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The Effect of Venture Capital Financing on the Economic Value Added Profile of Nigerian Micro and Small Business

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Abstract: *Micro and small businesses make up more than 60% of the total business ventures in Nigeria. Despite their relative importance, capital remains their major challenges. This paper examines venture capital as a source of financing small and micro businesses in Nigeria. It adopts survey research design. A sample of 56 respondents was selected from venture capital firms in Abia state using stratified sampling technique. Data were collected through questionnaire. Analysis were done using distribution table, frequency, mean and weighted average. Major findings include that small and micro businesses do not place much importance on venture capital; however, venture capital is an important source of fund for financing any form of business in Nigeria. It therefore recommends that proper enlightenment through the mass media to promote the services of venture capital firms to businesses operating in Nigeria.*

Keywords: *Micro, Small and Medium Enterprises (SME), Venture Capital, Capital Cost, Emerging Economy*

INTRODUCTION

The failure of previous financial policies of governments to achieve desirable economic growth was concerned about restructuring of the system, especially in the glare of an ailing economy (Orie, 2011).

The introduction of the structural adjustment:

Precisely, this scheme involves the use of venture capital (VC) financing, and financing history shows that many large corporations that encompass the world today actually started out with venture capital financial. E.g Frederick Smith founder of FedEx started out with VC funding of $72million in 1973, Hisrich and Peters (1998) venture capital is a subset of private of private equity capital which brings bright ideas and breakthroughs to reality. In other words, Nigerian SMEs that work closely with venture capitalists could transform to large enterprises within an acceptable period of time given the essential, ingredients of venture capital financing.

Again, entrepreneurs could receive venture capital financing at different stages (seed, start-up, expansion, development or bridge finance) implying that VC financing can sustain an enterprise to the point initial public offer (IPO) (Ihemeje, 2014). This study explores the effect of venture capital resources on the economic value added of Nigeria's SMEs such that they could add value to various strata of the Nigerian economy. The essential feature of this new window is its commitment towards effective delivery of financial resources, managerial skills and technical expertise. Could this be a reality or another myth in Nigeria, and how would it affect the society?

These are some questions that required answers after a reasonable period of stock taking since the commencement of SMEs in Nigeria. In 2001 when SMEs was introduced the Nigeria economy was experiencing crises of negative performance in all four macroeconomic indicators, price stability, employment, economic growth and external trade equilibrium. It was believed that SMEs would receive the SME sector. Similar contributions of VC financing to economic performance were confirmed in Europe, USA and Asia Mortin (2002) Wright (2002) and Pandey (2001), for instance, in Britain, venture capital firm created 46 new jobs per VC – backed Company with an overall investment of million jobs and $1.8 trillion in sales in 2003. In other words, Nigeria SMEs could achieve competitive advantage through innovation, quality, cost and speed. Thus, the thrust of this study is to compare the economic value added (EVA) of VC-backed and non-VC backed SMEs in order to establish the effectiveness of the assessment of EVA as an alternative to profit in evaluating the performance of SMEs using the three dimension of time (Agyemar, 2001).

LITERATURE REVIEW

Theoretical Framework

In every economy the real and financial sectors complement each other in order to maintain a progressive balance. This is important as a deficiency in one sector impairs development in the other. For instance, Sharp (1995) argue that there exists a strong relationship between highly developed financial sector and real investment. In Nigeria, however, evidence shows that both sectors are not so symbiotic such that the financial sector milk-dries the real sector (Soludo, 2004 and Sanusi, 2003). Banks declare huge profits even as factories close down they were to term trade financing and foreign exchange deals. This includes even the investment banks that were traditionally structured for long term financing. Indeed this remains the reason why Nigeria's real sector is largely infertile despite several interventions.

Empirical Review

Small and medium scale enterprise constitute a very heterogeneous group, complicity of a variety of firms that posses a wide range of sophistication and skills and operate in different markets and social environments. Some are dynamic innovative and growth oriented; others are traditional enterprises that are satisfied to remain small. In some countries, SSIs (Small Scale Industries) and cottage industries owners and workers are dominated by members of particular ethnic groups, such as raffia works among the Annangs of Ikot Ekpene in Akwaibom State, tie and die among the Yorubas of South West region or the bronze works among the Nupe people of Niger state of Nigeria

(Obadon, 2009). Despite differences in definitions of small scale industries both within and outside boundaries of countries. One of the distinctive features of SSIs is that they are sole proprietorships, partnership or limited liability companies. Both in most cases, even liability companies the true ownership is either one man or partnership (Udechukwu, 2003). Lack of adequate skills and technical know-how, capital inadequacies or sheer ignorance on the part of most of the promoters and founders of SSIs led them to purchase obsolete and inefficient machinery and equipment thereby making them defendant on important raw materials and spare parts. This will set the stage abinitio for lower levels of productive quality, output and market acceptability (Basil, 2005). It is therefore, not surprising that many of them had to either close down completely or scale down their operations at the expense of labour.

Conceptual Framework

Constraints to SMEs Financing in Nigeria

Banks by their nature and position in the economy remain the known formal sources of finance for enterprises. A 2001 World Bank Survey on Nigeria showed that although 85% of the firms had relationship with banks, most of them had no access to credit (Terungwa, 2011). The lack of adequate financing for the SMEs is traceable among other reasons, the reluctance of banks to extend credits to them for the following reasons:

i. Inadequate collateral by SMEs operations.
ii. Weak demand for products of SMEs as a result of the dwindling purchasing power of Nigerians.
iii. Lack of patronage of locally produced goods.
iv. Poor management practices by SMEs operators.
v. Under capitalization

Venture capitals and equity is another source of financing for SMEs. Some of the challenges facing Nigeria policy makers in the area of venture capital include:

i. Institutionalizing tax benefit from equity investment to attract foreign investors.
ii. Providing risk guarantees to create strategic ventures capital industries that improve self reliance and curb import quotas.
iii. Enhancing venture capital capacity to stimulate and promote the industrial expansion.
iv. Focusing equity investment on SMEs that optimize resources utilization and assist local raw material development.
v. Promoting innovative business ideas processes and techniques that boost both productivity and profitability.

Innovations/Initiatives to Overcome the Financing Constraints

The federal government policy interventions for the funding of SMEs are generally geared towards improving the expected contribution of the sector to the growth and development of the national economy. Government has over the years introduced a variety of financing scmenes and programs aimed at overcoming the financial contrants as witnessed by the SMEs in Nigeria (Ihemeje, 2014).

Some Ways of Financing SMEs

A Debt and Equity Financing

The capital structure of a firm involves decisions about debt and/or equity financing and the implication that higher leverage increases values seems to be more applicable to large corporations than a fledglings. Usually, at the early stage preference is given to survival and sustainability, in which case the first rule is to employ the structure that does not expose the enterprises to over bearing financial obligation during period of low cash flow and return on assets. Long term financial decision for SMEs favors private placements (Grinblaft and Titman, 1998). It has been proved severally that the value of a firm increases more with increasing leverage, Durand (1956) and Ezra (1963) perhaps, this explains why there is still strong emphasis on the use of dept despite the overwhelming contribution of Franco Modigliani and Merton Miller (MM) in 1958 on the irrelevance of capital structure. However, MM position in a world of taxes (which is a more realistic assumption) implies that expected return (Brealey and myers, 1996). Debt financing is cheaper only with mature businesses or business with high initial cash flow. It implies that past institutional enterprise promotion with debt finance was inappropriate, thus the outcomes were disappointing. Therefore, private equity/venture capital finance is more strategic (Tanous, 1997).

B. Venture Capital

Venture capital is a type of private equity financing involving investment in unquoted companies with growth potential. It is generally medium to long term in nature made in exchange for a stake in a company. The term venture capital is likely to be accepted as the generic term for business angles, Mezzanine equity, Institutional or any similar investment in early stages of business. In summary it is a professionally management pool of equity capital (Hisric and Peters, 1998). According to Berlin (1998) venture capitalists, take an active role in the management of firms they fund and work in close collaboration with the stock market to take firms they fund public. Therefore, they place emphasis on the support they offer start-ups and the control they might be granted as well as the exit strategy available. In all, they foster growth in companies through hands on involvement in financing, management, and technical support. In Nigeria, Small and Medium Enterprises Equity Investment Scheme (SMEEIS) represent the major institutional framework for the promotion of VC financing (Dagogo, 2009).

C. Economic Value Added

It is one thing to compare profits, yet it is another to measure the efficiency or cost effectiveness of capital employed. Economic value added (EVA) is the residual income a company earns after capital cost are deducted (Van Horne, 2002). It is operating profits minus the required (Naira) return for the capital employed, the required return is a market determined weighted average cost of capital (WACC), which reduces bias of debt and equity lob-siding (Ihemeje, 2015). In other words, comparism of EVA between the two categories of SMEs would show the effects of the independent variables propelled venture capital backed SMEs.

The Implications for using Venture Capital (VC) to Finance SMEs (Based theories)
The fact that VC-backed SMEs outperformed non VC backed in EVA is a clear signal for high level enterprise sustainability of the private sector in Nigeria. However, the following other factors are complementary to VC financing. Increasing local demand capacity, export promotion, continued promotion of private enterprises, opportunities for outsourcing and increasing local content corporations, tax incentives, improving information and communication technology, and supply of skilled labour (Orie, 2011). In order to sustain the meager succerss of VC firms, the following steps are necessary: strengthened systematic structures like power supply, establishment of technology and industrial parks, reduction in corruption index, attraction of Nigerians in Diasporas, protection of intelligent property rights, efficient exit windows for venture capitalists, and reduction of inflation to a single digit (Nuectiterlein, 2003).

For individual SME, the outcome implies greater competition for customers, financing resources, and raw materials. This further implies that product qualities must be standardized, cost efficiency must be met, innovative strategies preferred, and consolidation exercises such as merger, acquisition or virtual scaling implemented (CBN, 2012). Theoretically, the return on alternative investment, which defines the cost of capital is a major determinant of value added. If cost of capital is high value added reduces and vice versa keeping the operating income constant, the implication of higher value added therefore is that interest rate and the return on equity investment should reduce. But if that happens, there is no incentive for investment in the local economy, this inducing capital flight.

METHODOLOGY

Research Design

This study adopts the survey research design because the researcher lacks control over the variables. The researcher is only interested in observing what is happening to the variables without any attempt at manipulating or controlling them. The design of the research is cross sectional because of its size and time dimensions. In an attempt to carry out this study, a sample of 56 respondents from eleven capital ventures in Abia state selected using multi-stage sampling technique. The sampling method is informed by the relative homogeneity of venture capital characteristics in the area under study.

Data collection

The primary method of data collection was used mainly in this section. To obtain the required data/information, a detailed questionnaire was prepared and mailed to the respondents. The questions were structured in Likert format.

4.0 Data analysis and Discussion

Data presentation was made in tables while percentage, frequency and weighted average were used in data analysis. Furthermore, the mean score and standard deviation techniques were adopted to test the significance of the stated hypotheses. The weighted score utilizes the Likert score as follows:
Strongly agree=5

Agree= 4
Undecided=3
Disagree= 2
Strongly disagree=1
Based on the scoring system, a mean of 2.5 and above indicates a strong relationship while mean of less than 2.5 indicates a weak relationship.

Analysis and discussion of findings

To analyse the data collected which is the respondents' responses or answers given to the questionnaire, the weighted scale analysis was used.

Hypothesis

Ho: Venture capital does not significantly improve any form of business in Nigeria
Responses to questions 2, 3, 5, 6 and 9 were used to evaluate the extent to which venture capital can impact on the growth of any form of business.

Table 1: Relationship between venture capital financing and micro/small business growth

S/No	Statement	S.A. (5)	A (4)	U (3)	D (2)	S.D. (1)	Sum Average	Weighted Average	Ranking/ Remarks
2	Venture capital is an easy source of capital for business firms in Nigeria	25	13	2	9	7	208	3.7142	Agreed
3	Venture capital requires less and stringent collateral unlike banks	22	13	1	9	10	193	3.4464	Agreed
5	Venture capital provides cheaper loans that enhances micro business profitability	12	23	3	7	11	186	3.3214	Agreed
6	Venture capitalist provides more guarantee of lease financing	19	21	2	7	7	206	3.6786	Agreed
9	Poor knowledge on Venture capital limits ability of micro business to raise fund to develop their businesses	16	21	1	8	10	193	3.4464	Agreed

Source: Field survey, 2017

Table 1 shows the responses to the selected questions for analysis as well as their weighted average. Findings from the analysis shows that Venture capital makes it easy to obtain loans having scored an average weight of 3.712. Moreover, venture capital requires less and stringent collateral unlike banks based on an average weight of 3.4464. Responses also showed that Venture capital provides cheaper loans that enhance micro business profitability which is based on an average weight of 3.3214 while an average weight of 3.6786 was obtained for Venture capitalist provides more guarantee of lease financing. Findings from the analysis further provides that Poor knowledge on Venture capital limits ability of micro business to raise fund to develop their businesses which has a weight score of 3.4464. It can be deduced from the above that venture capital can contribute significantly to micro business growth if given adequate recognition and patronized by business owners.

From the results, except for the fact that small and micro businesses do not place much importance on venture capital all the other responses shows that venture capital is an importance source of fund for financing any form of business.

5.0 Conclusion

In Nigeria, small and micro businesses form the largest business enterprise employing well over 60% of the total working class in Nigeria. It is also the commonest of the business type existing in Nigeria. Despite the importance of the enterprises certain factors were found to limit their growth depending on the economic condition of the host nation. In Nigeria, the major problems of small and micro businesses in Nigeria were found to be lack of access to capital.

Venture capital is an important source of capital for small and micro businesses in Nigeria. Therefore, there should be proper enlightened campaign through the mass media to promote the services of venture capital firms in Abia State and in Nigeria. Venture capital firms should be reformed to make the industry stronger and more effective in propagating small and micro businesses to bigger businesses.

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QUESTIONNAIRE

1. Venture capital is relatively a new financial instrument in Nigeria?

(a) Strongly agreed ☐ (b)Agreed ☐ (c) undecided ☐ (d) Disagreed ☐

(e) Strongly disagreed ☐

2. Venture capital is an easy source of capital for business firms in

Nigeria.

(a) Strongly agreed ☐ (b)Agreed ☐ (c) undecided ☐ (d) Disagreed ☐

(e) Strongly disagreed ☐

3. Venture capital requires less and stringent collateral unlike banks

(a) Strongly agreed ☐ (b)Agreed ☐ (c) undecided ☐

(d) Disagreed ☐ (e) Strongly disagreed ☐

4. Policies provided by traditional banks limits access to capital by SMES.

(a) Strongly agreed ☐ (b)Agreed ☐ (c) undecided ☐

(d) Disagreed ☐ (e) Strongly disagreed ☐

5. Venture capital provides cheaper loans ☐ enhance micro business profitability.

(a) Strongly agreed ☐ (b)Agreed ☐ (c) undecided ☐

(d) Disagreed ☐ (e) Strongly disagreed ☐

6. Venture capitalist provides more guarantee of lease financing?

(a) Strongly agreed ☐ (b)Agreed ☐ (c) undecided ☐

(d) Disagreed ☐ (e) Strongly disagreed ☐

7. Government has made serious efforts in encouraging venture capital in Nigeria.

(a) Strongly agreed ☐ (b)Agreed ☐ (c) undecided ☐

(d) Disagreed ☐ (e) Strongly disagreed ☐

8. Many firms have succeeded through government encouragement in provision of venture capital.

(a) Strongly agreed ☐ (b)Agreed ☐ (c) undecided ☐

(d) Disagreed ☐ (e) Strongly disagreed ☐

9. Poor knowledge on Venture capital limits ability of micro business to raise fund to develop their businesses?

(a) Strongly agreed ☐ (b)Agreed ☐ (c) undecided ☐

(d) Disagreed ☐ (e) Strongly disagreed ☐

10. Small scale industries place important concern to venture capital.

(a) Strongly agreed ☐ (b)Agreed ☐ (c) undecided ☐

(d) Disagreed ☐ (e) Strongly disagreed ☐