An Evaluation of the Determinants of Venture Capital Financing of Small and Medium Scale Enterprises in Nigeria

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ABSTRACT

This study investigated the determinants of venture capital firms' decision to finance small and medium scale enterprises in Nigeria. The basic objectives were to identify and analyse the factors that determine venture capital financing of small and medium scale enterprises in Nigeria.It was hypothesized that there was no significant factor that determined venture capital financing of SMEs. The population of study comprised 7474 SMEs in southwestern Nigeria that registered with Corporate Affairs Commission. Purposive sampling was used to choose two states, namely Lagos and Oyo that had the largest percentage (79.3%) of registered SMEs in Southwestern Nigeria. Slovin's formula was used to select 374 SMEs in the states using population proportionate to size.**T**he findings of the investigation showed that Profit, growth potential, Corporate Governance, Government Policies and Business Plan were the significant factors that determined venture capital financing of small and medium scale enterprises in southwestern Nigeria. It was recommended that SMEs should acquaint themselves with the factors that determine venture capital firms' financing and provide the necessary business environment that will attract equity finance from venture capital firms. Equally, venture capital firms were advised to shift emphasis from profit making to long term goals like business size, investor protection and entrepreneurial experience which will ensure the survival of SMEs and benefit all stakeholders.

Keywords : Venture; Capital; Determinants; Finance; Enterprise; Evaluation; Firms; Nigeria; Business; Decision.

INTRODUCTION

One of the key elements that can help small and medium scale enterprises(SMEs) to build productive capacity, compete with others and create jobs in an economy bedeviled by poverty and unemployment is access to finance. Without adequate finance, it will be difficult for businesses to acquire or absorb new technologies nor can they expand to compete in the global markets or even strike linkages with larger firms(Idowu,2010)

Many of the small and medium scale enterprises in Nigeria face the financing challenge at one stage of the business or another. However, deposit money banks that are statutorily set up to accept deposits and lend money to the general public including seem not small and medium scale enterprises to be forth coming in helping them out of this dilemma. This is because there seem to be a disconnect between how much the actual small and medium scale enterprises ly need and how much banks are willing and ready to lend, based on certain conditions.

There is also the problem of loan tenure. Most banks want to lend short while the need small and medium scale enterprises long term finance to allow them time to grow and break even. Other demands by local banks include provision of collaterals and submission of well articulated feasibility studies. These factors are partly responsible for the reluctance on the part of banks to lend to small and medium scale enterprises

.It is therefore the inability of deposit money banks to meet the financial demands of that led small and medium scale enterprises to the evolution of venture capital.

Although venture capitalism pre dates independence in Nigeria, the 1993 Venture Capital (incentives) Act gave a boost to the growth of venture capital companies providing incentives including tax reliefs existing and would be venture capitalists. The venture capital sector in Nigeria is growing gradually, though it is trailing behind countries like Kenya and Ghana in terms of size.

Venture capital firms are those firms owned by wealthy individuals that invest their funds in start-ups and fast growing high tech companies for future gain. In most cases, the venture capital firms act as financial intermediaries as they fill the finance gap resulting from the shortfall between how much individual entrepreneurs are able to mop up from savings, borrowing from friends and relatives, and the actual amount needed for take -off and the smooth operations of the business concern. It should be noted that not all small and medium scale enterprises get a nod from the venture capital firms when they apply for funding. It is therefore necessary to find out what factors drive venture capital funding in Nigeria. To the best of my knowledge, no published research work has studied the determinants of venture capital funding in Nigeria, hence this study.

STATEMENT OF THE PROBLEM

It has been observed that although many small and medium scale enterprises desire more equity financining as well as funding through loans, not many of them actually get the funding from venture capital firms that are designed for this purpose by government.

Thus the basic question which this study is set to answer is ‘’what determines the willingness of the venture capital firms to finance small and medium scale enterprises”? Although the basic objective of the study is to identify and analyse the factors that determine venture capital financing of small and medium scale enterprises in Nigeria, it is hypothesised that there is no significant factor that determines venture capital financing of small and medium scale enterprises in Nigeria,

REVIEW OF LITERATURE

Venture Capital

According to Kortum and Lerner(1998) venture capital is “ a medium term, direct equity or equity-linked investments with a well-defined exit strategy in young, privately held companies’’. The investor or venture capitalist is a financial intermediary who in addition to raising and professionally managing the pool of money also acts as a director, an advisor, or even the manager of investee firm. This ensures safety of the fund and growth of the business.

According to Megginson and Weiss (1991), venture capital firms contribute to the success of investees by matching financing to entrepreneurs with good projects and certifying companies to other investors, which increases their ability to exit. This process leads to the commercialisation of innovation at the macroeconomic level, professionalization of start-up firms and productivity. At the end, if the business succeeds, it will lead to higher economic growth with its attendant positive effects.

Venture capital firms are structured in a manner that comprises venture capital fund that is a pooled investment vehicle, the limited partner that provides capital and the general partner that takes charge of the day to day running of the venture capital firm including decision making on behalf of the other parties.

Determinants of Venture Capital Funding

Various studies have come out with diverse but relevant factors that determine venture capital funding. Shepherd and Zacharaks (1999) affirmed that venture capitalists prefer the ability of the founders' team in terms of managerial skills or track record when deciding on which firm to fund. Baum and Silverman (2004) identified start-up assets of the firm as a major determinant, while Hsu (2007), asserted that an entrepreneur's prior firm-founders experience increases the likelihood of receiving venture capital investments. It has been suggested that venture capitalists should consider social networks as an important source of information when choosing which start-ups to fund.

Small and Medium Scale Enterprises

The Central Bank of Nigeria defined SMEs as enterprises with asset base (excluding land) of between N5 million and N500 million and labour force of between 11 and 300.According to NCI (2003), a small-scale industry is an enterprise with total cost (including working capital but excluding cost of land) above N1.5 million but not exceeding N50 million, with a labour size of between 11 and 100 workers, while the medium-scale industry has a total cost (including working capital but excluding cost of land) above N50 million but not exceeding N200million, with a labour size of between 101 and 300 workers. The Organization for Economic Co-operation and Development (OECD) viewed SMEs as firms with fewer than 500 employees. On the other hand, the revised operational guidelines of SMEEIS (2005) defined a small and medium enterprise as an enterprise with a maximum asset base of five hundred million naira (N500m) (excluding land and working capital), and with no lower or upper limit of staff. Small and Medium Industries Equity Investment Scheme (SMIEIS),viewed SME in Nigeria, as enterprises with a total capital employed of not less than N1.5 million, but not exceeding N200million including working capital, but excluding cost of land and/or with a staff strength of not less than 10 and not more than 300.

According to the National Council on Industry, an SME is defined in terms of employment i.e. as one with between 10 and 300 employees.

The International Finance Corporation defined SMEs as firms with less than 300 employees and total assets less than US$15 million.

EMPIRICAL REVIEW

Najmi (2019) examined the determinants of venture capital funding in G7 countries between the period 2007- 2017.The results of the study indicated that market capital return, interest rate, unemployment and ease of starting a business have significant impacton venture capital funding.

Biney (2018) also investigated the factors that drive venture capital investments activity in Ghana. Based on panel data analysis using logit regression model, it was discovered that SME owner/managers' gender, education, geographical location, business plan, social networks and interest rate charges influence the owner/managers' ability to obtain venture capital financing.

Groh and Wallmeroth (2016) studied the determinants of venture capital across 118 developing countries including 78 emerging markets for the period 2000 to 2013.The results showed that legal rights, investor protection, innovation, mergers and acquisitions activity, corruption, ,corporate taxes and unemployment have a significant impact on venture capital investments.

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Cherif and Gazdar (2011) investigated the macroeconomic variables that determine venture capital for 21 European countries for the period from 1997 to 2006.It was confirmed that research and development expenditures , GDP growth, market capitalisation, and the unemployment rate are the most macroeconomic determinants of venture capital investments.

Félix, Gulamhussen and Pires (2007) analysed the determinants of venture capital in Europe. using panel data for the analysis, They discovered that long-term interest rates, initial public offers and trade sales were positive and significant determinants of venture capital in Europe.

Jeng and Wells (2000) also analysed determinants of venture capital for a sample of 21 OECD countries between 1986 and 1995. The findings revealed that initial public offers , private pension fund levels and government policies are significant determinants of venture capital funding.

METHODOLOGY

Purposive sampling was used to choose two states, namely Lagos and Oyo that had the largest percentage (79.3%) of registered SMEs in Southwestern Nigeria..Equally 42 officials of the seven venture capital firms were selected for questionnaire distribution. Six officials were selected from each venture capital firm using stratified sampling method (i.e two each from management, senior and junior staff cadres) who provided answers for analysis of the factors that determine venture capital financing of SMEs. Out of the forty two copies of questionnare diostributed,40 (95.2%)were returned and used for analysis. The research work lasted for about six months.

Objectives

(i) To identify the factors that determine venture capital financing of small and medium scale enterprises in Nigeria.

(ii) To analyze the factors that determine venture capital financing of .small and medium scale enterprises in Nigeria.

Hypothesis

Ho: There is no significant factor that determines venture capital financing of small and medium scale enterprises in Nigeria.

FINDINGS

Table1 showed that out of the 40 respondents, 6 (15%) of the respondents disagreed that investor protection was a determining factor, 7 (17.5%) were neutral while 27 (67.5%) agreed that in fact investor protection was a key factor in deciding whether to finance an SME or not. On the other hand, 6 (15%) disagreed, 6 (15%) were neutral, while 28 (70%) agreed that corporate governance was one of the factors that determine venture capital financing of SMEs. In considering business plan, 14 (35%) of the respondents disagreed, 9 (22.5%) were neutral, while 17 (42.5%) agreed that venture capital firms consider business plan as one ofthe factors that determine SMEs' financing. Concerning growth potential, 7 (17.5%) of the respondents were neutral, while 33 (82.5%) agreed that growth potential was determining factor in venture capital financing especially as it concerns SMEs. Equally, 100% of the respondents agreed that profit was a major and most important determinant of venture capital financing of SMEs. Although 10 (25%) disagreed and 9 (22.5%) were neutral, 21 (52.5%) of the respondents agreed that government policies had a critical role to play in venture capital financing of SMEs.

Concerning entrepreneurial experience, 35 (87.5%) of the respondents agreed, while 5 (12.55%) were neutral regarding entrepreneurial experience as factor that determines venture capital financing. Pertaining to business size, 9 (22.5%) disagreed, 4 (10%) were neutral while 27 (67.5%) agreed that business size was a determining factor in the financing of SMEs.

Using the mean as a criterion, every factor that determined venture capital financing of SMEs was analyzed on a 5-point likert scale using greater than or equal to 3.00 as bench mark for agreement and lesser than or equal 3.00 as bench mark for disagreement. Table 4.11 showed that profit (4.550) was the most important factor, followed by growth potential (4.325), entrepreneurial experience(4.050), investor protection (3.700), corporate governance (3.70), business size (3.6750), government policies (3.350) and business plan (3.275) being the least important factor in determining venture capital financing of SMEs.This implied that all the factors considered were important factors and are relevant when considering the financing of SMEs by venture capital firms.

Kendall's W coefficient of concordance was also used to measure the level of agreement among raters. The level of agreement ranges from 0 (indicating no agreement among raters) to 1(complete agreement among the raters).The result on Table3 showed Kendall's W= .158, ?2=44.159, sig=0.000 which implied that there was statistical significance although there was a weak level of agreement among the respondents as to which factors determine venture capital financing.

Based on the above, the study identified profit, growth potential, entrepreneurial experience, investor protection, corporate governance, business size, government policies and business plan as the major determinants of venture capital financing.

Table1: Factors that Determine Venture Capital Firms' Financing of SMEs

Factors	**Response**	**Frequency**	**Percentage**	**Rank**
Investor Protection	D	6	15.0	**5th**
	N	7	17.5	
	A	27	67.5	
	Total	40	100	
Corporate Governance	D	6	15.0	**4th**
	N	6	15.0	
	A	28	70.0	
	Total	40	100	
Business Plan	**D**	14	35.0	**8th**
	N	9	22.5	
	A	17	42.5	
	Total	40	100.0	
Growth Potential	**N**	7	17.5	**3rd**
	A	33	82.5	
	Total	40	100.0	
Profit	**A**	40	100	**1st**
	Total	40	100	

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Government Policies	D	10	25	**7th**
	N	9	22.5	
	A	21	52.5	
	Total	40	100	
Entrepreneurial Experience	N	5	12.5	**2nd**
	A	35	87.5	
	Total	40	100	
Business Size	D	9	22.5	**5th**
	N	4	10.0	
	A	27	67.5	
	Total	40	100	

SOURCE: Field Survey, 2019

Table 2: Mean Rank and Kendall's W Coefficient

Factors	N	Mean	Rank	Std. Deviation	Kendall's W	Chi-Square	DF	Sig
Investor Protection	40	3.7000	4	.93918				
Corporate Governance	40	3.7000	5	.91147				
Business Plan	40	3.2750	8	1.15442				
Growth Potential	40	4.3250	2	.76418	.158	44.159	7	.000
Profit	40	4.5500	1	.50383				
Government Policies	40	3.3500	7	1.29199				
Entrepreneurial Experience	40	4.0500	3	.55238				
Business Size	40	3.6750	6	1.14102				

Source: Field Survey, 2019

Test of Hypothesis

Ho: There is no significant factor that determines venture capital financing of SMEs.

To test whether there was any significant factor that determined venture capital financing of small and medium scale enterprises, the one way ANOVA was used as the test statistic. The decision rule for significance test is, if $p< 0.05$, then factor is significant, and if $p> 0.05$ then the factor is not significant. Table 4.12 indicated that Profit (F=162.2, Sig=.0.000); growth potential (F=144.4,Sig=0.000), Corporate Governance (F = 16.5, Sig = 0.000) and Government Policies (F = 7.71 , Sig = 0.009), Business Plan (F =6.4, Sig = 0.016) were the significant factors that determine venture capital financing of small and medium scale enterprises. However, business size (F = 1.406, Sig = 0.243), investor protection (F = 1.221, Sig = 0.276), and entrepreneurial experience (F = 0.306, Sig= 0.584) were found not significant.

DISCUSSION OF FINDINGS

Based on the result of the analysis, the study found out that Profit, growth potential, Corporate Governance, Government Policies and Business Plan were the significant factors that determine venture capital financing of small and medium scale enterprises. This is in conformity with results of the studies by Mandodo (2014) which found corporate governance as one of the determinants of venture capital financing in Zimbabwe, and Hellman (2000) that identified government policy among others as a factor vital for the development of

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venture capital industry. Njoroge (2003) also identified profitability and written business plan as critical factors affecting venture capital financing in Kenya.However, business size, investor protection and entrepreneurial experience were found not to be significant determinants of venture capital financing.

Table3: Analysis of Variance of Factors that Determine Venture Capital Financing

Factors	Source of Variation	Sum Of Squares	Df	Mean Square	F	Sig.
Business Size	Between Groups	1.793	1	1.793	1.406	.243
	Within Groups	47.182	37	1.275		
	Total	48.974	38			
Entrepreneural Experience	Between Groups	.097	1	.097	.306	.584
	Within Groups	11.800	37	.319		
	Total	11.897	38			
Government Policies	Between Groups	10.904	1	10.904	7.711	.009
	Within Groups	52.326	37	1.414		
	Total	63.231	38			
Profit	Between Groups	7.892	1	7.892	162.231	.000
	Within Groups	1.800	37	.049		
	Total	9.692	38			
Growth Potential	Between Groups	17.758	1	17.758	144.403	.000
	Within Groups	4.550	37	.123		
	Total	22.308	38			
Business Plan	Between Groups	7.215	1	7.215	6.401	.016
	Within Groups	41.708	37	1.127		
	Total	48.923	38			
Corporate Governance	Between Groups	9.950	1	9.950	16.466	.000
	Within Groups	22.358	37	.604		
	Total	32.308	38			
Investor Protection	Between Groups	1.004	1	1.004	1.221	.276
	Within Groups	30.432	37	.822		
	Total	31.436	38			

Source: Field Survey, 2019

CONCLUSION

Based on the findings, the study concluded that Profit, growth potential, Corporate Governance, Government Policies and Business Plan were the significant factors that determined venture capital financing of small and medium scale enterprises in southwestern Nigeria.

RECOMMENDATIONS

As a follow-up to the findings, we recommend the following:

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(a) SMEs should acquaint themselves with the factors that determine venture capital firms' financing and provide the necessary business environment that will attract equity finance from venture capital firms.

(b) Venture capital firms should shift emphasis from profit making to long terms goals like business size, investor protection and entrepreneurial experience which will ensure the survival of SMEs and benefit all stakeholders.

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