Risks in Venture Capital Financing in Ghana

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Abstract
It has been widely accepted that SME’s are the “engine of growth” of an economy. However, SME’s are plagued with funding gap which inhibits the growth expected. In gaining help, SME’s had sought financial support primarily from commercial banks who demand collateral and high interest rates that are not met by SME’s. Yet, SME’s fail to access venture capital financing as the appropriate option for business funding. This failure or inability to access venture capital financing is attributed to the fact that, the scheme is of high risk nature.

This study sought to identify the risks that are inherent in venture capital financing for appropriate responses to make the venture attractive. The study therefore used as respondents; Venture Capital Trust Fund (VCTF), two practicing organizations as the venture capitalists and 50 (fifty) SME’s selected from the Ghana Association of Industries, using effective sampling methods for suitable representation. Emphasis was made for effective campaign and education to promote venture capital financing in Ghana as recommendations.

Key Words
Venture Capital, Risks, SMEs, Risk Management and funding

1.0. BACKGROUND TO THE STUDY
It has also been recognized by research that, SME’s have not embraced venture capital financing because of the fact that it is a high risk financial instrument; even though it is best suited for these organizations to obtain credit support for their business (Wonglimpiyarat, 2005). To assist SME’s to overcome the funding gap, and to realize their fullest potential in the acquisition of recommended financial support, it is important to make venture capital financing attractive. This will require that the thought of risks associated with venture capital financing be assessed and mitigated.

Venture capital financing that is supposed to be the financial intervention that provides SME’s with alternate source of funding, that is thought to be better than the traditional source of funding from main stream banks is not been embraced. Most venture capitalists and investors are risk averse. They see that the major risk is the risk of not getting their money back from an investment and therefore prefer to invest in other profitable businesses (Boocock and Presley, 1993).

The study seeks to identify the risks in venture capital financing for SME in Ghana.

2.0. REVIEW OF RELATED LITERATURE

2.1. Financing SMEs Ghana
Despite the fact that SMEs contribute immensely to the economic development of the nation, most of them are confronted with financing challenges essentially due to their characteristics of being small, inexperienced, managed by individuals and sometimes not having the requisite educational background and inadequate collateral (Mensah, 2004). In effect, SMEs are handicapped when it comes to getting access to credit and what makes this situation worse is the fact that there are rather fewer alternatives such as business angels, personal savings, lease financing and venture capital funding. It is therefore crucial that financial resources are made available to SMEs if their operations are to be sustained.

Several authors (e.g. Tagoe et al. 2005; Arthur, 2003; Mensah, 2004) have all concluded that Ghanaian SMEs face financial challenges essentially because of their unique and peculiar characteristics which make financial institutions uncomfortable in lending to these SMEs. As pointed out by Mensah (2004), lenders will only give credit to SMEs when they are convinced that the SMEs have the capacity to pay back, ability to manage their operations profitable, ability to manage risks confronting them, better and astute business management skills and having the required collateral.
Research further indicates that Ghanaian SMEs rely on multiplicity of financing sources with bank finance constituting approximately 27% and 33% of working capital requirements of the SMEs, respectively, (Hansen et al., 2012).

2.2. Venture Capital

Venture capital refers to the financing of a start-up, development, expansion and purchase of a firm in the act of which the Venture Capital Investment (VCI) acquires by agreement a proportion of the share capital in the business in return for providing funds (Reid, 1998). Bygrave and Timmons (1992), as well as Gompers and Lerner (2001) define Venture Capital as a source of funds that typically finance new and rapidly growing companies through equity participation. In other words, VC is pre-IPO equity capital provided by professional investors. The concept of modern venture capital is defined by Megginson (2002) as a professionally managed pool of money raised for the purpose of making equity investments in growing private companies with a well-defined exit strategy.

Several empirical studies have been done on venture capital financing in Ghana. For instance, Poku and Frimpong (2009) conducted a study with the objective of identifying the prospects and challenges of venture capital financing in Ghana. To realize this objective, the authors collected data from the SME members of the Association of Ghana Industries (beneficiaries of venture capital fund); venture capitalists and the VCTF. The authors further used the survey questionnaire to collect data from these respondents. In all, a total sample size of eighty (80) respondents was contacted. The authors found that generally, most of the SMEs contacted were unwilling to seek financial assistance from VCFCs even though they were aware of the fact that the venture capital fund is the answer to their financial constraints. The authors further found that the VCTF and the VCFCs are of the view that overall, the prospects of venture capital financing is bright but to sustain its operations, the government must create an enabling environment that ensures the growth of the industry.

Again, Amoamah et al. (2013) sought to identify the key variables or factors that are deemed important in determining the viability of business proposals submitted by SMEs at the desktop review stage of the venture capital screening. Typically, the business proposals as submitted by SMEs goes through three stages (commences with the desktop review; verification of the claim and the final stage which is the due diligence stage and which entails assessing issues such as legal, technical and financial). To achieve this objective, the authors used secondary data without using primary data to augment and indeed support their findings. The authors essentially found that the main factors impacting on business proposals submitted by SMEs who seek financial assistance are economic impact, financial viability, technical viability and market analysis. The main limitation of this study has to do with the failure of the authors to use primary data to support their findings. Ideally, the authors should have collected data from SMEs in order to enrich their findings and discussions.

2.2.1. Conceptual Framework of Venture Capital Financing

From what have been established in literature so far, the phenomenon of venture capital financing would be successful when the enumerated above could be overcome. This means that both the venture capitalist and the beneficiary, entrepreneur or SME have some risks to deal with before a successful venture capital engagement. It presupposes that before a successful venture capital takes place, VC’s and SME’s must look forward to encounter these risks which have become determinants for fruitful access to venture capital finance as depicted in the diagram in figure 2.4 below.
2.2. The Concept of Risk
According to Valsamakis (1999), risk is defined as a deviation from the expected value. It implies the presence of uncertainty, where there may be uncertainty as to the occurrence of an event producing a loss, and uncertainty on the outcome of the event, where the degree of risk is interpreted with reference to the degree of variability and not with reference to the frequency with which the event will occur or to the probability that it will display a particular outcome. Financial institution often distinguishes between expected and unexpected losses. Expected losses are those that the institution knows with reasonable certainty will occur such as default rate of corporate loan portfolio. Unexpected losses are those associated with unforeseen events. Financial institutions often rely on their capital as a buffer to absorb such losses. Risk is usually defined by the adverse impact on profitability of several distinct sources of uncertainty. The types and degree of risks a financial institution is often exposed to depend on its size, complexity in operations and volume of transactions (Oldfield et al, 1995).

3.0. METHODOLOGY
3.1. Research Strategy
The research philosophy adopted was the interpretivist approach. Interpretivism is an epistemology that advocates that it is necessary for the researcher to understand differences between humans in our role as social actors. This stance was appropriate as the study concerns social phenomenon of the roles, responsibilities, relationships etc. that were practiced by the actors engaged in venture capital financing (Denzin & Lincoln, 1994). This was to develop knowledge relating to the potential risks that were thought to be inherent in the roles and relationship among the players of venture capital financing (Hughes, 1994). With this philosophy the differences between the actors and their roles were understood and based on that, items thought to be risks affecting venture capital financing were identified and interpreted. This required that information be collated by eliciting respondents who are the actors of venture capital financing. The information collected were then analysed and interpreted in relation with the study, research questions and the objectives in order to identify the potential risks that are involved with the process of venture capital financing.
3.2. Research Design
The research design adopted for the study was a survey. The objective for this design was to elicit information from respondents with which the risks associated in venture capital financing could be determined. The essence of deploying the survey method in this research is to make sure that any later research or analysis of the attributes of the population sampled will be precise and also the findings and results being able to be generalized everywhere in the world. Another reason is because it is easier to administer and analyzed since the data collected involved asking SMEs structured and predefined questions. This research design was suitable because the study involved collecting information to gain insight into people or problems under study. It was fitting for data-gathering and analysis approach in which respondents were made to answer questions and / or responded to statements that were developed in advance.

3.3. Target Population and Sample Size
Representativeness and reliability of results as well as time and resource restraints were considered in determining the target population. Therefore the target population of this study was the owners and employees of SMEs, Managers of the VCTF and VCFCs all based in the greater Accra Metropolis. The actors of venture capital financing were selected organizations that had commenced venture capital financing in which both the venture capital firm and the investee organizations are enjoying the support of each other.

3.4. Sample Size
According to AGI (2014), its membership list made up of large, medium, small and micro enterprises is around 1140. Out of the 1140, almost half can be found in the Greater Accra Region alone and more than 80% of the half fall within the SMEs category. The researcher considered fifty (50) SMEs, as an appropriate sample size for the study to get the necessary or required information needed. The sample size is significant to create the representativeness of the sample for result generalizability (Sekaran, 2003). Kripanont (2007) proposed the following rules of thumb for determining the sample size: (i) sample sizes greater than 30 and less than 500 are suitable for most research; (ii) when samples are to be separated into sub-samples, a bare minimum sample size of 30 for each category is necessary; and (iii) in multivariate research, the sample size should be preferably 10 times or more as large as the number of variables in the research. Following this rule of thumb, the sample size of 50 SMEs in this research was considered sufficient. Again, this study contacted two Managers from the VCTF and two (2) each from venture capital organizations in Ghana; Bedrock Venture Capital Finance and Gold Venture Capital. The decision to contact two managers each from the venture capitalists was arrived at after discussing the objectives of the study with these institutions.

3.5. Sampling Techniques
According to Babbie and Mouton (2006), a sample is the percentage or fraction of the population that answers the survey. It can be said that the reasons for undertaking surveys is to enable the researcher generalize from the sample to the population that the hypothesis regarding attitudes, behaviour among others can be made (Babbie and Mouton, 2006). Thus how respondents are selected for a particular study is very critical for the success or otherwise of the study. To operationalize the objectives of this study, two sampling techniques were employed. With respect to the managers from the Venture capital firms, the purposive sampling technique was adopted. The purposive sampling is a type of non-probability sampling in which the researcher selects the unit to be observed on the basis of the researcher’s judgments about which ones will be the most useful or representative (Yin, 2003). Thus the Managers of the venture capital funds contacted were solely based on their expert knowledge of their institutions’ venture capital financing risks, strategies, policies and issues. With respect to the SMEs, the author used the convenient sampling technique taking cognizance of its drawbacks and random sampling partly. This was used because, it enabled the author to have reasonable control over the sample, use his judgment to select cases or units which best allowed him to answer the research questions and achieve the objectives of the study.

3.6. Data Collection Tools / Procedures
The data collection tool that was used for the study was a questionnaire. The questionnaire was designed systematically with sequence of questions with the objective to obtain information on risk items in venture
capital financing. As much as possible the questionnaire was designed with the respondents in mind and therefore was made clear, self-enumeration paper-based. Separate questionnaire were designed for each respective survey population. With respect to the SMEs, a self-administered was employed since it was easier for the respondents to fill and also cheaper as well. The questionnaire was set of questions that relate to potential risk items that may be inherent in the process of venture capital investment. Sampling error was anticipated because of the sample size of the survey population used for the study.

3.7 Data Analysis / Presentation

Data collected was analysed and interpreted by summarising the data and interpreting their meaning in a way that provided clear answers to questions that initiated the survey. Data analysis was designed to relate to the survey results to the questions and issues identified by the statement of objectives. The data was analyzed in both descriptive and quantitative forms such using frequency tables, percentages etc. The datasets so collected was then coded and translated to an SPSS (Statistical Package for Social Science) and Microsoft Excel. SPSS especially is a versatile computer package that has the ability to perform a wide variety of statistical procedures (Yin, 2003).

4.0. RESULTS AND DISCUSSION

This section presents the findings in relation to the risks associated with venture capital financing. It was found that there are several risks associated with financing operations of SME customers.

4.1 Weak Regulatory Environment/Legal Documentation

There is weak regulatory environment that venture capitalists operate in. This is because the industry is relatively new and still undergoing changes and this makes it difficult for operators to effectively operate. Other bodies such as the insurance industry have the NIC while the banks have the Bank of Ghana (BoG).

4.2. Inadequate Qualified Personnel

It was found that another risk confronting the venture capital firms is the lack of qualified staff who have the experience and training to handle all issues pertaining to their operations. Venture capital is still in its developmental stages and has therefore not had the time to grow a rich pool of personnel that the industry can draw from such as existing in other industries such as banking and finance. This is a challenge that must be addressed urgently since venture capitalist play important roles in facilitating the expansion of small scale enterprises. With the right pool of qualified personnel, the effects of venture capitalists can be far reaching. More importantly, deals can be structured really faster and by so doing, making their operations more attractive to their target market.

4.3. Wrong Public Perception

Another major risk is the wrong notion by some Ghanaians that the funds given to venture capital firms are for the government and for that matter, it is free money to be shared by all without paying. This mentality and wrong thought sometimes leads entrepreneurs going to political heads to coerce venture capital operators to disburse funds to cronies and party faithful even when they do not have legitimate and qualified business plans and proposals. To dispel this wrong notion and change peoples’ perceptions, the VC firms tend to spend much of their precious time explaining to Ghanaians what venture capital funding is all about. This finding further reiterates the fact that the venture capital industry has not done enough in terms of educating the public on their objectives and modus operandi. As explained by one of the fund managers, most of the entrepreneurs that come to them are always looking for loans and most of their enquiries and questions and concerns are geared towards issues such as the rate of interest charged, the terms of the loans, whether collaterals are needed. Obviously, these questions immediately lead to the conclusion that more education is needed since venture capital is definitely not about debt financing but equity financing.

4.4 SME’S / Investees Not Having Proper Structures

It was found from the respondents that another major risk of venture capitalist in the country has to do with the lack of proper structures in investees’ firms and this makes it difficult stepping in to assisting to have efficient management and operational structures. These entrepreneurs due to the rigid structure of requirements from venture capitalists find it difficult negotiation for funding successfully. This finding implies that internal operations and management structures of SMEs sometimes make it difficult for SMEs
to get assistance from financiers such as VCs. This finding actually echoes what Paramasivan and Subramanian (2009) found to the effect that most SMEs lack financial management discipline and that most are careless and reckless when it comes to the application of prudent financial management practices.

4.5 Exit Challenges
Another nagging challenge making the operations of VCs very challenging and also risky has to do with how to exit from the deal successfully without disrupting operations of the investee’s venture. As pointed out by Megginson (2002), a typical practice of venture capitalists is to structure their deals in such a manner that facilitates exiting from the deal profitably. This means that VCs must pay closer attention on explaining to investees how the exit will be done and when it will be done to forestall future misunderstanding. However, the respondents pointed out that there are few exiting options or venues available in Ghana currently and this tends to create problems for all parties to the deal. This means that the lack of exit options available to VCs is a major risk of VCs in Ghana. Another respondent added that even there are options available (where the VCs have the sole right of selling their investments to the investees), most of the investees do not usually have the financially resources to buy back VCs’ share. It was in the same vein found that investees seen exits as bad omens and therefore employ all manner of strategies to thwart the efforts of VCs from exiting and this tends to prevent them from moving on to sign new investees.

4.6 Poor/Weak Micro-Economic Environment
It was found from the respondents from the two VCTFs that the current economic conditions in the country does not auger well for venture capital financing. This is because major micro economic indices such as fluctuations of the Ghanaian currency and high interest rates make the operations of venture capitalists very challenging. This is especially due to the fact that the unstable exchange rates makes their operations unprofitable and unsustainable because most of their business operations are based on the cedi which is a local currency while the investment funding or source of funds are obtained essentially in foreign currencies from investors outside the country. This makes repayment difficult since the cedi is too weak against the major foreign currencies and the venture capital firms have to commit more funds in cedi value in order to repay investors in strong currencies such as the dollar and the euro. It was further found with respect to the interest rate given to customers that this tends to rather higher than what competitors offer and this tends to make their offerings unattractive to their customers.

4.8 Poor Keeping Of Records
Record keeping was also found to be a major challenge for VCs in their dealings with investee firms. It was found that most of the investee firms do not keep proper records of their operations and this makes the evaluation of the businesses very difficult and therefore forcing the VCs to resort to other methods of arriving at fair values of their operations. It was in the same vein found that divulging information for evaluation purposes was very difficult for some investee firms. This finding is not surprising but rather confirms what Megginson (2002) found to the effect that most SMEs do not have the proper structure of keeping records, forecasting their operations. This finding further point to the fact that most SMEs do not strategically plan their operations but mostly react to what pertains in the business environment and by so doing, failing to take advantage of business opportunities.

4.9 Investee Firms’ Owners Attitude about Control of Business
Most entrepreneurs according to the respondents are fixated on owning everything and are unwilling to share a certain percentage of their businesses to anybody and the VCs included. This tends to make negotiations very difficult since giving a certain portion of their business to VCs is regarded as “inviting outsiders to take control” and this according to the respondents makes the SMEs loose face in society. According to one respondent, “Most of the investee firms are so pre-occupied with the fact of sharing power and control of their businesses that they fail to see the bigger picture of being part of something bigger compared owning 100% of a tiny business”.

5.0. SUMMARY AND RECOMMENDATIONS

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The main risks confronting Ghanaian VCs were found to include weak regulatory environment that venture capitalists operate in; the lack of qualified staff who have the experience and training to handle all issues pertaining to their operations and the wrong notion by some Ghanaians that the funds given to venture capital firms are for the government and for that matter, it is free money to be shared by all without paying. Other challenges were found to include the lack of proper structures in investees’ firms and this makes it difficult stepping in to assisting to have efficient management and operational structures; and few exiting options or venues available in Ghana currently and this tends to create problems for all parties to the deal. It was further found that the current economic conditions in the country does not augur well for venture capital financing and that most of the investee firms do not keep proper records of their operations and this makes the evaluation of the businesses very difficult and therefore forcing the VCs to resort to other methods of arriving at fair values of their operations.

It was found that the challenges as identified have major impact on the ability of the VCs to effectively negotiate funding for investee firms. The two main impacts of the challenges were found to be the lack of motivation on the part of investors to invest at start-up and that the challenges affects the ability of VCs to extend their operations to other parts of the country essentially due to the lack of limited qualified personnel and the lack of resources to educate potential customers on the main functions of Venture capital funding. Based on the findings of this study therefore, the conclusion arrived at is that venture capital funding can be a viable alternative if and only of solutions are found that effectively mitigates and addresses the challenges of VCs.

This study found that most entrepreneurs and SMEs have wrong perceptions about the activities of VCs (such as being free money from government and also take over the control of businesses). This study therefore recommends that the VCs in concert with the government must embark on educational campaigns that will effectively educate Ghanaians on the actual role of VCs and also dispel the notion held by some that VCs only are in business to take over the management of firms. Proper education will change entrepreneurs’ attitude and this will make them consider venture capital funding as a viable alternative to debt financing.

REFERENCES


