changing. Investors and in particular those in Kenya, were open to this other source of capital and the SMEs were more willing to accept investments. Because of this, better and bigger deals were being seen across the country according to respondents. In agreement with this one respondent from VCF 2 said that,

> *"In Kenya, I think they are switched on to adopting VCFs, regionally they are catching up successful cases like Seychelles."*

Local partners are also teaming up with foreign investors, such as VCF 2, to raise funds. And locally based funds like VCF 6 "the first ones whose whole team is local" have raised a lot of confidence in local teams that invest in the region. Also, highly networked Kenyans are already investing in the market. This has helped to boost the pool of local partners or teams and a lot more people are getting trained either in Kenya or outside the country to work in this market because, as one respondent from VCF 7 put it,

> *"Entrepreneurs in Kenya are appreciating that this is a foreign market the way they think is different, culture is different so you need somebody who is local to be part of the partnership."*

However, many potential investors in Kenya and in the region think that probably venture capital is scary as it locks their money for possibly eight years in investments. They are also not familiar or comfortable with Kenyan sectors/companies, companies that focus on growth

as opposed to revenue. They explained that an investor has to be very tolerant to get into Venture Capital and most wealthy local money is not very risk tolerant. It is a cultural gap; most Americans have seen lots of people make money from Venture Capital and so they know by the nature of their experience how to tolerate the risk, but many Kenyans here have not been good at taking risks even when they can see high returns.

4.5.2.4 Exits

All the respondents interviewed said that there are quite a number of exits that have taken place in the market and this will continue to increase. They have also seen many companies which are beginning to invest in people who are buying in the market and people who are beginning to see returns in the industry. The respondents said that,

> "*We also got to see some exits from VC firms in the insurance industry, coffee house and wine making businesses.*"

Another respondent from VCF2 explained that,

> *"As a sector, our victory cases continue to push that agenda in terms of what a VC can do for you, such as one coffee chain business where Washington-based Emerging Capital Partners (ECP), which bought the stake in 2012 from the coffee chain's founders, Kevin Ashley and John Wagner, at Ksh.10bn. From such successful cases people are seeing what valuations are like and now believe that if I get this money I can pull this off."*

All the respondents hoped that there will be a mature VC market with the consolidation of investees, mergers, acquisition of companies as investments that are working in the same industry to build something big. They all agreed that we will see a lot more exits which will impact the market that will make people have a conversation on exits. One respondent from VCF5 said that,

> *"In 5 years we will see more exits and in the impact stage we have seen sector buying UAP and selling it, Java returning to the financier 5 times the impact stage; we cannot say very much."*

Another one said that

> *"If you have good stories in the market, the more stories you have in fund one, the more the entrepreneurs get convinced that these people can be partners."*

4.5.2.5 Investee (SMEs) confidence

The respondents also commented on the nature of investments in Kenya, saying that there were a lot of the funds mostly set up around the investee who can connect easily with other foreign entrepreneurs and that they need a lot of local entrepreneurs to be involved and help out. However, most of the entrepreneurs in Kenya do not know how to package themselves and they also do not pay attention to the important stuff.

Three of the respondents explained that although they work in different markets, jobs, ticket size, return for expectations they also play in different parts of the capital markets. They say that there are some parts of the market in this region that are really struggling and there are not enough early stage investors and only a few investors are willing to write a ticket size of 100,000 US dollars yet there are a lot of companies that are looking for that kind of money. This means that there are a lot of sectors that are under-invested, so there are more scenarios where we need investment. Most privately owned companies and family-owned businesses do not understand private equity and it only comes to them as last resort financing. One respondent from VCF3 explained that,

> *"When it comes to an understanding of private equity, most of the investee companies/ potential investment companies we are looking at don't understand what private equities are and we have to educate them on that element."*

The other opportunity is commitment to the success of the ventures by the entrepreneurs as most investees are hung up on the legacy of the founders. Another respondent from VCF6 argued that,

> *"They really don't want to give up the founding legacy of their businesses, they would like the business to stay with the family and that makes it difficult to make structural adjustments so even if you are looking at getting some potential to restructure the business, it becomes a whole different negotiation because they are not ready to give up equity or take up another identity so it is legacy plus the whole element of control."*

But they have seen changes for the companies that they have already made impact investments in i.e. built capacity, strengthened their systems and helped them build a proper team, these are now able to go to the banks and borrow loans so this has boosted the confidence of local SMEs.

4.5.2.4 Fundraising Round Two

The respondents interviewed said that fundraising for a VCF is different for each fund and this is mostly informed by the investment strategies of the fund, number, and type of investors and the type of fund. For funds that are funded by family or a single person, the need for fundraising does not exist and the fund is always acquired instantly. Charitable investment funds have multiple donors who believe in their activities, they have two kinds of investors those who donate money and expect no returns and those who expect returns on their investments. The majority of investments, however, raise funds from different potential investors, such funds need an anchor investor to ease the route of fundraising. Once the owner finds an anchor investor who sees the fund, the challenges in fundraising are removed because other funds are attracted to it as a catalyst.

The other factor that determines the duration of the fundraising is the relationship of the fund manager to the investors. This is because the investors have to trust the fund managers with their money. The level of trust, in this case, will be determined by the skills set of the fund manager and the local team. These factors can accelerate fund-raising or drag the exercise for up to 3 years.

4.6 Proposed Design Structures that can be replicated in Kenya

4.6.1 Operational Adjustments

Initially, when some of the funds began their operations in the region, their investments were not sector specific. Along the way they learned to be specialized in sectors they were investing in. They realized that it was easier to make money in some sectors like food, medicine and education, energy and agriculture.

Other funds were generally sibyl aspect as they invested in multiple sectors as long as their investment philosophy is met by the investee, potential investment company or fund manager. One respondent from VCF 4 agreed that:

> *"We don't look at any specific sectors, we look at companies that can become big and return the kind of venture returns that we seek at the market."*

Although most of the respondents acknowledged that their funds have largely remained the same and that the market is changing, since they are still funding deals and everything is still working they said they don't need to change anything. One respondent from VCF 4 said that

they have made operational adjustments by offering technical advice, having the local staff bonded with a local CEO based in Africa and that they are also investing into more portfolio management.

The major changes in the regulatory environment in Kenya will bring structural changes to some of the funds registered there. One of the respondents from VCF 3, believed that at the time they set up their VC in Kenya, the government should have done some things differently. There should have been a clear definition of what a non-profit venture is that would have allowed them to register the VC according to its operations. The respondent does not know whether the government knew it, however, they believe that their experience will inform the next person that wants to set up a similar VC in the country, and that they will have to set up in a commercial way. Alternatively, if registered as a non-profit, they should be able to prove that there is no commercial gain whatsoever. Such experiences have increased the level of documentation of the activities the company is interested in undertaking making it more rigorous. One respondent from VCF1, said that the changes will make them split their commercial entity from the charitable entity, splitting the operations will help them register their charitable entity as an NGO.

4.6.2 Hybrid Fund

Some of the Funds are a hybrid of private equity and venture capital. This is because of the investment in other Funds in capital markets and indirect investments ' *'so I can say we are sort of a hybrid between a PE and a Venture capital.*" A hybrid fund, according to one respondent, invests in both fund management and investment. The respondent explained that the fund was initially established to tilt into fund management and later branched into investment funding.

4.6.3 Investors Demands/Conditions

The process of negotiation is normally based on proposals made to investors by the local advisors. The respondents agreed that this process differs for Funds depending on their funding structure and the understanding between the Local Advisor and the LPs. This depends on, first, the profile and the ability of the local advisor to make financial decisions concerning investment and, second, one of the ways PEs would make money is leverage especially when companies can access cheaper debt, which can allow them to accomplish more.

The other change in the process of negotiation is for entrepreneurs to understand that the investor is a partner, not a banker. The investor will come on board to help with strategy, recruitment, and technical assistance. Their priority is as a partner because the business is complex and they need somebody to think through it and to bring a network that can help them work through it, not just the capital.

The process of negotiation also depends on the flexibility and the structures of the funding. If you are funded by a single LP (family outfit) it is a lot more flexible than typical capital funds where you have multiple LPs. Also, some multiple LPs can be flexible especially government funded LPs which have restrictions on how you use their funds. One of the respondents representing VCF2 said that,

> "*Our money is from the UK government and the Dutch government money. Each of them has restrictions on how you use their funds, so we have to choose standardized things so that we can accommodate everyone but not to bend ourselves out of shape. There is a rigid kind of structure than a family outfit which you can do what you want.*"

Some of the respondents also talked about meeting certain due diligence markers, this will be in form of questionnaires you have to address in terms of the sector you are looking to invest in, ticket sizes what content you need to invest in, governance structures. They can either find this attractive and invest in you or that you are not a match for them so that is the nature of selection.

The funds also need credible managing partners in all the areas: skills set, experience and credibility. One respondent said that the process of investment goes beyond a team, by noting that,

> *"Investment is very much a team activity and you need to demonstrate that you have a team. A fund needs to have in a team the right people on the ground."*

All the respondents also mentioned that a fund needs to have a deal flow which is the reason why funds need to have invested in companies before they raise money. Most of all they need to have the commitment from the general partners as well from the team that they will commit all raised resources to the fund. The implications of these findings are discussed in detailed in the next chapter.

CHAPTER 5:DISCUSSIONS, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

The aim of this study was to examine the factors that influence the pre-establishment design of VCs in Kenya. The objectives of the study were to i).examine designs used by VCFs in the pre-establishment phase of a Venture Capital fund in Kenya. ii). identify the key variables that need to be considered at pre-establishment of a VCF. iii) .identify the risks and opportunities considered by the venture capital funds at the pre-establishment phase in Kenya. iv) propose viable VCF pre-establishment designs and structures that can be replicated in Kenya. This chapter discusses the study findings, draws key conclusions and makes policy and practical recommendations. The chapter concludes by identifying areas for further research.

5.2 Discussion of Findings

The discussions are presented in line with the research objectives. Additionally, the contribution of the findings to the theoretical underpinnings of the study are discussed,

5.2.1 Designs used by VCFs in the pre-establishment phase

This study showed that the majority of VCFs investing in Kenya are not registered in this country. According to respondents, only one of the VCF was registered in Kenya. Five funds were domiciled in Mauritius, therefore, were registered as Mauritius-based funds operating in Kenya. The remainder were registered in Europe. Most VCs interviewed preferred this route because of ease of their operations in the region and to avoid double taxation since Mauritius has double taxation treaties with most of the countries in the region and is, therefore, a tax haven for companies, especially those operating in multiple countries. The findings in this regard agrees with findings from Wilson (2009) who argued that most venture capital investments are structured as convertible preferred stock with dividend and liquidation preferences.

The study discovered three structures of funds operating in Kenya, they included; family funded where an individual or a family put up their money to be invested in a region. This type of a fund is headed by a board of governors, which works with an investment committee headed by a CEO who manages a team of investors in the various countries they operate in. This fund type was found to be the most flexible one as decision making on investment is fast and easy. The second structure was the debt funded structure headed by a board of governors who work

with an investment team in the various countries they operate in. They raise their funds from multiple sources especially banks and they syndicate loans with the bank at a 50/50 rate for the entrepreneurs they invest in. The third was limited partners funded structure which is more complex and also very rigid in decision making as a lot of players are involved and they sit in different countries or continents in most cases. This finding was in consonance with Roberts (2011) study where he established that an important consideration to VCFs is the percentage of the company that they own on a fully diluted basis.

The study also looked into the financial contracts which included internal rate of return that the VCs had with their investors and found out that it was fairly standard across the board however a few funds had different or lower rates. These changes in rates are done as incentives to the investors to make the funds more attractive to invest in and to give them an investment opportunity and rates of return they cannot find either in Europe or in the US where most of them are based. This finding exposed a gap in that, the current structures were not appropriate for seed and early stage Venture Capitalist Funds and their portfolio companies, where the portfolio company is in need for continued funding after the initial Venture Capital period has ended (Murray, 1994). This gap could be solved if the Venture Capital Funds could embrace the Evergreen structure where the main goal is to generate high return without any time pressure to make exits.

On legislation relating to establishment of VCFs, the study found that Kenya may need to focus on structural issues for the establishment of VCFs to make investments in Kenya more attractive. This does not mean that the government has not put measures in place to make the country attractive for business; however, it means that their conditions are still not favorable for the venture funds operating in the region to set up here. The other aspect of regulation falls on the structure of the companies invested in. This study showed that most funds preferred to invest in private owned companies and not public listed companies owing to the rigorous approval process from the CMA. This becomes even more difficult especially if you want to trade in preferential shares which are always the most common method of investment. In addition, all of the investment companies (local advisors) are not subject to regulation by the CMA as they are private entities. The legislation gap in the industry can be addressed by introducing radical changes in the Kenyan Venture Capital industry which faces several difficulties. Just as proposed by Vermeulen (2012) the gap can be bridged by introducing proper legislations especially targeted at adopting Evergreen Venture Capital structure model.

The structure is suitable for different kind of investors. The prime factor in this structure is the view on exit, in other words the investment horizon.

5.2.2 Key variables at pre-establishment of a VC fund

The first variable to consider in the pre-establishment of VCFs was the business landscape in Kenya which the respondents agreed was robust, innovative, different, and scalable and had a network that was unique. It also narrowed down to specific sectors especially the renewable energy sector that was very popular with investors. The study found the market stable and boasted of the skill set and talent needed to carry out investment in this region. On the skills set, which was an important variable, however, some of the funds still preferred to have people of European descent manage their portfolios because of trust and belief that Africans are not well capable of managing funds. The other interesting result of the study was that it was difficult for first-time fund managers to get more than 80 million dollars investment funding due to the risk associated with this region. The management of the funds also depended on the contractual obligation and the due diligence signed by the partners during fund raising and the type of fund. The respondents identified two types of funds; evergreen funds where the VCFs plow back the returns into the funds and returnable investments where the investors expect returns for their investments. Some funds may have a combination of both evergreen and returnable funds while others are purely evergreen or returnable investments. This finding could be related to Klonowski (2013) who established that different variables are in different countries and reflects among other things varying economic and market conditions, the involvement of government and entrepreneurial potential.

The study found four different types of management based on the conditions set by the limited partners/investors. Some VCFs are purely philanthropic and get charitable donations from investors and are therefore managed as not-for-profit funds. Other funds are managed by partners who are expected to have access to local funds in the markets they operate in and also have a team that is already in place. The third management style needed an anchor investor who helps the VCF recruit, develop and maintain a team and they are fundraising. The fourth management style came from funders who come together and select a general partner from among them to manage the fund.

The other variable considered was the pipeline a VCF already developed in the sector and region of operation before raising the funds. This was one of the requirements for the investors to commit their money into a market that most were not very familiar with.

The last variable considered in the pre-establishment phase was the founder's motivation to start a fund and there were only two identified in this study. In the first case, the founders were individuals who had worked in Africa with charitable organizations either managing charities or grants or had business in this region and had come to a realization that people needed a sustainable way to do business and not through charities. The other group of founders was a group of people who came from the region, worked or were doing businesses in the region and had seen the potential to make money through investments.

5.2.3 Risks and opportunities for VCFs

Risks and opportunities are part of investing. These are dictated by the type of fund, the region and the sector of investment.

5.2.3.1 Risks considered in relation to investments in Kenya

Each of the respondents accepted that all the investments were accompanied by risks and that the best way to mitigate the risk was to invest across sectors. During the pre-establishment stage the VCFs considered several risks.

The first was the pipeline of investment. The respondents said that they needed to have deal flows that were highly bankable and needed external investment in their companies. The VCFs according to the findings faced agency risk and thus the respondents also agreed that their funds considered legislation before setting up in the country. All the respondents agreed that working with EAVCA had made it easier for them to work in the region; however, they were not subject to regulations in Kenya because most of them were domiciled in Mauritius or were registered under the companies act as private entities and were subject to taxation in Kenya. Even though the Kenyan government had tried to make the country investment friendly, investors choose to register their funds in Mauritius due to regulations of double taxation and unpredictability of the government with regard to capital gains. These findings were in consonance with similar findings by LiPuma and Park (2014) who argued that the greatest risk facing VCFs in the contemporary world is the manner in which the VCFs are regulated which changes from country to country. LiPuma and Park (2014) further posed that having gaps in regulation

procedures and guidelines leads to greater risks for the VCFs especially if existing regulations are not able to protect the special interests of the VCFs.

The second risk considered by the VCFs before investing in the country was the human resources risk which was related to skills set of the fund managers, investment teams, and local entrepreneurs. Regarding the human resources risk most of the fund managers had knowledge of the markets and the sectors they were investing in and were also qualified and experienced in both business and finance. The teams initially were mostly made of foreigners. However, this had changed as more Kenyans have studied in some of the best business schools and/or have been mentored and were now mentoring others to work in the sector. On the other hand, most of the investments in Kenya go to Kenyan based foreign entrepreneurs as they are conversant with the business language and know how to package their businesses. Yet, most local based entrepreneurs/SMEs have begun to understand the concept of investment and are now catching up. Some of the funds are also investing on improving the skill set of the local entrepreneurs they are investing in. These findings are similar to Kut (2006) and Smolarski (2005) who established that human resources risk which is measured by the lack of management performance and the lack of management focus can lead to uncertainty in way of operation for VCFs. Kut (2007) suggested that, to mitigate the risk related to the management, VCF can verify the track record of the management team and can invest in management teams which are previously known.

Third are the financial risks. This was because most of the funds with returnable investments expect exits between 3-5 years while others especially those with evergreen funds can invest and reside with a company for between 7-10 years. The duration of investment can help determine the kinds of returns a fund gets during the exit and also the sustainability of the SME after the fact.

5.2.3.2 Opportunities considered in relation to investments in Kenya

The study showed various opportunities in the Kenyan market that make the country attractive for investment. The change in legislation has opened a new opportunity for establishment and operation of the VCFs in Kenya; in 2015 the Kenyan government mandated the CMA to approve investments by the pension funds registered with the CMA in investment funds. This has opened doors for local funding of VCFs operating in the Kenyan markets. The other legislation was the recent interest rate cap that has reduced the number and volume of loans

given to local businesses by the banks. This has driven local SMEs to seek funding from VCFs investing in the market.

The emergence of local fund managers with local investment teams has also boosted confidence in investing in the region as investors are becoming aware of the availability of the local skill sets the Kenyan market has to offer. This has also boosted the confidence of local investors who are now getting the courage and patience to invest in local funds. As reported by KEPSA (2014) there have also been some big exits that have taken place in the Kenyan investment market like the UAP, JAVA, MWANAINCHI and others which have set a tone for investment in the region. This has boosted SME (investee) confidence and has led them to begin seeking partnerships with investment funds. Also, the big exits and the availability of skills set now seen in the country has attracted many more investors, and those raising funds for round two are not experiencing road blocks as they did initially.

5.2.4 Viable VC pre-establishment designs and structures

According to the study findings, the optimal form of VCF structure is designing it in the form of a family funded structure as the requirements and conditions are easy for fund manager to meet. In addition, the fund is an evergreen which can continue beyond five years even upto ten years. The advantage of such a structure is that it can fund start-up which is badly needed in Kenya and the rest of Africa. However, the findings differ from those stated by Kaplan (2008) which cited that a convertible equity structure is preferred. It states that designing the VCF in the convertible preferred equity makes the fund optimal by offering higher insurance for venture capitalists in case of bankruptcy, transferring risks from investors to entrepreneurs in case of an unsuccessful investment losses can be reduced and in case the fund performs badly it provides an opportunity for the VCF to take control over the venture being funded. Another benefit of the convertible preferred equity design is that it facilitates liquidating illiquid assets and mitigates the problems in connection to the selling of the company in consideration of agreements.

In terms of the family and debt structure, it is recognized that the two major forms of exits observed in venture capital are the initial public offerings (IPOs) and the Trade Sale (TS). Typically, a Participating Convertible Preferred Stock (PCP) stake is converted into common equity during an IPO exit but is not converted in a TS exit. The study shows that since VCFs can signal the quality of their venture in an IPO, by converting their PCP stake into common

equity and giving up some of their cash flow rights, this becomes an opportunity for families to take up control of the fund.

Convertible Preferred Equity is fit in achieving country specific legislations and regulations targeting though it has substantially higher transaction costs since the company's governing documents must be reworked to create a new class of ownership, but it also comes with attractive terms and protections for investors. Preferred equity holders have a higher priority (called a "liquidation preference") than common equity holders to receive proceeds from the liquidation or sale of the company (and often in the distribution of ongoing profits). The holder of preferred equity also receives additional governance rights (called protective provisions), such as the right to appoint board seats or the right to veto certain actions. However, the terms of preferred equity vary widely from deal to deal and can be complex to negotiate.

In this regard, these regulations as defined by CMA are adequate as they define the entities that can be set up as VC funds and set out the manner in which they are registered with the Capital Markets Authority (the regulatory authority governing the capital markets in Kenya). The regulations also set out the manner and extent in which VC funds can make investments. Venture capital funds in Kenya therefore do not require to set their own regulations or guidelines since the existing regulations provide proper legislative framework.

In terms of setting up VCF based on sectors, it should be considered that Africa has at least 200 separate tech hubs which have sprung up in the last few years. The number of new tech ventures has also risen to 3500, with $1 billion in venture capital available to accelerate these from 2016. These hubs have consistently made headlines in their effort to bring or rather accelerate technology businesses to the grassroots level. They have brought many new ideas/innovations, have provided a rich source of employment and new business formations. The origin of Africa's tech movement can be traced back to Kenya, which has been home to several major technological innovations between 2007 and 2010. These innovations birthed Kenya as the Silicon Valley of innovation in Africa. Now, Kenya is known to all as the Silicon Savannah.

5.3 Conclusions

In conclusion, this study offers insights into the pre-establishment designs for the VCF in Kenya. The study found that, the best design for the VCF to work in Kenya is to have them structured in a convertible preferred equity. The study also concludes that other operational adjustments made in the market like offering technical advice, training of staff, internship, having the local staff on board employing a local CEO based in Africa will help in structuring in the pre-establishment processes of the VCFs.

5.4 Recommendations

1. For the government

The current study has shown the intricacies of formation to funding raising of venture capital. It has shown that most venture capital funds are domiciled in Mauritius due to tax incentives that they receive. Mauritius as a country has provided a number of incentives such as no withholding tax gains, on capital gains tax, no capital duty on capital, well-regulated offshore businesses and adherence to standards of best practices and a double taxation treaty among others. The policies should be favourable to allow foreign venture capital funds to be domiciled in Kenya. Policies such as offering tax incentives, providing an enabling environment for foreign business, will attract more funds to be domiciled in Kenya. The other issue that the findings revealed is that most of the venture capital funds are funding foreign based businesses. This means that Kenya based businesses are not successful in securing these funds simply because they have not mastered how best to pitch for their businesses in the shortest time possible. Therefore, the government should provide technical assistance through institutions such as KIE which was one of the reason it was formed to support SME and provide them with the necessary technical assistance. Finally, the study also showed that most of the venture capital funds operating in Kenya employed foreign managers as opposed to Kenyans. Policies should be put in place to ensure that after a two years, a Kenyan should fill those positions.

2. For prospective venture capital funds and existing venture capital funds

The current study helps to shed light into the challenges that the VCF face especially with the investors. In the pre- establishment phase the study showed that there are three types of structures that VCF adopt, one is the family-operated fund, the second is the debt structure and the third was one with limited partners. Family operated fund is recommended to be the most flexible type of structure since they do not demand so much from the VCFs and decision

making is much easier as compared to that of limited partners since one has to convince a number of investors who have varying demands. Therefore new VCF should target families that fund investors.

The risks faced by investor was the agency risk which means that they rely on the fund managers, therefore it is recommended that investors should have some adequate understanding of the countries that the VCFs operate in and not make stringent demands that are not applicably. Another risk that the VCF face is the human risk, which can lead to lack of management performance and lack of management focus. Therefore the investors can verify the track records of the management team before they invest into any VCFs.

With the interest cap which has reduced the number and volume of loans, the VCF has an enormous opportunity to narrow the finance gap that has continued to wider now that most banks have not been actively lending to SMEs. It is recommended that the VCF can work with consultants to meet this finance gap. For sectors such healthy, having a tripartite arrangement with local banks can assist VCFs to increase their lending to such sectors.

3. For academic researchers and industry consultants

The study shown that there is no single source of information that one can get to know the list of VCF operating in Kenya. Further, it established that there is an Association of Venture Capital Funds in East Africa based in Nairobi but even with this very important Association, it was not possible to establish the numbers of VCFs since the association is for members only. Therefore, the academic researchers, industry consultants and others could contribute industrial and market data for VCFs in Kenya. In the Field of Tax, the academicians could finds ways that could create tax incentives which is one of the issues that makes them domiciled in Mauritius. The role played by VCFs cannot be underscored, hence universities could incorporate Venture Capital unities in the finance curriculum or develop a venture capital programe which can be used to mentor start-ups to know how to pitch for funding.

5.5 Areas for Further study

This study focused on the factors that influence the design of Venture Capital Funds at pre-establishment. Other studies could focus on a comparative analysis of the various types of funding organizations such as for-profit and not-for-profit which includes angel, VCF or

Private Equity to see the different types of returns. Another area of study could be towards a more diverse concept of returns such financial, social returns, job creation and attach value to each of them.

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APPENDIX I: SAMPLE OF INVITATION LETTER TO VENTURE CAPITAL

[Date]
[Addressee]
[Company Name & Address]

Dear [Sir/Madam or Addressee's Name],

I am a final year Masters of Business Administration (MBA) student at Strathmore University. As part of the requirement to complete the MBA degree, I am required to undertake a research project that would add value to the society.

The market has determined that there has been a significant failure of Venture Capital in Kenya. To this end, I am undertaking a research to establish the reasons for the high failure rate and I am particularly trying to establish whether the causes of this failure could relate to the design of the fund and if these could be mitigated to facilitate success. Therefore, my research thesis will focus on identifying factors that influence the design of Venture Capital funds in Kenya at pre-establishment.

Your firm has been identified to participate in the study owing to your involvement in the venture capital sector. I would like to request an interview with a General Partner. The information gathered from your firm will be treated with utmost confidentiality and your firm will remain anonymous. No specific reference will be made to the firm or the individual(s) interviewed in the research report. I will provide a generic overview of the research findings with your firm upon completion of my research.

You may contact me on telephone number 0722845437, or via mobuya2000@gmail.com. You may also contact my university supervisor Prof. Ruth Kiraka at rkiraka@strathmore.edu for any clarification or queries.

Thank you for your consideration.

Yours Faithfully,
Marceline Obuya

APPENDIX II: INTERVIEW GUIDE

FACTORS THE PRE-ESTABLISHMENT DESIGN OF VENTURE CAPITALIST FUNDS IN KENYA

A. DETAILS OF THE FIRM

RESPONDENT'S NAME			
CONTACT DETAILS			
COMPANY AME			
NUMBER OF OFFICES		NUMBER OF EMPLOYEES	
NAME OF FUND(S)			
VALUE OF FUNDS UNDER MANAGEMENT			

1. Please provide a general background and the focus of your company

   ____

   ____

   ____

2. What type of fund are you?

   ____

   ____

3. How long did it take you to establish your firm?

   ____

   ____

   ____

4. Probe further reasons for delay if any

   ____

   ____

   ____

5. What markets do you operate in?

Geographical:

____

Sectoral:

____

6. When did you first make entry to the market in which you presently invest in?

____

____

7. Do you have any specific sector approach? (If yes please specify) and why

____

____

____

____

8. What is your target investee business? (Probe for the respondent to explain further)

____

____

____

____

9. In your experience how has the market evolved over time? What is your view of current market conditions and what do you foresee in the future of the VC industry in Kenya?

When you started

____

____

____

Current conditions

____

____

____

Next 3 – 5 years

____

____

____

B. PURPOSE AND PARTNERS

1. What motivated you to set up a VC fund in Kenya?

2. How did you select the partners?

3. What time of skill set did you require for a GP?

4. Did you face any challenges in the selection of partners and how did you deal with the challenges?

C. OPPORTUNITIES, RISKS AND SIZE

1. Describe the opportunities, risks & mitigation at the pre-establishment stage?

2. How was the process of designing of investment process, committees and timelines?

3. How was the process of negotiation between the fund and the investors?

4. What were the investor's requirements before they could invest in your VC? b) Please describe the experience?

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____
____

5. What mechanism(s) did they use to minimize the potential risks for getting investors (agency model)?

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____
____

6. How did the VC determine the fund size?

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____
____
____

7. What is the structure of financial contracts with LP investors?

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____
____
____

8. What is the target internal rate of return (IRR) for the fund, and what is the basis for this?

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____
____

9. What is your view on current capital market authority requirement on VCs?

____
____
____
____

10. Is there a regulatory gap in the licensing and implementation of VCs in Kenya in your opinion?

11. What do you think the government should have done differently at the time you set up your VC?

12. In your view what have been the major changes in the regulatory environment for Venture Capital in Kenya?

13. Have you had to make any operational adjustments due to the changes mentioned?

14. Of what significance is the recent revolutionary change in Kenya's financial market to your VC business in the country?

15. From your experience in setting up and fundraising in this market, what advice would you share with:
    - A VC that is new to the market

- Regulatory authorities

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____
____
____

- Promoters of East Africa monetary union

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____
____
____

- Other investors

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____
____
____

16. What is your view on current capital market authority requirement on venture capital fund like yours?

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____
____
____

17. Is there a regulatory gap in the licensing and implementation of Venture Capital in Kenya?

____
____
____

18. What do you think the government would have done differently at the time you set up your VC?

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____
____
____

D. PRE-ESTABLISHMENT OUTPUT

1. How much were they able to raise and over what period? Was this in line with what they expected?

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____

2. How long did it take you take you to raise the funds?

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____

____

3. Which sectors and geographical areas did you chose at pre-establishment?

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____

____

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4. In the process of setting up your VC firm, did you have to revise your investment strategy? Please explain your answer

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5.What challenges did you face while setting up in Kenya?

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____

____

6. What advise can you give to someone setting up a VCF?

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